PURbase

Re Indiana-American Water Company, Inc.

Cause No. 42029

— PUR4th —

Indiana Utility Regulatory Commission

November 6, 2002

Before Ripley, commissioner.

BY THE COMMISSION:

On June 29,2001, Indiana-American Water Company, Inc. ("Petitioner," "Indiana-American" or "Company") filed its petition in this cause for authority to adjust its rates and charges for water and sewer service and for approval of new schedules of rates and charges applicable thereto. In the Petition, Petitioner provided notice of its intent to file in accordance with the Commission's rules on minimum standard filing requirements ("MSFRs"), 170 IAC 1-5-1 *et seq.*, subject to certain modifications hereafter described.

Petitions to intervene were filed by Praxair, Inc., the Town of Schererville, the City of Crown Point and the City of Seffersonville. These petitions were granted by docket entry, and these entities were made parties to this cause.

Pursuant to the Prehearing Conference on July 24,2001, the Prehearing Conference Order dated August 1, 2001, and notice of hearing given as provided by law, proof of which was incorporated into the record by reference and placed in the official files sf the Commission, public hearings in this cause were held on December 6-7, 2001 and February 19-21,2002, in Indianapolis, Indiana. At the hearings, evidence offered by Petitioner, the Office of Utility Consumer Counselor (the "OUCC") and the Intervenors was admitted.

On February 11,2002, the Commission issued a Docket Entry asking Petitioner to respond to a number of questions regarding the classification of certain expenses in Petitioner's miscellaneous expense account and provide additional detail as to certain expense items. At the hearing on February 20,2002, Petitioner presented written responses to the Docket Entry which

© Public Utilities Reports, Inc., 2003

were admitted as Petitioner's Exhibit JLC-R7.

At the hearing on February 19,2002, Petitioner and the OUCC presented to the Commission a proposal regarding the treatment of security costs incurred by Petitioner. At that time very limited supplemental testimony of Petitioner regarding the security costs was also admitted. On May 3,2002, Petitioner and the OUCC filed a Stipulation and Settlement Agreement regarding the security costs and information relating thereto. Petitioner also filed a motion for protection from public disclosure of certain limited confidential information regarding its expenditures for security-related operation and maintenance expenses that Petitioner proposed to submit under seal pursuant to the agreement with the OUCC. The motion is granted by the Commission on an interim basis,

Pursuant to Ind. Code § 8-1-2-61(b), a public field hearing was held on January 17,2002, in the City of Gary, the largest municipality in Petitioner's service area, at which time members of the public were afforded the opportunity to make statements to the Commission. Public: field hearings were also held in Indianapolis on January 9,2002, Somerset on January 14,2002, and Jeffersonville on January 29,2002.

Having considered the evidence and being duly advised, the Commission now finds:

*1. **Notice*** and *Jurisdiction.* Due, legal and timely notice of the filing of the Petition in this cause was given and published by Petitioner as required by law. Proper and timely notice was given by Petitioner to its customers summarizing the nature and extent of the proposed changes in its rates and charges for water and sewer service. Due, legal and timely notices of the Prehearing Conference and the public hearings in this cause were given and published as required by law. Petitioner is a "public utility" within the meaning of that term in Ind. Code § 8-1-2-1 and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. This Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

*2. Petitioner's **Characteristics.*** Petitioner is an Indiana corporation engaged in the business of rendering water utility service to approximately 264,000 customers in 21 counties in the State of Indiana. Petitioner's corporate office is located in the City of Greenwood. Petitioner provides water service by means of water utility plant, property, equipment and related facilities owned, leased, operated, managed and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution and sale of water for residential, commercial, industrial, sale for resale and public authority purposes. Petitioner also provides public and private fire service. In addition, Petitioner provides sewer utility service in Somerset, Wabash County, Indiana and in Delaware County in or near Muncie, Indiana.

*3. **Corporate** Acquisition History.* Indiana-American was formed in 1983 from the merger of five Indiana water utility subsidiaries of American Water Works Company, Inc. ("American"). In 1993, Indiana-American acquired the common stock of Indiana Cities Water Corporation ("Indiana Cities"). Indiana Cities subsequently was merged into Indiana-American. The Commission has dealt with the treatment of the purchase price paid by Indiana-American to acquire Indiana Cities in two prior cases. The first order dealing with this issue was the Commission's Order in Cause No. 40103, 169 PUR4th 252, dated May 30, 1996 (the "1996 Rate

© Public Utilities Reports, Inc., 2003

Order"). The Commission again considered this issue in its Order in Cause No. 40703 dated December 11, 1997 (the "1997 Rate Order"). Indiana-American's most recent rate case was resolved by settlement. Indiana-American Water Company, Inc., Cause No. 41320, July 1, 1999. Since Indiana-American's last rate case, it has made a number of additional acquisitions, including Northwest Indiana Water Company ("Northwest"), United Water West Lafayette Inc. ("UWWL"), United Water Indiana Inc. ("UWIN"), and the Cementville system of Watson Rural Water Company ("Cementville"). The treatment of the purchase prices for these acquisitions is an issue presented for the first time in this cause.

4. Existing Rates. Petitioner's existing basic rates and charges for water and sewer service provided in the fifteen counties Indiana-American served at the time of its last rate case were established pursuant to the Commission's Order in Cause No. 41328 dated July I, 1999. Petitioner's rates for water service in the portion sf its service area formerly served by Northwest were approved by the Commission's Order in Cause No 41033 dated May 27,1998. Petitioner's rates for water service in the portion of its service area formerly sewed by UWWL and UWIN (hereinafter sometimes referred to collectively as "United") were approved by the Commission's Orders in Cause No. 41046 dated July 8, 1998 and Cause No. 41047 dated July 8, 1998, respectively. The Commission Orders approving the merger of these companies Into Indiana-American authorized Indiana-American to adopt the rates of these predecessor companies for application in the areas formerly served by them. Petitioner's rates for water service applicable to the industrial park within the Seymour Municipal Airport known as Freeman Field were approved by the Commission's Order in Cause No. 41655 dated April 4, 200% which Order approved a two-stage movement to the Seymour Operation rates for the newly acquired Freeman Field System. Since its last rate order, Indiana-American has also implemented certain public fire protection surcharges pursuant to Ind. Code § 8-1-2-103(d) and the Commission Orders in Cause Nos. 41476,41536,41920,42056 and 42147.

5 Proposed Three-Step Rate Procedures. One of *the* major elements of this proceeding involves Petitioner's construction of a new underground water intake tunnel from offshore Lake Michigan to Petitioner's Borman Park Water Filtration Plant in Gary (the "Tunnel Project"). The Commission's Order in Cause No. 41484 approved the merger of Northwest into Indiana-American. That Order also approved a settlement agreement between Indiana-American, the OUCC and industrial intervenors which provided, among other things, that (a) Indiana-American would file a petition by March 31, 2000 seeking Commission approval of the Tunnel Project and (b) if the Tunnel Project were approved, Indiana-American would be permitted to use a three step ratemaking procedure with regard to Northwest in its next rate case. Indiana-American filed a petition for approval of the Tunnel Project on March 21,2000, and the Tunnel Project was approved by the Commission's Order in Cause No. 41692 dated November 8, 2000. In its petition in the present cause, Petitioner did elect to use the three-step procedure, but for its entire body of ratepayers.

The Prehearing Conference Order provides that Indiana-American shall submit evidence as to the estimated cost and in-service date for the Tunnel Project and may also include estimated costs and in-service dates for two other projects - a source of supply project in Newburgh (the "Newburgh Project") and treatment plant improvements in Terre Haute (the "Terre Haute

Project" or the "Wabash Valley Project"). The Prehearing Conference Order further provides that the first step of any rate increase granted in this cause shall be **effective upon** the issuance of a rate order herein and shall not include costs of the Tunnel Project, Newburgh Project or Wabash Valley Project. The second step shall be effective on the first day of the next month following the an-service date of the Tunnel Project and shall include (i) the application of the Commission-determined cost of capital to the estimated Tunnel Project costs (or the actual certified costs if lower), plus related income tax expense; (ii) depreciation expense on the Tunnel Project; and (iii) property taxes and other operating expenses associated with the Tunnel Project. Petitioner was also permitted by the Order to request inclusion in the second step of the same types of costs relating to the Newburgh Project and the Wabash Valley Project, provided they are placed in service on or before the Tunnel Project; they are found reasonably necessary; and the cost estimates for such projects are found reasonable. The third step is proposed to be effective after any retirement of the existing water intake tunnel to reflect the application of the Commission-determined cost of capital to the estimated cost of removal (or the actual certified cost of removal if lower), related income taxes expense and any change in operating expenses, **depreciation,** property taxes and other items reflected in steps one and two because of the retirement of the existing tunnel.

6. Petitioner's Request In This Case, Petitioner originally proposed that its operating revenues, which impact forty or more Indiana communities, be increased by 10.71% in Step One, 8.00% in Step Two and 0.09% in Step Three. Petitioner proposes that the Newburgh Project and the Wabash Valley Project be included in the Step Two increase, As discussed above, the Step Two and Step Three rates are proposed to be subject to adjustment if the actual **costs are less than** the estimates. However, Petitioner's original proposal was affected by subsequent developments, including, apparently, the proposed settlement agreement regarding security costs. We have authorized a Two Step process in this Order. The proposed Step Three, involving less than one-tenth of one percent, over the entire rate base is not necessary.

Since the 1996 **Rate Order, Petitioner has** implemented single tariff pricing on a phased-in basis except in the areas formerly served by Northwest and United and except for the Wabash Operation which remains separate for a specified time due to a settlement agreement approved in the 1997 Rate Order. Petitioner groposes further movement toward common rates in this proceeding.

This Commission approaches single tariff pricing carefully, considering proximity, connectivity, and comparability of costs in each case; and, where appropriate, we will look to a weighted average, and not favor a mere move to the highest rate.

7. Test Year. **As provided** in **the Prehearing Conference Order, the** test year to be used for determining Petitioner's actual and pro fonna operating revenues, expenses and operating income under present and proposed rates is the twelve months ended March 31,2001. The financial data for this test year, when adjusted for **changes as provided in the** Prehearing Conference **Order,** fairly represents the annual operations of Petitioner and is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

8. Acquisition Adjustment Request. Petitioner seeks authority to earn returns on acquisition premiums (an "acquisition adjustment"), related to the purchase of several utilities acquired since

© Public Utilities Reports, Inc., 2003

its last rate case.

Acquisition Adjustment, as used herein, is summarized as follows:

> The general rule related to the acquisition of utility plant previously used in the utility function is that the rate base component for the plant includes only the original cost of the property to the first owner devoting the property to public service. Therefore, if a utility purchases fixed assets from another utility at a price in excess of the seller's original cost (net of accumulated depreciation), the addition to the purchasing utility's rate base reflecting the acquired assets is limited to the undepreciated original purchase price. The excess amount paid is referred to as an acquisition adjustment and is placed in a separate account to be treated for ratemaking purposes as so authorized by the jurisdictional regulatory commission. Hahne, Aliff, *Accounting For* Public *Utilities*, §4.04 [2], 4983.

Indiana-American proposes that the rates authorized in this proceeding provide a return on the fair value of Indiana-American's property which included an opportunity to earn a fair rate of return on the full purchase prices of the Northwest, United and Cementville acquisitions. Indiana-American has sought to justify this treatment by showing (a) the fair value of the acquired assets is no less than the purchase prices; (b) a fair rate of return would be no less than the Company's cost of capital; (c) the-purchase prices were the result of arm's length bargaining and were reasonable compared to comparable transactions, other marketplace measures and the value of the underlying assets; **and (d)** the **resulting** consolidation has produced cost savings and service enhancements for its customers that exceed the fair value increment Indiana-American is seeking. The Public opposed Petitioners authorized recovery of a return on the acquisition's of Northwest, United and Cementville and asserted that the reasonableness of the purchase prices of those utilities have not been shown and that cost savings and service enhancements occurring as a result of the consolidation have not been shown to exceed the fair value increment Indiana-American is seeking.

It is the established policy of this Commission to allow an acquisition adjustment in rates in only two events, namely:

1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service and/or lower rates?

2. Does the acquisition result in correction or salvage of an entity identified by this Commission as a "troubled" utility?

Further we note that Petitioner in this Cause attempts to aggregate all of its transactions into one analysis. Our policy is to evaluate acquisitions on a case-by-case basis. In the case of merged operational [1] (1) and management services, they will be separated for purposes of rate consideration insofar as possible. A case-by-case analysis will prevent the benefits, if any, from one transaction being conveyed to another transaction and ensure that each acquisition is measured on its own merits. To allow utilities to aggregate their cost savings to show ratepayer benefits would in essence allow utilities favorable treatment on acquisition adjustments where no ratepayer cost savings exist for that particular acquisition. Such a cost savings credit would erode

© Public Utilities Reports, Inc., 2003

the ratepayer benefit of those savings by using them to justify ratepayer funded acquisition premiums. We will not **endorse the recovery of acquisition adjustments** without sufficient proof that a particular acquisition meets one or both of the two standards set out above.

A. The Northwest **Acquisition.** Prior to its merger with Indiana-American, Northwest was a public utility providing water utility service to retail customers located in and adjacent to the communities of Bums Harbor, Chesterton, Gary, Hobart, Merrillville, Portage, Porter, and South Haven in Lake and Porter Counties. Northwest also provided wholesale service to various communities and utilities in those counties as well. Northwest served approximately 65,000 customers and a population of approximately 250,000 people. All of the common stock of Northwest was owned by Continental Water Company ('Continental" or "CWC") which was a wholly owned subsidiary of National Enterprises, Inc. ("NET").

On June 25, 1999, NEI was acquired by and merged into American Water Works. On January 1,2000, pursuant to authority granted by the Commission in Cause Nu. 41484, **Northwest was merged** into Indiana-American, with Indiana-American being the surviving corporation. After the merger, Indiana-American commenced service in the areas and to the customers previously served by Northwest.

Petitioner has requested authority to earn a return on an imputed acquisition premium of $21,472,000. Petitioner applied its 8.36% weighted cost of capital to this amount to calculate its requested fair value increment of $1,795,059 before tax gross up. The calculation is as follows:

```
[Graphic(s) below may extend beyond size of screen or contain distortions.]

Purchase price                    $ 48,752,000
Shareholder's equity @ 6/30/99 27,280,000
Acquisition Premium               $ 21,472,000
```

Thus, Petitioner seeks authority to earn a return on an acquisition adjustment representing the difference between what it paid to acquire Northwest and the net book value of the utility's equity at the time it acquired Northwest. We consider this request in the light of our previously stated standards:

1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service andior lower rates?

2. Does the acquisition effect correction or salvage of an entity identified by this Commission **as a "troubled"** utility?

Indiana-American has requested9 the Commission find that the full amount paid for Northwest, as allocated, is in fact, the "fair" value on which Indiana-American's shareholder (AWWA) should earn a return. In order to justify the amount requested, Petitioner's witness, Christine J. Doron, Indiana-American's vice-president and treasurer, provided evidence on her claim that benefits to the consumers outweigh the additional costs those customers will incur by paying a return on the acquisition premium.

© Public Utilities Reports, Inc., 2003

Ms. Doron listed several areas of Operations & Maintenance expense where she believed savings have occurred since the mergers. She also listed areas of capital expendimre where she believes savings have occurred. In addition, Ms. Doron stated the cost of capital for Northwest and the United companies has been reduced due to the mergers thus resulting in savings associated with borrowed funds. Ms. Doron asserted that she only has included savings which were quantifiable. Her original testimony concluded that savings to customers would outweigh the cost customers would pay on the acquisition adjustment by $16 million (Corrected Exhibit CJD-4) if those savings held true and steady for the next 40 years. Ms. Doron claimed savings of $4,039,590 per year for the United and Northwest acquisitions combined. In her rebuttal testimony, she made an alternative calculation which included a year-zero savings at a minimum of $4,487,686 and annual savings of $4,094,210. She asserted these would show savings to customers sf almost $20 million. Her calculation included several assumptions which we will detail later in this order.

Ms. Judy Gemmecke, a CPA, and utility analyst for the OUCC, criticized Ms. Doron's calculations and methodologies. Ms. Gemmecke's calculations showed that, if the OUCC's calculated savings were considered along with the rate treatment Petitioner seeks regarding its acquisition adjustment (i.e. acquisition adjustment not amortized at same rate as asset lives), there would be a net cost to consumers over the next 40 years of $8 million dollars (Public's Exhibit 2-D). Ms. Gemmecke commented on Petitioner's request to obtain a return on the amount of the acquisition adjustment, or fair value increment, in perpetuity by not reducing through amortization the acquisition adjustment at a rate consistent with the assets to which they are related.

We also discuss below the annual savings Petitioner asserts derive from the acquisitions of United and Northwest. This analysis is complicated by the fact that Petitioner has merged some services of United and Northwest, as noted above.

a. Amount of Savings Related to O & M Expenses. The Petitioner's witness Ms. Doron and the OUCC's witness, Ms. Gemmecke estimated different total O & M savings related to the acquisitions sf United and Northwest. Whereas Ms. Doron estimated total annual savings of $4,094,210 related to the acquisitions of United and Northwest, Ms. Gemmecke calculated savings of only $2,695,868.

i. Labor and Benefits. Whereas Ms. Doron estimated total annual savings of $3,054,987 in the category of Labor and Benefits, Ms. Gemmecke calculated savings of only $2,900,956. Ms. Doron calculated labor expense savings for the Northwest operation by determining the gross labor expense plus overhead for a reduction in labor force, further reduced by the amount of labor and overhead capitalized, then netted against additional personnel hired at the corporate headquarters and customer service center which were necessary to cover the duties of those employees dismissed. However, Ms. Gemmecke noted Ms. Doron's calculation for the United systems did not detail net positions eliminated, but rather took wages plus overhead for calendar year 1999 and compared that with calendar year 2000 for the same systems. Combining the results of these two different methodologies resulted in her conclusion that net savings from labor and benefits were $2,965,942 adjusted to $3,054,987 in her rebuttal testimony. Petitioner's witness, Mr. Cole elaborated on the types of staffing reductions and re-organizations that have

taken place. He also stated that he has included staffing reductions associated with the Peoples Water and Shorewood Forest acquisitions in his calculations of Northwest.

First, the OUCG criticized Ms. Doron's analysis by noting that Ms. Doron's calculation of the percent of labor recorded as an O&M expense as opposed to a capitalized expense was based on 1998 percentages. But in calculating the savings, Ms. Doron had used the **1999** wage totals and inflated them to reflect 2001 equivalent amounts when she applied the 1998 percentages. This **created** a mismatch **of inflated** 1999 O&M wages with 1998's O&M percentage resulting in an overstatement of labor savings associated with the Northwest acquisition. Also, Ms. Gemmecke noted that Ms. Doron compared United's "pre-merger" mount to a "current" amount, but does not state what periods were used. Ms. Gemmecke further noted that the pre-merger amount did not equal the amount reported on United's 1999 IURC report: nor did the current amount equal the test year of April 1 - March 31,2001. This would result in an overestimation of savings if the amount used did **not reflect a total year's costs.**

Ms. Gemmecke compared **1999** totals for the categories with test year totals for the same categories. Thus she obtained the true net savings by comparing costs before any of the mergers with the costs encompassing a full 12 months after the mergers. Ms. Gemmecke stated in her testimony on page 18 "This calculation includes savings due to reductions in force and savings associated with better bargaining." We accept Ms. Gemmecke's analysis of this issue.

*ii. **Group** Insurance.* Whereas Ms. Doron estimated total annual savings of $21**3,563** in the category of Group Insurance, Ms. Gemmecke found no additional Group Insurance savings noting that such savings had already **been included in Labor and Benefits savings. Ms. Doron** made an additional calculation for group insurance savings based upon the remaining employees and the differences in insurance rates under their former ownership compared to those rates under their current ownership. Ms. Doron purports an additional savings of $239,964. Ms. Gemmecke noted that Ms. Doron had included in "Labor" items known as "Overhead". Ms. Gemmecke stated that items included in "overhead" already included group insurance. Thus, Ms. Doron counted part of the group insurance savings twice.

Ms. Gemmecke made a similar adjustment, but included her calculation under Labor and Benefits savings as **we** discussed earlier.

Taking the Labor and Benefits, including group insurance savings in total, the two parties are about $368,000 apart in savings (Pet's **$3,268,550 —** OUCC's $2,900,956). While this may not appear to be substantial, the net present value over 40 years would be ***$6.6*** million ($367,594 inflated at **3%** per year for 40 years @ 7.56%); or **$5.9** million using Petitioner's requested weighted cost of capital of **8.36%.** The difference of $368,000 calculated for a 20-year period, the present value amounts would be $4.7 million using 7.56% or $4.4 million at **8.36%** weighted cost of capital.

Again, we believe the OUCC has more precisely determined **this** item

iii. Management Fees. Petitioner and the OUCC also calculated the effect of the mergers on management fees. Whereas Ms. Doron estimated total annual savings of $302,224 in the category of Management Fees as a result of the acquisitions, Ms. Gemmecke testified that Petitioner had actually incurred additional costs of $639,256. Before the mergers. both Northwest and United

were part of a larger corporate structure and each had management fees allocated to them. Ms. Doron gives no further details at how she arrived at her figure other than stating she compared pre-merger amounts with post-merger amounts on a per customer basis.

In her testimony, Ms. Gemmecke states Ms. Doron had arrived at a management fee pea customer of $6.25 that was effective before the mergers. Ms. Gemmecke further states that Ms. Doron used an amount less than the calendar year 2000's management fees to calculate a per customer management fee, Ms. Gemrnecke further criticizes Ms. Doron's "post-merger" calculations as being incomplete as certain elements were missing from the "post-merger" management fees. To compensate for these missing elements, Ms. Gemmecke used management fees as expensed in the test year. Her comparison of "pre-merger" to "post-merger" management fees reveal an increase in management fees, thus no savings were realized in this cost area. Ms. Gemmecke explains this result in her testimony:

> In this particular case, methods may have been changed and employees eliminated, however new charges were added via corporate and service company allocations that **greatly diminished the savings.**

We find no savings have been shown in this area of Petitioner's costs in this case.

iv. Chemical Savings. Petitioner's witnesses Ms. Doron and Mr. Cole both refer to savings in the costs related to chemical purchases. Ms. Doron states these savings amount to $163,017 whereas the OUCC found **that these savings were only $84,592. Mr. Cole described the treatment** processes that have changed in Northwest since being merged with Indiana-American. Mr. Cole attributed these changes to the superior knowledge of employees of American Water Works Service Co. in the area of water quality. Mr. Cole stated these immediate savings were realized "only because of the affiliation with American." Ms. Cole stops short of saying this was a patented system, or that this specific knowledge has been withheld from the rest of the water service providers.

OUCC's witness, Ms. Gemmecke, criticized Ms. Doron's calculation on the basis that: I) two different methods of calculation were used for Northwest and United, and *2)* one of the savings factors Ms. Doron used for calculating Northwest chemical savings had not yet occurred, even though Mr. Cole stated that these were "immediate savings". Ms. Gemmecke calculated cost **savings** of $81,592 **by using the methodology of comparing 1999 costs with test year costs. We** find this methodology to be sound and adopt the Public's calculation of chemical savings.

v. Rate Case Savings. Petitioner's witness, Doron, stated the amount of savings she had derived was the result of comparing current levels of rate case costs to the most recent rate cases for Northwest, UWWL and UWIN amortized over the same period as in their respective previous rate case. She stated her estimated savings were conservative because her estimated cost of a current rate case did not include a reproduction cost new less depreciation study, cost of service study, nor depreciation study. She provided no further evidence of her calculation into evidence.

OUCC's **witness, Ms.** Gemmecke, **provided evidence based upon a** comparison **of rate** case expense approved in Northwest's and United's last rate cases with the actual rate case expense

© Public Utilities Reports, Inc., 2003

being requested in this cause, as allocated to the respective operating systems. Ms. Genmecke has provided her calculations in her testimony as schedule JIG-11, page 6. We note that Ms. Gemmecke's calculation uses actual historical expense, increased to 2001 level through an inflation adjustment less Petitioner's requested allocated amount of rate case expense in this cause. This calculation reveals a savings of $143,570 compared to Petitioner's savings estimate of $159,417. We find the Public's calculation to more accurately reflect a reasonable estimate of rate case savings.

vi. Other O&M Savings. Petitioner has asserted additional O & M savings to be realized as a result of the acquisitions in the categories of computer related costs ($90,495), audit fees ($61,583), general legal fees ($28,370), lab fees ($14,379) and bank fees ($14,179). The OUCC did not provide evidence to dispute these claimed amounts and we find such savings should be attributed to the acquisitions of United and Northwest.

b. Amount of Savings Related to Rate Base. This area of savings encompasses depreciable assets, the purchase of which was avoided. The depreciation expense associated with those assets is also avoided. Thus each subject area has two cost swings components: The savings associated with the return on investment, and the savings associated with the elimination of depreciation expense. For the computer upgrades, Petitioner suggests a savings of $323,559 on an investment of $1,147,900 over the next 5 years. The savings on depreciation expense associated with the computer upgrade avoidance was suggested as being $229,580 annually for the next 5 years. OUCC claims the savings would be $37,256 return on an investment of $149,526, plus $29,905 savings related to the depredation expense over the next 5 years.

i. Computer Upgrades. Petitioner stated that Northwest, prior to the merger, had been investigating upgrades or replacements of accounting software. Due to the merger with Indiana-American, the upgrade and replacements were not necessary. Ms. Doron concluded that consumers will benefit from the avoidance of a $1.148 million investment. Her conclusion was based on information obtained through documents and conversation from prior Northwest management concerning EMA Services. Petitioner did not offer any further evidence to collaborate the assertion regarding the prior owner's intent in this regard.

OUCC's witness, Ms. Gemmecke relied on evidence provided to the Commission in Petitioner's Minimum Standard Filing Requirements (MSFR's). From what Petitioner provided, Ms. Gemmecke came to the conclusion that the recommendation by the vendor (costs be shared with the other CWC utilities) would have been accepted by the management if the purchase had been consummated. Therefore, she concluded the price of the particular system would have been shared by other affiliates of Northwest. She also stated that the evidence was merely a proposal presented by a salesperson. She contended it was unclear whether Northwest could not have come to purchase the software at a lower price. Ms. Gemmecke came to the conclusion that Northwest's share of the avoided investment would have been $149,526. We do not find Petitioner's evidence on this issue to be persuasive and accept the Public's estimate of savings

ii. Vehicles. Ms. Doron testified to savings related to the disposal or reassignment of 29 vehicles due to a reduction in the number of employees. Ms. Doron explained in her rebuttal testimony that the reduction was the result of a reduction in employees and a review of vehicle policy. Ms. Gemmecke's direct testimony relied on Ms. Doron's direct testimony for the

© Public Utilities Reports, Inc., 2003

calculations of savings related to a reduced fleet. She stated it didn't make sense to see a reduction of 29 vehicles for every 55 employees. She also criticized Ms. Doron's calculation of the savings based upon the average original cost. Ms. Gemmecke believed some accounting of the depreciation must be included in the calculation. Ms. Gemmecke calculated savings on I I vehicles, then applied one year of depreciation to that figure.

For the savings associated with vehicles, Petitioner claims savings of $491,084 on an investment of $248,419 aver the next 20 years. Further savings relate to depreciation expense of $21,081 annually. OUCC claims the savings would be $4 86,280 on investment of $1 64,664 over 20 years plus savings related to depreciation of $7,699 annually. We find the OUCC calculation to be the more reasonable.

c. Cost d *Capital Savings.* Petitioner purports savings relating to the cost of capital in an amount of $215,791 annually. Ms. Doron stated that financially Indiana-American is a larger and stronger company than either Northwest or United, She further pointed to access to private and public debt markets through American Water Capital Corporation. Mr. Eckart stated the now combined companies of Indiana-American/United/Northwest have a wider dispersion of risk which allows it to demonstrate greater stability of earnings, and thus more attractive to potential investors. He further stated that purchases should be attracted to larger-sized bond issues, which is what American Water Capital Corporation (Am.Cap.) provides for Indiana-American.

OUCC's witness, Edward Kaufman, disagreed with Ms. Doron's analysis of the reduction in cost of capital. Be described Ms. Doron's analysis as including increasing debt by $5 million and reducing equity by the same amount. Mr. Kaufman stated that when a utility "increases its percentage of debt and reduces its percentage of equity both the cost of debt and the cost of equity increase." This will, therefore, increase the weighted cost of capital. With the small reduction in capital Ms. Doron claimed (4 basis points), only a small change in the cost of debt or cost of equity will reduce the capital savings Ms. Doron claims exist. Mr. Kaufman further pointed to Petitioner's own testimony in this case which shows an equity percentage of 42.87% which is higher than that used to support its savings claims (42.41%). Mr. Kaufman pointed out that Petitioner's capital structure is not guaranteed to remain the same as presented in the analysis of savings attributable to the acquisitions and Petitioner has given no such assurances. As such, we do not find any savings associated with the cost of capital.

d. Year Zero Savings. Petitioner has included in their calculation on savings associated with the acquisitions, what i s termed Year Zero Savings. This is expected as the savings that have occurred from the time of the merger until this rate case. This, as Ms. Doron explained in her direct testimony, consists of savings achieved as sf May, 2002.

OUCC witnesses Gemmecke and Gassert both asserted that any savings prior to this rate case have benefited Indiana-American's shareholder, not the customers. Mr. Gassert goes further, saying, "If you accept Petitioner's claimed savings figures, it has already received a significant amount of compensation." Mr. Gassert's claim that any of Indiana-American's captured savings in Year Zero went to the shareholder is illustrated by the fact that Petitioner did not reduce its rates to consumers since before the mergers in 2000. Therefore, Petitioner has 'kept its savings for 2.5 years until this order is finalized. Mr. Gassert further stated that Petitioner has made no adjustment *to* its revenue requirement for past savings it is now saying has benefited consumers,

thus Petitioner will benefit twice under their proposal - once through the direct benefit of cost savings it has retained and again in a return on its full acquisition adjustment,

Mr. Gassert testified that Indiana-American did not credit the ratepayers with the compensation it claims it has already received. Indiana-American seeks to earn a return on its unamortized acquisition premiums without reducing the requested revenue requirement by the compensation it has or will receive by the time an order is issued in this Cause. Thus, to the extent the savings were achieved, the utility will be compensated twice under Petitioner's proposal.

On Rebuttal, Ms. Doron adjusted her Year Zero savings from $7.35 million to **$4.49 million** to reflect a shorter period of time, which the customers would have benefited. Ms. Doron stated consumers have benefited from Year Zero savings from the avoidance of an additional rate case. Ms. Doron stated that in Indiana-American's last rate case, Indiana-American agreed to a rate **moratorium.** "We **knew we were agreeing to skip a rate case which had otherwise been assumed in** our forecasts. It was only because we knew we would be able to achieve acquisition related savings that we were able to agree to skip that case," However, upon cross-examination, Ms. Doron stated **that, at the time, they were only aware of an estimated level** of **tabor savings,** Further evidence indicated that no dollar estimates of any savings related to the merger with Northwest bad been calculated as of September, 1999, which we note was after the June 3, 1999 settlement agreement. (Doron transcript page F-104 — **F-105)**

We note that when parties reach a settlement agreement both parties have given something in exchange for something else. Ms. Doron claimed that Indiana-American could have recovered more in rates if it had not agreed to the rate moratorium. In exchange for agreeing to a rate moratorium, Indiana-American presumably received a rate it could accept without the uncertainty that comes of a fully litigated rate proceeding. In any event, we find that it would appear to be retroactive ratemaking to allow Petitioner to recover the past "loss" to which it had agreed by imputing savings to ratepayers they have not and will never receive.

e. Amortization of Acquisition Adjustment/Fair Value ***Increment,*** Petitioner's testimony and supporting schedules indicate their request to earn a return on the acquisition adjustment. Petitioner's Exhibit CJD-4 page 5 of 5, as corrected, reveals a revenue requirement, adjusted for taxes of **$4,654,589** per year. Petitioner does not adjust their acquisition adjustment fox any amortization.

OUCC's **witness, Gassert, noted that Indiana-American has used the unamortized acquisition** premium balance to calculate its fair value increments not only for Northwest and United acquisitions, but also for the Indiana Cities acquisition. He also states Petitioner included income taxes **associated** with **the fair value increments as a component of revenue requirements, which** Mr. Gassert believes to be inappropriate.

OUCC's witness, Ms. Gemmecke, also makes note of Petitioner's request to earn a return on the acquisition adjustment without any reduction for amortization. Thus, she concludes, Petitioner "... is expecting the proposed fair value of the purchased plant to never decrease — not after 10,50 or 100 years of wear and tear!"

In rebuttal testimony, Ms. Doron criticized Ms. Gemmecke's schedule JIG-11 as not

© Public Utilities Reports, Inc., 2003

presenting the OUCC's position on the amortization of the acquisition adjustment.

Ms. Gemmecke explained that the schedule shows the OUCC's calculated savings compared to the cost Petitioner glans to impose on the customers in the form of a return on the acquisition adjustment (or fair value increment). Thus, if Petitioner's proposed treatment of the acquisition adjustment (fair value increment) is adopted (i.e. a return on a never-diminishing acquisition adjustment), the consumers would fund the cost ofacquisitions, not reap a savings. We agree with the OUCC analysis of this issue.

f. O & M ***Savings*** *Generally.* Mr. Gassert expressed concerns about the O & M savings generated as a result of the Northwest acquisition. Mr. Gassert considered it doubtful that Indiana-American has generated the O&M savings it has claimed in this cause. For example, according to Petitioner's Exhibit CJD-4, gage 1 of 5, Petitioner has identified annual projected savings of $4,669,642. Of this amount, $4,325,721 is related to the Northwest merger. Yet O&M costs for Northwest are higher in this case than they were in Northwest's last rate case even though Petitioner has claimed $4.3 million dollars of O&M savings. Even if the O&M expenses approved in Northwest's last rate case of $14,653,263 are increased by 3% for inflation for the last 3.5 years, Northwest's O&M would have increased to $16,252,196. Yet, Petitioner has proposed that Northwest's O&M expenses in this case are $14,876,434, This would indicate that Petitioner has achieved annual O&M savings of only $1,375,762 ($16,252,196-$14,876,4341, well short of the $4,325,721 savings Petitioner claimed in this cause. Mr. Gassert noted our position on cost savings in Cause No. 40703:

> Since the acquisition would produce benefits in cost savings in excess of the purchase price, modem finance theory prescribes that Indiana-American should have bought the Company at the purchase price it paid ($37 million). And in a competitive market the cost savings would enhance the purchaser's operating income and thereby cover the capital costs assodated with the purchase price it paid ($37 million). And in a competitive market the cost savings derived by combining the two companies would enhance the purchaser's operating income and thereby cover the capital costs associated with the purchase (interest on debt and earnings for the common shareholder). (p. 30, Final Order)

Mr. Gassert further asserted that, even if Indiana-American did achieve the level of savings it has claimed, the comments about the competitive environment made in the final order of Cause No. 40703 were not intended to apply in the long term. He contended the comments are applicable only in the short term because in a competitive market, the cost savings achieved by ***combining*** two companies would only enhance the purchaser's operating income in the short term. Mr. Gassert noted that in the long term, competitors to ***the*** combined company would be required to implement similar efficiencies and lower their prices to remain competitive. Therefore, the savings would only ***be available*** in ***the short*** term ***to*** cover ***the*** capital costs associated with the purchase. Finally, Mr. Gassert noted that the Missouri Public Service Commission discussed the short-term nature of savings in its order in Case No. WR-2000-844 wherein it made the following statement:

© Public Utilities Reports, Inc., 2003

1.D. Should the Company be allowed to recover a portion of any "savings" which resulted from the AWK/NEI merger from Company's customers under its proposed "Sharing Savings Plan"?

> Regulation is intended to be a substitute for competition, In a competitive market, a company that achieves gains in efficiencies only gets to keep the benefit of those gains until its competitors implement similar efficiencies, and the company is forced to lower its prices to remain competitive. *A regulated company does not get to keep the benefit of its efficiency gains indefinitely either.* If the gains are large enough and not offset by increased costs elsewhere in its operations, a utility will get to keep the gains only until a complaint is brought and resolved. If the gains are offset by increased costs, the utility will only get to keep them until a rate increase case is filed and resolved. Gains in efficiency are "captured" in a rate case, and forward-looking rates me set taking the gains into account.
>
> This last situation is the one in which the Company finds itself: it claims it has achieved gains in efficiency from the merger of NEI and AWK, but nonetheless has found it necessary to request an increase in rates, The Company asks to be allowed to share (i.e., keep 50 percent) of the savings it asserts it has achieved from the AWK/NEI merger. This Commission, in keeping with regulation's role of simulating competition, will not approve the shared savings plan.

Mr. Gassert added that Missouri-American Water Co. had not sought to recover an acquisition premium related to the NEI acquisition as it has in Indiana. Rather, American only requested recovery of the transaction costs related to the merger and to share the claimed savings. Both requests were denied. Finally, Mr. Gassert notes that OUCC witness Judy Gemmecke provides a more in-depth look at Petitioner's unsupported claim of savings.

Mr. Gassert concluded his analysis on the Northwest acquisition request by recommending that no revenues be provided to compensate Indiana-American for its proposal to recover an imputed acquisition premium related to its parent company's purchase of NEI. He further recommended that if the Commission does determine that revenues should be provided, then the ratepayers should be credited with the compensation Indiana-American has already received during the 2 1/2 years it has been able to retain the savings it claims. Mr. Gassert stated that this treatment would be necessary to prevent double compensation of Indiana-American. The compensation was earned in 2 1/2 years and should be spread over the 3-year life expectancy of these rates and would calculate to be a $3.92 million ($1 1.75/3 yrs) annual reduction to annual revenue requirements. Finally, Mr. Gassert recommended that if the Commission does determine that a fair value increment is warranted, the Commission should consider disallowing a portion of the additional $58 million of additional investments. The amount disallowed could be tied to the amount of the acquisition premium allowed. Thus, if the Commission allowed the full $21.472 million Petitioner is seeking, then Petitioner's original cost rate base could be reduced by the same amount.

© Public Utilities Reports, Inc., 2003

Mr. Gassert testified that "Based on the Commission's comments, if the cost savings achieved are not in excess of the purchase price, then American paid too much money to acquire the utility ..." The Public also noted that the Missouri Commission stated that it is regulation's role to substitute competition and Mr. Gassert noted that in a competitive environment savings would only be available in the short term to cover the capital costs associated with the purchase. Both Mr. Gassert and Ms. Gemmecke are opposed to Petitioner's use of what is termed "year-zero savings"-

Finally, Mr. Gassert noted that Petitioner's claimed savings figures would seem to indicate Indiana-American has already received a significant amount of compensation, Petitioner claimed approximately $4.3 million of annual O&M savings resulting from the Northwest and United mergers. The Northwest merger was effective 1/1/00 and the United merger one month later. Any savings achieved would flow to Indiana-American because it did not lower its rates to reflect the O&M savings achieved. In fact, those savings will remain with Indiana-American until an order is issued in this Cause. Therefore, Petitioner will have been able to keep those savings for 2 1/2 years. Applying Petitioner's $4.3 million claimed savings to a 2.5 year factor generates $11.75 million of compensation Petitioner has already or will receive by the time an order is issued in this Cause.

On behalf of Intervenor Crown Point, witness Gregory T. Guerrattez, President of Financial Solutions, Inc., also criticized Petitioner's analysis of merger-related savings. Mr. Guerrattez criticized Ms. Doron's failure to consider the effect of corporate overhead to be allocated to Northwest customers He states that hy not including this amount, the benefit of the merger and acquisition has been overstated. Mr. Guerrattez then criticized Petitioner's use of a 40-year analysis. He suggested a 20 year analysis would be more "real world". Mr. Guerrattez has calculated a cost above (over) alleged savings to be about $93 million to Northwest Indiana Customers over the next 20 years.

Intervenor Schereville's witness Theodore J. Sommer, Partner with London Witte Group LLC also criticized Petitioner's analysis of merger-related savings. While not necessarily opposed to the centralizations and consolidations of functions that will produce cost savings, Mr. Sommer expressed concern about the potential lack sf control Petitioner has over costs imposed by its service company and other affiliates. This potential lack of control affects the projection of merger savings that support the return being sought by Petitioner on its acquisition adjustment. Mr. Sommer also commented on the use of inflation rates in the analysis of the alleged savings and provided several schedules using various rates of inflation in 1/2% increments. Mr. Sommer indicated that assumptions about the inflation rate have a substantial impact on the amount of savings being projected by the Petitioner. He further stated that if Petitioner's calculation of savings is overstated by only 12.67%, this alone would negate all present value savings.

g. Commission Findings on Ratepayer Benefits. The OUCC and Intervenors expressed concerns over O&M savings claimed by Petitioner. Mr. Gassert presented an analysis based on actual O&M numbers requested in this case and O&M expenses approved in Northwest's last rate case. This analysis indicated that Petitioner only achieved savings of $1.375 million while it claimed $4.325 million. Ms. Doron did not dispute the accuracy of his calculation but responded by stating that the O&M expense requested in this rate case includes the corporate allocation. Ms.

© Public Utilities Reports, Inc., 2003

Doron did not believe it was appropriate to include the corporate allocation wsts in the savings analysis because it is not an incremental cost. We find that the corporate allocation should be considered in this analysis. In order to determine the ratepayer benefits to Northwest's ratepayers, we must consider *all* the costs these ratepayers are being asked to recover. We note that the allocated costs are for various services rendered such as accounting and customer service. If these costs were not provided at the corporate level, the services would need to be acquired directly by the Northwest system at some cost. Therefore, if these costs are not included, it would not be a complete or accurate analysis since these services provided by corporate are necessary and come with a cost. Therefore, we believe Mr. Gassert's analysis more accurately depicts the actual savings achieved.

We also note from our order in Cause No. 40103, page 7, the following:

> Additionally, we perceive that some cost savings are the natural result of a sensible consolidation of utility systems, which would appear to undermine Petitioner's claim of its responsibility for the generation of significant savings through management effort. We do not believe such natural synergies are the type sf substantial savings and benefits sufficient to invoke an exception from the general propensity of the traditional standard to disallow favorable treatment of an acquisition adjustment.

This statement is applicable in this cause as well.

The parties further disputed Petitioner's claimed savings wherein Mr. Gassert also testified that if Petitioner's claimed savings figures were accepted, Petitioner will have received $11.75 million in compensation by the time an order is issued in this Cause because, in this application, Indiana-American did not credit the ratepayers for savings it already achieved in its fair value increment request. On rebuttal, Ms. Doron argued that Petitioner was able to agree to a rate moratorium in its last rate case and defer a rate case. However, on cross-examination, it was revealed that the stipulation and settlement agreement that included the negotiated rate moratorium was executed on June 3,1999 (F-107). It was further revealed that in Cause No. 41484, Petitioner's President responded to discovery in September, 1999 indicating that "the savings have not been quantified" (F-105). Ms. Doron suggests that a preliminary estimate of labor savings was available in a separate document. However, it was further revealed on cross-examination that the document in question was dated only by a fax machine which date was February 14,2002 (F-108). It was also shown that, when that document was provided in discovery it was provided with the qualification that it may very well have been prepared as of the time the Stipulation and Settlement Agreement was executed. When Ms. Doron was questioned if the document was prepared at the time the agreement was negotiated, she responded, "We don't have dates." (F-109). Based on this discussion, we find that: if Petitioner did achieve the level of savings it claimed, then Petitioner did receive compensation for its acquisition of Northwest notwithstanding our findings.

Our task is to determine if the cost savings, which may or may not have occurred warrant some rate-relief treatment. Petitioner claims savings of $52.5 million over *the next* 20 years (net present value Exhibit CJD-R-4 page 1 of 5) outweigh the costs to consumers of $41 million (net

© Public Utilities Reports, Inc., 2003

present value). The OUCC calculates that costs to consumers of $42 million would outweigh the benefits of $34.6 million, in which case consumers would be paying more for their water service merely because the water companies in question were acquired.

There is no claim or argument that the Northwest acquisition meets our "troubled utility" test, therefore, we are left only to determine whether this purchase results in significant and demonstrable benefits to ratepayers.

Viewing the evidence as a whole, we find that ratepayer benefits do not exceed the costs of the acquisition premium requested. Accordingly, we deny Petitioner's request on Northwest.

B. The United Acquisition.

a. Background and Position of the Parties. Prior to their merger with Indiana-American, UWWL served approximately 7,500 customers in Tippecanoe County in and adjacent to the City sf West Lafayette and UWIN served approximately 9,208 customers in and adjacent to Mooresville in Morgan County, Warsaw (including Winona Lake) in Kosciusko County, and Winchester in Randolph County. UWWL and UWIN were subsidiaries of United Water Idaho, Inc., which was a subsidiary of United Waterworks, Inc., which in turn was a subsidiary of United Water Resources, Inc.

On February 1,2000, Indiana-American acquired all of the outstanding common stock of UWWL and UWIN and on the same date UWWL and UWIN were merged into Indiana-American.This transaction was approved by the Commission in its Order in Cause No. 41516 issued on December 15,1999.

The stock purchase agreement provided a purchase price of $11,250,000 for the common stock of UWWL and $16,000,000 for the common stock of UWIN, both subject to adjustment for certain changes in the common equity balance of the two United companies occurring before the closing dare. After these adjustments were made, the actual purchase prices paid by Indiana-American were $17,209,039 for UWWL and $16,653,615 for UWIN. These purchase prices exceeded the book value of the common equity of UWWL and UWIN by 1.69 times and 1.71 times, respectively. (Id., p. 31.) This resulted in a total acquisition adjustment of $12,405,032, of which $5,080,417 relates to the UWWL transaction and $7,324,615 relates to the UWIN transaction.

Petitioner seeks authority to earn a return on an acquisition adjustment representing the difference between what it paid to acquire United and the net book value of the utility's equity at the time it was acquired. Again, the combining of the United and Northwest evidence is a complicating factor.

Here, again, there is no assertion that Petitioner acquired a "troubled utility", and, so, our review will consider the possible benefits to ratepayers only.

Petitioner's witness, Mr. Eckart, testified that he believed the purchase prices for the United properties were fair and reasonable, and that he personally made the decision on what Indiana-American was wiling to pay to acquire UWWL and UWIN. He asserted his decision

© Public Utilities Reports, Inc., 2003

was based on what he thought was in the best interests of Indiana-American and the Indiana consumers. Mr. Eckart **also said he assumed fair** ratemaking **treatment consistent** with policies previously expressed by this Commission. We stated he understood the burden would be on Indiana-American to demonstrate the benefits of the acquisition and stated his decision was not influenced by the regulatory treatments of other states.

Petitioner's witness Duane D. Cole, Petitioner's Vice President of Operations, claimed that customers in the areas formerly served by United (the "United Operations") have seen a substantial benefit in the area of support services. United had maintained a minimal support staff. Now those operations have tbe same level of support as all Indiana-American operations. Mr. Cole also identified a number of benefits related to day-to-day operations, predominantly also in the United Operations. Me identified benefits that had been achieved in the United Operations related to the use of chlorine.

Mr. Cole also stated Indiana-American has filters in the **Winchester** Operation **and claims** it now has a better configuration resulting in more efficient use of the source of supply there. He adds that System Control and Data Acquisition ("SCADA") equipment has been installed in Winchester, which is monitored now seven days a week. This greatly enhances the ability to respond to emergency situations, Further, Petitioner changed the United policy of not maintaining or flushing hydrants that were located in apartment complexes, taking the position that this **was** the responsibility of the apartment owner. Indiana-American has also initiated a storage tank inspection program in the acquired operations and has already identified and corrected some problems in the Winchester Operation in connection with the electric heater.

According to Mr. Cole, the most dramatic improvement has been seen in the Warsaw Operation. IDEM had issued to United a public notification within the twelve months prior to the merger for exceeding the maximum contaminant level for vinyl chloride in Warsaw. Mr. Cole said that after the acquisition, Indiana-American immediately pursued an answer to this quality issue and has installed a larger, mare efficient aerator which has reduced the vinyl chloride to a non-detectable level

Mr. Cole also stated the United Operations have benefited from Petitioner's deferred main extension monthly payment program. This is a provision of Petitioner's rules and regulations of service which establishes terms for the extension of mains and provision of service to already developed areas where it otherwise would not be affordable. Petitioner has developed a program which allows a main extension deposit essentially to be deferred and recovered without interest over a ten-year period. The first place where Petitioner has had the opportunity to use this program was within the Mooresville Operation for two main extensions to serve 88 customers.

Public's witness testified that Petitioner's asserted savings do not offset the **fair** value increment requested. Mr. Gassert testified that only $343,924. of the asserted savings are derived from the United transaction while the cost of United's fair value increment is $1,704,409. Public's witness M h e r noted that this deficit would cost the ratepayers $42 million over the next forty years while receiving essentially the same service. Petitioner acknowledged this fad but noted that the customers have seen a benefit in the area of support services and day-to-day operations and provided examples of these service enhancements. Given that there appears to be no dispute that the savings do not offset the fair value increment: we need to measure as best as possible the

© Public Utilities Reports, lnc., 2003

benefits derived from the service enhancements asserted. We are aware that United Water Co. is a large *national* water company owned by an even *larger* French utility company. We are also aware of the resources available to large companies such as Indiana-American. Therefore, we are nor as inclined to accept that the utility service provided by that national water company (United) was significantly deficient from what Indiana-American provides and we are reluctant to give significant weight to such claimed service enhancements. Further, we are aware that United's Indiana properties were not in the troubled utility category where we typically see customer service deficiencies, and in such an extreme case, customer service enhancements alone may provide the ratepayer benefits necessary to receive favorable ratemaking treatment. In this case, we do not accept that the customer service enhancements Petitioner claims warrants recovery of an acquisition premium in rates. Further, we note that the claimed O&M savings fall significantly short of the requested fair value increment requested.

Mr. Gassert testified that in Cause No. 40703, we stated the following about cast savings:

> In that case, Indiana-American submitted extensive evidence regarding the cost savings from the combination of Indiana-American and Indiana Cities, showing that the savings were greatly in excess of the cost of the capital invested in order to make those savings possible. Under informed fair value ratemaking, Indiana-American will be compensated for that investment by recognition of the full amount of the purchase price in the fair value rate base. Indiana-American continues to incur the capital costs associated with the debt and equity funds used to acquire Indiana Cities. We must also continue to grant a fair value return increment which provides that compensation, an issue we shall discuss in more detail later. p. 30.

In granting the fair value increment in that Cause, Mr. Gassert noted, we relied on Indiana-American's showing that savings substantially exceeded the cost of capital to make the savings possible. Since, in this Cause, the capital invested by Indiana-American to acquire the United properties does not generate net savings, and in fact, the costs are in excess of the savings, no fair value return increment should be granted.

b. Commission Discussion and Findings on United Acquisitions. Again, there appears to be no dispute that none of these utilities were troubled. Therefore, our discussion and evaluation of each transaction will focus on ratepayer benefits. Indiana-American has sought to justify the ratemaking treatment it seeks on its recent acquisitions of Northwest, United, and Cementville by asserting "the resulting consolidation has produced cost savings and service enhancements for its customers that exceed the fair value increment Indiana-American is seeking" (Petitioner's proposed order, p. 17) Again, it appears that, in order to grove cost savings, Petitioner aggregates these transactions into one analysis so as to justify an acquisition adjustment for ratemaking purposes. And, again, we prefer to consider the transaction standing alone for the reasons previously stated.

Having determined that ratepayer benefits fall significantly short of the cost of the acquisition premium and being mindful of our observation that "... regulators have long been cautious about increasing a utility's valuation based solely on an acquisition price." *Harbour Water Corp.,*

© Public Utilities Reports, Inc., 2003

Cause No. 41661, we find that Petitioner's request to recover a fair value increment related to its United acquisition should be denied.

C. The Cementville Acquisition. As in Northwest and United there is no allegation that the acquired entity ought be considered "troubled", for purposes of an acquisition adjustment. Therefore, our discussion and evaluation of this transaction will focus on resulting ratepayer benefits. Petitioner is requesting to earn a return on an acquisition premium of $335,992 related to its purchase of Cementville's assets from Watson Rural Water.

Petitioner asserts there were unique benefits from this acquisition, including benefits to the remainder of Watson's customers. Petitioner noted that Watson had substantial investments to make in other parts of its system and used the proceeds from the Cementville sale to help defray the costs. However at the same time, Watson could not afford the improvements that were necessary to improve pressure and flow for the Cementville customers. The Public's witness, Mr. Gassert noted that while Petitioner treated this acquisition the same as its Northwest and United mergers, by including it in the rate case as a fair value increment, the Cementville acquisition was not included in Petitioner's Corrected Exhibit CJD-4 that asserts claimed savings exceed fair value revenue requirements. Thus, of the annual $4,039,590 claimed savings in that exhibit, none are attributed to the Cementville acquisition. Therefore, no savings were presented to offset the rate impact of Petitioner's request.

Mr. Gassert also noted that Indiana-American provided very little evidence to justify the inclusion of the Cementville acquisition premium in rates. The most notable benefit he could find is on pages 36 and 37 of Mr. Cole's testimony where Mr. Cole notes that these customers now have iron and manganese filtration and an increase in water pressure. Mr. Gassert testified that it appears that most of the benefits from the transaction flowed to the seller Watson Rural Water. Mr. Cole indicated that Watson avoided a $600,000 investment and the receipt of the $500,000 purchase price allowed Watson to reduce its borrowings for improvements to the remainder of the system. We consider this to be a benefit to another utility's customers the cost of which obviously should not be borne by Indiana-American ratepayers.

Indiana-American has sought to justify the ratemaking treatment it seeks on its recent acquisitions of Northwest, United, and Cementville by asserting "the resulting consolidation has produced cost savings and service enhancements for its customers that exceed the fair value increment Indiana-American is seeking." (Petitioner's proposed order, p. 17) Indiana-American has not shown or quantified any savings that will inure specifically to the Cementville customers.

As we have previously stated, to allow utilities to aggregate their cost savings to show ratepayer benefit would in essence allow utilities favorable treatment on acquisition adjustments where no cost savings exist for that particular acquisition. We do not endorse the recovery of acquisition adjustments without sufficient proof that relates to that particular acquisition.

Based on the evidence, we find that cost savings that relate to Cementville have not been shown.

D. The Peoples Water Company And Shorewood Forest Utilities Acquisition. Prior to its merger into Indiana-American, Northwest acquired the water utility systems of two small water utilities - Peoples Water Company, Inc. ("Peoples") in 1999 and Shorewood Forest Utilities, Inc.

© Public Utilities Reports, Inc., 2003

("Shorewood") in 1998. Mr. Cole explained that Peoples was a utility in Gary serving a low-income area whose shareholders were no longer interested in owning the utility. (Petitioner's Ex. DDC, p. 8.) Shorewood was a nor-for-profit utility in Porter County seeking improved water quality for its members. (*Id.*) There were small acquisition premiums associated with these acquisitions that Petitioner originally proposed to include in its original cost rate base. (Petitioner's Ex. **JLC-2,** Sch. 3.) OUCC witness Gassert argued that allowing a return on the Peoples acquisition adjustment was inconsistent with the Commission Order approving that **transaction and in neither case did Indiana-American submit evidence as to ratepayer cost savings** attributable to the acquisition. In its rebuttal testimony, Indiana-American did not respond to Mr. Gassert's testimony regarding Peoples and Shorewood. We find that the Peoples and Shorewood acquisition adjustments should not be included in Petitioner's original cost rate base.

9. Rate ***Base Issues (Step One) - Petitioner's*** *Original Cost Rate* ***Base.*** Petitioner presented evidence for the first phase of its rate increase that estimated its net original cost of plant as of July 31, 2001. **The OUCC** used the same general rate base valuation date. A general rate base update after the end of the test year is permitted by the Minimum Standard Filing Requirements provided it is made as of a date prior to the hearing on Petitioner's case-in-chief.

Petitioner's prefiled case-in-chief, contained actual pliant balances as of June 30,2001 and estimated the amount of the construction projects expected to be closed as of July 31,20011. Mr. Cutshaw commented at the hearing on its case-in-chief that the actual balance closed to utility plant in service as of July 31,2001 was **$2,900,725** higher than his estimate in his prefiled testimony. (Tr., 12/7/01 hearing, p. **79)** No workpapers or revised schedules were provided until Petitioner filed its rebuttal testimony.

Mr. Cutshaw criticized Ms. Lynn for not updating Petitioner's rate base when she filed her testimony. However, Ms. Lynn amended her testimony and exhibits on February 15,2002. As noted in Ms. Lynn's revised testimony, she did not receive updated rate case summary schedules from Petitioner until February 12th. Although these updates were received well after Petitioner's hearing on its **rase-in-chief, we will include the actual** July **amounts in our determination of** Petitioner's original cost rate base.

Based on the evidence provided, there were four differences between Petitioner's rebuttal schedules and the OUCC's February 15th revision. First, the actual plant balance for Petitioner's Wabash district was inadvertently not updated by Ms. Lynn (Tr., pp. 27-29). We shall use the actual amount for the Wabash district which is approximately $30,000 higher than the estimated amount on Ms. Lynn's schedules.

The second difference is due to an adjustment made by the OUCC for artwork and unused **furniture.** The OUCC **explained that it eliminated $96,559 for assets that were not reasonably** necessary for the provision of water utility services. Such assets included; $37,375 for artwork at the Greenwood office; $28,495 for artwork located in the Southern Indiana District; $19,253 for bookcases **bought for the president's office; and $1 1,077 of furniture for the accounting and** finance staff that were eliminated as a result of the Shared Service Initiative. We are troubled by the uncontroverted revelations of Ms. Lynn, wherein she noted the difficulties the Public encountered in attempting to confirm the accuracy of fixed asset additions due to the conversion of data in October **1998** to a new **J.D.** Edwards accounting system and supporting detail not

. © Public Utilities Reports, Inc., 2003

being easily accessible. When Petitioner made this conversion, it combined each fixed asset account into one amount. Petitioner's staff stated that detail existed at a location off-site in the form of ledger books and detailed report binders and that the hiring of additional personnel would be necessary to retrieve the information requested for review. As a result, all supporting detail could not be produced without an exhaustive effort by Petitioner's staff as well as OUCC audit staff, Ms. Lynn did not adjust rate base For $51,588 in interior design fees, $194,477 in cubicles, countertops, overhead cabinets, filing cabinets and electrical services, associated with the displaced employees from the shard service initiative and $421,362 for office remodeling for the Gary location that she could not reconcile due to inadequate documentation.

Mr. Cutshaw testified that most of Ms. Lynn's adjustments were immaterial. Thus, the amount is not unreasonable and should remain in utility plant. He also noted that the unused space Ms. Lynn mentioned would be used in the near future. Petitioner argues that the items involved represent a small dollar amount when compared to Petitioner's total rate base, however, all components of that base are subject to review by the Public and this Commission, and it is incumbent upon the Petitioner to provide *all* records. Nevertheless, based on the evidence before us, we accept the Petitioner's adjustments on this issue.

The third difference proposed by the OUCC was an adjustment for invoices Ms. Gemmecke testified should be capitalized rather than expensed. Ms. Gemmecke pointed out that about half of those invoices related to the lining of two wells and the remainder consist of instruments and construction materials of a financial magnitude that warrant capitalization. Indiana-American accepted some of these adjustments. Indiana-American acknowledged that two of the items ($4,203 and $3,395 for work on well 3a in Warsaw) were improperly expensed in the test year but were reclassified to utility plant after the test year but before the rate base cutoff. Accordingly, these items have already been included in the Company's presentation of original cost rate base. Petitioner also acknowledged that $5,048 for pipe installed in well 2a in Warsaw during cleaning, $3,250 for installation of an 8" tie-in in Southern Indiana, and $2,029 for three hydrant meters in Northwest should have been capitalized. Mr. Cutshaw testified, and we find, that these items, totaling $10,327 should be removed from expense and should be reclassified as an increase to rate base. We have included this amount in our finding on original cost rate base.

The final difference pertains to the inclusion of the acquisition adjustments for People and Shorewood which we have previously discussed.

Based on the evidence and our previous findings, we find that Petitioner's original cost for water and sewer property used and useful is as follows:

[Graphic Not Displayed Here]

A. Rate Base Issues (Step One)-Petitioners's Fair Value Rate Base. A fair value rate base is not necessarily synonymous with a utility's original cost rate base. Indiana Code 8-1-2-6 established that this Commission values a public utility's property at its "fair value." I.C. 8-1-2-6, as amended, has been interpreted in various fashions since its inception in 1913. In Indianapolis Water Co. v. Public Serv. Comm'n., 484 N.E. 2d 635 (Ind. App. 1985), the court addressed what

factors could be considered in determining fair value. The court stated that "fair value" is a final conclusion drawn by this Commission from various values and factors, including original cost and reproduction cost. Certainly the fair value of a utility can equal its original cost. See Office of Utility Consumer Counselor v. Gary Hobart Water Corporation, 650 N.E. 2d 1201 (Ind. App. 1995). The Indiana Court of Appeals, in Indianapolis Water Company v. Public Service Commission, 484 N.E. 2d 635 (1985), indicated the following:

> In our determination of fair value, this is not an either/or situation regarding the use of original costs or reproduction costs new less depreciation. But rather fair value is the conclusion or final figure drawn from all the various factors offered in evidence. While original cost is one of the factors the Commission may consider while arriving at fair value is not: in sf itself an accurate reflection of the fair value of the utility's property.

I.C. 8-1-2-6 also states "[a]s an element in determining value the commission may also take into account reproduction costs at current prices, less depreciation, ..." This Commission has routinely accepted RCNLD studies into the record and considered it as evidence in support of Petitioner's fair value. While this Commission has routinely considered RCNLD studies, reproduction cast is just one factor amongst many that this Commission typically considers in its determination of fair value.

B. Petitioner's Position. Petitioner presents a reproduction cost new less depreciation (RCNLD) study by Mr. DeBoy which estimates a replacement cost new less depreciation of $1,099,428,470. This figure is then converted into a trended cost adjusted for technological change figure to estimate a replacement cost of $756,281,105. However, Petitioner does not use the results of either study to estimate the fair value of its used and useful plant. In fact, based on its direct and rebuttal testimony, Petitioner proposes to earn its cost of capital multiplied by its original cost rate base plus its cost of capital multiplied by its unamortized proposed acquisition adjustments *to* estimate its proposed net operating income.

C. Public's Position. The *OUCC* determined Petitioner's NOI by multiplying its cost of capital by its original cost rate base plus its cost of capital multiplied by certain acquisition adjustments. The key difference is that the OUCC does not believe that Petitioner should be entitled to earn a return on the acquisition adjustment from the merger with Northwest Indiana Water or the acquisition of the United Water properties.

D. Replacement Cost New Less Depreciation. As discussed above Petitioner's Witness, Alan J. DeBoy, Vice-President Engineering, provided testimony and sponsored the study to determine the; Replacement Cost New Less Depreciation ("RCNLD") value of Petitioner's utility plant in service ("UPIS"). Mr. DeBoy states that the purpose of the RCNLD study is "to assess the cost to reproduce the existing utility plant in service based on current material and equipment prices and current construction and wage levels."*Exhibit-AJD*, p.24, lines 1-3. He utilized the Trended Original Cost Method to determine the Replacement Cost New ("RCN") value of the property. He explained that "the Trended Original Cost Method is based on the actual historical cost of construction of the property as reflected on the Company's books and records." *Exhibit-AJD,* p.24, lines *14-15,* The primary source of the trend factors used in Mr. DeBoy's study was the

© Public Utilities Reports, Inc., 2003

Handy-Whitman Index of Public Utility Construction.Costs for Water Utilities. He also used the U.S. Bureau of Labor Statistics to trend some accounts. Mr. DeBoy explained that the Utility has "calculated the RCN of its utility property by using the Trended Original Cost Method by means sf the Handy Whitman indexes" Exhibit-AJD, p. 27, lines 17-18. Mr. DeBoy's study, which trended the original cost of the Utility Plant In Service (UPIS), resulted in a RCN value sf $1,408,981,763. *Exhibit-AJD-1*, Schedule 1.

To determine the RCNLD value, Mr. DeBoy had to estimate the amount of depreciation associated with the RCN value. Therefore, Mr. DeBoy calculated the depreciation or percent condition to be equal to the complement of the depreciation reserve divided by the plant investment as of July 31,2001. ***Exhibit*** *AJD*, p. *33,* lines 4-5. He then applied the resulting percent condition of 78.03 to the RCN to determine the RCNLD value. Mr. DeBoy's study resulted in a RCNLD value for Petitioner's UPIS of $1,099,428,470.

Petitioner's Witness, Dr. John A. Boquist, requested that Mr. DeBoy reduce the RCNLD value by **4.34%** per year to make sure the impact of technological change was not understated. Dr. Boquist explained that 1.34% figure "is the measure of the average annual rates of change in multifactor **productivity in thc U.S. manufacturing sector during the period 4950 through 2000 as** measured **by** the U.S. Bureau of Labor Statistic" ***Exhibit-JAB,*** p. *49,* lines *8-11*. The resulting RCNLD value after adjusting for the 1.44% technological factor was $756,281,105. Dr. Boquist then added materials and supplies of $1,846,388 and other rate base items to arrive at what he calls a "total replacement cost rate base of $763,952,972." ***Exhibit-JAB,*** p. ***59,*** line 5. Dr. Boquist stated that "the fair value of property is the amount that a willing buyer would gay a willing seller in an arm's length transaction when both parties have complete information." ***Exhibit-JAB,*** p. 36, lines ***21-22.*** He also added "In theory fair value should represent depreciated replacement cost of the property." *Exhibit* JAB, p. 37, lines 1-2. He concludes that "[a]sset replacement cost valuations can be used to estimate the fair value of property of a utility such as Indiana-American." *Exhibit-JAB*, p. 37, lines 16-18.

In OUCC Witness Scott A. Bell's testimony, he pointed out that Petitioner has presented a RCNLD study to support a fair value rate base figure in each of its last seven rate cases. The Commission has accepted each of these studies into the record as evidence the respective cases. He added that in Indiana-American's last three rate cases (Cause Nos. ***41320,40703*** and 40103), Dr. Boquist provided testimony on fair value rate base and replacement cost valuations. However, Mr. Bell points out that "the Commission has consistently determined that the fair ***value*** **rate** ***base is*** **not** ***equal*** **to** Indiana-American's proposed ***RCNLD*** value ***or*** its Replacement Cost value." OUCC ***Exhibit-No.*** 6, p. 4, line ***16-1***8. We created the following table of the past seven rate cases to illustrate his point. ***OUCC Exhibit*** No. ***6,*** p. 5, lines 1-3.

[Graphic(s) below may extend beyond size of screen or contain distortions.]

Cause No.	Order Date	Commission's Determination of Original Cost Rate Base	Petitioner's Proposed RCWLD Value	Commission's Fair Value Rate Base Determination
41320	07/01/99	293,003,938	*492,108,096	No Determination
40703	12/11/97	221,628,031	*398,701,046	318,331,583

© Public Utilities Reports, Inc., 2003

40103	05/30/96	186,279,406	*303,571,716	261,571,000
39595	02/02/94	114,762,256	299,336,080	166,500,000
39215	05/27/92	107,435,891	289,367,162	155,800,000
38880	09/26/90	90,964,050	273,239,652	127,000,000
38347	07/06/88	80,721,738	209,196,578	107,415,200

"Adjusted downward for technological change by Dr. Boquist to determine Replacement *Cost.*

The Commission notes that the OUCC (in Table 2) used the fair value rate base in Cause No. **40703** that includes Construction in Aid of Construction (CIAC). The Commission's finding excluded CIAC thus finding a fair value rate base of $31**1,804,823.**

Mr. Bell explained that during the first four rate cases (Cause No. **38347,38880,3921**5 and 39595), **Petitioner did not make any adjustments to the RCNLD value for technological change,** as proposed in this case. OUCC *Exhibit No. 6*, p. 5, lines 7-8. He pointed out that the Commission, in each of those four cases, determined that the fair value rate base was significantly less than Petitioner's proposed fair value determined by the RCNLD studies. He also stated that in Petitioner's next four rate cases (Cause No.'s 401**03,40703,41320** and again in this cause), that Dr. Boquist requested the RCNLD value be downwardly adjusted by a technological change factor to determine a "Replacement Cost" value. *OUCC Exhibit-No. 6*, p.6, lines 3-5. Mr. Bell propounds that, even with the downward adjustment for the technology factor, the Commission found that Petitioner's adjusted RCNLD in Cause No. 40103 and **40703** did not represent the fair value rate base. OUCC *Exhibit No. 6*, p. 6, lines 43-15. Mr. Bell stated that a review of the Commission's decisions in two Northwest Indiana Water rate cases (Cause No. 40467 and 39585), and Indianapolis Water (Cause No, 39713/39843) were consistent in that the valuation studies in those cases were found not to be representative of fair value.

Mr. DeBoy used a generally accepted method of performing the RCNLD study. However, Mr. Bell pointed out that the methodology employed by Mr. DeBoy assumes that the Utility's plant would be reproduced exactly today if it were to be rebuilt. Mr. Bell contends that the current water and sewer facilities Rave been constructed over a period in excess of 100 years in some areas. He **also stated that the plant was constructed under different customer demands,** financial conditions and management practices that influenced the original construction of the plant that exists today. He concluded that the plant would not be rebuilt as it exists today. OUCC *Exhibit No. 6*, p. 8, lines 1-5. Mr. Bell also pointed out that the Commission had the same concerns in prior cases. Mr. Bell provided a quote from the Commission's Final Order in Cause Nos. 39871 and **40078,** as well as, from the Commission's Final Order in Cause Nos. 39713 and 39843 to illustrate his concerns.

Finally, Mr. Bell states that the RCNLD valuations have not been useful indicators of fair value **in past** cases **and that the** Commission has not relied upon these valuations to determine fair value. OUCC *Exhibit No. 6, p. 10, lines 16-20.* He states that the Commission seems to have

determined the fair value rate base figure based on a percentage of the original cost rate base. *OUCC Exhibit* No. 6, *page 10, lines* 25-28. He provided Table **2** in **his testimony to illustrate his** point. Table No. 2 illustrates the fact that, based on past rate cases, the fair value rate base on average was approximately 42% higher than the original cost rate base. Therefore, Mr. Bell recommends that the Commission give the RCNLD and Replacement Cost valuations no more consideration or weight than the Commission has given them in past determinations of fair value rate base. *OUCC* Exhibit No. *6, p. 11, lines* ***5-8.***

E. Commission ***Findings.*** The evidence presented regarding the fair value Petitioner's plant covers a wide range. Petitioner's evidence indicates an RCNLD valuation of $1,099,428,470, .which, after adjustments for technological change was reduced to $765,281,105. The OUCC appears to suggest that the fair value of Petitioner's plant should be identical to the original cost of that plant, i.e., $403,085,800.

In rare circumstances, this Commission has accepted the OUCC's **proposal that fair value** can be equated to original cost. This is not one of those rare circumstances, and the OUCC has not presented sufficient evidence to persuade the Commission otherwise. The Commission is equally dubious of the Petitioner's proposed valuation. In reviewing past Commission determinations of fair value for this utility, the Petitioner's proposed valuation represents a considerable leap in value, with no compelling justification given to support such an increase,

In the past, the Commission has used prior fair value determinations of a utility as a starting point for determining a new fair value rate base, In the case at hand, the Commission finds an appropriate methodology for determining fair value **would be** to **take the fair value determination** from the last rate proceeding for Indiana-American and each of the acquired utilities, adjust those fair value determinations to reflect inflation from the date of the respective Commission Orders (using the inflation factors found in E. Kaufman's Attachment 1), and then add net plant additions (at cost) of $112,422,000. On the basis of the foregoing evidentiary findings and determinations, we find that the fair value of Petitioner's in service and used and useful for the convenience of ***the*** public **at July 31, 2001 is $562,680,669, as shown in the table below:**

[Graphic(s) below may extend beyond size of screen or contain distortions.]

Order Date	Petitioner's Cutshaw Exhibit JLC-1, Schedule 4FVRB	IURC Findings	Adjusted for Inflation
12/11/1997	IN-AM, Cause No. 40703:	5311,805,000	$337,507,760
3/26/1997	Northwest, Cause No. 40467	85,000,005	92,006,734
8/24/1994	United Properties, Cause Nos. 39838-41	17,571,000	20,744,175
	Net Plant Additions		112,422,000
	Fair Value Rate Base		$562,680,669

10. Cost of Common Equity. The Commission having determined the fair value of Indiana American's used and useful property must now determine what level of net operating income represents a reasonable return on its investment. While cost of capital is not synonymous with fair rate of return it is typically a major consideration in our determinations of a fair rate of return.

A. Petitioner's Cost of Equity. Petitioner's witness Dr. Boquist relied on a proxy group of four publicly traded water companies covered by Value Line. Dr. Boquist performed both a discounted cash flow ("DCF") and capital assets pricing model ("CAPM") analysis. His DCF analysis resulted in an unadjusted cost s f equity of 9.79% and CAPM analysis resulted in an unadjusted cost of equity of 10.34%. Dr. Boquist then added a 100 basis point company specific risk adjustment to the results of his DCF analysis and a 150 basis point adjustment to the results of his CAPM analysis, This produced an overall range of estimates of 10.79% to 11.84%. Dr. Boquist recommends a cost of equity of 11.58%.

Dr. Boquist's DCF analysis was based on the 2-stage DCF model, thus his model has two estimates of growth (g) in his DCF model. For the first stage Dr. Boquist assumed that dividends for each company in his proxy would grow over the next ten years as they did in the previous ten years. For the second stage Dr. Boquist assumed that water company dividends would grow at the same rate of nominal GNP. Dr. Boquist's estimate of future nominal growth of nominal GNP is based on the average historical. GNP over the last 21 years.

Dr. Boquist's CAPM analysis was based on an arithmetic risk premium and income bond returns. Dr. Boquist argued that if the Commission gives weight to both the arithmetic and geometric risk premium calculations, that it should give the vast majority of its weight to the arithmetic risk premium.

B. Mr. Kaufman's Cost of Equity. The Public's witness, Mr. Edward Kaufman used the same proxy group of water companies that Dr Boquist used, but he estimated a lower cnst of common equity than Dr. Boquist. He used both a DCF model and a CAPM analysis and estimated a cost of common equity for Petitioner of 9.50%. Mr. Kaufman's DCF analysis produced a range of 8.14% to 8.28%, while his CAPM analysis produced a range of 7.36% to 9.33%. Mr. Kaufman concluded that due to Petitioner's somewhat smaller size they had more business risk than the proxy group. To account for Petitioner's company specific risk Mr. Kaufman increased the results of his analysis by 0-25 basis points. This resulted in a range of cost of equity estimates of 7.34%-9.58% Mr. Kaufman then recommended a cost of equity of 9.50%.

Mr. Kaufman relied on the more traditional single stage DCF model. He based his estimate of growth (g) on historical and forecasted growth in earnings per share ("EPS"), dividends per share and book value per share ("BVPS"). Mr. Kaufman also completed a CAPM analysis. His CAPM analysis relied on both an arithmetic and geometric mean risk premium. Mr. Kaufman also relied on total bond returns instead of income bond returns to estimate the market risk premium.

Mr. Kaufman adjusted the results from proxy group to consider Petitioner's specific business and financial risk. He concluded that, based on Petitioner's size and the percentage of equity in its capital structure, Petitioner is similar in risk to that of the proxy group. Mr. Kaufman then

© Public Utilities Reports, Inc., 2003

adjusted the results of his equity analysis by 0-25 basis points. Mr. Kaufman asserted that a 9.50% cost of equity was reasonable in today's markets. He pointed out the forecasted inflation over the next few years was expected to remain Low and asserted that lower inflation rates translates directly into low-er capital costs.

*C. **Petitioner's Rebuttal.*** In rebuttal Dr. Boquist criticized Mr. Kaufman's DCF approach, including his failure to adjust for a full year of forward growth in determining the dividend yield. Dr. Boquist said the half-year forward yield procedure was inconsistent with the mathematical derivation of the model, *was* theoretically *unjustified and* would result in the *investor* perpetually being short one half of the expected dividend growth. Dr. Boquist also disagreed with Mr. Kaufman's use of EPS and BVPS *growth* rates in determining the perpetual dividend growth rate. Dr. Boquist said BVPS was a particularly poor indicator of dividend paying ability. Dr. Boquist noted that Mr. Kaufman's single-stage DCF model used growth rates for California Water and American States of 2.72% and **3.33%** which axe well below the historical rate of inflation and much too low to use as perpetual dividend growth rates. Dr. Boquist disagreed with Mr. Kaufinan's contention that a forecasted GDP growth rate would be more appropriate in the second stage of Dr. Boquist's DCF model because typical forecasts do not encompass a long-term time frame as required for the second stage.

'With respect to the CAPM, Dr. Boquist criticized Mr. Kaufman's use of geometric averages as an inappropriate way of estimating uncertain forward-looking expected returns. Dr. Boquist also said Mr. Kaufrnan failed to match the bond terms used for the risk-free rate with the 20-year maturity period represented by the Ibbotson data. Dr. Boquist testified that it was incorrect for Mr. Kaufman to ***use treasury*** bond ***total returns as*** the risk ***free rate in the market*** risk **premium** calculation because they are affected by changes in value. Only the income return (interest) from treasury bonds is truly riskless. Dr. Boquist stated that Mr. Kaufman's company-specific risk adjustment of 0-25 basis points was inadequate. Dr. Boquist said that Mr. Kaufman failed to recognize that since Petitioner" last rate case, risk had increased substantially for both common stocks generally and Petitioner in particular. He testified Mr. Kaufman failed to give any consideration to the significant regulatory and liquidity risks faced by Petitioner relating to the Commission's polices on acquisition investments and the OUCC's position with respect thereto.

D. Commission **Endings.** For reasons described hereafter, the Commission finds that a cost of common equity ranges between 9.50% to 11.50%.

There was considerable disagreement between the parties over the mechanics of the DCF model. First regarding the calculation of the forward dividend yield in **the** DCF model, Dr. Boquist chose the full-year method, while Mr. Kaufman utilized the half-year method. Second, regarding the estimation of the perpetual growth rate (g), Dr. Boquist chose the ten-year historical growth rate of dividends for the tirst stage of his DCF model and the nominal **growth** rate of GNP for the second stage of his DCF model. Mr. Kaufman relied upon 10-year, 5-year and forecasted growth rates of dividends, earnings and book value per share.

Dr. Boquist agreed during cross-examination that Dr. Lewellen, testifying on behalf of Indiana-Cites Water Company, used the half-year growth method to estimate the forward dividend yield.

© Public Utilities Reports, Inc., 2003

This Commission believes that the DCF remains a viable model to aid in our determinations of Petitioner's cost of equity. As stated in our Final Order in Cause 40103 pages 40-41:

> The Commission has considerable experience with the DCF model for estimating the cost of equity, We are well aware of the advantages and limitations of the various approaches used by each of the witnesses, For example, the half-year method used by the OUCC for calculating the forward yield is the most frequently used approach in this jurisdiction and is rarely a point of contention in DCF analysis. We believe it fairly represents the dividend payments expected and received by investors, while the full-year method employed by Petitioner overstates dividend yield. A recalculation sf Petitioner's DCF using *the* half-year method by the OUCC resulted in a 20 basis point reduction (Sudhoff direct, p. 29). On the issue of deriving growth rates this Commission has sanctioned the use of per share data for earnings, dividends and book value. *Northern Indiana Fuel and Eight,* Cause No. 39145, January 29,1992 p. 25. In all cases however, the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis.

As we stated in Cause 40103 the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis. This Commission has concerns regarding Dr. Boquist's implementation of the 2-stage DCF model. Dr. Boquist has used a high estimate of dividend growth (g) for the second stage of his DCF model. Additionally, Dr. Boquist's quarterly DCF analysis assumes that dividends will grow each and every quarter.

In the past this Commission has consistently sanctioned the use of both historical and forecasted per share data. We continue to believe that both historical and forecasted earnings, dividends and book value per share data are useful when employing the DCF model.

There was also considerable disagreement regarding the CAPM analysis. The OUCC has relied on both the arithmetic and geometric mean in estimating the market risk premium while Petitioner *relied* exclusively on the arithmetic mean premium. Petitioner's reliance on the arithmetic risk premium alone increases the risk premium by more than 150 basis points higher than the blended risk premium used by Mr. Kaufman. In recent rate cases this Commission has given weight to both the arithmetic mean risk premium and the geometric mean risk premium. *See* p. 12 of the *Peoples Natural Gas* Order in Cause No. 39315:

> As in the ***Indiana Cities*** case, [Cause No. 39166, July 8, 1992] we find there is merit in using both the arithmetic and geometric means and that neither result should be relied upon to the exclusion of the other.

This Commission also reaffirmed its position in *Indiana American Water Company,* Cause No. 40103, Order dated May 30, 1996. On page41 of that Order this Commission stated:

> The debate over the proposed use of the arithmetic and geometric means is one we

© Public Utilities Reports, Inc., 2003

> consider resolved. As we stated in *Indianapolis Water Company,* Cause No. 39713-39843, each method has its strengths and weaknesses, and neither is so clearly appropriate as to exclude consideration of the other. (Emphasis added)

Dr. Boquist has responded to our finding that both methods should be considered by arguing that if we consider both methods we should give the vast majority of weight to the arithmetic mean. We decline to set. such a balance.

We repeat that, while ***the*** debate over the proposed use of the arithmetic and geometric means continues, however, each method has its strengths and weaknesses, neither is so clearly appropriate as to exclude consideration of the other.

Statements from Dr. Ibbotson's 1982 edition of *Stocks, Bonds, Bills, and Inflation: the Past and the **Future*** support our findings that both methodologies should be given weight. On page 59 Dr. Ibbotson stated as follows:

> The arithmetic mean historical return component **is used in making one-year** forecasts, since the arithmetic mean represents the average performance over a one-year period. Over a long forecast period, however, the geometric mean historical return represents average performance over the whole period (stated on a compound annual basis), Therefore, we input the arithmetic mean for the one-year forecast, the geometric mean for the twenty-year forecast, and intermediate values for two, three, four, five and ten-yeas. **forecasts.**

Both Mr. Kaufman and Dr. Boquist recognized the need to adjust the results of their proxy group for Petitioner's company specific risks. To account for Petitioner's company specific business risks Dr. Boquist increased his estimated s f Petitioner's cost of equity by 100-150 basis points, while Mr. Kaufman's company specific adjustment was 0-25 basis points. Having determined the range to be 9.50% to 11.50%, we find that Petitioner's cost of common equity is 10.50%.

11. Cost of Capital and Capital Structure. Having determined cost of equity we can now determine Petitioner's cost of capital. When a 10.50% cost of equity is incorporated into Petitioner's capital structure as shown below, the weighted cost of capital is 7.96%.

[Graphic(s) below may extend beyond size of screen or contain distortions.]

Capital	*Amount*	*Ratio*	*Cost*	*Weighted Cost*
Common Equity	$ 159,334,390	39.34%	10.50%	4.138
Preferred Equity	$ 510,000	0.12%	6.009	0.01%
Long-Ten Debt	$ 221,236,755	51.38%	7.30%	3.75%
Pre-1971 ITC	$ 187,483	0.04%	0.00%	0.00%
Post-1970 ITC	$ 3,415,751	0.79%	8.69%	0.07%

© Public Utilities Reports, Inc., 2003

Deferred Income Taxes	$ 33,560,843	7.79%	0.00%	0.00%
Customer Deposits	$ 98,426	0.025	6.00%	0.00%
Post Retirement Benefits-net	$ 2,184,031	0.51%	0.00%	0.008
CIAC-Muncie	$ 35,654	0.01%	0.006	0.00%
Total	$ 430,623,293100.00%	7.96%		

Petitioner and the OUCC computed the debt cost rate by dividing (a) the sum of the annual interest and issuance cost amortization by (b) the amount outstanding less the unamortized issuance costs. Crown Point witnesses Guerrettaz divided (a) the sum of the annual interest and **issuance amortization by (b) the amount outstanding. In rebuttal, Ms. Doron stated that** Petitioner's method of computing the debt cost rate has been used in numerous rate cases. In this cause we adopt the method used by both Petitioner and the OUCC. The cost rate for Job Development ITC-Post 1970 **was calculated as follows:**

[Graphic(s) below may extend beyond size of screen or contain distortions.]

Capital	Amount	RatioCostWeighted	Cost	
Common Equity	$ 169,354,390	43.31%	10.50%	4.55%
Preferred Equity	$ 510,000	0.13%	6.008	0.01%
Long-Term Debt	$ 221,236,755	56.56%	7.308	4.13%
Total	$ 391,141,145100.00%	8.69%		

12. Fair Rate of Return and NOI.

A. Petitioner's Position. In its direct testimony Petitioner proposes to determine its NOI by **multiplying its cost of capital by its original cost rate base plus its cost** of **capital by its proposed** acquisition adjustments. Although Petitioner never asserts that its cost of capital is a fair rate of return, the clear implication from its testimony is that the Commission should directly apply **Petitioner's cost of capital to determine the appropriate level of net operating income for** Indiana American Water Company.

Dr. Boquist testified that the **return** of a utility should correspond to the return investors could earn on investments of comparable risk in the unregulated sector. If investors can earn a larger return and bear identical risks, or conversely earn identical returns with less risk, by investing in other industries, they will do so. Failure to recognize this fact would make it difficult for utilities to raise capital on a competitive basis. Dr. Boquist expressed the opinion that Petitioner should

© Public Utilities Reports, Inc., 2003

be allowed to earn a fair rate of return on the fair value of its property similar to the rate of retum which unregulated companies of comparable risk earn on the fair value of their assets. Dr Boquist performed a detailed study to determine that rate of return.

Dr. Boquist first identified a large group of comparable-risk unregulated companies by using the approach advocated by Fama and French in a 1992 study published in the *Journal of Finance* and in subsequent papers. Fama and French concluded that the size of a firm measured by the market value of its equity ("ME") and the ratio of a firm's book value of equity to a firm's market value of equity (book-to-market equity ratio or "BE/ME") are the two risk factors influencing common stock returns because they have strong ties to economic fundamentals such as profitability and the growth of earnings and assets that have long been associated with investment performance. Fama and French contend these factors explain stock returns better than beta.

Dr. Boquist replicated the Fama and French study approach by performing a computer analysis sf nonregulated firms in the New York Stock Exchange, American Stock Exchange and NASDAQ return files from the Center for Research in Security Prices and the merged COMPUSTAT annual industrial files of income statement and balance sheet data. The time period covered by this study extended from 1963 through 2000. The companies were then partitioned into matrixes for each year based upon the two key Fama and French risk factors. Dr. Boquist then developed for each year a portfolio of comparable companies reflecting the range of ME and BE/ME values for his four proxy companies, the results which would be predicted by the Fama-French. Dr. Boquist then determined the pse-tax rate of return earned by the comparable companies on the depreciated replacement cost of their assets. To determined replacement cost, Dr. Boquist used the techniques described in the work of Lindenberg and Ross, published in the *Journal of Business* in *1981,* which prescribes a methodology for estimating replacement cost of a firm's assets from its accounting statements. This method considers price level changes, technological change, real economic depreciation and investment in new plant and equipment. The same 1.34% technological change adjustment used by Dr. Boquist in his determination of Petitioner's depreciated replacement cost was used for the comparable companies. Dr. Boquist testified that he measured before income tax operating profit to eliminate the effects of leverage (the interest of which affects income taxes), the tax strategies some firms employ and tax loss carryforwards and carrybacks available to some companies. From this study Dr.Boquist determined that the average annual pre-tax rate of return on replacement cost for the comparable companies form 1965 through 2000 was 11.88% (Petitioner's Ex. JAB, p. 55.) He concluded that a rate of return of 11.88% before income faxes on the depreciated replacement cost of Petitioner's property, would, therefore, be fair and reasonable.

B. Public's Position. As discussed above the Public used a similar process as Petitioner did to estimate an appropriate level of NOI for Indiana American Water Company. The key difference is that the Public did not believe it was appropriate for Petitioner to earn a return on its proposed acquisition adjustment from its merger with Northwest Water Company or its purchase of the United Water properties.

Through its witness Mr. Edward R. Kaufman the Public challenged Dr. Boquist's return on replacement wst analysis. Mr. Kaufman had several concerns regarding Dr. Boquist's Fama-French analysis. The key concerns expressed by Mr. Kaufman were: Dr. Boquist's return

on replacement cost analysis does not react to changes in capital markets: Dr. Boquist's analysis is based on operating returns while the Fama-French analysis is based on market returns: and the results of Dr. Boquist's analysis are contrary to the model.

Specifically Mr. Kaufman asserted that Dr. Boquist's return on replacement cost analysis does not react to changes in market conditions. In models such as the DCF or CAPM, changes in investor expectations are quickly incorporated into expected returns. That is not the case in Dr. Boquist's return on replacement cost analysis. For example, a change in interest rates will impact investor expectations, and the results of both a CAPM or DCF analysis will, in turn, quickly react to reflect the change in investor expectations. The U.S. Federal Reserve cut interest rates eleven times in 2001. However, Dr. Boquist's return on replacement cost analysis fails to either react lo or incorporate the change in interest rates over the Iast year into his return on replacement cost analysis.

Next **Mr. Kaufman criticized Dr. Boquist's use of operating returns. The Fama-French** analysis assumes that firms in the same grid location will earn similar market returns. Market returns refers to price appreciation plus dividends. Dr. Boquist's analysis is based on net **operating profit. Dr.Boquist uses operating income before taxes as his measure of return in** estimating his return on replacement cost. While Dr. Boquist analysis assumes that firms in the same grid location will earn similar operating returns, he presents no evidence to support his opinion that the Fama-French analysis can be extended to include his assumption. Mr. Kaufman agreed that there will be some relationship between market returns and operating returns, but he stated that there were many other factors which will influence market returns that may have little or no impact on operating returns. Mr. Kaufman asserted that operating returns and market returns are distinct. Companies may have similar market returns yet have very different operating returns.

Mr. Kaufman demonstrated that the results of Dr. Boquist's return on replacement cost analysis produced results that were contrary to the model's predicted results. The Fama-French model **predicts that:** it) **smaller companies will earn a higher rate of return than larger companies** and 2) companies with a higher book-to-market ratio will earn a higher rate of return than companies with a lower book-to-market ration. [2] (2) In his workpapers, Dr. Boquist provides a calculation of returns by grid location for each of the *25* grid locations on his 5 by 5 grid. He does this on a year-by-year basis for each year from 1965-2000 and on a composite basis for all years. Mr. Kaufman provided a schedule that replicates the composite or average results of Dr. Boquist's analysis for all years (Schedule 4, page 3). Mr. Kaufman also included a copy of Petitioner's workpaper (Schedule 4, page 4) that contains the data provided in Schedule 4, page 3. In his analysis Dr. Boquist separates the companies into quintiles, as measured by market equity, and get larger going left to right (grid locations I to 5j. Companies are also separated into quintiles as measured by book-to-market ration with an increasing book-to-market ratio going top to bottom (grid locations 1 to *5).* Thus, companies in grid location (1,1), which are in the upper left hand comer have the smallest market equity and the lowest book-to-market ratio. Conversely, companies in grid location (5,5), which are in the lower right hand corner, have the largest market equity and have the highest book-to-market ratio. Under the Fama-French model smaller companies should earn higher rates of return than larger companies, therefore rates of

© Public Utilities Reports, Inc., 2003

return should increase as one moves horizontally from grid 5 to 1 (right to left). Likewise, under the Fama-French model, where firms with a lower book-to-market ratio should earn lower rates sf returns, rates of retum should increase as one moves vertically from grid 1 to grid 5 (top to bottom),

Mr. Kaufman then explained that figures in Dr. Boquist's analysis did not follow the theory put forth by the Fama-French model. In fact, grid location (5,1) which contains the largest companies with the smallest book-to-market ratio shows the highest rate of return (20.27%) when, in fact, the theory dictates it should have the lowest rate of return. Additionally, under the Fama-French model the highest rate of return should appear in grid location (1,5) which contains the smallest companies with the highest book-to-market ratio. But under Dr. Boquist's analysis grid location (1,5) has one of the lowest rates of return (8.57%).

During rebuttal testimony and cross examination Dr. Boquist argued that his results were **consistent with the Fama-French model and that one should** *expect* small *companies* will simultaneously *e m* a lower operating rate of return on replacement cost while earning a higher market rate of return on market value than large companies with a similar book-to-market ratio.

Additionally Mr. Kaufman compared the final results of Dr. Boquist's analysis in this case to the results in his last case. This comparison caused Mr. Kaufman to question the validity of the study's results. Although Dr. Boquist and Mr. Kaufman disagreed on Indiana American's cost of equity, both of them estimated a cost of equity that was similar to what each witness estimated in Indiana American's last rate case, Cause No. 41320. Despite this fact Dr. Boquist's estimated return on replacement cost has increased from 9.58% in Petitioner's last rate case to 11.88% in Petitioner's current case. [3 (3)] Between Petitioner's last rate case and this case he had increased his estimate of Petitioner's cost of equity by 25 basis points and his estimated fair rate of return by 430 basis points. Yet, Dr. Boquist did not explain this dramatic increase in his estimated return on replacement cost during a period where capital costs have remained relatively stable.

Finally, Mr. Kaufman showed that Dr. Boquist performed no review or analysis of his results to test the validity of his study. For example, in his analysis there are approximately **27,370** return on replacement cost estimates from 1990-2000. This sample has an average return of 6.04% and a standard deviation of 17.12%. According to Mr. Kaufman such a high standard deviation raised concerns, in addition to the concerns he expressed earlier in his testimony, and should not be ignored. In his opinion, Dr. Boquist had not demonstrated the validity of his analysis and it should not be given any weight by this Commission.

C. ***Commission Findings.*** We agree that there are numerous concems with the application of the Fama-French methodology. The use of operating returns while the Fama-French model is based on market **returns is certainly one such difference.** Beyond some of the mechanical deficiencies in the results of Dr. Boquist's model, any model that shows increasing rates of returns during periods of stable or declining capital costs raises questions.

In the past four cases where Dr. Boquist has filed a similar return on replacement cost analysis based on Fama-French model it has produced the following results. In three previous studies the results were clustered around *7.25%.* The current study produces a usually higher result. This is particularly strange since the current study has overlapping years with the previous

studies. The addition of a few years should not have this dramatic of an impact on the study's overall results.

{Graphic(s) below may extend beyond size of screen or contain distortions.}

Cause Nos. 40667 and 46703 (same study)	7.28%
Cause No. 40103	7.03%
Cause No. 41320	7.58%
Cause No. 42029	11.88%

Finally, the results of Dr. Boquist's analysis fail any test of reasonableness when compared to the results that would be generated under original cost ratemaking for the identical NOI. As we have stated in the past, although the Commission does not advocate using the OUCC's original cost test for determining the reasonableness of a fair value finding, the test can be performed to exclude results that are outside the range of reasonableness under any methodology. According to Dr. Boquist's analysis Indiana American could reasonably request a pre tax operating income of 11.88% times $763,952,972 or approximately *$90.8* million. To produce a pre tax operating income would require us to authorize a cost of equity in excess of 25.0%.

Despite Petitioner's emphasis on fair value and fair rate of return, their case is essentially an original cost case plus a return on its proposed acquisition adjustments. Neither party's case-in-chief presented a single fair rate of return to be multiplied by a fair value rate base to determine a proposed NOI. Despite the lack of specific evidence the Commission must make a finding on fair rate of return. The record does in fact provide ample evidence to make a finding on fair rate of return. As discussed above we have rejected Petitioner's proposal to earn a return on its merger with Northwest Indiana Water Company or its acquisition of United Water properties; Cementville, Peoples, and-Shorewood. Having considered the evidence on valuation, determined original cost and fair value, we must continue our efforts to balance the interests of Indiana American's owners and customers by determining what level of net operating income represents a reasonable return. This determination requires a balancing of the interests of the investors and the consumers. In *Bethlehem Steel Corp. v. Northern Ind. Public Serv. Co.* (1979), Ind. App., 397 N.E. 2d 623,630, the court explained that "[w]hat annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts."

We will use the following standards and criteria to determine a fair rate of return on Petitioner's investment in its utility plant:

(i) Return comparable to return on investments in other enterprises having corresponding risks;

(ii) Return sufficient to ensure confidence in the financial integrity of the Petitioner;

(iii) Return sufficient to maintain and support the Petitioner's credit;

(iv) Return sufficient to attract capital as reasonably required by the Petitioner in its utility business.

© Public Utilities Reports, Inc., 2003

One recognized method for evaluating the reasonableness of a utility's allowed return involves investigation of the utility's capital structure. From such investigation, we can develop the overall weighted cost of capital. This cost s f capital may then be considered in determining a fair return.

Having previously determined the Petitioner's fair value rate base is 5562,680,669, it is our duty to determine a fair sate of return that can be used to calculate a fair dollar return for Petitioner's net operating income.

It is clear that because the cost of capital and the fair value rate base are derived in different manners the two may not be directly applied to each other. If the fair value rate base is found to be other than the original cost rate base, determining return by multiplying the cost of capital including a consideration for inflation by a fair value rate base which also includes inflation would overstate the required return by reflecting a redundant consideration of the anticipated impact of inflation on the value of Petitioner's property.

The ratemaking process involves a balancing of all these factors and others; especially a balancing of the owner's or investors' interest with the consumer's interest On the one side, the rates may not be so Pow as to confiscate the investor's interest or property; but, on the other, the rates may not be so high as to injure the consumer by charging an exorbitant price for service and at the same time giving the utility owner an unreasonable or excessive profit. *PSC v. City oj Indianapolis, 235* Ind. 70, 131 NE2d 308, 318 (1956). Therefore, the results of any return computation will be tempered by the Commission's duty to balance the respective interests involved in ratemaking. Finally, the end result of this Commission's Orders must be measured as much by the success with which they protect broad public interest entrusted to our protection, as by the effectiveness with which they maintain credit and attract capital.

The Commission further finds that the foregoing is a proper application of relevant Indiana Statutes as clarified by the courts. The return allowed to Petitioner is reasonable and just and in compliance with the October 31, 1985 decision sf the Indiana Court of Appeals in ***Indianapolis Water Co. v. Public Service Commission of Indiana*** (1985) *484* NE2d 635.

Furthermore, this Commission has asserted in previous rate eases that, since the fair value rate base contains inflation that it is historic and not prospective inflation, it should be removed from the debt component of the cost of capital to estimate a fair rate of return. For example, in ***Indiana-American Water Company,*** Cause No. 40103, May 30, 1996, p. 48, the Commission explained as follows;

> In order to avoid aver-compensating Petitioner for the effects of historical inflation it is necessary to remove the historical inflation component from the costs of capital to derive a fair return.

The Commission, after deducting from the embedded cost of debt a historical inflation rate of 3.9%, (Petitioner's Exhibit JLC-1, Schedule 4), finds the adjusted cost of capital of 5.93%.

Based on the evidence of record, we believe that a fair rate of return of 5.93% will provide

© Public Utilities Reports, Inc., 2003

Petitioner with a fair and reasonable return on the fair value of its used and useful properties. When **applied to a fair value rate base** of **$562,688,669 a 5.93% fair rate of return will produce a** required **NOI** of $33,368,321.

13. Operating Results Under Present Rates. Pursuant to the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and pro forma operating revenues, expenses and operating income under present and proposed rates is the 12 months ended March 31, 2001.

A. Uncontested Revenue Adjustments. Petitioner's operating revenues during the test year were $116,277,954. Petitioner made adjustments to this figure for bill analysis reconciliation, removal of unbilled revenue, large customer consumption (except for Whiteland), and annualization of the acquisitions of Freeman Field and Prairieton, which adjustments were not contested. Petitioner accepted the OUCC's adjustment for residential and commercial customer growth.

B. Contested ***Revenue Adjustment*** *Usage Normalization.* Both Petitioner and the OUCC proposed to adjust test year revenues to reflect the normalization of residential customer usage. A usage normalization adjustment is to account for potential unusual or unseasonable conditions during the test year which impact the demand for water, It is accomplished by comparing the test year usage to the average usage over an historical period. The difference between Petitioner's and the OUCC's adjustment is the historical period chosen over which average consumption is computed. Petitioner proposed to use a three-year average whereas the OUCC proposed a **five-yearaverage** Both adjustments have **the effect of increasing revenuer;from** the test year levels; however. the OUCC's adjustment would increase revenues to a greater extent. No other party took a position with respect to usage normalization.

OUCC witness Judy Gemmecke explained her objection to Petitioner's three-year average. She testified that in Cause No, 41320 Petitioner used a five-year average but has now switched to a three-year average in this case. In her opinion, this switch was made without justification. According to Ms. Gemmecke, Petitioner did not present any evidence that weather variations in Indiana changed dramatically over the last three-year period versus a five-year period to justify the use of a shorter period.

Petitioner's witness Duane D. Cole testified on rebuttal regarding why a three-year average is being proposed for this case. According to Mr. Cole, Petitioner's base consumption per customer **(houschold usagc exclusivc of outside usage) has decreased over the past several years and all** indications are that it will continue to decline. Re explained that usage normalization based upon longer historical averages will overstate revenues since the recent trend in base consumption reflects a **more severe decline. If an adjustment is to made at all, Mr. Cole explained that the** period over which the average is to be computed should be shorter rather than longer to avoid including years where the base consumption per customer is higher than it is anticipated to be again, thus overstating normal usage. Mr. Cole presented graphs which show the residential consumption per customer during the 6 winter months of the past 5 years. He states that he chose the wintertime, so as to eliminate variables such as lawn sprinkling, car washing and other outside water uses, thus reflecting the base usage for residential customers. This graph shows a declining trend for consumption per customer for the months examined. He testified that the

reduced consumption is due to efforts on multiple fronts to conserve water. The Building Officials and **Code Administrators** ("BOCA") have promoted **building codes requiring** law flow plumbing fixtures to be installed in new and remodeled construction. He also testified that low Row toilets reducing the flow required for each flush from approximately 7 gallons to 1.3 gallons per flush, low Row shower heads, faucet combinations and other plumbing fixtures have had an impact on consumption levels, In addition, old style high capacity top loading washing machines use between 40 and 44 gallons of water for a complete cycle, whereas modern front load machines use 15 to 19 gallons of water. Mr. Cole states that as new homes are constructed and older homes remodeled with these lower usage fixtures and as appliances are replaced, average consumption per customer will continue to decline. As a result of the declining consumption, Mr. Cole testified that the use of a three-year average is more accurate for usage normalization than a five-.year average, He noted that the most predominant variable for which the usage normalization attempts to adjust is rainfall and that over Petitioner's proposed three-year period, rainfall approximates the thirty-year average. Me opined that, except for the declining consumption per customer created by conservation devices and as shown by winter usage, the three-year average would be nearly perfect for purposes of accomplishing the objective of the usage normalization adjustment. Mr. Cole summarized that it would be inappropriate to include any further historical years, because the older data will inappropriately skew the results even more as a result of the consumption trend. (Petitioner's Ex. DDC-R, pp. 2-5).

The purpose of the usage normalization adjustment is to adjust test year revenue levels so as to eliminate the effects of unusual events and weather variations. Ms. Gemmecke offered no explanation for why 5 years is better than 3 years. Mr. Cole, on the other hand, did explain his rationale. We are persuaded by Mr. Cole's analysis that by using the five-year average we will be reflecting a base consumption level greater than current trends indicate thus overstating revenues. Because whether during the three-year period approximates the thirty-year average, the use of the three-year period appropriately captures this most significant variable for which the usage normalization is an attempt to adjust. We therefore find that Petitioner's proposed three-year average for purposes of usage normalization is appropriate.

i. *Whiteland* Leak **Repairs.** Indiana-American proposed a $53,148 revenue adjustment to account for the reduction in sales to the Town of Whiteland ("Whiteland") based upon Whiteland's discovery and repair of significant leaks. Whiteland is one of Petitioner's sale-for-resale customers. During the test year, Whiteland engaged a professional leak detector who discovered leaks in Whiteland's **water distribution** infrastructure. **Whiteland repaired these** leaks in the Spring of 2001. Petitioner's witness Jennifer K. Tower calculated Petitioner's adjustment based upon Whiteland's estimate of the amount of water lost through the repaired leaks on an annual basis. Based on the evidence demonstrating that an **estimated 102,1145** cubic feet ("ccf") of water per year was escaping from these leaks, Indiana-American conservatively estimated that Whiteland had purchased approximately 60,000 ccf of water during the test year that was lost to leaks that have now been repaired. Although the OUCC **did** not dispute that a revenue adjustment was necessary, Ms. Gemmecke proposed to adjust Indiana-American's revenue by only $23,994. The OUCC's adjustment was calculated by comparing the test year sales to the prior year,

© Public Utilities Reports, Inc., 2003

The source for disagreement between the OUCC and Indiana-American on this issue is the calculation of the amount of water lost through the leaks. Nobody knows for sure how long the leaks existed. As Ms. Tower explained on rebuttal, her objection to the OUCC's comparison is that its accuracy is dependent on the leaks appearing sometime between the two periods the OUCC compared. However, if one of the leaks repaired existed during both periods, the OUCC's calculation would result in no adjustment being made for the repair. As Ms. Tower noted, Whiteland retained the leak detection expert because of excessive unaccounted for water, so it is reasonable to expect that these were not new leaks.

Based on the evidence, we find Indiana-Amemcan's method of estimating the amount of water Whiteland lost to leaks was the most accurate. The OUCC methodology fails to consider when the leaks occurred. Consequently, we find that Indiana-American's adjustment of $53,148 should be accepted for ratemaking purposes and reject the OUCC's adjustment.

ii. *Accrued Utility* Revenue. Petitioner presented a balance sheet, which indicated that Petitioner had $6,322,250 of Accrued Utility Revenues on March 31, 2001. No party proposed or suggested that any adjustment to test year revenues should be made on account of this amount. Mr. Guerrettaz, on gage 6 of his testimony stated that the test year in this cause "is representative of a normal operating year." On page 18 of his testimony, however, be states that "the Commission should take note of the $6,322,250 of Accrued Utility Revenues." At the hearing held in this Cause, Mr. Guerrettaz clarified that he was not proposing any adjustment regarding Petitioner's level of Accrued Utility Revenues. (Tr., pp. E8-9).

On rebuttal, Ms. Cutshaw testified that accrued revenues are unbilled revenues, which Petitioner records in accordance with Generally Accepted Accounting Principles, He opined that there is no need to offset this amount against the revenue requirement because the Company has included a full twelve months of revenues for the customers in the rate case. On cross-examination, Re explained the adjustments which assure a full twelve months of revenue are already reflected and that Petitioner's treatment of unbilled revenues is the same treatment which has been approved in prior cases. (Tr., pp. H9-13 and 67).

Mr. Guerrettaz stated that the test year in this cause is representative of normal operations, hence the Petitioner has included twelve months of revenues in its pro-forma income statement and we find that no adjustment has been proposed or is required due to the level of Accrued Utility Revenues on Petitioner's balance sheet.

The Commission finds test year revenue, adjusted for fixed, known and measurable changes to have occurred within twelve months of the test yeas to be $118,736,711.

C. Uncontested Operating Expense Adjustments. There were no material differences at pro forma present rate levels between the accounting exhibits of Indiana-American and the other parties regarding adjustments for pension expense, insurance expense, customer accounting expense, and amortization expense. The OUCC accepted Petitioner's adjustments to annualize labor expense, management fees, group insurance (including FAS 106), waste disposal, rent expense, miscellaneous expense (including temporary employees, 401K and ESOP costs, deferred revenue shortfall from Cause 41408), depreciation expense, and other taxes (IURC fee, property, and payroll taxes), except for the specific contested items mentioned subsequently. In

© Public Utilities Reports, Inc., 2003

addition, Petitioner did not challenge the OUCC's proposed adjustments for allocation of compensation for four employees to other states, addition of an omitted employee in the Southern Indiana Operation, allocation of a portion of the Corporate Office lease to the Service Company and back to Petitioner through management fees, and certain adjustments to miscellaneous expenses, including deletion of David Saylor consulting fees and non-recurring items.

D. Contested Operating Expense Adjustments.

i. Incentive Pay Program. OUCC witness Dana Lynn proposed to adjust Petitioner's labor expense, management fees, and payroll taxes so as to remove Petitioner's Annual incentive Program ("AIP") as a cost of service. She testified that incentive pay is not reasonably necessary to the provision of utility service. According to Ms. Lynn, incentive pay is typically a benefit used to motivate employees to *make* the utility more profitable for the shareholder. She therefore concluded that Petitioner should pay incentive compensation out of its authorized return rather than through operating expenses.

On cross-examination of Mr. Eckart, we learned that Petitioner has included only 85% of the AIP in its pro forma level of expense. (Tr., pp. F50-51). Thus, part of the AIP is being funded through the authorized return and part is funded through rates under Petitioner's proposal.

Although Ms. Lynn's testimony is silent as to the precise operation of Petitioner's plan, Mr. Eckart set out a detailed description of the AIP in his rebuttal testimony. (Petitioner's Ex. SEE-R, pp. 16-23). Mr. Eckart noted that *all* salaried employees who are exempt from overtime *pay* participate in the AIP. Mr. Eckart explained that the plan consists of three key features - gatekeepers. performance goals and individual multipliers. First. the AIP contains a gatekeeping component that ensures that AIP payments are made only when two targets are met: A minimum earnings per share ("EPS") of American and the attainment of individual performance expectations of the participating company and employee. (*Id.*, pp. 17).

Mr. Eckart testified that if the gatekeepers are met, the precise amount of the AIP payout is based upon achievement in two equally weighted performance goals. Specifically, the participant's overall performance goals are divided into two equally weighted categories - Financial Performance Goals and Operational Goals. The aim of the Financial Performance Goal is to have the participant achieve a return, on capital equal to the weighted average cost of capital of the company. The Operational Goals are a function of customer satisfaction. The AIP first measures customer satisfaction through a detailed customer survey. This survey evaluates customer satisfaction through four categories: "Overall satisfaction with the Company"; "Overall satisfaction with water quality"; "Leader in the water industry"; and "Overall utility value." (*Id.*, pp. 18). The Operational Goal is measured as a percentage of survey respondents who stated that they were satisfied or very satisfied with the four stated categories. For a participant to receive a payout from the AIP, the subsidiary must achieve at least a 60 percent swre in the Operational Goal category, meaning at least 60 percent of the survey respondents reported that they were satisfied or very satisfied with the company. Additionally>the Operational Goal score will be reduced if a district experiences any of the following four service quality situations: (1) "a public notification or customer advisory is issued due to a violation of any state or federal drinking

water regulation or any monitoring or reporting failure occurs"; (2) "a customer experiences an interruption of water service due to a facility failure for a period extending longer than twelve hours without an alternative supply of drinking water being available"; (3) "any customer experiences more than two intermittent service interruptions extending for longer than a twelve-hour duration"; and (4) "water usage is curtailed due to the inability to meet customer demands." (*Id.*, pp. 20.) Mr. Eckart testified that avoiding these situations is necessary to meet the basic service expectations of the Company's customers.

To calculate the precise amount of the AIP for an employee, the third component - the Individual Performance Multiplier - must be factored into the equation. This value allows the participating company to adjust the AIP award based on the actual performance of the employee receiving the award. (Id.)

Mr. Eckart testified that Ms. Lynn failed to account for the substantial benefits to customers achieved through the Performance Goals of the AIP. As demonstrated by its numerous mechanisms for measuring and rewarding customer satisfaction, the AIP is intended to benefit both shareholders and customers, and these mutual benefits are in fact interrelated. Financial performance allows the Company to attract the capital and qualified people necessary to provide the service desired by customers. Customer satisfaction is important for financial success which benefits shareholders.

Mr. Eckart testified that it was not unusual for a company such as Petitioner to provide this type of pay arrangement. He testified that 72 percent of utilities provide more than one variable pay plan and that 93 percent of all companies that provide incentive plans provide them to middle management. Moreover, Mr. Eckart provided a table that measures the types of compensation plans offered by utilities and other companies. This table shows that reward based systems, including incentive pay glans, are common:

[Graphic(s) below may extend beyond size of screen or contain distortions.]

	Utilities	All Industries
Merit Pay	85.7%	75.2%
Skill Based Pay	14.3%	. 15.58
Bonus	57.1%	65.2%
Incentive Pay	28.5%	28.28
Key Contributor	0.0%	7.35,
Team Incentives	28.5%	13.0%

We took administrative natice of two of our previous orders that guide our analysis of this issue. First, in *Indiana Natural Gas Corp.*, Cause No. 40382 (IURC 10/2/96), an order cited by Ms. Lynn, the Commission accepted an OUCC adjustment to remove the utility's profit-sharing plan on grounds that the expense was not reasonably necessary for utility service. In that case, the petitioner included as an expense $60,000 for the plan, which was characterized solely in terms of profit sharing. There were no operational performance objectives in the plan; only financial performance was considered. The utility attempted to justify this expense on grounds that it was necessary for employee retention, The problem with this argument was that the utility's work

force was in Orange County, Indiana, and the profit sharing package caused the average salary to be **double that of the average wage for the area**

The second Order, *PSI Energy, Inc.*, Cause No. 40003 (IURC *9/27/96),* was issued the week before the *Indiana Natural Gas* Order and therefore reveals our approach to two different types of plans in a relatively short timeframe. We allowed as a recoverable expense PSI's "annual incentive plan." The PSI Order shows that, contrary to Ms. Lynn's assertions, the Commission has found incentive pay programs to be reasonably necessary for the provision of utility service. The PSI plan, like Petitioner's AIP, was not a pure profit-sharing plan. The plan acted as an incentive for company-wide improvement which related directly to the quality of service to the customers. Indeed, like the AIP, the PSI plan was based on an equal division of corporate financial goals and individual performance measures. In fact, most of the evidence and discussion in the cause focused on the calculation of PSI's performance level, a fact that suggests that the OUCC, the intervenors and the Commission recognized that the plan did provide customer benefits and was reasonably necessary. Further, as with the AIP, PSI had not sought recovery of 100% of the incentive pay. Ultimately, we approved recovery of incentive pay in PSI **because the compensation was reasonably necessary for PSI *to* he competitive in attracting its** workforce.

Two things can be taken fi-om these two orders: (1) a pure profit-sharing plan which only incents employees to become more profitable may be more appropriate for funding solely by the shareholders than a plan which also ties compensation levels to better service to the customers; and (2) a plan which causes compensation to exceed levels which are reasonably necessary for the utility to attract its workforce should be disallowed as an unnecessary expense. Using these guideposts, we find that Petitioner's AIP should be recovered through rates at the level proposed by Petitioner.

First, Petitioner's plan is not a pure profit-sharing plan. An associate's incentive pay will be reduced based upon drinking water regulation violations, service interruptions, usage restrictions, and poor **customer satisfaction. Ms. Lynn admitted that these include aspects that benefit the** customer. (Tr., pp. E38-40). Second, Ms. Lynn could identify only one other water utility in the State with a comparable work force and which competes with Petitioner for employees. That other utility also has an incentive pay program, and Ms. Lynn was unable to state whether the other utility's total compensation package was less than or greater than Petitioner's. (Tr., pp. E41-44; Petitioner's Ex. CX-2). Thus, it cannot be concluded that Petitioner's AIP causes ***the*** compensation levels to reach excessive or unnecessary levels. Thus, we find that Ms. Lynn's proposed adjustment should be rejected.

(ii) Normalization of Work Hours. As has been the case in the last few rate cases. Petitioner adjusted test year labor expense to reflect normalization of work hours in an average year. Ms. Lynn opposed Petitioner's adjustment to 2,088 hours per year for hourly associates in **determining** pro forma **labor expense. She claimed that this was not the amount of work** hours during either the test year or the 12 months following. Accordingly. she opposed the adjustment of test year labor expense to reflect this level of normalized hours in rates in this case.

Mr. Cutshaw explained the basis tor the adjustment. He said that 2,088 hours has been used in the last four rate cases based upon this Commission's ruling in Cause No. 39215. We stated

© Public Utilities Reports, Inc., 2003

that while there may have only been 2,080 hours during the test year and during the 12 months following, there are 2,088 hours during calendar years 2001, 2002, and 2003, and 2,096 hours during calendar year 2004. Therefore, under the OUCC's proposal, rates would be set based upon a level of work hours lower than what will be experienced during any year of the expected life of these rates. Mr. Cutshaw stated if the Commission were to accept the OUCC's position, the Commission would have to use 2,096 hours in future cases where the year following the test year will include 262 working days, as it will in 2004. He further stated that Ms. Lynn's adjustment was incorrectly calculated in that she did not adjust only the amount which was recorded lo labor expense. Further, she removed hours of individuals for whom the Company did not make the normalization adjustment. Those individuals have union contracts which require them to work more than the standard number of hours or to be paid for holiday hours and vacation times.

We have reviewed our Order in Cause No. 39215 where we first approved the use of normalized hours. In that case, Petitioner had computed its labor expense based upon 2,096 hours, which was the number of work hours for the 112-month adjustment period, as Mr. Cutshaw indicates will be the case in the year 2004. The OUCC in that case had originally proposed that labor expense be based on 2,080 hours based upon the test year level, but at the final hearing, proposed the normalization of hours to 2,088 work hours per employee. "OUCC witness Lesa S. Paul examined the work hours in each of 12 consecutive 12-month periods. In 7 of those 12-month periods the hours worked were 2,088 and the average of all 12 annual periods was approximately 2,088." Order, pp. 4-5. Based upon the evidence, we found in that Order:

> The Prehearing Conference Order provides that adjustments should be made for changes which are fixed, known and measurable and which will occur within 12 months after the end of the test year. It is undisputed that 2,096 work hours per employee, in fact, will occur during the 12 months following the test year. This fact is fixed, known and measurable. However, as Ms. Paul also testified, a 2,096 work hour year will not again occur during the period she analyzed. The Commission finds that for purposes of this Cause, 2,088 work hours should be used in the adjustment consistent with the OUCC's revised proposal. This is a representative level of work hours per employee. This amount can also be derived by dividing the number of days in a normal year (365) by the number of days in a week (7), multiplying the result by 48 hours per week and adding 2 hours to account for the occurrence of the leap year every 4 years. Therefore, it can be viewed as giving some consideration to the additional labor costs resulting from the leap year. (*Id.*)

We approved in that case the normalization of work hours when strict adherence to the adjustment period would result in the use of more work hours than will typically be the case. When one normalizes, there will be occasions where the effect will be to increase from the test year and occasions where the effect will be to decrease from the test year. It would be inappropriate to approve normalization of work hours only when the effect is to reduce the adjusted test year level. Accordingly, we find that Ms. Lynn's position should be rejected and that Petitioner's proposed adjustment to the normalized level of work hours should be accepted.

(iii) Vacant Positions at Conclusion of Test Year End. OUCC witness Lynn proposed to

© Public Utilities Reports, Inc., 2003

reduce Indiana-American's adjustment to Labor and Employment Expense by $343,795 to **account for** *six* **positions** *that* **were vacant** during the entire **test year. (Public's Ex** 1, pp 16-17) Mr. Cutshaw opposed Ms. Lynn's adjustment.

Mr. Cutshaw testified that the six positions at issue were (1) Director Human Resources, (2) Communications Assistant, (3) Executive Secretary, (4) Manager Information Technology, (5) Engineering Technician, and (6) Maintenance Specialist. (Petitioner's Ex. JLC-R, pp. 15-16.) Ms. Lynn incorrectly asserted that all of these positions were vacant during the entire test year. Mr. Cutshaw's testimony demonstrates that the Director of Human Resources position did not become vacant until the seventh month of the test year and the Manager Information Technology position was vacant only two and a half months of the test year.

We find that Ms. Lynn's proposed adjustment should be rejected. Indiana-American provided testimony that each of these positions would be filled by March 34,2002 (Petitioner's *Ex.* JLC-R, p. **15) —** ***within*** **the adjustment period provided** by the Prehearing Conference **Order in this** cause. In fact, Mr. Cutshaw provided evidence that Indiana-American had already filled the position of Director of Human Resources (Petitioner's Ex. JLC-R2, p. 1), Communications Assistant (id., p. 2), **and** Executive Secretary (id., p. 3). Furthermore, Indiana-American is actively seeking to fill the positions of Manager Information Technology, Engineering Technician *(id.,* p. 4), and Maintenance Specialist (id., p. 5). Mr. Cutshaw opined that these positions should remain in Indiana-American's pro forma labor expense, except as adjusted for the difference in the actual salary for the two employees now serving as Communications Assistant and Executive Secretary which amounts to ($21,406). We have previously acknowledged that "companies incur employee turnover in the normal course of events." See *Gary-Hobart Water Corp.*, Cause No. **38996, pp.** 17-18 **(IURC 4/3/91)** (rejecting **the** OUCC's proposed adjustment to labor expenses for a position that was vacant during part of the test year and had not been filled as of the time of the rate case). We find that these expenses are fixed, known and measurable and should be recovered and reject the OUCC's proposed adjustment, We accept Indiana-American's proposed adjustment to account for the difference in the actual salary for the employees filling the positions of Communications Assistant and Executive Secretary which amounts to ($21,406).

(iv) ***Shared*** *Services* Initiative. In Cause No. 42043, Petitioner has sought our authority **to** relocate its accounting records outside the State of Indiana to New Jersey where they will be kept at the Shared Services Center which will be performing various accounting-related functions for all of the American regulated subsidiaries. Our approval was sought because Ind. Code §8-1-2-15 requires that "[n]o books, accounts, papers, or records required by the Commission to be kept within the state shall be at any time removed from the state, except upon such conditions as may be prescribed by the Commission." We have plot yet issued an order in that Cause, and so Petitioner continues to maintain its books and records in Indiana. During the interim, Petitioner is participating in the Shared Services Center to the extent the participation does not require the relocation of Petitioner's records pending our resolution **of** the request in that cause.

Mr. Cutshaw explained the adjustments related to Petitioner's proposed Shared Services **Initiative. American has announced** Shared **Services Initiatives that will consolidate certain** accounting/financial services and call center functions over the next two years. Treasury, cash

management and accounting functions were consolidated in Iate 2001. A system wide customer call center was opened in April 2001. Conversions to the new call center will take place over the next years. The Shared Services Center will assume primary responsibility for such areas as accounts payable, cash management, fixed asset management, general accounting, payroll processing, taxes and associated benefit coordination. Mr. Cutshaw made a series of five adjustments to reflect the implementation of the Shard Services Center. These adjustments were labor-related and also included adjustments to management fees to reflect the operating costs that will be incurred by the Shared Services Center and then allocated to the regulated affiliates based on the number of customers. In addition, the adjustment included a ten-year amortization of the implementation costs allocated to Indiana-American for establishing both the Shared Services Center and the Customer Call Center.

Ms. Lynn explained the OUCC's position with respect to Shared Services. She noted that the OUCC opposed implementation of the Shared Services Initiative in Cause No. 42043. In that case, the OUCC has noted that it is currently anticipated that the increase to management fees as a result of the implementation of the Shared Services Initiative will result in higher costs of approximately $1 80,000 annually as compared to current costs. Ms. Lynn noted that, despite the anticipation of higher costs, Petitioner's proposed adjustment in this case has a net effect of zero on Petitioner's revenue requirements. A zero impact on revenue requirements was accomplished by limiting the adjustment to management fees to a "plug" number. As the OUCC witness did in Cause 42043, Ms. Lynn objected to the allocation of implementation costs of *the* Shared Services Center based upon the number of customers as required by the affiliated interest contract on file with the Commission. She noted that use of this allocation methodology produces Barge savings in some states, while it causes costs in Indiana apparently to increase. The reason Petitioner will not see the larger savings is because Petitioner has already achieved significant savings that have not yet been achieved in other states. Further, she objected to the decision to exclude unregulated affiliates from participating in the Shared Services Center.

In addition to the adjustments Petitioner identified, Ms. Lynn identified further adjustments as a result of the Shared Services Initiative. She proposed adjustments to labor expense to reduce the salary of Mr. William Wolf and the elimination of one-fourth of Petitioner's Corporate Office lease to reflect space which is now vacant due to the elimination of positions in Indiana.

On rebuttal, Mr. Cutshaw disputed the adjustment to Mr. Wolfs salary, testifying that at a minimum, the salary of a person with Mr. Wolf's credentials should be at or above the top of the current salary range for this position. He also explained that the allocation of implementation costs of the Shared Services Center is made pursuant to the affiliated interest agreement on file with the Commission. To change that allocation to produce a particular result in Indiana would require modifying the allocation methodologies in all states for Service Company costs, which may or may not result in less cost being allocated to Indiana. Further, he explained that there are significant qualitative benefits from Petitioner's participation in the Shared Services Initiatives related to improved treasury and financial accounting services. (Petitioner's Ex. JLC-R, pp. 10-11.)

Ms. Doron disputed the adjustment to the Corporate Office lease. She identified other functions which are soon to be relocated to the Corporate Office and utilize the space which

© Public Utilities Reports, Inc., 2003

would become available through the Shared Services Initiative. Ms. Doron also explained that Ms. Lynn has missed the point of Petitioner's Shared Services Initiative adjustments. Ms. Doron explained that the adjustments were presented merely for informational purposes. While preliminary estimates may currently be that the move to Shared Services will cause costs to increase, there are savings from this move which have not yet been identified and measured. While Petitioner disagrees that those savings include the items identified by Ms. Lynn, Petitioner anticipates there will be other savings and benefits which no party has identified. As a result, Ms. Doron explained that the affect of the move to Shared Services is not truly fixed, known and measurable at this time. Instead, this is a move that is still in transition, There may be pieces of the savings which cars be identified and Petitioner has adjusted for those pieces except for the full effect of the allocation of the Shared Services Center operating cost to Indiana. Petitioner has limited that adjustment so as to keep the costs of providing these functions at the same level at which they would Rave been without the Shared Services Initiative. As a result, Petitioner's adjustments for Shared Services are essentially designed to explain to the parties and the Commission what is being proposed, but those adjustments are held to a net effect of zero. On moss-examination we heard that Ms. Lynn's proposed adjustments do not have a net effect of zero. Rather, Ms. Lynn's adjustments have the effect of reducing Petitioner's revenue requirement if the relief sought in Cause No. 42043 is granted. (Tr., p. E33.)

We find that Petitioner's proposed adjustments related to Shared Services should be accepted since they have a net effect of zero. We further find that an adjustment related to the Shared Services Initiative which has an effect other than zero should not be approved until after all of the savings and costs related to the Shared Services Initiative are fixed, known and measurable. Finally, the OUCC is concerned both in this case and in Cause No. 42843 that Petitioner may in a subsequent case seek recovery of the full impact of the move to the Shared Services Initiative, To the extent such recovery would cause costs to Indiana customers to increase, we remind the parties that we have the authority to disallow recovery of any item of expense to the extent we find the expense to be unnecessary or excessive.

(v) Security Costs. After the Company had prefiled its case-in-chief but before the first evidentiary hearing, Petitioner requested that certain claimed security costs be added to the expenses considered in this rate case. Petitioner's witness Cole submitted supplemental direct testimony claiming that the amount of increased security operation and maintenance expenses which the Company is now incurring on an annual basis is $2,457,350. These expenses would be in addition to the level of total expenses and revenue requirements presented in Petitioner's case-in-chief as originally prefiled. He also stated that the Company will not make publicly available the details of what security measures are being taken or the breakdown of the annual amount because doing so would jeopardize the security program.

After the initial hearing, Petitioner and the OUCC agreed upon an arrangement by which the OUCC could review the substance of this proposed adjustment. Pursuant to a non-disclosure agreement, the Utility Consumer Counselor met with Mr. Cole and reviewed the details of the adjustment. After this meeting, Petitioner and the OUCC announced at the final evidentiary hearing that an agreement had been reached as to how to address security costs. That agreement was later reduced to writing in the form of a Stipulation and Settlement Agreement which was

filed with the Commission *on* May 3,2002.

The Stipulation provides that Indiana-American recover through rates in this case additional O&M expenses identified by Mr. Cole of $2,457,350 annually. The parties agreed that this amount represents only O&M expense and does not include any capital additions. Further, Indiana-American agreed that it would submit on a semi-annual basis under sea! to this Commission a summary of the amounts it has incurred during the previous six months related to security costs. A copy of this information would also be made available prior thereto to the Utility Consumer Counselor and to the OUCC's Rates and Sewer/Water Director pursuant to nondisclosure agreements executed by each.

We note that the parties to this settlement submitted no detail or substantive evidence in support of the proposed increase in operation and maintenance expenses of $2,457,350, to be passed on to the ratepayers.

The Prehearing Conference Order issued by the Commission in this Cause on October 1, 2001 provided as follows:

> Settlements may also be presented to the Commission at either of the evidentiary hearings scheduled pursuant to Paragraph 4 or 11 hereof. *In* the event of settlement, the parties are directed to comply with the Commission's GAO 1995-4, and the provisions of 170 HAC 1-1.1-17(d). *Order*, p. 4.

The referenced Code provision permits parties "at any time prior to the issuance of the final order," to submit settlement proposals, or request a hearing for purposes of submitting a settlement proposal. The Code provision also requires that "the settlement must be supported by probative evidence."

The Commission is mindful of and sensitive to the need for security of our utilities. However, **this Commission takes very seriously its duty to base a charge against ratepayers only on** adequate, probative evidence substantiating that charge. In the immediate matter, no such evidence has been presented, and for that reason the proposed settlement is denied.

The parties may, at their discretion, petition under this Cause Number for a hearing on ***the*** proposed security costs that they would seek to have absorbed by the ratepayers of this utility.

(vi) Property Taxes. **Indiana-American's** witness Cutshaw proposed **a pro-forma** adjustment to Indiana-American's test year property tax expenses to reflect the 2001 average tax rate times additions to Indiana-American's plant through July 31,2001 (the sate base cutoff date). Mr. Cutshaw stated that these calculations are consistent with the methodology **used** by Indiana-American in previous rate cases. The OUCC did not contest Petitioner's adjustment for property taxes and in fact utilized Petitioner's calculation of the property taxes pertaining to the update of utility plant to actual as of July 31,2001.

Crown Point witness Guerrettaz opposed the adjustment for property tax expense in Step One "**due** to regulatory **changes** *in* **the *way*** property ***taxes*** **are** assessed here in Indiana."

On rebuttal, Mr. Cutshaw explained that the Step One property tax adjustment was based

© Public Utilities Reports, Inc., 2003

upon the most recent assessment received from the State Board of Tax Commissioners and includes an assessment for additions in utility plans from December 31, 2000 **until** July 31,2001, the cut-off date for rate base additions in this cause, Mr. Cutshaw also stated that this same method of calculating property tax expense has been approved by the Commission in Indiana-American's last three rate cases. Mr. Cutshaw cited the Commission's Order in Cause No. 39166, dated July 8, 1992, that found that it is appropriate to include property tax as an adjustment for all items found to be in rate base.

The Commission finds that the method used by Indiana-American in its case-in-chief is consistent with prior Commission Orders in Indiana-American's last three rate case proceedings.

(vii) Chemical Expense. Indiana-American's witness Tower proposed four pro-forma adjustments to Indiana-American's test year chemical expenses. On Petitioner's Exhibit JKT-2, Schedule 3, Petitioner proposed increasing the expenses due to an increase in caustic soda prices; a decrease in expenses due to changes in large customer consumption; an increase due to the water usage normalization adjustment discussed infra; and adjustments due to increased usage resulting from the Freeman Field and Prairieton acquisitions.

OUCC witness Lynn opposed the adjustment for caustic soda because she stated that it was her understanding that Petitioner's Seymour location would no longer use caustic soda; therefore, while the price might increase, quantity would decline. Ms. Lynn calculated the chemical expenses using the 2002 bid awards, sorted by chemical, and multiplying them by the usage denoted on the bid awards, which resulted in a pro-forma decrease of $1 04,676.

On **rebuttal,** Ms. Tower explained **that** the **2002** bid **award** used by Ms. Lynn for her chemical expense calculation does not state reliable usage figures, but rather states figures which bidders were to use as guidelines. Ms. Tower stated that the prices in the Bid Award Sheet were reliable as the basis of a pro forma adjustment, but that the usage is not. Ms. Tower also disagreed with Ms. Lynn's assertion that the Seymour operation would not use caustic soda. Ms. Tower testified that Indiana-American uses caustic soda to treat both ground water and surface water.

We find that the method used by Indiana-American in its case-in-chief is more accurate in that it uses actual test year usage adjusted for known changes in large customer usage volumes, changes in residential usage due to the normalization adjustment approved herein, changes due to acquisitions and reflects the increase in the cost of caustic soda.

(viii) Waste Disposal Expense. The Gary Sanitary District learned that it had mistakenly undercharged Indiana-American for waste disposal services performed from 1996 through 1998. The *Gary* Sanitary District sent Indiana-American a bill in the amount of the undercharge. Because Indiana-American paid the bill during the test year, it included this amount as an expense in its rate calculation. As explained by Ms. Tower, the expense was proposed to be amortized over a three-year period. The OUCC and Intervenor proposed to eliminate this expense claiming its inclusion would result in retroactive ratemaking.

This expense is not properly labeled retroactive ratemaking. The prohibition of retroactive ratemaking is a result of the "cardinal principal of ratemaking that a utility may not set rates to recoup past losses..." *PSI Energy, Inc.*, Cause No. 39195 *(IURC 2/26/92), citing Nadar v. Federal Communications Comm'n. 520* F.2d 182,202 (D.C. Cir. 1975). Indiana-American is not

attempting to set its rates to recoup a past loss. Rather, it is including an expense paid within the test year As Ms Tower recognized, not granting this adjustment would penalize Indiana-American for an error made on the part of the Gary Sanitary District.

The more appropriate label for this expense is nonrecurring. We cannot even properly assume that the expense will not likely repeat itself, because nothing prevents the Gary Sanitary District from making similar mistakes in the future. Thus, at best we can state the expense will occur infrequently. Our appropriate ratemaking treatment of such nonrecurring or infrequently occurring expenses incurred during the test year is to amortize them over a period of time, which is what Petitioner has proposed. ***See,*** *e.g., Wayne County Rural Elec. Mem. Corp.*, Cause No. 38804 (IURC 1/17/90), p.4. We find that Petitioner's adjustment should be accepted and that Ms. Lynn's and Mr. Guerrettaz's adjustment should be rejected.

(ix) Well Cleaning Expense. Indiana-American's witness Tower proposed two pro-forma adjustments to Indiana-American's test year maintenance expenses. On Petitioner's Exhibit JKT-2, Schedule 8, Petitioner proposed increasing the maintenance expenses due to well cleaning in the Wabash Operation and Southern Indiana Operation that were not completed during the test year. OUCC witness Lynn opposed the adjustments stating that having reviewed Petitioner's response to a data request, the well cleaning costs paid during the test year were representative of Petitioner's historic average.

On rebuttal, Ms. Tower explained that in the narrative included in the data response to which Ms. Lynn referred, Indiana-American explained that there were no historical charges for the Southern Indiana Operation due to the fact that their source of supply has changed from surface water to ground water, and that five of the Southern Indiana wells were to be cleaned before March 31,2002 (twelve months following the end of the test year). Ms. Tower testified that the average cost to clean one well would be approximately $5,000, so the adjustment of $25,000 is reasonable and should be allowed. Ms. Tower also testified that the invoice for the cleaning of the Wabash well was received shortly following the end of the test year, and that the invoiced amount was $7,883.

We And that: the proposed adjustment for the Southern Indiana well cleaning is reasonable, given that the wells will be cleaned within twelve months following the end of the test year and that the historical average would have included no cleanings for the Southern Indiana Operation since the wells were not in operation prior to 1999. As for the invoice paid following the close of the test year, the Commission finds that the wel4 was cleaned during the test year and that the invoice was paid within twelve months following the test year, hence it is fixed, known and measurable, and should be allowed as a pro-forma adjustment. Petitioner should be allowed a pro-forma adjustment for maintenance expense of $33,883.

(x) Purchased Power. Mr. Guerrettaz proposed an adjustment to reduce the cost of test year purchased power based on Northern Indiana Public Service Company's ("NIPSCO") rate investigation pending in Cause No. 41746. Mr. Guerrettaz (p. 10) noted that "[a]t this point in time, the best information [the Intervenor has] is that a reduction in NIPSCO's rates are likely to occur in the amount of 15%, based on the Commission's Staff Report." Ms. Tower opposed Mr. Guerrettaz's adjustment because the Commission had not yet ruled in Cause No. 41746.

© Public Utilities Reports, Inc., 2003

We reject the Intervenor's proposed adjustment to reduce Indiana-American's cost of test year power costs because it is neither fixed, known and measurable nor will it occur within twelve months of the close of the test year, which is the adjustment period. Mr. Guerrettaz acknowledges his adjustment is little more than speculation by indicating that the calculation is based on "'the best information" currently available. (*Id.*, p. 10.)

(xi) General Office Expense. Mr. Guerrettaz proposed to adjust general office expense so as to remove $330,899 which he labeled as "non-justified." He claimed that he could find no support for this amount in the workpapers or the exhibits filed in this cause.

On rebuttal, Ms. Tower identified where: the support for this expense is contained in Petitioner's case-in-chief and workpapers. She explained that the amount Mr. Guerrettaz is proposing to remove is the allocation of Corporate and Customer Service general office expense to the Northwest Operation. She then identified how the amount at issue traces directly through all of the schedules. The test year level of Corporate and Customer Service general office expense is $1,318,549. Based upon the number of customers, the Northwest Operation is allocated 25.15% of this amount. The total amount can be found on Petitioner's Exhibit JKT-1, page 5 of 10, line 17 in Column 2. Then in Column 3, the Corporate Allocation Column, the same amount is deducted from the operating statement of Corporate and Customer Service. It is deducted on this gage so that it can be allocated and added to the operating statements of the various Company operations on other pages of Petitioner's Exhibit JKT-1. The amount of general office expense allocations is also verified by adding the amount shown on line 17 of Petitioner's Exhibit JKT-1 pages 2 through 4 and pages 6 through 10 of 10 Since thic is simply an allocation using the customary allocation methodology and since the Company did not propose an adjustment to the test year level of this expense., Ms. Tower explained that no workpapers were submitted showing the allocation.

It is apparent that Mr. Guerrettaz simply was unable to identify the source for the number which he is proposing to adjust. Ms. Tower has explained where that source is and how it is allocated among the various operations. Because Mr. Guerrettaz does not challenge either the total amount of general office expense of $1,318,849 or the allocation methodology, the amount which is to be allocated to the Northwest Operation cannot be challenged as nonjustified. We therefore find that Mr. Guerrettaz's proposed adjustment should be rejected.

(xii) Rate Case Expense. Indiana-American originally sought a rate case expense adjustment of $339,000, to bc amortized over thirty-six months resulting in a pro forma regulatory expense of $127,808. OUCC witness Lynn proposed modifying Indiana-American's proforma regulatory expense to $122,031 which includes a depreciation study cost of $14,808. The basis for Ms. Lynn's modification was her conclusion that "it appeared [Indiana-American] was requesting postage for customer notices twice." (Public's Ex, 1, p. 27). Ms. Lynn's conclusion came from her inquiry into $21,000 contained in miscellaneous expense for rate case expenses. Ms. Lynn testified that Indiana-American explained that this miscellaneous expense was an estimate based on actual costs associated with copying and binding testimony and postage to mail the customer notices during the last rate proceeding. Since Indiana-American already had a line item in its estimate for customer notices of $41,000, Ms. Lynn concluded Indiana-Amencan was twice counting its expenses for postage to mail customer notices.

On rebuttal, Mr. Cutshaw updated the original estimate of rate case expense based upon the significant level of activity in this case. He also explained his basis for disagreement with Ms. Lynn's modification. Mr. Cutshaw testified that Indiana-American had underestimated the costs of direct mailing the second customer notice. (Petitioner's Ex. JLC-R, p. 23.) The second notice was sent so that all customers would receive the same level of notice. Mr. Cutshaw further explained that the miscellaneous expense line item included Mr. Hartnett's directly charged time and expense for participating as a witness in this case.

We find that Petitioner has adequately explained the items challenged by Ms. Lynn, but that Petitioner's original estimates should be used. For these reasons, we find that Indiana-American's adjustment for rate case should be **$339,000,** resulting in pro forma regulatory expense of $127,808.

(xiii) Miscellaneous ***Expense.*** We begin our discussion of contested adjustments to miscellaneous expenses by reiterating our standard for reviewing de minimis expenses. As we noted in Indiana-American's last litigated rate case and its rate case before that in addressing proposed adjustments to reduce for expenses for safety programs:

> The resources expended to prove an expense item should never exceed the value of the expense item itself, and should always be congruous with the materiality of the expense item relative to the totality of expenses being considered... We know that analyses to evaluate the effectiveness of these types of programs can be difficult to formulate and expensive to monitor, and are often more subjective than objective. Far these reasons, the cost of demonstrating their worthiness and reasonableness for inclusion in rates can often exceed their absolute value, and their value relative to more significant items in the rate case. We are also aware that the magnitude of expenses for service and safety programs relative to total expenses for operation and maintenance are less than one percent of the total, and therefore immaterial.

(1997 Rate Order, pp. **58-59** and **1996** Kate Order, p. 18.) As will be apparent from our discussion, many of the disputed issues in this section will fall into this category.

a. Lobbying Expense. Ms. Gemmecke proposed to disallow all lobbying expenses, stating that our test for allowing recovery of lobbying expenses through rates is whether the lobbying produces a material benefit for the customers. Mr. Cutshaw and Ms. Doron opposed Ms. Gemmecke's disallowance and argued that the lobbying can produce a material benefit for the customers.

We have not previously approved the recovery of lobbying expenses. Petitioner pays a retainer to a local law firm for lobbying. They also pay membership dues to certain organizations wherein a portion of the dues also are attributable to lobbying the government. The Commission has ruled in Indiana-American's Cause Numbers 40103 and **40703,** Boone County Rural Electric Membership Corp's Cause No. **39929,** and Hoosier Energy Rural Electric Cooperative's Cause No. **37294** where-in **the Commission's standard for inclusion or** exclusion **of lobbying expense** was based upon proof of material benefit to the ratepayers. Petitioner's witness, Mr. James

Cutshaw, stated in rebuttal testimony these expenses were used to allow investor owned utilities the opportunity to participate in the State. Revolving Fund ("SRF") and also was instrumental in the repeal of federal income taxes on contributions in aid of construction ("CIAC"). Petitioner's inclusion of such expenses as part of its pro-forma expenses indicates a belief that such expense is fixed, known, and measurable and that similar benefits from lobbying will be incurred in the future. The Commission notes firstly that the repeal of the Federal taxability of CIAC was decided in 1996 and is not part of the current expenses of the Petitioner. Secondly, the Federal guidelines for the Safe Drinking Water Revolving Fund, whereby the State obtains funding for its SRF, has always allowed investor owned utilities to participate since its inception. As of July 1, 1999 (before the beginning of the test year), private (investor owned) drinking water systems have been allowed to participate in the State Drinking Water State Revolving Fund. It is clear that the test year lobbying expenses, both direct and indirect through memberships. did not create any material benefit to the ratepayers. It is also clear that including such lobbying expenses in future rates does not meet the criteria of fixed, known, and measurable in that neither the issues nor the benefits to the ratepayers are determinable. Therefore, we disallow this claimed expense.

b Capitalized Items The OUCC proposed an adjustment for invoices Ms. Gemmecke testified should be capitalized rather than expensed. Ms. Gemmecke testified that about half of those invoices related to the lining of two wells and the remainder consist of instruments and construction materials of a financial magnitude that warrant capitalizing them. Indiana-American accepted some of these adjustments. Indiana-American acknowledged that two of the items ($4,203 and $3,395 for work on well 3a in Warsaw) were improperly expensed in the test year but were reclassified to utility plant after the test year but before the rate base cutoff. Accordingly, these items have already been included in the Company's presentation of original cost rate base. Indiana-American also acknowledged that $5,048 for pipe installed in well 2a in Warsaw during cleaning, $3,250 for installation of an 8" tie-in in Southern Indiana, and $2,029 for three hydrant meters in Northwest should have been capitalized. Mr. Cutshaw testified, and we find, that these items, totaling $10,327 should be removed from expense and should be reclassified as an increase to rate base. We have included this amount in our earlier finding on original cost rate base.

Mr. Cutshaw opposed the OUCC's proposal to capitalize the remaining expenses. (Petitioner's Ex, JLC-R, p. 31.) Mr. Cutshaw explained that the $2,730 to Ortman Drilling in Warsaw was to inspect and test well 3a and is an ongoing cost Indiana-American has always properly expensed. The $1,632 to Meriam Instrument in Northwest was for labeling tape and for a label-making machine that produces labels that are chemical and heat resistant. Mr. Cutshaw testified that not expensing these items would be analogous to capitalizing the cost of Xerox paper. Finally, the $6,979 and $4,092 to Wisner Controls in Northwest are for 15 replacement transmitters and indicators for the SCADA system across the system. Mr. Cutshaw testified that these transmitters and indicators must be replaced from time to time due to lightning strikes, electrical failures, etc. and would be used within a year. We find Mr. Cutshaw's explanation of these contested items to be satisfactory and therefore reject Ms. Gemmecke's proposed adjustment.

c. NAWC Dues. Ms. Gemmecke disagreed with Petitioner's proposed adjustment to increase

© Public Utilities Reports, Inc., 2003

the test year expenses for NAWC dues. Mr. Cutshaw explained there were three significant differences concerning the parties' calculation of NAWC dues. The first related to Ms. Gemmecke's exclusion of the lobbying portion of NAWC dues, a subject we have already addressed. The second related to Mr. Cutshaw's use of the more current formula for calculating dues. Dues are calculated by applying a formula to Petitioner's revenues, and so we find the more current formula should be used. Finally, Mr. Cutshaw testified that Ms. Gemmecke did not make any adjustment to annualize the dues for the Indiana chapter of the NAWC. According to Mr. Cutshaw's testimony, the most rcccnt invoice was for *$25,000* which rcquircs an adjustmcnt of $18,756 over the test year expense level. We find that Petitioner's calculation of and adjustment for NAWC dues should be accepted and Ms. Gemmecke's adjustment should be rejected.

d. Employee Benefits. The OUCC proposed several adjustments to exclude expenses for employee benefits. OUCC's witness, Judy Gemmecke, has reduced miscellaneous expenses by $45,509 for Food and Beverages given to employees. The disallowance proposed by the OUCC consisted of food supplied to employees during, before, or after meetings, and coffee and tea provided to employees during work hours. Petitioner's witness James Cutshaw has objected to this reduction which he has segregated at $3,833 for food related to meetings and training, and the remaining being coffee and tea service which, he contends, should be allowed in rates as it is an industry practice. While these items may be part of a business practice that Indiana-American proscribes to, the Commission has previously deemed such expenses non-allowable for ratemaking purposes (Cause Number 37959 *Fayette-Union County Rural Electric Membership Corporation.* page *6;* Cause Number 39314 *Indiana Michigan* Power *Company*, pages 122-127; Cause Number **39128** ***Indianapolis Watcr*** Company). The Commission recognizes the need for meetings and training sessions, however, food and beverages given to employees who already receive a living wage is excessive when it comes to setting rates. Petitioner has not shown how such purchases relate to providing waterisewer service, increase employee's knowledge regarding their job. nor avoid other costs which would have been borne if not for these particular purchases. The Commission finds the OUCC's adjustment to be correct and consistent with this Commission's previous orders.

e. Training and Meetings. Ms. Gemmecke proposes to eliminate $3,833 in expenses relating to Indiana-American meetings and training. Mr. Cutshaw. in opposing such adjustment, explained these expenses. The cost consists primarily of food purchased for meals during working lunches or training meetings. These meeting and training sessions are held at Indiana-American's Corporate Office in Greenwood, which avoids the expense of renting a facility. Employees from the operations come to the Corporate Office to participate in training on such topics as safety, water quality, and defensive driving, among others. Mr. Cutshaw testified that the lunches ordered are modest and of reasonable cost. We find that Mr. Cutshaw's explanation for these expenses is reasonable, especially given their de minimis impact. We find that they should be recovered through rates and therefore reject Ms. Gemmecke's adjustment.

f. Website Expenses. The OUCC proposed to exclude $7,249 related to Indiana-American's website. Mr. Cutshaw opposed excluding these expenses related to Indiana-American's website. He explained that the website included Indiana-American's tariffs, contact information, answers to service-related questions and water quality information. Mr. Cutshaw explained that these

expenses provided a benefit to Indiana-American's customers and fulfill a regulatory obligation.

We **agree with Indiana-American that expenses related to Indiana-American's website should** not be excluded. Our General Administrative Order 1998-2 declares the Commission's policy that public utilities having a website, or with a parent corporation with a website. are to place certain information thereon for the benefit of the customers. Indiana-American's website promotes this policy and serves its customers by providing a resource to answer questions and gather information on water quality information. We find that the OUCC's proposed adjustment to exclude $7,249 related to Indiana-American's website should be rejected.

g. Community Related ***Expenses.*** Ms. Gemmecke proposed to exclude $49,965 of expenses related to Indiana-American's membership in community organizations such as the Chamber of Commerce, Rotary, Economic Development Corporations, County Alliances, etc. and $6,097 in expenses dated to community relations. Mr. Cutshaw, in opposing Ms. Gemmecke's proposed **adjustment, testified that informing the** communities **Indiana-American serves about its** operations, additions to plant in service, winter freeze protection, and other such matters are beneficial and should be recognized. According to Mr. Cutshaw, the communities Indiana-American **serves** are **very interested in its** construction **projects and the impact they will** have on water service and that these expenses help to inform the Communities of such projects. Furthermore, 'these costs have been allowed in previous Indiana-American rate cases. We reject Ms. Gemmeck's proposed adjustment for community related expenses and find that such expenses should be recovered from rates.

h. Other ***Expenses. The OUCC*** proposed omitting $2.788 in expenses relating to bill inserts informing Indiana-American customers about the Express Cheque program and $916 of operations related expenses. Mr. Cutshaw opposed these adjustments. Me testified that informing customers about the Express Cheque program provided information that would help customers save money in postage and help Indiana-American save money in bank fees. Furthermore, the operations related expenses encompassed office supplies, safety supplies, hardware and an American flag that **should be included in rates because they are normal costs** of providing **service** to customers and are de minimus. We reject the OUCC's proposed adjustments relating to the Express Cheque program and the other operations related expenses and find such costs should be recovered through rates.

(xiv) Non-Recurring ***Expenses. The*** OUCC made a downward adjustment to account for certain items expenses by Petitioner in the test year which are unlikely to occur again. Most of the items listed on OUCC's schedule JIG-10 and summarized on OUCC witness Dana Lynn's schedule 6, adjustment **12,** relate to Petitioner's move from their Camby Court location in Greenwood, to their current location on County Line Road in Greenwood, IN. Petitioner has not addressed this issue in its rebuttal nor during the hearing. The Commission agrees with the OUCC's adjustment for non-recurring expenses in the amount of $83,815.

(xv) State Income Taxes. **Mr. Gassert identified that** the OUCC's calculation **uf** state income taxes is presented on D. Lynn, Schedule 7. The tax calculations on that schedule differ from Petitioner's. The difference relates to Petitioner's add back of $11.3 million of property taxes in calculating their state taxable income. I.C. 6-3-1-3.5 effective 1/1/99 eliminated the property tax add back for the state income tax calculation.

© Public Utilities Reports, Inc., 2003

(xvi) Amortization of Acquisition Adjustment. As previously discussed, we will not include in operating expenses any amortization of the acquisition premiums relating to the acquisitions of Indiana Cities, Northwest, United or Cementville.

(xvii) Depreciation Expense. Depreciation expense shall be computed on the depreciable property included in rate base using the approved depreciation accrual rates.

(xviii) Water Quality Concerns. Public Field Hearings were conducted by the presiding officers in Gary, Indianapolis, Somerset and Jeffersonville, in order to obtain ratepayer input from a cross-section of the state rate base. During these hearings, the Commission received numerous complaints from customers about the quality of water supplies by Petitioner. For example, at the Somerset Hearing a senior citizen customer of Indiana American living on a fixed income, complained about the quality of water from the Company. She testified that she installed three (3) water heaters in 12 years, has a water softener and buys bottled water for her coffee maker. Lisa McCoy, a representative of Dalton Corporation, described her employer, formerly the largest customer of Indiana American in Warsaw, Indiana, and reported that, when the Petitioner changed its water source this caused the iron content to exceed EPA guidelines, and, upon receiving Dalton's complaint, Petitioner told Dalton that it would not deal with the iron issue,

Jerry B. Moser also complained that the water ruined his coffee maker and requires him to flush out the water heater. Carol Joy Matson complained that she replaced the toilets because of Iime in spite of the filter system she installed. David Compton also complained about installing his fourth water heater, too much chlorine in water and inability to drink the water.

From elsewhere in the state, Phyllis J. Graves of West Lafayette testified via e-mail that the water smells and tastes strange and is not drinkable. Another West Lafayette customer buys bottled water to drink. She indicated that the water company told her after her complaint that they tested the water and nothing was wrong. She said she had lived in the same place for 30 years and the quality of water did not used to be like this.

Eric C. McVeigh from Portage, Indiana provided written comments stating that since his family moved to Portage, where Indiana American is the service provider, they found the public wates of such poor quality that his family uses bottled water to drink and cook. Additionally, two members of his household use bottled water for brushing and rinsing their teeth because the tap water gives them mouth sores.

Mr. William Koon, a customer of Indiana American in Kokomo, stated that the Company does not provide good enough service to *warrant* a rate increase. Dick Persinger of Kokorno is concerned about **the water quality and** stated **that he still** buys water **since they moved to** Kokomo four years ago. Mr. Persinger also stated that he knows of no one who drinks the water. Susan Roberts from Winchester, Indiana testified that water quality has gone "down hill" since Indiana **American** bought **the water system and** that **the water** is **now "yellow".**

Connie Henderson of Gary stated that her water does not taste good. Booker Douglas, also from the Gary area has concerns about source water contaminations and the Company's continued use of lead pipe.

© Public Utilities Reports, Inc., 2003

The Commission also received letters from officials and customers in Terre Haute, Mooresville, Noblesville, Shelbyville, and Franklin regarding the Company's responsiveness and reliability in those areas.

The widespread complaints from customers regarding water quality cannot be ignored. We note that some complainants submitted samples of water that demonstrated the unsatisfactory quality of water that some customers receive. Customers who pay for the cost of service including cost of improvements to the Utility's plant through rates should receive adequate water quality. The fact that numerous customers reported that they don't use the Company's water to drink and cook, having to install softeners or filters, and replacing water heaters, requires Indiana American to responsibly identify the problem and correct it in order to continue to merit the confidence of this Commission and its customers.

With regard to service in Northwest District, we note that Petitioner's witnesses testified that the system they acquired from Northwest Indiana was in generally good operating condition. The witnesses also testified that even the existing tunnel despite its old age is operating soundly and that the new tunnel project is to replace an aging structure that would have to be retiled in the near future. 'Thus, we fail to understand why the Company has not addressed the issue of water quality in this rate case, especially since this area is subject to the highest proposed rate increase in the entire Company system, with an increase of 50% proposed.

Indiana American's record with this Commission has demonstrated its responsiveness in stepping in and taking over troubled utilities to provide reliable and adequate water service to the citizens of those utilities. We are confident that the utility wants to maintain this record statewide.

Indiana American is directed to submit a report within 90 days of the date of this Order identifying the water quality problems in each area, their causes, the corrective measures to be taken, and a reasonable implementation time-table of these measures. The Company shall file a copy of this report to the OUCC. The Company shall, thereafter, file an annual status report on each implementation on or before the anniversary date sf the original report.

14. Net Operating Income At Present Rates. Based upon the evidence and the determinations made above, we find that Petitioner's adjusted operating results under its present rates are as follows:

[Graphic(s) below may extend beyond size of screen or contain distortions.]

	Total Company
Operating Revenues	$118,736,711
O & M Expenses	44,918,070
Depreciation	19,128,388
Amortization	400,800
Other Taxes	13,938,661
State Income Tax	1,249,228
Federal Income Tax	8,600,417
Total Operating Expenses	88,235,564
Net Operating Income	$30,501,147

In summary, we find that with appropriate adjustments for ratemaking purposes, Petitioner's annual net operating income under its present rates for water service would be $30,501,147. We have previously found that the fair value of Indiana-America's utility property is $562,680,669. A return of $30,501,147 represents a rate of return of 5.42% on the fair value rate base. We find that this opportunity is insufficient to represent a reasonable return. We therefore find that Petitioner's present rates are unreasonable and confiscatory.

*15. **Authorized Rate Increase** (**Step** One).* On the basis of the evidence presented in these proceedings, we find that Petitioner should be authorized in Step One to increase its rates and charges to produce additional operating revenue of $4,712,484 or a 3.97% increase in its water revenue, resulting in total annual operating revenue of $123,449,194. This revenue is reasonably **estimated** to allow Petitioner the opportunity to **earn net** operating **income** of $33,368,323 as follows:

PROFORMA OPERATING INCOME STATEMENTS AT AUTHORIZED RATES — STEP 1

[Graphic(s) below may extend beyond size of screen or contain distortions.]

	Water Groups 1,2,3	Wabash	Total Sewer	Northwest	Mooresville
Operating Revenues	$82,458,493	$1,863,101	$ 284,737	$31,581,685	$ 1,437,748
Operating Expenses					
O & M Expenses	$25,934,360	$ 861,853	$ 180,750	$14,826,260	$ 578,515
Depreciation	14,388,370	271,798	17,000	3,390,202	505,986
Amortization	335,688	3,051	1,521	47,032	2,319
Taxes Other Than Income	8,297,660	159,306	35,994	4,778,085	152,675
State Income Tax	1,056,949	18,394	1,763	295,670	18,250
Federal Income Tax	7,332,785	125,765	12,447	2,075,904	129,887
Total Operating Expenses	$57,347,812	$1,440,167	$ 249,475	$25,419,153	$ 1,087,629
Net Operating Income	$25,110,681	$ 442,934	$ 35,262	$ 6,162,532	$ 350,119

[Graphic(s) heiow may extend beyond size of screen or contain distortions.]

	Warsaw	West Lafayette	Winchester	Total Company
Operating Revenues	$ 2,066,117	$2,983,270	$ 754,043	$123,449,194
Operating Expenses				
O & M Expenses	$ 936,504	$1,302,535	$ 329,599	$ 44,950,373
Depreciation	296,545	438,235	114,252	19,129,388
Amortization	2,633	5,231	1,325	400,800
Taxes Other: Than Income	188,576	313,901	73,758	13,999,355
State Income Tax	21,835	35,831	8,384	1,457,076
Federal Income Tax	151,553	256,165	59,773	10,144,279
Total Operating Expenses	$ 1,597,646	$2,351,898	$ 587,091	$ 90,080,871
Net Operating Income	$ 468,471	$ 631,372	$ 166,952	$ 33,366,325

The Commission finds that rates estimated to produce this level of revenues would be just and fair and should allow Petitioner the opportunity to earn a fair rate of return on the fair value of its property dedicated to providing water and sewer service to the public. These determinations **reflect** the **effect of additional revenue on** income **taxes, the gross receipts** tax, **the IURC fee** and uncollectible accounts consistent with the gross revenue conversion factors shown on Petitioner's Ex. JLC-1, Sch. 3, p. 1 and Public's Ex. 1, Sch. 1, p. 2.

16. Implementation of Step One Rate Increase. In the 1997 Rate Order, we approved the Petitioner's request (as modified by a settlement agreement mentioned below) to consolidate thirteen of its separate water rate schedules into four rate groups for general water service, and three groups each for public and private fire service in a phased approach toward single tariff pricing ("STP"). In addition, we approved Petitioner's proposal to retain two separate rate groups for sewer service but move the sewer rates closer to STP. Finally, we approved a settlement agreement to keep the Wabash Operation from being included in the STP rate groups for a specified period of time.

In our order dated July 1, 1999 approving a Stipulation and Settlement Agreement in Cause No. 41320, we noted that the rate design resulting from the increase accomplished a further move towards STP in two ways. First, the number of general water service groups was reduced from four to three. Second, each of the rate groups was moved closer to the ST? rate before the balance of the increase was applied on an across-the-board basis. We also noted that the Wabash Operation rates continued to be separately derived consistent with the settlement agreement approved in the 4997 Rate Order. Finally, we noted that public fire protection increases were limited in order to mitigate the impact of moving communities to public fire protection surcharges as and to the extent municipalities elect to do so pursuant to Ind. Code 5 8-1-2-103.

In the current case, Petitioner is proposing to make a third step towards STP by again moving the water and sewer rate groups closer together and by eliminating another of the general water service rate groups, as depicted below:

[Graphic(s) below may extend beyond size of screen or contain distortions.]

Group	% of STP General Water Service
1	120% to 115%
2	101% to STP
3	96% to STP

Group	Private Fire Protection
1	112% to 107%
2	80% to 84%
3	61% to 64%

© Public Utilities Reports, Inc., 2003

Petitioner proposes as a result of these movements to eliminate General Water Service Group 3, moving Crawfordsville, Newburgh, and Shelbyville into Group 2, which is the STP Group. Since in this Order we have not approved the rates sought by Petitioner, and we have not allowed subsidies in the Northwest Water and Sewer, it would be inappropriate to rule on the proposed elimination of Group 3 of the General Water Service without allowing Petitioner to reexamine its proposal in light of the increase in operating revenues authorized by this Order.

Petitioner **is directed to report to** the Commission **within 7 days of the date of** this **Order,** whether it still seeks to eliminate Group 3. Petitioner should also file new tariffs reflecting the authorized increases.

Petitioner also proposed to bring the individually calculated public fire protection surcharge for Newburgh and Sullivan (approved in Cause Nos. 41536 and 41920) to the appropriate Group rates and to implement the surcharge by meter size for all customers in the respective operation instead of just for the customers within the Town/City limits, consistent with Petitioner's proposals in the above referenced cases. Since the filing of this case, orders have been issued in Cause Nos. 42056 and 42147 approving surcharges by meter size for Greenwood and New Albany. Consistent with Petitioner's proposals in those cases, the individually calculated surcharges should be brought to the appropriate Group rate and the surcharge by meter size should be charged to all customers in these operations.

Petitioner again proposed to limit the increase for public fire protection group rates to 6%, consistent with its last rate case, and described the development of the rates fox the Freeman Field customers consistenr with out order in Cause No. 41655.

Petitioner explained that the proposed rates for the operations in Wabash, Mooresville, Warsaw, West Lafayette, and Winchester were determined by increasing the current rates across-the-board based upon the required revenue increase calculated from their individual rate bases and operating income statements. No party opposed this proposal and we find its should be approved

Finally, Mr. Cutshaw explained that proposed rates for the Northwest Operation were limited to a 17.41% accross-thc-board increase based upon the additional revenue requirement due to growth in net original cost rate base and related expenses since Northwest's last rate case. He explained that Petitioner made this adjustment because it realized that its standard practice of allocating all Corporate and Customer Service Center costs on a per customer basis had shifted a substantial portion of these costs from other operations due to the fact that the Northwest Operation has more than 25% of the customer base. The difference between the revenues resulting from the use of the 17.41% and the increase calculated on Schedule 1 of Petitioner's Exhibit JLC-1 was included in the across-the-board increase applied to the General Water Service. As we have previously stated, (Para. 6, p.4 herein), we approach single tariff pricing carefully on a case-by-case basis. In this case we are not persuaded by Petitioner's argument that Northwest's rates should be partially subsidized by allocating a portion of its revenue requirements to the Water Groups. Therefore, we don't limit the Northwest rates increase to 17 41%, as proposed.

With respect to the implementation of the Step One increase, the Participating parties raised

two concerns. First, Schererville took issue with the allocation of Corporate costs within the Northwest Operation on an across-the-board basis, thus **requesting** that the **increase he** implemented for the Northwest Operation in a fashion other than across-the-board. Second, Grown Point took issue with the exclusion of sewer customers from the allocation of Corporate costs.

Mr. Sommer, testified that Corporate costs should be allocated among the rate classes on a per-customer basis. He testified that Petitioner allocated its Corporate costs to its various operations on the basis of the number of customers, and that this allocation should be carried directly to the end customer. In **Mr.** Sommer's opinion, a cost of service study is not needed to perform the allocation in Mr. Sommer's requested fashion. He stated that there are seven resale customers in the Northwest Operation compared to 65,251 total customers, but those seven resale customers are allocated 10.73% of the Petitioner's Corporate costs. Under Mr. Sommer's proposal, each of these resale customers would pay the same percentage as a single-family residential customer.

Schererville witness Sue Haase performed the calculation and the resulting rate impact from **Mr. Sommer's proposal. She calculated the percentage of the total Step One increase for the** Northwest Operation before the impact of the limitation described by Mr. Cutshaw. Of the total increase before limitation, 41.25% was generated by revenue requirements specific to the Northwest Operation; the balance of 58.75% according to Ms. Haase was determined based solely on the number of customers. She then applied the 58.75% to the requested Northwest Operation increase (as limited per Mr. Cutshaw's methodology) to arrive at $2,732,890 which she claimed was being allocated on a per customer basis. She then multiplied this amount by the percentage of total customers in each rate class to determine the proposed allocation to sale-for-resale customers, such as Schererville.

On rebuttal, Mr. Cutshaw explained that the increase for the Northwest Operation was an across-the-board increase because no cost of service study had been conducted. Further, he testified that to adopt Schererville's **proposal,** one **would have** to **assume that a large** wholesale customer like Schererville causes the same Corporate cost as one residential customer, an assumption Mr. Cutshaw claimed was unreasonable absent a cost of service study. He recounted the testimony of customers who spoke at the Gary Field Hearing, who believe that they are already paying too much in relationship to those who live in surrounding communities that are wholesale customers of Indiana-American.

To argue that Schererville causes Corporate costs identical to a single residential customer defies logic. For example, no single residential customer intervened in this case. Plainly, resale customers cause higher Corporate costs than residential customers. Moreover, we find that there is a basic error in Ms. Haase's calculation. As explained by Mr. Cutshaw, Petitioner has held the Northwest Operation increase to the level which is produced by the incremental rate base in the Northwest Operation. In other words, **Petitioner** has already **limited** the allocation of Corporate costs to the Northwest Operation. Ms. Haase assumed that Petitioner limited both Corporate costs and direct costs proportionately. Her proposal results in the allocation of essentially no **Corporate costs** to sale-for-resale **customers. Under her analysis, $206,783 is** allocable **to *the*** wholesale customers solely from the direct costs which she does not dispute can be allocated

based upon percentage of revenues. After she performs her calculations, however, the total increase which she believes is allocable to resale customers is only $293 more. (Schererville Ex. PSH-2.) This is the amount of Corporate cost she seeks to allocate to resale customers, which we find to be inappropriate absent a cost of service study. The Commission finds that the Petitioner's proposal is the most reasonable presented, and Petitioner's proposed methodology of allocation of shared expenses is hereby approved.

Petitioner proposed that sewer customers, who are also water customers, not be allocated shared Corporate costs. Crown Point witness Mr. Guerrettaz testified that each customer should share in the Corporate allocation. Ms. Tower testified that the sewer customers in Muncie and Somerset are also water customers in their respective operations, and the allocation of additional Corporate costs to them would be a "double-allocation" for those customers. At the field hearing held in Somerset, the customers expressed several concerns, The Commission finds that the "double allocation" of Corporate costs, when the Petitioner did not make such a proposal, would not be in the public interest. Therefore, Petitioner's proposed exclusion of sewer customers from the allocation of shared Corporate costs is hereby approved.

Petitioner also proposed to subsidize certain races by allocating a substantial amount of the revenue requirements sought for the sewer operations to the Water Groups. Mr. Cutshaw testified that with the few number of customers of sewer service and the investments the company made, the resulting sewer rate increase would be: "unacceptably high". Mr. Cutshaw concluded that mitigating rate impacts is one of the benefits of STP. Again, we reiterate our caution for STP. We disagree with Petitioner's proposal to subsidize sewer rates by water rates. These are two different and distinguished services, and do not pass our standard for comparability. However, we agree that the proposed rate increase would cause rate shock if it were implemented in one step. Therefore, we will phase-in the sewer rate increase in two steps but without subsidization.

17. Step Two Rare Increase. As explained previously, the Prehearing Conference Order authorized a three-step rate increase, with Step Two to reflect the Commission-determined cost of capital to the cost of certain capital projects plus associated changes in income tax expense, depreciation expense, property tax expense, and other associated operating expense changes. However, reviewing this rate matter as a whole, and noting that the proposed Phase Three provided for a requested increase of less than one-tenth of one percent, we find that a two-step process is the more reasonable. Any trailing costs related to the Tunnel Project may be addressed as provided in that applicable Order.

As demonstrated in graphs below, a total sewer increase of 50.83% is authorized in two equal steps. The First step takes effect immediately and the Second Step to be implemented one year from the date of this Order. Only Northwest Operations and the Water Groups will have a Step Two rate increase for water service.

*A. Cost of Plant to **be** Reflected in **Step** Two.* There are three projects for which a Step Two increase is authorized by the terms of the Prehearing Conference Order: (1) the Tunnel Project; (2) if approved, the Newburgh Project; and (3) if approved, the Wabash Valley Project (collectively, the "Step Two Projects").

(i) The Tunnel Project. Mr. DeBoy testified that the Tunnel Project is the replacement of the

existing water intake tunnel which supplies the Borman Park Treatment Plant (the "Borman Plant"). In 1997, Northwest conducted a comprehensive inspection of the existing original tunnel which had been constructed in 1908 and confirmed that the remaining service life of the tunnel might not extend beyond 2002 to 2004. This existing tunnel is the current source of water supply for one of the most populated areas of our State and so it was plain that something needed to be done to address the situation. As required by the Settlement Agreement in Cause No. 41484 wherein this Commission approved the merger of Northwest and Indiana-American, Petitioner filed the Petition in Cause No. 41692 seeking preapproval pursuant to Ind. Code § 8-1-2-23 of Petitioner's proposed plan to replace the existing tunnel.

Mr. DeBoy testified that seven different alternatives were considered and presented in Cause No. 41692:

[Graphic(s) below may extend beyond size of screen or contain distortions.]

1A - New tunnel in bedrock
1B - New tunnel constructed in bedrock inland, but trenched under the Lake
2A - New tunnel constructed In clay
2B - New tunnel constructed in clay inland, but trenched under the Lake
3 - New tunnel constructed entirely in trench
4 - Renovation of existing tunnel
5 - Trench to U.S. Steel property, then tunnel in clay under the Lake

Alternative 1B was initially considered the preferred option, using a quantitative and qualitative screening process which was described in detail in that cause and summarized in this case. Alternative 1A had not yet been rejected at the time of our approval, however, so in Cause No. 41692 we approved both Alternatives 1A and 1B, with the final selection to be made after bids were received. Mr. DeBoy testified that bids were solicited on both alternatives and that **Alternative** IA proved to be the lower cost alternative. The Tunnel Project is currently under construction and anticipated to be in service in April 2003. The current estimated cost is $48 million.

Mr. Guerrettaz proposed a capacity adjustment based upon his claim that a portion of the Tunnel Project will not be used and useful until a later time. He claims that the Tunnel Project will have a capacity of 100 million gallons per day ("MGD") and that Petitioner will only have treatment capacity of 78 MGD. In his opinion the full capacity of the Tunnel Project will not be needed until some time during the next 100 years. He therefore proposed to reduce the cost of the Tunnel Project to be included in rate base for purposes of Step Two rates by 20% of the cost estimates for the Tunnel Project. He arrived at this amount by rounding the treatment capacity to 80 MGD and subtracting that amount from the 100 MGD capacity of the Tunnel Project, leaving a difference of 20 MGD. He then divided 20 MGD by 100 MGD to arrive at his 20% capacity adjustment.

Mr. DeBoy had three objections to Mr. Guerrettaz's adjustment. First, he noted that we have already preapproved the capacity of the Tunnel Project to 100 MGD. Mr. DeBoy identified where in Cause No. 41692 he had testified the new tunnel would have a capacity of at least 100 million

© Public Utilities Reports, Inc., 2003

gallons per day. Second, he testified that Mr. Guerrettaz has conducted none of the analysis which is necessary to propose a capacity adjustment Finally he testified that tn restrict the capacity of the Tunnel Project to 80 MGD as proposed by Mr. Guerrettaz would have in fact resulted in a greater cost of the Tunnel Project. This is a very long shaft with portions in bedrock. The Tunnel Project is being completed with a boring machine. That boring machine cuts a hole which must be large enough not only for the machine itself but also for the workers and ventilation, power supply and other equipment that are necessary to construct a tunnel. He testified that the contractor would have used a machine to cut an 11 1/2 foot diameter hole regardless of whether Indiana-American had requested a tunnel with capacity of 100 MGD or 80 MGD. As such, to restrict the capacity of the Tunnel Project to 80 MGD as Mr. Guerrettaz requests would have required the use of more concrete to shrink the size of the hole so as to allow less water. The result is that a tunnel limited to capacity of 80 MGD would have cost more to build than the current tunnel.

We find that there are several shortcomings to Mr. Guerrettaz's analysis. First, and perhaps most importantly, we have already approved the Tunnel Project to a capacity of at least 100 MGD. In our Order in Cause No 41692, we explained that the *context* in which our preapproval had been sought was the Settlement Agreement we had approved in Cause No. 41484 wherein we had approved the merger of Indiana-American and Northwest. That Settlement Agreement which we had approved "required Petitioner to file a petition with the Commission by March 34, 2000, seeking Commission approval of the Tunnel Project. To the extent the Tunnel Project is approved by the Commission, the Settlement Agreement also permits Petitioner at its option in its next general rate case to include the Tunnel Project in its rate base through the use of a three step increase." Order, Cause No. 41692, p.3. We then recited the testimony concerning the proposed size of the tunnel:

> Mr. DeBoy stated that the intake system would include a suction shaft near the Borman Plant. The tunnel segment from the suction shaft to the near shore shaft will be a minimum of 96 inches in diameter. There will be an intermediate access shaft, approximately halfway between the suction shaft and the near shore shaft. Assuming Alternative 1B is selected, the segment from the near shore shaft to the intake crib will be 96 inch diameter pipe, installed in a trench excavated at the bottom of the lake. The pipe material will likely be prestressed concrete cylinder, steel or ductile iron, depending upon the results of the contractor bids. The tunnel will have a capacity of at least 100 million gallons per day.

Order pp. 5-6. After reciting this evidence, we then proceeded to find that the proposed 100 MGD Tunnel Project should be approved:

> Here, persuasive and undisputed evidence has been submitted showing that the Existing Tunnel is nearing the end of its remaining service life and should be replaced, and that Petitioner's proposed Tunnel Project is the most reasonable solution. Accordingly, we find that the Tunnel Project and the expenditures associated therewith

© Public Utilities Reports, Inc., 2003

> should be approved to the extent that they do not exceed the updated cost estimate in Petitioner's next rate case. Once the Tunnel Project is completed and placed in service, we find it should be included in Petitioner's rate base consistent with the terms of the Settlement Agreement.

Order pp. 7-8. Finally, we ordered: "Petitioner shall be and hereby is authorized to include the Tunnel Project in its rate base for ratemaking purposes after the Tunnel Project is placed in service and consistent with the terms of the Settlement Agreement." Order, p. 9. In sum, we find that Mr. Guerrettaz's proposed adjustment has already been rejected.

Even apart from the preapproval for the Tunnel Project, Mr. Guerrettaz has presented none of the evidence which we have stated is necessary to support a challenge of excess capacity. In the 1997 Rate Order we announced our standard for reviewing challenges of excess capacity:

> The OUCC cites no support for its approach to measuring the value of used and useful plant. To address the level of appropriate capacity, the Commission has outlined the factors that must be considered and addressed. They are as follows:
>
> (1) The prudence of the decision to construct the new plant;
>
> (2) The reasonableness of the demand forecasts;
>
> (3) Whether there were changed circumstances during the construction, necessitating *a reevaluation of the decision to* continue with construction;
>
> (4) The lead time to construct new facilities;
>
> *(5)* The necessity to provide adequate and reliable utility service;
>
> (6) The utility's need for a margin of safety or reserve;
>
> (7) The financial impact on the utility of a finding of excess capacity and the long-term effect on the ratepayers; and
>
> (8) The risk that changes in demand projections will impact the utility's reserves and ability to serve its customers.
>
> *Northern Ind.* Pub. *Serv. Co.,* Cause No. 37458, 67 PUR4th 396,401-02 (PSCI 6/19/85). To this we will add another factor particularly important for water utilities - the utility's need to comply with the requirements of environmental agencies.
>
> The OUCC presented no evidence on any of these points which are central to an excess capacity challenge.

(1997 Rate Order, pp. 15-16.)

Mr. Guerrettaz's proposed adjustment has not met the standard as set out in the 1997 Rate Order. He has not claimed it was imprudent to build the Tunnel Project to 100 MGD, but has assumed that only a percentage of the new tunnel will be used currently. He has then made the same assumption we rejected that the cost of plant varies directly and proportionally with

© Public Utilities Reports, Inc., 2003

capacity by reducing the cost of the Tunnel Project by 20%. It is perhaps for these reasons that he did not consider the limits on construction pointed out by Mr. DeBoy which would have caused the Tunnel Project to be more expensive had its capacity been limited to 80 MGD.

We therefore find that Mr. Guerrettaz's proposed capacity adjustment in Step Two should be rejected. The cost of the Tunnel Project should therefore be included in the calculation of Step Two rates as provided in the Prehearing Conference Order. The cost to be included shall be the actual cost not to exceed $48 million.

(ii) The Newburgh Project. Mr. DeBoy testified that the Newburgh Project will make available an additional 2.0 MGD of supply for the Newburgh Operation. It will include construction of 2.0 MGD groundwater supply and construction of a 2.0 MGD iron and manganese removal plant. Re testified that it is needed because demand routinely approaches and exceeds the current capacity. The estimated cost of the Newburgh Project is $4.68 million. No party submitted any evidence in opposition to the Newburgh Project. We find the Newburgh Project is reasonably necessary and that Petitioner's cost estimates are reasonable. We therefore find that to the extent it has been placed in service on or before the in-service date of the Tunnel Project, Petitioner may include the cost of capital, income tax expense, depreciation expense, property taxes and other operating expenses related to the Newburgh Project in Step Two rates. The cost to be included shall be the actual cost not to exceed $4.68 million.

(iii) The Wabash Valley Project. Mr. DeBoy explained that the Wabash Valley Project provides for residuals management and improvements to existing chemical feed and storage arrangements at the water treatment plant in Terre Haute. The improvements are needed in order to comply with the new National Pollution Discharge Elimination System ("NPDES") permit. The anticipated cost is $3.78 million, No party submitted any evidence in opposition to the Wabash Valley Project. We find that the Wabash Valley Project is reasonably necessary and that Petitioner's cost estimates are reasonable. We therefore find that to the extent it has been placed in service on or before the in-service date of the Tunnel Project, Petitioner may include the cost of capital, income tax expense, depreciation expense, property taxes, and other operating expenses related to the Wabash Valley Project in Step Two rates. The cost to be included shall be the actual cost not to exceed $3.78 million.

B. Operating Expense Adjustments. The only dispute related to operating expenses associated with the Step Two Projects relates to property taxes. As explained previously, Mr. Guerrettaz testified that there was uncertainty regarding how property taxes would be computed due to the potential for new legislation during the 2002 Session of the Indiana General Assembly. He therefore believed that an adjustment for property taxes is not fixed: known and measurable and should not be approved.

Mr. Cutshaw explained that any changes to the property tax calculation are not anticipated to reduce property taxes for utility property. On cross-examination, he explained that House Bill 1004 contains a provision specifically providing that taxes for public utilities would not be reduced regardless of the impacts for other types of property and taxpayers. (Tr., p. H 6.) He also explained that there is no question there will be property taxes assessed for the Step Two Projects. Finally, he testified that the Prehearing Conference Order already authorizes property taxes to be included in the adjustment, even though all of the uncertainty surrounding property

© Public Utilities Reports, Inc., 2003

tax reform existed at the time we issued the Prehearing Conference Order. He testified that by Mr. Guerrettaz's adjustment, Intervenor Crown Point is not accepting the record as it stood at *the* time Crown Point intervened, in contradiction to what Crown Point committed to do as a condition to its intervention. On cross-examination, Mr. Cutshaw agreed that the Company would be willing to accept a true-up to actual property *tax* expense for the Step Two Projects based upon potential property tax reform between now and the implementation of Step Two Rates, so long as the true-up can work both ways. In other words, if property **tax** reform reduces property tax expense on the Step Two **Projects** from what is anticipated, the Step Two Rates will be reduced accordingly; on the other hand, if property tax reform increases property tax expense from what is presently anticipated, the Step Two Rates will be increased accordingly. (Tr., pp. H7-8.) We find this true-up proposal to be reasonable.

We find that we have already considered the appropriateness of including property tax expenses on the **Step** Two Projects at the time we issued the Prehearing Conference Order. In that Order we authorized the inclusion of property taxes on the Step Two Projects as a part of the Step Two rate increase. At the time we issued that Order, the uncertainty concerning how property taxes will ***be mechanically*** computed ***as a*** result of property **tax** reform existed to the same extent it exists today. We know that property taxes will be assessed on the Step Two Projects and that Petitioner's method of calculating these expenses is the current best estimate of what those expenses will be. We therefore find that Mr. Guerrettaz's proposed exclusion of property tax expense from the Step Two Rate Increase should be rejected.

We therefore find that the Step Two Rate Increase should also include the operating expense adjustments, including property taxes, proposed by Petitioner, subject to the true-up formula described above.

C. Implementation of Step Two Increase. Petitioner proposed ***to*** implement the Step Two rate increase by increasing the Northwest Operation rates *to* a level which is approximately the single tariff rate for residential customers. The balance is proposed to be spread across-the-board among all other operations **except** for the Wabash Operation and the former United Operations for which single tariff authority has not yet been approved. We have determined that we will not allow this mechanism in this proceeding.

Based on the estimated costs of the Step Two Projects approved above, Petitioner is authorized to increase its rates after completion of the Tunnel Project by up to $7,528,905 per year or 6.10% from the Step One Rates, depending upon the certified actual costs of the projects, as follows: The fair value finding for Step Two adjusts the fair value finding in Step One to include inflation up to the second quarter of 2003 plus net plant additions. Thus, the ***Step*** Two fair value rate base is $639,949,626. Using the previous found fair value rate of return of 5.93% equates to a required NOI of $37,949,064.

[Graphic Not Displayed Here]

The following graph shows the **percentage** of change **by** service area:

*PERCENTAGE CHANGE FOR **EACH** STEP BY SERVICE AREA*

[Graphic(s) below may extend beyond size of **screen** or contain distortions.?

	Step 1	*Step 2*
Water Groups 1, 2, 3	-0.738	1.35%
Wabash	14.94%	0.00%
Total Sewer 4 (4)	50.83%	0.00%
Northwest	18.113	20.20%
Mooresville	7.57%	3.00%
Warsaw	-2.248	0.00%
West Lafayette	-3.08%	0.00%
Winchester	24.02%	0.00%
Total Company	3.97%	6.10%

*IT IS **THEREFORE** ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:*

I. Petitioner is hereby authorized to adjust and increase its rates and charges for water and sewer utility service for Step One in accordance with the findings herein which rates and charges shall be designed to produce total annual operating revenues of $123,449,194 which, after annual operating expenses of $90,080,081, are expected so result in annual net operating income of $33,368,323. Petitioner is further authorized to adjust and increase its rates and charges for water and sewer utility service for Step Two in accordance with the findings herein which rates and charges shall be designed to produce total annual operating revenues of $130,978,098, which, after annual operating expenses of $93,029,034, are expected to result in annual net operating income of $37,949,064.

2. Petitioner shall file new schedules of rates and charges with the Gas/Water/Sewer Division of the Commission on the basis set forth in Finding Nos. 16 and 17 herein. Such new schedules of rates and charges shall be effective upon filing and approval by the Gas/Water/Sewer Division and shall apply to water and sewer usage from and after the date of approval.

3. The Settlement Agreement regarding security costs between Petitioner and the OUCC is denied.

4. Petitioner is authorized to adjust and increase its rates and charges for water and sewer utility service upon placement in ***service*** of **the** Tunnel **Project** in **accordance** with Finding No. 15 and the terms of the Prehearing Conference Order, which rates are designed to produce further additional annual operating revenues of not more than $7,528,905, or a 6.10% increase from Step One Rates, which amount shall be subject to downward adjustment to the extent certified actual costs of the Step Two Projects are less than Petitioner's estimates herein as provided in the Prehearing Conference Order.

5. This Order shall be effective on and after the date of its approval.

FOOTNOTES

[1] United and Northwest, acquired about the same time and with quite similar operations, will be considered as a unit in view of the quantity of evidence presented in this case. Petitioner is directed to separate entities in future applications.

[2] According to the Fama-French model a firm's book-to-market ratio is a measure of financial distress. Firms with a high book-to-market ratio (a **low** market-to-book ratio) are financially distressed and require a higher rate of return.

[3] Dr. Boquist recommend 11.25% COE in Petitioner's last case and 11.50% in Petitioner's current case.

[4] Due to the potential effect of "rate shock", the total sewer increases will be spread over a two year period, the second step to take place one year from the date of this Order.

© Public Utilities Reports, kc., 2003

Endnotes

1 (Popup)

[1] United and Northwest, acquired about the same time and with quite similar operations, will be considered as a unit in view of the quantity of evidence presented in this case. Petitioner is directed to separate entities in future applications.

2 (Popup)

[2] According *to* the Fama-French model a firm's kook-to-market ratio is a measure of financial distress. Firms with a high book-to-market ratio (a low market-to-book ratio) are financially distressed and require a higher rate of return.

3 (Popup)

[3] Dr. Boquist recommend 11.25% COE in Petitioner's last case and 11.50% in Petitioner's current case.

4 (Popup)

[4] Due to the potential effect of "rate shock", the total sewer increases will be spread over a two year period, the second step to take place one year from the date of this Order.

© Public Utilities Reports, Inc., 2003

PURbase

Re Indiana-American Water Company, Inc.

Cause No. 42043

— PUR4th —

Indiana Utility Regulatory Commission
November 20,2002

Before Ripley, commissioner.

BY THE COMMISSION:

On July 27,2001, Indiana-American Water Company, Inc. filed with the Commission its request for authority to maintain certain of its records outside the state of Indiana pursuant to IC 8-1-2-15.

Following due, legal and timely notice, this Commission held a Prehearing Conference on September 17,2001, and established a procedural schedule including provision for the filing of testimony by Petitioner and the Office of Utility Consumer Counselor ("OUCC" or "Public"). Also pursuant to due, legal and timely notice, this Commission held an Evidentiary Hearing on October 24,2001, at 10:00 a.m., EST, in Room E-306, Indiana Government Center South, 302 West Washington Street, Indianapolis, Indiana at which time evidence was presented by the Petitioner and the Public.

I. Applicable Law, Jurisdiction and Notice. **Petitioner is *a* public utility providing water** service in the State of Indiana and is also a subsidiary of American Water Works Company, Inc. ("AWW"), which owns the common stock of 25 utility subsidiaries throughout the United States. Petitioner proposes to relocate its **physical accounting records** from **Greenwood, Indiana to Mt.** Laurel, New Jersey as part of a shared services initiative with other subsidiary affiliates of AWW. The records of participating affiliates are proposed to be maintained at a Shared Service Center ("SSC") operated by American Water Works Services Company, Inc., **also *a*** subsidiary of AWW. The physical accounting records Petitioner proposes to relocate would include continuing property records, invoices, payroll accounting records, inventory records, construction records, and others generated after November 1,2001.

Indiana Code Section 8-1-2-15 provides in pertinent part that "Each public utility shall have an office in one (I) of the towns or cities in this state in which its property or **some part** thereof is located, and shall keep in said office all books, accounts, papers and records as shall be required by the Commission to be kept within the state. No books, accounts, papers, or records required by the Commission to be kept within the state shall be at any time removed from the state except upon such conditions as may be prescribed by the Commission." As such, the Commission has jurisdiction to consider Petitioner's request for authority to relocate its records.

2. Petitioner's Case-in-Chief. Petitioner's case-in-chief consisted of the testimonies of its employees William J. Wolf, Comptroller, and James L. Cutshaw, its Director of Rates and Revenues. Mr. Wolf testified that as a result of computers, it is no longer necessary for accounting records to be physically located in Indiana for the records to be accessible. Mr. Wolf further testified that because of advances in technology, records such as vendor invoices that would be input at the Shared Services Center would continue to be available at Indiana-American's offices no later than under the current system and that from the time the SSC receives such an invoice, it should take no longer than three days for the invoice to be imaged into the SSC's computer.

Mr. Wolf testified that Petitioner is seeking authority to relocate its records at the SSC in order that its parent corporation, AWW, could realize certain efficiencies by centralizing the location of the accounting records of its utility subsidiaries. Mr. Wolf stated that the initiative would allow associates' skills to be used across the entire American Waterworks System and promote shared knowledge. Mr. Wolf also noted that the SSC could be viewed as an extension of the operating company's staff to ensure the SSC's customers, the operating companies, would receive timely and accurate completion of their requests.

Mr. Wolf stated that Indiana-American will have access to the accounting records electronically for its normal ongoing use. Mr. Wolf also noted the accounting records would be available for the consolidated financial reporting of AWW. Mr. Wolf stated that a single accounting department can more efficiently handle records **maintenance and** accounting functions as compared to the provision of those services by each individual affiliate for its respective operations.

Mr. Wolf testified that the OUCC and the Commission would benefit from the Shared Services by having access to accounting records in Indiana through the computer obviating the need for data requests. To the extent any records are unavailable within the state of Indiana, or it is impractical to make the records available in Indiana, Mr. Wolf testified that Petitioner would reimburse the Commission, its staff and the OUCC for reasonable travel expenses incurred in traveling to the SSC.

Mr. Cutshaw explained the costs Indiana-American will avoid and the costs it would incur by maintaining accounting records at SSC. Mr. Cutshaw testified that Indiana-American would avoid payroll and benefits costs related to 14 positions in the Accounting and Finance departments of the Corporate Office in Greenwood. Mr. Cutshaw noted that Petitioner would be billed a pro rata share of the operating costs of SSC based upon the number of customers of Petitioner compared to the total customers of all American Utility subsidiaries. In addition, Mr.

© Public Utilities Reports, Inc., 2003

Cutshaw noted Petitioner would recognize an annual amortization of its portion of the costs to implement SSC operations. Mr. Cutshaw testified that initial data provided by the service Company indicates that the conversion should be essentially a "wash" in terms of operating expense for Indiana-American after factoring in a ten-year amortization of the allocated implementation costs. Mr. Cutshaw testified that although the proposal does not result in any net avoided costs to Indiana-American, it permits Indiana-American to obtain a superior accounting system without an increase in its accounting costs. Mr. Cutshaw stated that the centralization of the accounting records of American Water utility subsidiaries would result in enhanced availability of records, increase skills of employees in their functional areas, and promote standardization of the accounting systems of Indiana-American and its utility affiliates in other states.

3. *Public's Case-in-Chief.* The OUCC's Director of Rates and Water/Sewer Division, E. Curtis Gassert, testified on behalf of the Public. Mr. Gassert noted the claims made by Mr. Wolf of AWW realizing efficiencies and economies of scale. Mr. Gassert also noted Petitioner indicated three cost reductions in the categories of labor, group insurance: and payroll taxes and two new costs American Water Works Service Company will charge Petitioner in the form of an annual service charge of $1,134,995 and an implementation charge to be amortized over 10 years. Mr. Gassert disagreed with Indiana-American's assertion that zero net revenue effect would result from the shared services initiative. Mr. Gassert testified that data request responses from Petitioner indicate that costs to Indiana-American would actually increase more than the schedules in Indiana-American's then pending rate case reflected (Cause No. 42029). Mr. Gassert noted that documents provided reflect an annual savings of $58,206 but that this amount will be offset by the $2,400,358 implementation costs amortized over 10 years in the amount of $240,036 per year, Mr. Gassert testified that a net increase of $1 81,830 for 10 years would occur as a result. Moreover, Mr. Gassert noted that if one assumes the $58,206 is permanent, it would take 41.23 years for Petitioner to recoup its investment. Conversely, Mr. Gassert noted that the payback period on a program-wide basis was only 2.23 years.

Mr. Gassert further noted that Petitioner's witnesses have not testified that Indiana-American intends to forego recovery of its $1 81,830 amortized investment in future rate cases and suggested the actual costs will be reflected in future cases, Mr. Gassert suggested that Petitioner, as a for-profit utility has an obligation to maximize profits for its shareholders. Moreover, Mr. Gassert testified that even if Petitioner were willing to reduce operations and maintenance expenses by $1 82,000 in all future rate cases, their proposal would not be acceptable since it would not provide *any* cost savings to be obtained from the greater economies of scale that a shared services initiative should be able to obtain.

Mr. Gassert noted that several of AWW's subsidiaries in other states may derive significant benefits from the shared services initiative, but suggested that Petitioner's proposal is to derive cost savings for those: subsidiaries at the expense of Indiana-American's ratepayers.

Mr. Gassert also expressed concern about the regulator's lack of control over affiliated companies noting that Regulators do not have the same access to affiliate books and records as they do those of regulated entities. Without the same oversight, Mr. Gassert suggested it would be difficult for regulators to control affiliate costs regulated companies may seek to include in

© Public Utilities Reports, Inc., 2003

rates. Mr. Gassert further noted that while economies of scale and cost savings can be achieved through the use of affiliates, it makes no sense to pursue transactions where no cost savings are achieved and certainly makes no sense in situations where, as in this case, costs will rise as a result, Mr. Gassert noted that in most orders he reviewed involving a records relocation request, there was an indication of cost savings as a result of the transfer of records outside the state and that in no orders was there any indication of a cost increase.

Mr. Gassert also disagreed with Mr. Wolfs contention that it will be more efficient for OUCC or Commission auditors to get information directly from the new system and that it would require having the OUCC auditors to actually obtain the information from a software system on which they will have no training or experience. Mr. Gassert further noted the importance of being able to address questions directly to the accounting staff who actually made the entries and that regulation of the utility will therefore become less efficient.

Finally, Mr. Gassert noted that if the Commission did allow Petitioner's records to be taken out of the state that it should be subject to the same conditions imposed by the Commission on Indiana-Michigan Power Company in Cause No. 40863. That would include reimbursement to the Commission and OUCC for reasonable travel expenses incurred to travel to the shared services center.

In addition to Mr. Gassert's testimony, the Public submitted into evidence Petitioner's responses to the Public's data request Set No. 1 which consisted of eight questions. Finally the Public requested, without objection, that we take administrative notice of the final orders in Cause No.'s 38923, 39270, 40140, 40444, 40445, and 40863.

4. Petitioner's Rebuttal. Petitioner submitted the testimony of Mr. Wolf and Mr. Cutshaw in rebuttal to the testimony of Mr. Gassert.

Mr. Wolf testified that the benefits of the SSC include not only economies of scale but also significant increases in the quality of the treasury and accounting services that will be provided to Indiana-American and the other regulated subsidiaries of American Water Works Company., Inc. Describing benefits to AWW subsidiaries, Mr. Wolf noted that centralization of tasks by function would lead to their being performed by functional experts, financial and accounting personnel would become more knowledgeable users of the JD Edwards Enterprise Resource System, and the utilization of state of the art computer technology would become feasible due to economies of scale at SSC. In response to Mr. Gassert's concern about the changes in access to Petitioner's records, Mr. Wolf noted that Petitioner would still maintain in Indiana a staff of financial/rate analysts. Mr. Wolf acknowledged that Indiana-American's books and records are currently kept in accordance with Generally Accepted Accounting Principles (GAAP) and the Uniform System of Accounts.

Mr. Wolf testified that when his predecessor was transferred to New Jersey in furtherance of the shared services initiative, he was promoted from Director of Accounting to Comptroller. Mr. Wolf testified that his promotion involved an increase in his salary. Mr. Wolf further testified that if the Commission were to grant the requested relief he would no longer hold the title of Comptroller but would become a senior financial analyst but at his current salary.

In his rebuttal, Mr. Cutshaw disagreed with Mr. Gassert that the increased costs Petitioner

will incur as a result of relocating its records to the Shared Services Center is a reason to deny the relief requested in this cause. Mr. Cutshaw stated that the costs attributable to SSC are not at issue in this proceeding and that in a future rate proceeding the Commission has the ability to disallow any of the expenses incurred in connection with the SSC which it considers to be imprudent or excessive.

Mr. Cutshaw asserted that although some utilities have relied on cost savings to explain why they wish to relocate certain records outside of Indiana, the Commission has never used cost savings as a prerequisite to obtaining permission to maintain books and records outside the state of Indiana. On cross examination, Mr. Cutshaw was asked to read a portion of one of the orders he cited for the premise that the Commission has never used cost savings as a prerequisite. That portion showed that in Cause no. 39270, the Commission indicated it had granted a request under IC 8-1-2-15 in Cause no. 38923 as a result of evidence showing an "ultimate benefit to its customers being the resulting cost savings."

Mr. Cutshaw rebutted Mr. Gassert's concerns about the diminished regulatory oversight over the American Water Works Service Company, Inc. by noting that Ind. Code 8-11-2-49 provides the Commission with **certain authority to regulate affiliate transactions. Mr. Cutshaw added that** the lack of regulatory oversight over the unregulated utilities does not appear to have caused any hardship to ratepayers. However, when asked if the Commission has the same ability to review the records of Indiana-American's affiliates as it does Indiana-American, Mr. Cutshaw stated he did not know the answer to that question.

Mr. Cutshaw disagreed with Mr. Gassert's assertion that the allocation of the Shared Services Companies costs would be unfair to Indiana-American's customers. Mr. Cutshaw asserted that the costs of implementing the shared services are being fairly attributed to each regulated affiliate based on the number of customers each serves but acknowledged that the operations savings to be shared among AWW subsidiaries will not be shared on the same basis.

Mr. Cutshaw agreed that the portion of the implementation cost to be supplied by Indiana-American, $2.4 million, represented a little more than 10 percent of the total cost. He also acknowledged that of the $10,684,862 estimated annual operations savings to be shared among AWW subsidiaries, Indiana-American's portion of $58,206 is less than one percent of the total. Mr. Cutshaw further acknowledged that amount does not include the $2.4 million implementation cost to be born by Petitioner-

Mr. Cutshaw added that the reason Indiana-American is not saving more at this time is because it has already centralized and streamlined its financial functions within the State of Indiana.

5. Commission **Findings.** Indiana Code 8-1-2-15 requires that each public utility have an office in one (1) of the towns or cities in this state in which its property or some part thereof is located, and shall keep in said office all books, accounts, papers and records as shall be required by the Commission to be kept within the state. No books, accounts, papers, or records required by the Commission to be kept within the state shall be at any time removed from the state except upon such conditions as may be prescribed by the Commission.

The Public testified that based on information provided by Petitioner, the resulting costs

savings of $58,206 would be more than offset by the $2,400,358 implementation cost proposed by Petitioner to be amortized over 10 years. Assuming there were no unforeseen cost increases or savings, this would result in a net annual increase in cost of $181,830 to be born by Indiana-American. Petitioner did not dispute this fact.

Rather it suggested through rebuttal testimony that the issue of projected cost increases or savings that would result from the requested relief is not relevant to this proceeding. For instance, Mr. Cutshaw stated that in the final orders in Cause No. 40863 and 40444, no mention is made of costs. But a review of an Order in Cause No. 40863 shows the Commission did, in fact, mention costs by nothing that the petitioner in that cause presented evidence that the relocation will create economies of scale. On cross-examination, Mr. Wolf acknowledged that the term "economies of scale" allows efficiencies that typically imply cost savings to the utility. Likewise, the cases cited by the Petitioner for the proposition that the Commission has never used cost savings as a prerequisite to obtaining permission to maintain books and records outside the state of Indiana suggests the opposite. For instance, our findings and conclusions in the final order of Cause No. 40140 acknowledges the cost savings to be realized by the ratepayers and expresses our reluctance to diminish those savings in order to impose certain access safeguards. Likewise, our factual representations and findings section in our final order in Cause No. 39270 discusses the cost savings afforded by the relocation of records. Thereafter, we used the phrase "Based upon the above" before we found that the petitioner in that cause should be allowed to relocate its records. It cannot be said that we did not use cost savings in that cause as a prerequisite to obtain permission to relocate records out of the state. That final order also acknowledged that, in Cause No. 38923, which was also cited by the Petitioner, evidence was presented to ultimately show the removal of records would provide a benefit to customers through resulting cost savings and that as a result the Commission granted the requested relief.

We do not agree that a projected cost increase to Indiana-American is irrelevant to this proceeding. If we have not made that more clear in our previous orders, it is due to the fact that we have never before been faced with the prospect of a records relocation request for the sake of efficiency that will actually result in projected cost increases to the requesting utility.

As we noted in our final order in Cause No. 40863, "The removal of a public utility's books and records from Indiana is not a matter of right but rather is a privilege which is subject to the discretion and the requirements of the IURC." Moreover, the Commission in that cause responded to the claim that it would be discriminatory for the Commission to deny or restrict petitioner's request as unfounded. The Commission rioted that in prior proceedings on petitions for removal of records, the OUCC had not challenged the removal of records. Therefore, the Commission was free to consider the OUCC's evidence and deny or limit the requested relief. Unlike the request in Cause No. 40863, it is uncontested that the requested relief in this matter would cause a net cost increase at least for the first ten years.

Moreover. we note the significant inequity among AWW's 23 utility subsidiaries. This inequity results from the lack of correlation between shared implementation costs and resulting cost savings. Petitioner's responses to the Public's data request included a list of all participating AWW subsidiaries with number of customers for each utility, the amount each utility will be paying in implementation costs and the total cost of the initiative. Of the total cost of

© Public Utilities Reports, Inc., 2003