ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN WATER COMPANY, INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER AND SEWER SERVICE AND FOR APPROVAL OF NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO	)	CAUSE NO. 42520
	)	APPROVED: NOV 1 8 2004

BY THE COMMISSION:
Judith G. Ripley, Commissioner
William G. Divine, Administrative Law Judge

INDIANA UTILITY REGULATORY COMMISSION

ORDER

CAUSE NO. 42520

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ORDER

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I. BACKGROUND

On September 30, 2003, Indiana-American Water Company, Inc. ("Petitioner," "Indiana-American" or "Company") filed its *Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements* ("Petition") with the Indiana Utility Regulatory Commission ("Commission"), seeking authority to increase its rates and charges for water and sewer service and for approval of new schedules of rates and charges applicable thereto. Petitioner's notice of its intent to file in accordance with the Commission's rules on minimum standard filing requirements ("MSFRs") was given pursuant to 170 IAC § 1-5-1 *et seq.* (2000).

Pursuant to notice and as provided in 170 IAC § 1-1.1-15 (2000), a Prehearing Conference was convened in this Cause on November 6, 2003, at 9:30 a.m. EST, in Room E306, Indiana Government Center South, Indianapolis, Indiana. Proofs of publication of the notice of the Prehearing Conference have been incorporated into the record and placed in the official files of the Commission. Attending the Prehearing Conference were Petitioner and the Indiana Office of Utility Consumer Counselor ("OUCC" or "Public"). The procedural, scheduling, and other matters determined at the Prehearing Conference were memorialized in the Commission's Prehearing Conference Order approved and issued on November 20, 2003.

Petitions to intervene in this Cause were filed on November 14, 2003, by the Town of Schererville; on December 12, 2004, by a group of industrial customers of Indiana-American ("Industrial Group"); and on February 13, 2004, by the Town of Merrillville. These petitions to intervene were granted by Docket Entries issued on December 5, 2003, December 29, 2003, and February 24, 2004, respectively, thereby making these entities parties to this Cause.

Pursuant to notice published as required by law, a public Evidentiary Hearing commenced on January 13, 2004, at 9:30 a.m. EST, in Room TC-10 of the Indiana Government Center South, Indianapolis, Indiana. Proofs of publication of the notice of such hearing were incorporated into the record of this proceeding by reference. During the Evidentiary Hearing conducted on January 13 and 14, 2004, evidence constituting Indiana-American's case-in-chief was offered and admitted into the record and its witnesses were offered for cross-examination.

On January 14, 2004, the Evidentiary Hearing was continued to January 27, 2004, for the purpose of conducting, pursuant to Ind. Code § 8-1-2-61(b), a public field hearing in the City of Gary, which is the largest municipality in Petitioner's service area. During this public field hearing, members of the public provided oral and/or written testimony in this Cause. On January 27, 2004, the Evidentiary Hearing was continued to February 18, 2004, for the purpose of conducting an additional public field hearing in the City of Jeffersonville, at which time members of the public provided oral and/or written testimony in this Cause. On February 18, 2004, the Evidentiary Hearing was continued to February 25, 2004, for the purpose of conducting, in the City of Muncie, a third public field hearing, at which time members of the public provided oral and/or written testimony in this Cause.

On February 25, 2004, the Evidentiary Hearing was continued to March 5, 2004, the date established in the Prehearing Conference Order for the parties to present any settlement and evidence in support thereof. The parties advised that they had not reached any settlement and, on March 5, 2004, the Evidentiary Hearing was continued to April 19, 2004. During the Evidentiary Hearing conducted on April 19, 20 and 21, 2004, evidence constituting the respective cases-in-chief of the Public and the intervening parties was offered and admitted into the record and their witnesses were offered for cross-examination. In addition, Petitioner's rebuttal evidence was offered and admitted into the record, and Petitioner's rebuttal witnesses were offered for cross-examination. The Evidentiary Hearing in this Cause was adjourned on April 21, 2004.

Having considered all of the evidence presented in this proceeding, and based on the applicable law, the Commission now finds:

II. NOTICE AND JURISDICTION

Due, legal and timely notice of the Petition filed 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 other 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(a)(2) 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. Accordingly, this Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

III. PETITIONER'S CHARACTERISTICS

Petitioner is an Indiana corporation engaged in the business of rendering water utility service to approximately 272,000 customers in twenty-one (21) counties in the State of Indiana. 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 Wabash County in Somerset, Indiana and in Delaware County in or near Muncie, Indiana.

IV. CORPORATE HISTORY

Indiana-American was formed in 1983 from the merger of five (5) 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. In 1999, American acquired the common stock of the parent company of Northwest Indiana Water Company ("Northwest"). Northwest was merged into Indiana-American on January 1, 2000. On February 1, 2000, Indiana-American acquired the common stock of United Water West Lafayette Inc. and United Water Indiana Inc. (collectively "United"), and on the same day United was merged into Indiana-American. Petitioner also has made a number of smaller acquisitions in recent years.

In addition, American was acquired recently by an international water company. American is a holding company that owns the common stock of subsidiaries (such as Indiana-American) which provide water utility services, wastewater utility services and other water resource management services to approximately fifteen (15) million people in twenty-eight (28) states and three (3) Canadian provinces. In 2003, American was acquired by Thames Water Aqua Holdings GmbH ("Thames Water"), a subsidiary and the water division of RWE AG, an international, multi-utility service provider, organized under the laws of the Federal Republic of Germany. RWE AG's core businesses are in electricity, water, gas, waste management and utility-related services. RWE AG is active in more than 120 countries on six (6) continents.

V. EXISTING RATES

Petitioner's existing basic rates and charges for water and sewer service were established pursuant to the Commission's Orders in Cause No. 42029 dated November 6, 2002; January 22, 2003; and December 30, 2003 ("2002 Rate Order"). Petitioner also implemented a Distribution System Improvement Charge pursuant to Ind. Code § 8-1-31 and the Commission's Order in Cause No. 42351-DSIC 1, dated February 27, 2003. Since its last rate case, Indiana-American also has implemented public fire protection surcharges in four (4) communities pursuant to Ind. Code § 8-1-2-103(d) and the Commission's Orders in Cause Nos. 42285, 42470, 42449 and 42566.

VI. RELIEF REQUESTED

Petitioner originally proposed that its rates be increased by 14.31%. (*Petitioner's Exhibit JLC-1, Sched. 1*, line 36.) Prior to the final hearing, Petitioner filed supplemental direct testimony and exhibits reducing the requested increase to 10.55% to reflect a rate base true-up, Petitioner's capital structure at December 30, 2003, the issuance of the Order in Cause No. 42029 dated December 30, 2003, regarding Petitioner's security expenses, and the receipt of some updated property tax information. (*Petitioner's Exhibit JLC-1-UA, Sched. 1*, line 36.) The requested increase was further reduced as a result of the filing by Petitioner of final property tax rates available from the Department of Local Government Finance as of the close of the record. These updated rates covered all counties where Petitioner has property except for Clark County. The effect of the updated property tax information is discussed in the *Property Tax* section of this Order. (*See* Sect. IX. B. 14.) In addition, Petitioner proposes further movement toward common rates in this proceeding.

VII. TEST YEAR

As provided in 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 twelve (12) months ended June 30, 2003. The financial data for this test year, when adjusted for changes as provided in the Prehearing Conference Order, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

VIII. TESTIMONY FROM FIELD HEARINGS IN GARY, JEFFERSONVILLE AND MUNCIE

The Commission conducted three (3) public field hearings in this proceeding as forums for affected ratepayers to express their views about Petitioner's proposed rate increase. These field hearings were conducted in the northern part of the State in the City of Gary, in the southern part of the State in the City of Jeffersonville, and in the central part of the State in the City of Muncie. Below are summaries of the testimony presented in each of these field hearings.

A. City of Gary Field Hearing

This field hearing, conducted on January 27, 2004, at Indiana University Northwest, 3400 Broadway, Gary, Indiana, satisfied the requirement of Ind. Code § 8-1-2-61(b), which states:

> In any general rate proceeding under subsection (a) which requires a public hearing and in which an increase in revenues is sought which exceeds the sum of two million five hundred thousand dollars ($2,500,000), the commission shall conduct at least one (1) public hearing in the largest municipality located within such utility's service area.

Lawful notice of this public field hearing was published in newspapers serving Johnson, Lake and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. At the hearing, members of the public shared their concerns regarding Indiana-American's proposed rate increase, the Company's quality of customer service and water quality. In addition to the oral and written testimony received at the hearing, some individuals not in attendance at the field hearing mailed or electronically mailed comments to the OUCC, which were later filed with the Commission.

A majority of the oral and written testimony remarked on the frequency of Indiana-American's rate increases and the high rates of increase on Lake County consumers and those in the surrounding service area. Witnesses testified that most households have had two (2) water use and sewer rate increases in the last three (3) years, while other users cited three (3) rate increases. The consumers stated their water use rates were 38% higher than before Indiana-American purchased Northwest; another increase of approximately 14% would create a difficult burden on them and would be particularly hard on those individuals with fixed incomes. Witnesses remarked that any increase by the water utility would be unbearable, particularly given the broad increase in property taxes on Lake County residents. An individual consumer questioned the need for increased rates since the water sources were close to the service areas. Also, a representative of a municipal fire department noted that Indiana-American's proposed Public and Fire Protection rate increase appeared high and did not reflect the trend of minimal hydrant use in the community.

In addition, consumers maintained that the Commission should not order a rate increase to help the utility finance its increasing insurance costs, refinance the debt from facility acquisitions or improve employee benefits and pensions -- priorities stated in the Company's informational materials included in billing statements. First, ratepayers asserted that Indiana-American should absorb these costs as part of doing business and not ask for additional funds from consumers to meet expected and predictable increases in operating and acquisition expenses. Reflecting on their own positions, ratepayers living on fixed pensions or Social Security benefits noted that they are expected to pay their increasing insurance and other financial obligations without seeking additional funds. Second, small business owners and local and state government representatives asserted that the parent company and Indiana-American's shareholders, not the ratepayers, should finance these expenses by reducing the anticipated rate of return on the company's investment or exercising more effective fiscal discipline. Many residents do not believe that consumers should compensate the company for acquiring investment property through higher rates.

While some individual consumers acknowledged Indiana-American's investments in the Northwest facility, other consumers noted better customer service and a better water product prior to the company's acquisition of Northwest and the other small water utilities. Concerned with water quality, many consumers reported having to purchase bottled water to drink due to their tap water's high chlorination and chemical odor and taste, all while paying higher water rates. Some residents complained of receiving very low estimated water use and sewer bills for months prior to receiving a significantly higher bill based on metered readings. One municipal entity stated that Indiana-American's lack of communication and cooperation when the municipality made road repairs resulted in additional road expenses after an underground water pipe burst.

B. City of Jeffersonville Field Hearing

This field hearing was conducted on February 18, 2004, at KYE's, 400 Missouri Avenue, Jeffersonville, Indiana. Lawful notice of the hearing was published in newspapers serving Clark, Floyd, Johnson and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. Witness testimony focused on the proposed rate increase, Indiana-American's presence in southern Indiana and ratepayers' water quality.

A majority of individuals testifying voiced concerns over Indiana-American's proposed rate increase. Citing Indiana-American's approved rate increase in 2002, individual ratepayers observed that Indiana-American waited less than two (2) full years before seeking another rate increase and that the Company's current proposal represents a distressing trend. Individuals expressed concern with the projected amount of the increase, which they perceived to be nearly three (3) times as great as the 2002 actual rate increase. One individual, recalling that Indiana-American promised that consumers would receive benefits and savings achieved through the Company's acquisition of other water utilities and building economies of scale, questioned the need for a rate increase before consumers received the promised savings. Other individual users stated that a rate increase, so soon after the last increase, combined with additional county assessments on water treatment and water run-off would further stress household budgets -- budgets already burdened by the statewide, court-ordered property tax reassessment. Many individuals in attendance voiced their opposition to increased rates that would allow Indiana-

American to improve employee benefit and pension plans and pay for existing facilities when the company will not improve water quality, be more responsive to customers and those with billing inquiries, implement a satisfactory complaint process or aid individuals on fixed incomes as permitted under Indiana law.

Witnesses offered mixed assessments of Indiana-American's impact on and presence in southern Indiana. Two individuals representing not-for-profit organizations promoting business interests in the region complimented Indiana-American's major investments in improving regional water distribution, installing new water mains and expanding water service to small communities. They acknowledged that Indiana-American's investments aided economic growth by improving the infrastructure necessary to retain and attract commercial users, and concluded that Indiana-American should be permitted to make a return on the company's investment. However, small business owners testified that the past rate increases and those proposed in this Cause would further burden their businesses and make it more difficult to compete against like businesses serviced by other, locally-owned water providers charging lower water usage and sewer rates. A business owner anticipated that another rate increase to support Indiana-American's facilities and employee pension and benefits packages would negatively impact his own plant and facility and employee salaries and benefits. An owner of a property management company, who had a negative experience with Indiana-American's Alton, Illinois Customer Satisfaction Center ("Customer Satisfaction Center," "Alton CSC," "Alton Center") in November and December 2003, did not believe his needs were adequately addressed by an out-of-state representative.

Lastly, individual homeowners and private landlords commented on the poor water quality coming from their home water taps. Those testifying asserted that their tap water smelled of chlorine for as few as two (2) to three (3) days per month to having a continuous odor. They claimed they did not drink their tap water, consuming bottled water instead. Also, they commented that they did not complete common household tasks (i.e., laundry) using tap water when the water was heavily chlorinated. One witness at the hearing would favorably consider Indiana-American's proposed rate increase if the water quality improved.

C. City of Muncie Field Hearing

The final field hearing in this Cause was conducted on February 25, 2004, at City Hall, 300 North High Street, Muncie, Indiana. Lawful notice of the hearing was published in newspapers serving Delaware, Johnson and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. At the hearing, attendees shared their concerns regarding Indiana-American's proposed rate increase and the Company's inadequate response to sewer problems in Farmington Meadows, a Muncie residential development. In addition to the oral and written testimony received at the hearing, some individuals not in attendance at the field hearing mailed or electronically mailed comments to the OUCC, which were later filed with the Commission.

Like residents at the prior field hearings, those attending the Muncie hearing voiced their strong disapproval of Indiana-American's recent proposal for water and sewer rate increases within two (2) years of filing the Company's last request. Echoing the comments of consumers in

Gary and Jeffersonville, some Muncie area residents urged the Commission to deny Indiana-American's proposed 15% to 19% rate increase to finance the company's increasing insurance costs, refinance the debt from facility acquisitions and improve employee benefits and pensions. Consumers stated that Indiana-American should pay for these expenses out of existing corporate funds and assets, such as anticipated profits, and not rely on consumers repeatedly to finance anticipated corporate expenses and planned acquisitions. Lastly, senior citizen and single-adult household consumers with limited incomes, particularly those living in the Farmington Meadows subdivision in Muncie, expressed their difficulty paying present high sewer and water rates, noting that increased rates by Indiana-American would strain their fixed budgets already pressured by increased taxes and rising insurance and health costs.

Residential consumers attending the field hearing reminded the Commission that Indiana-American provides all water service to Muncie residents, but only a portion of Muncie's sewer service, in the Farmington Meadows subdivision; the Muncie Sanitary District ("MSD") provides sewer service to residences surrounding Farmington Meadows and beyond. The president of the Farmington Meadows Association and many members of the Association supplied testimony and written comments noting that that Indiana-American has been aware of a problem with one of the sewer lines from the subdivision but has failed to identify, communicate precisely or remedy the problem. The utility's failure to communicate and act has resulted in subdivision residents paying a flat monthly rate for sewer service that amounts to more than double the amount an average resident is charged by MSD. Farmington Meadows residents voiced displeasure with their current high sewer and water rates and strongly opposed any increase in sewer or water rates without dramatically improved customer service and maintenance.

IX. RATE BASE

A. Original Cost

In its case-in-chief, Petitioner presented the actual plant balances at the end of June 2003 and August 2003 and a pro forma rate base reflecting projected changes in Petitioner's rate base components. Petitioner's proposed rate base in its proposed order also reflects the retirement of the old water intake tunnel in the Northwest Operation and the retirement of computers no longer being used. In its supplemental direct testimony and exhibits, Petitioner updated its rate base to reflect actual balances as of December 31, 2003, and the actual cost of the Enhanced Customer Information System ("E-CIS") project. The amount included for the E-CIS project in the original filing was estimated. For the purpose of our consideration of the E-CIS project, we find that it meets the definition of "major project" in the MSFRs and was placed in service on March 8, 2004, which is more than ten (10) business days before the final hearing. However, we also note the OUCC maintains that the E-CIS project was purchased by Indiana-American's parent company and Indiana-American's allocated portion should be considered an operating cost and part of Indiana-American's costs of participating in the Alton Customer Satisfaction Center.

There were five (5) contested differences between Petitioner's original cost rate base and that of the OUCC. The OUCC proposed the following exclusions from rate base: (1) the cost of one well in the Seymour Operation and one high service pump in the Southern Indiana

Operations and Treatment Center ("SIOTC"), (2) the E-CIS project[1], (3) certain assets for which it said it could not find sufficient detail, (4) certain replacement meters and (5) the Company's building in Richmond. There is a sixth difference resulting from the OUCC's proposal to change our policy of allowing depreciation expense on contributions in aid of construction ("CIAC") and the OUCC's corresponding amortization of CIAC, which we shall address in our discussion of operating expenses. (*See,* Sect. XI. B. 4. Depreciation Expense on Contributions in Aid of Construction.) The Company did not contest the OUCC's elimination of acquisition adjustments for the Turkey Creek and Westwood acquisitions. No other party presented evidence on original cost rate base.

1. Excess Capacity

OUCC's Position. Roger A. Pettijohn, a Utility Analyst for the OUCC's Sewer/ Water/Rates Division, proposed to remove from Petitioner's rate base as excess capacity one of the five (5) wells used by Petitioner to provide service in the Seymour Operation. (*Public's Exhibit 4*, p. 10, lines 9-19.) Mr. Pettijohn testified that Seymour's peak day usage is approximately four (4) million gallons per day ("MGD"). Because each of the five (5) wells is individually capable of producing 1,100 gallons per minute or 1.54 million gallons per day, Mr. Pettijohn believed only three (3) of the five (5) wells are needed to meet the peak day usage for Seymour. (*Id.* at p. 10, lines 13-15.) Mr. Pettijohn proposed a similar adjustment for the SIOTC, removing as alleged excess capacity one high service pump. (*Id.* at p. 10, line 20 through p. 11, line 3.) Mr. Pettijohn testified that according to the *Recommended Standards for Waterworks* only four (4) high service pumps were necessary to meet peak demand with the largest pumping unit out of service. (*Id.* at p. 10, lines 20-23.) As a result of Mr. Pettijohn's recommendations, the OUCC proposed to remove $987,967 from utility plant in service and $253,441 from accumulated depreciation.

Petitioner's Rebuttal. Petitioner's witness Alan J. DeBoy, Vice President of Engineering for Indiana-American, explained why it was necessary to construct five (5) wells in Seymour and five (5) high service pumps at the SIOTC. (*Petitioner's Exhibit AJD-R*, p. 4, lines 5-8; p. 5, lines 17-19.) With respect to Seymour, Mr. DeBoy testified that if the total nominal capacity of three (3) of the five (5) wells is simply summed, it would suggest those three (3) wells have capacity to supply enough water to meet the Seymour peak day usage. However, this ignores the impact each well has on the others. He testified that the actual capacity of the wells is below the simple sum of the nominal capacities when three (3) or more are running simultaneously. (*Id.* at p. 4, lines 5-8, 11-12.) Mr. DeBoy explained that this is because the wells have an influence on each others' individual capacity due to pumping level impact (aquifer

[1] Petitioner witness Mr. James L. Cutshaw, a Senior Financial Analyst for Indiana-American, filed supplemental testimony and requested that the Commission approve the return on and of $6,248,821 related to the purchase and development of the E-CIS software. (*Petitioner's Exhibit JLC-U*, pp. 7-9; *Petitioner's Exhibit JLC-UA*, line 21, col. 2.) The OUCC recommended that the $6.2 million associated with the E-CIS software be disallowed and removed from rate base and that Petitioner be denied the $282,528 in amortization costs of the $1.3 million deferred asset balance associated with the conversion to the Alton CSC. Finally, the OUCC recommended that the Commission accept its $194,360 downward adjustment to offset the increased O&M costs that are embedded in Petitioner's management fee adjustment for the Customer Satisfaction Center. Given the assertions of the OUCC and the relationship between the Alton CSC and the E-CIS software, we will address both of these items in the Operating Expense section of this Order. (*See* Sect. XI. B. 5. Operating Results Under Present Rates.)

characteristics) and hydraulic condition changes under different flow rates. (*Id.* at lines 14-17.) Mr. DeBoy noted that historical operating data indicates that when various combinations of three (3) wells in Seymour operate simultaneously, the combined output ranges from 3.9 MGD to 4.1 MGD, which is below the maximum day of 4.3 MGD recorded in August 2002. (*Id.* at lines 17-23.) Consequently, four (4) simultaneously operating wells are necessary to satisfy the current maximum day demand leaving one well for back-up should a failure occur in one of the other wells. (*Id.* at p. 5, lines 1-3.)

Mr. DeBoy also testified that Mr. Pettijohn had not taken into account the design and construction characteristics of the SIOTC clear water reservoir in evaluating the number of high service pumps necessary to meet Petitioner's peak demand. (*Id.* at lines 17-19.) Mr. DeBoy explained that the SIOTC clear water reservoir was designed to include two (2), one million gallon compartment areas so that either of the one million gallon compartments can be removed from service for maintenance or rehabilitation. (*Id.*) Three (3) pumps serve the west reservoir and have a total capacity of 28 MGD, and two (2) serve the east reservoir and have a total capacity of 22 MGD. (*Id.* at p. 5, line 22 through p. 6, line 5.) Mr. DeBoy testified that all five (5) of the pumps are necessary to ensure that Petitioner can meet its peak demand with one of the reservoirs out of service.

Commission Discussion and Findings. In the rate order we approved for Petitioner in 1997, we listed factors that must be addressed in considering the appropriate level of capacity:

(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 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.

N. Ind. Pub. Serv. Co., Cause No. 37458, 67 PUR4th 396, 401-02 (PSCI, Date Issued June 19, 1985). To this we will add another factor particularly important for water utilities -- the utility's need to comply with the requirements of environmental agencies.

Ind.-Am. Water Co., Cause No. 40703, 15-16 (Indiana Utility Regulatory Commission, Order Issued Dec. 11, 1997) ("1997 Rate Order").

In its rebuttal testimony, with respect to the Seymour wells, Petitioner explains that the simultaneous running of the various wells results in a capacity level that is less than the sum of each individual well's capacity. The OUCC's contention that only four (4) wells are necessary is based on the sum of each individual well's capacity. Petitioner explains that four wells would need to run simultaneously in order to achieve the historical daily maximum capacity of 4.3 MGD, even though the nominal capacity of each well is 1.54 MGD. Under such circumstances, Petitioner would have only one backup well. We find that Petitioner has demonstrated an appropriate level of capacity with respect to its five (5) Seymour wells.

Regarding the five (5) pumping units at the SIOTC, the OUCC relies on the recognized expertise of *Recommended Standards for Waterworks* to demonstrate that Petitioner has excess pumping capacity of 15.7 MGD with its largest pumping unit out of service. Petitioner attempts to rebut this contention by discussing an isolation feature in the clear water reservoir associated with the high service pumps in question. This feature is explained as the ability to divide the reservoir into two (2), one million gallon compartments, and to take one compartment out of service for rehabilitation and maintenance work while the other compartment is in service. According to Mr. DeBoy, each compartment should have pumping capacity to meet peak day demand, and therefore, no excess capacity currently exists.

Mr. DeBoy's rebuttal testimony indicates that this feature has not yet been used but will be needed "at some point in the future." The non-contradicted evidence established that Petitioner, with the largest unit out of service, has 15.7 MGD more capacity than the required 22 MGD. Since Petitioner's case to reject the alleged excess capacity is founded on justifying the need to have this reservoir-isolation technique, we thus need to determine whether this feature is used and useful. Mr. DeBoy's testimony on this point is limited to testifying that reservoir maintenance will be needed at some point in the future. We note that this is the first time this specific feature has been brought to our attention and has not been a contested issue in Petitioner's previous cases. Therefore, we shall make our decision based on the evidence of record that we now have before us. We find that Petitioner did not provide evidence to support the time frame within which this engineering feature will be used and useful. Further, we find Petitioner's evidence lacked information that we deem necessary in order to allow this plant in rate base, this information includes but is not limited to:

- the frequency that the reservoir maintenance occurs,
- the amount of time necessary to carry out the maintenance of the reservoir,
- the time of year when Petitioner plans to carry out the maintenance of the reservoir,
- whether Petitioner could implement the reservoir maintenance during non-peak months, and
- whether Petitioner needs five (5) pumps at the SIOTC if the reservoir's maintenance could be implemented during non-peak months.

We find that Petitioner's rate base should be reduced by $753,378 for excess capacity at the SIOTC and that the accumulated depreciation should be also reduced by $232,248.

2. Miscellaneous Rate Base Reductions

OUCC's Position. OUCC Utility Analyst Dana M. Lynn proposed several adjustments based on two (2) issues that resulted in a reduction to Petitioner's proposed original cost rate base of $179,994. The first issue raised by the Public was Petitioner's failure to provide adequate support for the level of costs it proposed to include in rate base. Ms. Lynn testified that Petitioner added over $149 million in fixed asset additions over the last three (3) years. She testified that she made numerous attempts to review a small percentage of Petitioner's utility plant. She explained that, on numerous occasions, she addressed questions to Indiana-American employees James L. Cutshaw, a Senior Financial Analyst for Petitioner; William J. Wolf, Petitioner's Director of Rates and Planning; and Ms. Sharon Keeney, Mr. DeBoy's Assistant. She also provided both informal and formal discovery to attempt to review fixed asset records. (*Public's Exhibit 3*, p. 18, lines 22 through p. 19, line 8.) She testified that the documentation Petitioner ultimately provided almost two (2) months later through a formal request was still inadequate. (*Id.* at p. 17, lines 21-23.) Ms. Lynn stated that Petitioner's delay substantially limited the amount of time for the OUCC's review. (*Id.* at p. 22, lines 26 through p. 23, line 2.) Ms. Lynn pointed out that it took Petitioner several attempts to provide the detail that it purported would support her request. Ms. Lynn testified that of the ten (10) fixed asset additions she ultimately reviewed, Petitioner provided adequate support for only one-half of those. The OUCC has proposed that the remaining five (5) assets be reduced from Petitioner's rate base by $170,703, which is the amount that Petitioner failed to support. (*Public's Exhibit 3, Sched. DML-1*, p. 1.) Ms. Lynn stated that none of Petitioner's staff could successfully retrieve full information from Petitioner's computerized accounting system. (*Public's Exhibit 3*, p. 19, lines 16-20.)

The second issue raised by the Public was Petitioner's accrual of Allowance For Funds Used During Construction ("AFUDC") on comprehensive planning studies, amendments to comprehensive plans and tank inspections reports. Ms. Lynn proposed to reduce Utility Plant in Service and Accumulated Depreciation by $13,380 and $4,089, respectively. Ms. Lynn further testified that Petitioner accrued AFUDC in excess of the cost of the tank inspection reports Petitioner capitalized in 2002. She explained that Accounting Instruction 19 in the 1996 National Association of Regulatory Utility Commissioners' ("NARUC") Uniform System of Accounts for AFUDC states that "AFUDC includes the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used." (*Id.* at p. 24, lines 1-3.) She stated that comprehensive planning studies and tank inspections are not considered a capital asset under NARUC's description of components of construction. (*Id.* at lines 7-13.) Ms. Lynn stated that these costs are more properly considered maintenance costs and should not be included as a component of rate base. She stated that Petitioner defines maintenance costs by referring to the NARUC Uniform System of Accounts:

> - Inspecting, testing, and reporting on condition of plant specifically to determine the need for repairs, replacements, rearrangements and changes, and inspecting and testing the adequacy of repairs which have been made.

> - Work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant.

Id. at lines 16-24.

Ms. Lynn explained that comprehensive planning and tank inspections are clearly defined as maintenance costs and Petitioner should not capitalize these costs and, moreover, should not accrue AFUDC. The net effect of Ms. Lynn's adjustment is a recommended reduction to rate base of $9,291.

Petitioner's Rebuttal. Petitioner's witness DeBoy testified that he reviewed the specific projects where Ms. Lynn recommended rate base adjustments due to recorded expenditures that were not fully supported and stated he was able to substantiate and verify the appropriateness of all costs booked for these projects. (*Petitioner's Exhibit AJD-R*, p. 8, lines 21-23.) He stated copies of the supporting information for these assets are found in Petitioner's Exhibit AJD-R1. Mr. DeBoy explained in step-by-step fashion how the supporting information was retrieved from Petitioner's computerized accounting system. Mr. DeBoy testified that additional assistance can be provided to the OUCC in the future to satisfy its audit process. (*Petitioner's Exhibit AJD-R*, p. 9, lines 10-12.) As to Petitioner not supporting the cost of a building in Richmond that had been used to house Petitioner's call center, Mr. Cutshaw testified that once Petitioner responded to the Public that it did not have the purchase agreement for the Richmond Building, he did no further research until the Public filed its testimony and exhibits which excluded the building purchased in 1994. (*Petitioner's Exhibit JLC-R*, p. 3, lines 12-17.) In its rebuttal testimony, Petitioner provided a warranty deed and a memo memorializing the terms of the agreement. Mr. Cutshaw testified that only $435,332 of the purchase price has been included in rate base since Cause No. 40103 (Cause No. 40103, 169 PUR4th 252 (Indiana Utility Regulatory Commission, Date Issued May 30, 1996), "1996 Rate Order").

Petitioner's witness Mr. Wolf explained why Petitioner was unable to provide the data requested by the OUCC. He testified that the fixed asset records requested by Ms. Lynn are not routinely accessed by Petitioner's finance staff. Instead, the Petitioner's field personnel are proficient at navigating this part of Petitioner's J.D. Edwards accounting system because they use it on a daily basis. Mr. Wolf testified that in future cases, Petitioner's finance staff will undergo further training so as to be more helpful. (Tr. pp. H-66 - H-67.)

Mr. DeBoy also responded to the accrual of AFUDC. He testified the comprehensive planning studies and tank inspections are engineering functions that ultimately lead to capital projects. Since engineering functions which lead to capital projects are typically capitalized and AFUDC accrued, Mr. DeBoy testified that Ms. Lynn's adjustment should be rejected. (*Petitioner's Exhibit AJD-R*, p. 9, lines 18-22.)

Commission Discussion and Findings. Our concern about Petitioner's fixed asset records not being accessible to the Public was previously discussed in our Order in Cause No. 42029, wherein we stated the following:

> We are troubled by the uncontroverted revelations of Ms. Lynn, wherein she noted the difficulties that 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 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 $41,588 in interior design fees[;] $194,477 in cubicles, countertops, overhead cabinets, filing cabinets and electrical services, associated with the displaced employees from the shared service initiative[;] and $241,362 for office remodeling for the Gary location that she could not reconcile due to inadequate documentation.

Ind.-Am. Water Co., Inc., Cause No. 42029, 22-23 (Indiana Utility Regulatory Commission, Date Issued Nov. 6, 2002).

It appears that our concern raised in Order Nos. 42029 and 42043 about the adequacy and accessibility of Petitioner's fixed asset records has not been fully addressed. (*See 2002 Rate Order* and *Ind.-Amer. Water Co.*, Cause No. 42043 (Indiana Utility Regulatory Commission, Date Issued Nov. 20, 2002).) Petitioner has added over $149 million in fixed assets over the last three (3) years and requests that we include these improvements in rates. Petitioner did not dispute any of the difficulties raised by Ms. Lynn and in fact concurred that they could not provide her the documentation she needed to review fixed assets. (*See Petitioner's Exhibit WJW-R;* Tr. p. H-66, lines 9-12.)

A review of the documentation provided by Mr. DeBoy to rebut Ms. Lynn's adjustment suggests, for the most part, a lack of adequate documentation. For example, the documentation Petitioner provided to support the $70,458 for the tank painting located at Interstate 65 includes $24,246 identified as a monthly allocation of CWIP overhead and an additional $30,709 in engineering fees that are supported by nothing more than a print screen from Petitioner's J. D. Edwards system. There is nothing to explain why these costs were necessary and what was included in these costs. Furthermore, it appears from Petitioner's documentation that at times it charges engineering costs based on monthly allocations and not as direct charges. Also, for example, the credit card statement for Jeff G. Robinson does not add to the reconciliation provided by Petitioner. There are no references that tie any of the task order numbers to the asset numbers identified by Ms. Lynn, and it appears that certain assets have more than one task order number. Finally, Petitioner paid over $3,800 in sales tax for a piece of equipment that is used in the provision of providing water, thus, sales tax should not have been paid.

Given this recurrence of the OUCC's inability to fully obtain needed information from Petitioner, it seems reasonable to conclude that Indiana-American has been unwilling to fully cooperate in allowing the OUCC to carry out its responsibility to protect the public interest when a public utility is seeking a rate increase. A full review of the OUCC's testimony on this issue reveals unacceptable responsive conduct by Petitioner to discovery requests made by the OUCC. Petitioner has presented no acceptable reason as to why any of the information sought by the OUCC, whether in electronic or paper form, should not be readily available, organized and, if needed, explainable. What confounds Petitioner's conduct all the more is, first, that the OUCC's responsibility as the public advocate in a proceeding such as this is well explained by statute, including its right to examine Petitioner's records. Second, by filing for relief under the Commission's MSFRs, Petitioner is seeking a resolution to its request for a rate increase within an expedited timeframe. This expedited timeframe does not allow for any party to have to endure an unreasonable lack of cooperation in its discovery efforts. Petitioner has stated that it can be more helpful in future cases. We hope so. In the meantime, having reviewed the OUCC's frustration as well as the information actually provided and not provided by Petitioner, we find, with the exception of the Richmond building, that Petitioner has not adequately supported the costs associated with the assets Ms. Lynn removed from rate base and find that these assets should be removed from Petitioner's proposed rate base. With respect to the Richmond building, we find the warranty deed provided by the Petitioner adequately supports the amount included in the rate base.

Finally, we agree with the Public that Comprehensive Planning Studies and Tank Inspection Reports are not components of construction and, therefore, should neither be capitalized nor accrue AFUDC. Petitioner claimed these costs are "engineering functions" that ultimately *lead* to capital projects, and we agree. (*Petitioner's Exhibit AJD-R*, p. 9, line 19.) These engineering functions are used to evaluate what Petitioner's system may or may not need. A comprehensive plan is typically a current and projected analysis of a utility system's needs, and tank inspections are performed to evaluate the condition of a tank. Both tank inspections and comprehensive plans involve inspections, testing and reporting on the condition of plant specifically to determine the need for repairs, replacements, rearrangements and changes. These types of engineering functions can also be performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant. Based on Petitioner's definition of maintenance expense and the Accounting Instruction contained in the NARUC Uniform System of Accounts that defines AFUDC, tank inspections and comprehensive planning studies should not be considered a component of construction and, thus, should not be included as a capitalized cost that accrues AFUDC. We believe that comprehensive plans are for planning and a Preliminary Engineering Report ("PER") may be developed from this plan, but it is the PER that is part of the construction project. Neither a comprehensive plan nor a tank inspection report is ever placed in service. It is unreasonable to suggest that AFUDC should accrue on planning tools that may identify the need to develop a project in the future. Accordingly, we accept the OUCC's net adjustment, and reduce rate base by $9,291. We direct Petitioner for all future costs associated with tank inspections and comprehensive planning to expense these costs as they occur.

The Public has raised another issue associated with Petitioner's Tank Inspection Reports that merits discussion. According to the OUCC, Petitioner's early retirement of these assets allows Petitioner to forever earn a return on the undepreciated balance of the asset retired. Public's Exhibit 3, Attachment No. 13, page 1, offered by Ms. Lynn, shows that Petitioner recorded $62,301 for its 2002 tank inspection costs in account #339600 - Other P/E CPS Post 1997, shown in the Asset Cost Subsidiary column. The annual depreciation would equal $12,460 ($62,301/5-years), with a depreciation accrual rate for this account of 20% or five-years. It was undisputed that the tank inspections costs were retired within a year of being recorded in Utility Plant in Service.

Thus, Petitioner will earn a return on assets that are no longer used and useful in the provision of Petitioner's water utility service. It is unreasonable for Petitioner to accrue AFUDC in excess of the cost for any asset. The Public provided undisputed evidence that Petitioner accrued $40,623 in AFUDC on its 2002 tank inspection reports that cost only $21,678. Petitioner capitalized these costs and then retired them the following year. Petitioner has over 100 tanks that it inspects and the Public only looked at one year in which five (5) tank inspections were completed. This is a valid issue raised by the OUCC, and further justifies our direction to the Petitioner to not capitalize these costs, but to expense them as they occur.

3. Muncie Meters

OUCC's Position. OUCC witness Roger Pettijohn testified that Muncie operations manager, Randy Moore, informed him that Petitioner is replacing meters every five (5) years in Muncie. Mr. Pettijohn testified that a ten (10) year replacement program is more reasonable because Muncie water meters undergo no unusual conditions with respect to water quality, pressure or volume. Mr. Pettijohn testified Petitioner spent $773,264 over a two (2) year period for meters, and that $353,989 was designated as new meters for new installation. Mr. Pettijohn proposed an adjustment to Petitioner's meter purchases pursuant to implementing a ten (10) year replacement program. He proposed that Indiana-American's annual meter allotment of $386,000 should be reduced by half ($193,000). The OUCC also proposed to reduce accumulated depreciation by $71,772.

Petitioner's Rebuttal. In rebuttal, Duane D. Cole, Vice President of Operations for Indiana-American, disagreed with Mr. Pettijohn's proposed adjustment, asserting that it is based on incorrect or misunderstood information. Mr. Cole testified that Petitioner's policy for meter replacement for all of its operations, including Muncie, is ten (10) years. Mr. Cole claimed that Muncie operations manager, Randy Moore, said that the ten (10) year replacement policy has been and currently is being followed. Mr. Cole stated that there is no need to adjust the annual meter purchases because the ten (10) year replacement program that the OUCC supports is already in effect. (*Petitioner's Exhibit DDC-R*, pp. 4-5.)

Commission Discussion and Findings. Petitioner and the OUCC seem to agree that Muncie spent an average of approximately $383,000 on meters in calendar years 2002 and 2003; that Muncie spends approximately $50 for a 5/8 inch meter (*Public's Exhibit 1, Attach. RAP-6*); and that a ten (10) year change-out program is advisable for Muncie. Since Muncie has a residential base of approximately 24,000 services, a ten (10) year meter change out program would require 2,400 meters per year at a cost of approximately $120,000 per year. With the $383,000 per year Muncie actually incurred for meter replacement, Muncie would have purchased 7,660 meters ($383,000 ÷ 50) in each of the last two (2) years.

In rebuttal, Petitioner did not challenge any of the OUCC's calculations, but confined its rebuttal testimony to disputing the OUCC's assertion that the Muncie operation employs a five (5) year meter replacement program. In a post-hearing reply brief to the OUCC's proposed Order, Petitioner argued that had it known the OUCC's testimony with respect to the amounts spent for meter replacement were relative to the *Muncie* operation it would have submitted rebuttal testimony that these are *total company* numbers. We find this argument to be unreasonable. The whole of the OUCC's direct testimony on this issue is found within a discreet discussion titled the "Muncie Water District." We have no hesitation in concluding that the OUCC was presenting testimony confined to meter replacement in Muncie. If Petitioner thought the OUCC was discussing amounts attributable to all of Petitioner's meter replacements, it should have been obvious that a recommendation by the OUCC to reduce by half the total Company amount for meter replacements was misplaced in the context of a concern limited to the Muncie Water District. Based on the evidence presented, we find that a ten (10) year meter replacement program has not been but should be put into place. Therefore, we approve the OUCC's proposed adjustment to Petitioner's annual meter purchases in the Muncie district.

B. Acquisition Adjustments

1. Northwest Acquisition Adjustment

Prior to its merger into Petitioner, Northwest was a public utility providing water utility service to approximately 65,000 retail customers in Lake and Porter Counties. Northwest also provided wholesale service to various communities and utilities in those counties. On June 25, 1999, Northwest's ultimate parent company, National Enterprises, Inc. ("NEI"), was acquired by American for stock valued at $475 million. (*Petitioner's Exhibit JEE*, p. 21.) Of that amount, $48,752,000 was allocated to the Northwest acquisition. (*Id.* at p. 22.) It has been Petitioner's contention that this exceeded the book value of Northwest's equity by $21.472 million. Pursuant to approval granted by the Commission in its December 15, 1999 Order in Cause No. 41484, Northwest was merged into Petitioner effective January 1, 2000, with Petitioner being the surviving corporation. Thereafter, Petitioner commenced service in the areas and to the customers previously served by Northwest.

On February 1, 2000, one month after the Northwest merger, Petitioner acquired all of the common stock of United, and on the same date these two companies were merged into Petitioner. (*Petitioner's Exhibit JEE*, p. 23.) The United acquisitions resulted in the creation of another acquisition adjustment in the amount of $12,405,032. (*Id.* at p. 25.)

In Cause No. 42029, Petitioner proposed that the revenue requirement used to set its rates includes a fair value increment to net operating income ("NOI") reflecting a return on the Northwest and United acquisition adjustments, as well as a much smaller acquisition adjustment relating to Petitioner's acquisition of the Cementville system from Watson Rural Water Company; Petitioner sought an acquisition adjustment for Watson Rural consistent with the Commission's treatment of the Indiana Cities acquisition adjustment. In support, Petitioner submitted evidence on the aggregate cost savings achieved by the Northwest and United acquisitions and non-monetary benefits from the acquisitions, including improved service.

Our analysis in the 2002 Rate Order concluded that Petitioner should not be allowed favorable ratemaking treatment for the Northwest and United acquisition adjustments. Further, Petitioner asked us to reconsider this finding in its *Petition for Rehearing and Reconsideration* filed in that Cause which we again denied. Petitioner is not, in this proceeding, seeking a return on the United acquisition adjustment.

Petitioner's Position. John E. Eckart, President of Indiana-American, testified that in this case Petitioner has responded to our 2002 Rate Order by quantifying the amount of the savings found by the Commission in that Order that resulted solely from the Northwest acquisition. He said these savings are greater than the revenue requirement relating to the amount by which the purchase price allocated to Northwest exceeded the book value of Northwest's common equity, which equals the Northwest acquisition adjustment. Based on this analysis, Petitioner proposes that the Commission authorize a fair value increment sufficient to allow it to earn a reasonable return on the Northwest acquisition adjustment. Mr. Eckart asserted that when the Northwest acquisition is viewed separately, the standard set out in the 2002 Rate Order for recognition of the Northwest acquisition adjustment is easily satisfied.

Wayne W. Brownell, Vice President of Finance for Indiana-American, testified on the quantification of the cost savings from the Northwest acquisition accepted by the Commission in the 2002 Rate Order, identifying for each type of savings the page of the Order where findings on the cost savings are made. (*Petitioner's Exhibit WWB*, p. 11.) In most cases the findings related to the Northwest and United acquisitions are in the aggregate. However, Mr. Brownell explained that, by reference to testimony and exhibits of the OUCC and work papers submitted pursuant to the MSFRs, the share of the savings attributable to Northwest alone can be determined. (*Id.* at p. 12.) Mr. Brownell testified that the Northwest portion included operation and maintenance expense savings of $2,718,463 per year and investment savings of $312,030. (*Petitioner's Exhibit WWB-5*, p. 1.) Applying the cost of capital determined in the 2002 Rate Order to the net amount of the Northwest acquisition adjustment (the original acquisition adjustment of $21.472 million less the accumulated amortization as of each year through 2004), Mr. Brownell computed an excess of savings over revenue requirement as follows:

Year	Savings minus Revenue Requirement
Acquisition	($19,529)
1999	$15,583
2000	$85,810
2001	$156,035
2002	$226,260
2003	$296,487
2004	$366,712

Id.

Mr. Brownell testified that Petitioner investigated whether the savings quantified in the 2002 Rate Order continue to be achieved in the same or a greater amount. Mr. Brownell discussed each type of savings and explained how the sustainability of the savings had been confirmed. In the case of the labor cost savings, for example, the Northwest Operation employee level is actually lower now than at the time of the last rate case. Mr. Brownell said the lower employee count meant that the labor cost savings included in his analysis are underestimated by about $450,000.

Mr. Eckart testified that the acquisitions of Northwest and United are directly related to solving the problem of small and troubled water utilities because they added many new operating centers (hubs) from which extensions can be made (spokes) to reach small and troubled systems within a reasonable radius. He stated that it is feasible for larger well-run and financially-sound utilities to acquire small and troubled utilities when they are within twelve (12) to twenty-five (25) miles of a hub. He referred to this as the "hub and spoke" approach to consolidation and regionalization. He also identified a presentation by the Chief of Staff of the USEPA's Office of Ground Water and Drinking Water recognizing that the geographic proximity to larger systems is key to resolving the infrastructure challenge faced by small water utilities. (*See Petitioner's Exhibit JEE*-3.) Mr. Eckart also testified that small systems become subject to more strict USEPA standards after they are acquired by Petitioner.

OUCC's Position. E. Curtis Gassert, Director of the OUCC's Sewer/Water/Rates Division, testified for the Public. In his testimony in Cause No. 42029, which he incorporated into his testimony in this Cause, Mr. Gassert explained that he considered the acquisition premium to be "imputed" because the transaction was accounted for as a pooling of interest. Mr. Gassert asserted that under this method of accounting for acquisitions no acquisition premium is recorded. Rather, the assets and liabilities of the acquired company are simply added to the books of the acquiring company. Therefore, he asserted, there is no acquisition premium for the utility to recover. Mr. Gassert stated that the utility should not be allowed to recover something that does not exist. Mr. Gassert further testified in Cause No. 42029 as follows:

> Mr. Gassert noted that the negative impacts of allowing Indiana-American to recover an acquisition premium that does not exist could be staggering. He noted the then recent announcement that RWE offered to acquire American Water Works for $4.6 billion. Also, he noted that AES completed its purchase of IPALCO. According to Mr. Gassert, if it becomes acceptable for these purchase prices to be allocated to their regulated utility subsidiaries and imputed or pushed down as indicators of fair value to the utilities, Indiana ratepayers will be required to pay millions of additional dollars just because their utility's parent company was acquired.

Mr. Gassert added that a similar request was made in Cause No. 41661 where Harbour Water requested to earn a return on an acquisition premium that was "pushed down" from its parent company. Mr. Gassert noted that the Commission did not allow Harbour Water to earn a return on that "pushed down" or imputed acquisition premium.

Mr. Gassert also asserted that the purchase price imputed to the Northwest acquisition was not representative of the fair value of Northwest's assets for several reasons. First, Mr. Gassert cited evidence indicating that substantial goodwill or going concern was included in the purchase price. Mr. Gassert defined goodwill as the excess of the purchase price paid to acquire a business over the market value of the assets acquired. He further noted that goodwill is different than other assets because goodwill can only be identified with the business as a going concern. For this reason, goodwill is sometimes referred to as "going value" or "going concern value." Mr. Gassert cited examples of goodwill which included brand values; market share; monopoly conditions; superior earnings potential; strategic location; access to natural resources; governmentally-conferred privileges, such as franchises and grants; and other strategic benefits and competitive advantages.

Mr. Gassert stated that the Commission must exclude from fair value any amounts for goodwill and going value according to Ind. Code § 8-1-2-6. He further stated that any valuation performed on a utility's assets must include going concern because such an evaluation presupposes attached customers, a given demand for service, appropriate business organization and management, and, thus, earning power. If the properties were not actually a going concern and were not regarded as such, their market value would be much less than reproduction cost less depreciation. Practically all the plant and equipment would have very little resale value. Essentially, the utility's plant is worth very little without customers. Thus, he asserted, the going value of a business is an essential element in the proper valuation of a public utility. To support his contention, Mr. Gassert noted the following discussion by the Supreme Court of Wisconsin:

> In the proper valuation of a public utility for condemnation or sale purposes certain main elements usually present in every case may legitimately be considered. These are the present value of its physical property; the present and prospective reasonable earnings of its business; the going value thereof; and the amount of money presently needed to put the plant in good condition. There may be other elements, but these are generally the essential ones.... <u>The going value of a utility is that part of its value due to its having an existing established business.</u>

Oshkosh Waterworks Co. v. R.R. Comm'n, 161 Wis. 122, 127, 152 N.W. 859, 861-862 (1915) (emphasis added). Mr. Gassert concluded that it is inherent that the purchase price already includes some amount of going value and cannot be relied upon to set the fair value.

Second, Mr. Gassert also noted the poor condition of the intake tunnel which required significant investment that will be more than $58 million in the first three (3) years following the acquisition. Mr. Gassert noted that when the $48.752 million purchase price is combined with the $58 million of additional investments, Indiana-American will have spent $106.752 million for a utility that had a book value of $27.280 million when acquired. Mr. Gassert asserted the premium Petitioner paid does not reflect a utility that required such substantial additional investments. Mr. Gassert concluded that such a premium for a utility requiring substantial investment indicates the purchase of something other than the tangible assets and, therefore, should be excluded from rate base.

Mr. Gassert stated that the amount of needed investment in an acquired utility should reduce the amount paid to acquire that utility. In Cause No. 40103, Mr. George Johnstone, President and CEO of American, made the following statement:

> In fact, I can think of examples where you would buy a utility at lower prices than book value, and the reason that you would end up getting that price acceptable is the investment needed to bring the facilities up to the level they need to be at."

See Ind.-Am. Co., Inc., Cause No. 40103, 169 PUR4th 252 (Indiana Utility Regulatory Commission, Date Issued May 30, 1996), Tr. p. GWJ-37, line 24.

Mr. Gassert testified that goodwill and required investment were not the only reasons to indicate that the purchase price of Northwest could not be relied on to determine the fair value of Northwest's tangible assets. Third, when the NEI purchase price was allocated between the non-regulated and regulated utilities, the Company allocated an excessive amount to the regulated utilities. Mr. Gassert asserted that this could be determined by reviewing the Merrill Lynch valuation information provided on page 8 of Mr. Hartnett's testimony in Cause No. 42029. Mr. Gassert reproduced Mr. Hartnett's data below:

	Low (Millions)	High (Millions)
Water Companies	$ 346.8 or 82.1%	$ 436.8 or 82.7%
Securities Held at Market	62.7	78.6
Other Holdings	12.9	12.9
Total	$ 422.4	$ 528.3

From reviewing the Merrill Lynch data above, the water company values range from 82.1% to 82.7% of the total NEI holdings. But, as Mr. Gassert noted, the amount actually allocated to the regulated water companies was 87%. This amount was calculated by dividing the $415 million allocated to the water companies by the total $475 million NEI purchase price. Mr. Gassert further observed that, if the average of the low and high valuations are used, then the purchase price allocated to the regulated water utilities would be $391.4 million ($475 million x 82.4%). Mr. Gassert explained this would result in an over-allocation of $23.6 million ($415 million - $391.4 million) to the regulated water utilities.

Mr. Gassert explained that a portion of the over-allocation can be attributed to the improper allocation of income taxes that would result from the sale of nonutility assets to the regulated water utilities. As explained on page 11 of Mr. Hartnett's testimony, a "valuation adjustment" was applied to the values of the nonutility assets to reflect the taxes that would be paid when these stocks were sold. After these adjustments were made, the net values of the nonutility assets were subtracted from the total purchase price to determine the purchase price for the water utilities.

Mr. Gassert posited that the impact of the "valuation adjustment" is to allocate income taxes from the sale of nonutility stocks to the purchase price of the regulated water utilities which is clearly improper. He stated the income taxes that will be paid when the nonutility stocks are sold add no value whatsoever to the regulated water utilities and these income taxes should not be added to the purchase price of the utility stocks.

Mr. Gassert compared the allocated purchase prices to the Merrill Lynch valuation analysis and determined that the $475 million total price paid for NEI falls directly in the middle of the valuation range of $422.4 million to $528.3 million. However, the $415 million price allocated to the water companies falls on the high side of the valuation range of $346.8 to $436.8 million. The $391.4 million calculation Mr. Gassert performed above falls directly in the middle of the valuation range for the water companies and provides additional assurance that an unreasonable amount was allocated to the water companies.

In addition to the foregoing, Mr. Gassert expressed another concern about the amount allocated to the Northwest purchase price. Mr. Gassert noted that the NEI purchase price was allocated based on book equity and net income as of September 30, 1998. Mr. Gassert stated that allocating the purchase price in this manner does not represent the true value of the acquired utilities that an independent valuation might generate. For instance, this method of allocation does not consider the condition of the assets when acquired. As previously stated, Indiana-

American will have invested $58 million in Northwest since its acquisition. The poor condition of its intake tunnel assets should have been reflected in the purchase price allocated to Northwest but was not because the NEI purchase price was allocated based on book equity and net income.

In his testimony prepared for this Cause, Mr. Gassert noted that in an effort to seek approval of Indiana-American's acquisition adjustment for the Northwest Acquisition, Mr. Eckart discussed at length the benefits of Indiana-American expanding its "footprint" and how its acquisitions of Northwest and United created new hubs that provide the potential to help small and troubled water utilities not previously within Indiana-American's reach. Mr. Gassert disagreed that the acquisition of Northwest and United created new hubs to help small and troubled water utilities. While Mr. Gassert agreed that the acquisition of those existing hubs may have assisted Indiana-American in acquiring certain small and troubled utilities not previously in its reach, those hubs for acquiring small and troubled utilities preexisted their acquisition by Indiana-American. (*See Public's Exhibit 5*, pp. 29-30.) Mr. Gassert suggests that Mr. Eckart's analysis fails to acknowledge the contributions Northwest could and did make in acquiring small or troubled systems. According to Mr. Gassert, Mr. Eckart's argument rests on the false premise that only Indiana-American could have and would have acquired the small utilities it merged into the Northwest operation.

Mr. Gassert noted that well before Indiana-American acquired Northwest, which had 65,000 customers and was owned by a parent that owned four (4) water utilities, Northwest was an existing hub that possessed the technical, financial and managerial ability to acquire small and troubled utilities and exercised that ability before it was acquired by Petitioner's parent. Mr. Gassert noted that Northwest was both willing and able to acquire smaller systems to create a larger regional water utility. Mr. Gassert stated that its growing regionalism was one of the factors that caused Northwest to change its name from the Gary-Hobart Water Company to the Northwest Indiana Water Company in 1994.

By way of example of Northwest's willingness and ability to acquire smaller systems, Mr. Gassert stated that before it was acquired, Northwest acquired Shorewood Forest Utilities, Inc.; People's Water Co.; Independence Hill Third Addition Water Works, Inc.; water utility properties of Utility Services Corp.; the water distribution system of Chesterton; and the water distribution system of Burns Harbor. These six (6) acquisitions were all completed within the ten (10) years prior to Indiana-American's acquisition of Northwest and without any effort on the part of Northwest to seek acquisition adjustments. Mr. Gassert also described the willingness of many water utilities in Indiana to acquire small and troubled water utilities specifically listing such municipal utilities as Bloomington, Elkhart, Merrillville Conservancy District and the Cities of Woodburn and Whitestown.

Mr. Gassert concluded that he cannot see that Indiana-American's acquisition of Northwest and United made possible future acquisitions of small and troubled utilities that were not previously feasible. Mr. Gassert reiterated that Northwest was very active with the acquisition of small systems and there is no reason to believe that the practice would not have continued without Petitioner's ownership. Therefore, Mr. Gassert did not believe Indiana-American's hub and spoke system justifies the recovery of the Northwest acquisition adjustment, which was denied in the last case and which it again seeks.

Further, Mr. Gassert expressed concern that Petitioner's request appears to be an effort to replace the Commission's long standing "troubled" utility standard with a new less stringent standard. However, he added that even if the troubled utility standard were to be replaced with a standard that reviews whether the acquisition makes possible future acquisitions of small and troubled utilities that were not previously feasible, Petitioner would fail that standard since it was already feasible for Northwest to make acquisitions of small and troubled utilities before being acquired by Indiana-American. (*Public's Exhibit 5*, p. 27, lines 5-13.)

With respect to Petitioner's hub and spoke concept, Mr. Gassert agreed that it is better to have larger more regionalized water utilities rather than tens of thousands of smaller systems. But he disagreed with the benefit, as described by Petitioner as it relates to the Northwest acquisition, that it has created something where nothing previously existed and should get credit for its creation. Indiana-American did not create Northwest Indiana Water. Indiana-American was the successful acquirer of an existing hub. Further, Northwest did not become a hub to acquire small and troubled systems only after its acquisition by Petitioner's parent. Northwest had established a record of such transactions before being acquired. Mr. Gassert concluded that the Commission should not provide favorable ratemaking treatment for the Northwest acquisition based on Petitioner's hub and spoke argument.

Addressing Petitioner's claim of savings resulting from the Northwest acquisition, Mr. Gassert stated that Mr. Brownell's asserted annual savings of $2,789,494 overstates the annual savings and understates the annual revenue requirement. Mr. Gassert explained that Mr. Brownell failed to include the management fee expense category. Referring to page 9 of the Commission's order in Cause No. 42029, Mr. Gassert noted that Petitioner's witness calculated savings in this category of $302,224, while the OUCC's witness calculated increased costs of $639,256. Relying on the data reported on OUCC Utility Analyst Judith Gemmecke's Schedule JIG-11, page 4 of 6 submitted in Cause No. 42029, Mr. Gassert calculated Northwest's portion of the management fee to be $304,930. Mr. Gassert asserted that the annual savings corrected for the omitted management fees would be $2,413,533 ($2,718,463 - $304,930).

During his questioning at the Evidentiary Hearing, Mr. Gassert noted that Mr. Brownell, in his rebuttal testimony, disputed the management fee figure used by Mr. Gassert. Mr. Gassert testified that he performed an analysis assuming the savings Mr. Brownell said should apply. Mr. Gassert explained that Mr. Brownell suggested that the number Mr. Gassert used to calculate management fees for Northwest was incorrect, and so he inserted the number that Mr. Brownell indicated was the correct number to use. Mr. Gassert noted that, even using the number which Mr. Brownell provided, he still determined there were no savings.

Discussing how Mr. Brownell understated the revenue requirement related to the Northwest acquisition, Mr. Gassert noted that Mr. Brownell failed to include the annual amortization of $536,800 as a component of the revenue requirement. Both Mr. Eckart and Mr. Brownell have requested to recover the annual amortization through rates if the net acquisition adjustment is used to determine the NOI as previously discussed.

Mr. Gassert noted that the first year revenue requirement, corrected for the annual amortization, is $3,201,074 and calculated on Attachment ECG-4 of his testimony. (*Public's Exhibit 5, Attach. ECG-4,* pp. 1-2.) Mr. Gassert compared his results to Mr. Brownell's by summarizing his results in the same format as found on Mr. Brownell's exhibit. (*See Petitioner's Exhibit WWB-5.*) The OUCC's results indicate Petitioner's costs exceed the anticipated savings by a substantial amount in each of the first seven (7) years. The amount that cost exceeds savings is represented by the positive numbers. The negative numbers in Petitioner's Exhibit represent claimed savings over costs.

OUCC results:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenue Rqmt.	$ 3,201,074	$ 3,143,461	$ 3,085,849	$ 3,028,237	$ 2,970,625	$ 2,913,012	$ 2,855,400
Cost Savings	2,484,564	2,484,564	2,484,564	2,484,564	2,484,564	2,484,564	2,484,564
Costs over (Savings)	$ 716,510	$ 658,897	$ 601,285	$ 543,673	$ 486,061	$ 428,448	$ 370,836

Results from Petitioner's Exhibit WWB-5:

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Revenue Rqmt.	$ 2,809,023	$ 2,773,911	$ 2,703,684	$ 2,633,459	$ 2,563,234	$ 2,493,007	$ 2,422,782
Cost Savings	2,789,494	2,789,494	2,789,494	2,789,494	2,789,494	2,789,494	2,789,494
Costs over (Savings)	$ 19,529	$ (15,583)	$ (85,810)	$ (156,035)	$ (226,260)	$ (296,487)	$ (366,712)

Mr. Gassert disagreed with the following testimony presented by Mr. Brownell:

> Q. Are you saying that the customers will actually pay less for water service as a result of the merger of these companies even with Indiana-American's proposed ratemaking treatment?
>
> A. Yes. The customers pay less for water service than they would have if the merger had not taken place because they get the benefit of 100% of the savings. Indiana-American will receive a return on the amount paid to make the savings possible but it is disadvantaged compared to the customers if it is only allowed a return on the acquisition adjustment net of accumulated amortization but is not allowed to recover the amortized amount as an expense.

Petitioner's Exhibit WWB, p. 17.

Mr. Gassert disagreed that the ratepayers will receive 100% of the savings under Petitioner's proposed ratemaking treatment as stated by Mr. Brownell. He explained that the only way the ratepayers could receive the benefit of 100% of the claimed savings would be for the utility to not recover any portion of the acquisition adjustment in rates. Even if actual savings were equal to costs (which Mr. Gassert asserted he has demonstrated is not the case), the ratepayers would not benefit but only break even. Mr. Gassert concluded that the entirety of the savings claimed by Petitioner is offset by the costs of the acquisition adjustment.

Mr. Gassert had other concerns regarding Petitioner's proposal to recover the Northwest acquisition adjustment in rates. He added that, as can be seen from reviewing Petitioner's Exhibit JLC-1-U, Schedule 1, all ratepayers across Petitioner's operations have been allocated a portion of the acquisition adjustment. The Northwest district itself has been allocated 28.7% of the fair value increment. Therefore, under Petitioner's proposal, ratepayers in the Southern Indiana operation will pay higher rates so that Northwest's ratepayers will pay, what Petitioner claims to be, lower operation and maintenance ("O&M") costs. Mr. Gassert concluded that unfortunately, everyone will pay more with the inclusion of the Northwest acquisition adjustment in rates.

In addition to the difficulty with proving and verifying merger savings and uncertainty about whether the savings can even remain over a forty (40) year period of time, Mr. Gassert identified another issue that he claimed needs to be considered when reviewing merger savings. Mr. Gassert believes the Commission should consider whether the savings are achievable only because of the merger. Mr. Gassert noted that in Cause No. 40103, the Commission stated:

> 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 of 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.

In.-Amer. Water Co., Inc., Cause No. 40103, p. 7.

Mr. Gassert asserted that a significant portion of the claimed savings could have been achieved without the merger. The largest single component of the $2,789,494 claimed savings relates to labor expense. The claimed labor expense savings is $2,357,003. Mr. Gassert noted that a list of eliminated positions was provided on page 19 of Mr. Cole's testimony in Cause No. 42029. That list reveals that fifty-five (55) positions were eliminated. Of those fifty-five (55) positions, twenty (20) can easily be identified as the type of positions that could have been eliminated through centralization. Those twenty (20) positions are broken down as follows: four (4) engineering, five (5) accounting and eleven (11) customer service.

Mr. Gassert believed much of this reduction could have been completed through centralization because Northwest Indiana Water Co. was owned by Continental Water Company (which was owned by NEI). Continental owned four (4) subsidiaries that were engaged in the provision of water utility service in Indiana, Illinois, Missouri and New York. The twenty (20) positions discussed above relate to functions that could have been centralized by Continental to gain these efficiencies. In support of this notion, Mr. Gassert noted that the engineering, accounting and customer service functions have been centralized by Indiana-American.

Mr. Gassert also questioned the accuracy of the merger savings calculation. As stated in Cause No. 40103, estimates of cost savings by utilities have always been hotly disputed because the calculation of the actual savings is very nebulous, subjective and difficult to quantify. The difficulty with proving and verifying merger savings and costs lies in the difficulty of identifying and quantifying these savings and costs. Obviously, according to Mr. Gassert, utilities have an incentive to identify and quantify as much merger-related savings as possible while ignoring or minimizing costs. The OUCC asserted that testimony in this case reveals that Indiana-American is a very large, complex organization made more so by the interaction of its operations with other American subsidiaries.

Next, Mr. Gassert provided testimony of examples where he believed Indiana-American's previous merger savings calculations overstated the benefits to the ratepayers. For instance, in Cause No. 40103, Indiana-American applied a 3.75% growth rate to the O&M savings it calculated. Thus, it increased the anticipated savings every year for forty (40) years by 3.75%. However, in Cause No. 42029, Petitioner used a 3.0% growth rate. According to Mr. Gassert, the effect of using a 3.75% growth rate in Cause No. 40103 rather than a 3.0% growth rate caused Petitioner to overstate its O&M savings over forty (40) years by more than $34 million as calculated in Public's Exhibit 5, Attachment ECG-5. Mr. Gassert also asserted that in Cause Nos. 40103 and 42029 Petitioner used a tax gross-up factor that did not reflect new higher state taxes. In Cause No. 42029, Petitioner used a tax gross-up factor 1.6435. Due to changes in the tax laws, the tax gross-up factor in this Cause has increased to 1.7239. Petitioner, however, has continued to use the tax gross-up factor of 1.6435. Mr. Gassert testified that this has caused Mr. Brownell to understate the revenue requirement on Petitioner's Exhibit WWB-6 in every year for forty (40) years. In the first year, for example, Mr. Brownell calculated the required gross-up to be $1,099,852 ($1,709,171 x .6435). However, the actual required gross-up is $1,237,269 ($1,709,171 x .7239), and the amount should be reflected in Petitioner's rate schedules. Thus, in the first year, Mr. Brownell understated the acquisition adjustment revenue requirement by $137,417 ($1,237,269 - $1,099,852). Mr. Gassert concluded from his testimony that it is apparent that Petitioner has not been successful at estimating savings from its previous mergers over very short periods of time let alone over forty (40) years, and that Indiana-American's proposal would place the risk of overestimated savings on its ratepayers

Intervenors' Positions. Intervenor Industrial Group's witness Michael P. Gorman, a consultant for the firm of Brubaker and Associates, Inc., disputed the recovery of the Northwest acquisition adjustment. According to Mr. Gorman, Petitioner did not reflect all of its labor and benefit costs for the Northwest district because the management fees from American Water Works Service Company ("AWWSC") have increased as a result of the Northwest acquisition. Mr. Gorman testified that Petitioner's examples of labor cost savings are entirely or largely offset by increased management fees. (*Industrial Group Exhibit 1*, p. 32.) In his opinion, Petitioner had not shown that the net savings of the acquisition offsets the acquisition adjustment revenue requirement.

Intervenor Schererville's witness Theodore J. Sommer, a member of the firm of London Witte Group, LLC, provided testimony that the savings did not include an allocation of the corporate costs, which should have been included in such savings calculations. Witness Sommer referred to our order in Cause No. 42029 to support his conclusions. (*Intervenor Schererville Exhibit 1*, p. 12, line 17 through p. 13, line 14.)

Petitioner's Rebuttal. In rebuttal, Mr. Eckart stated that he believed Mr. Gassert has taken the hub and spoke concept out of context. Mr. Eckart said he did not contend Petitioner is the only utility that can resolve small troubled utility problems, but did believe Petitioner, through its size, can accomplish this on a larger basis. For example, when the OUCC asked Petitioner to help at Farmington and Prairieton, Petitioner was able to step in because it owned adjacent operations (hubs) at Muncie and Terre Haute. Mr. Eckart also said it is not merely a question of ability, it is also a question of willingness to step forward. While Petitioner has shown this willingness, others owners have elected to exit the business in Indiana.

With respect to acquisition adjustments, Mr. Eckart stated that consistent and fair regulatory treatment is necessary to allow management to make acquisition decisions. He noted that a responsibly run business cannot invest large sums without a reasonable opportunity to achieve a return on and of its investment.

Mr. Eckart also expressed concern about the "all or nothing" test advocated by the OUCC. While he believes the evidence supports full recognition of the acquisition adjustment, if the Commission believes the evidence supports something less, the Commission should allow recognition for the amount which the Commission finds the benefits support.

Mr. Brownell testified that he did not include the amortization as part of the revenue requirement because he followed what he understood to be the treatment for the Indiana Cities acquisition adjustment adopted by the Commission in the 2002 Rate Order. Mr. Brownell disagreed with the comments of Mr. Gassert and Mr. Gorman about management fees because the 2002 Rate Order accepted neither the Petitioner's position that there were management fee savings nor the OUCC's position that there were management fee increases. His analysis was based on the Commission's findings which were neutral on the management fees issue.

Mr. Brownell also said the OUCC's management fee analysis was flawed because it did not adjust its "post-merger" scenario for the reclassification effective April 1, 2000, of certain employees in Petitioner's Greenwood Office from Indiana-American's payroll to AWWSC's payroll. Although this change increased management fees, it did not increase Petitioner's overall costs because of the offsetting reduction in Indiana-American's own labor costs. Mr. Brownell also showed that, if the OUCC's analysis is adjusted to an "apples to apples" basis, there is no increase in management fees, even under the OUCC's calculation.

Mr. Brownell said the Northwest savings he quantified could not have been captured by Northwest without the acquisition. Mr. Brownell testified that Northwest already had a centralization strategy with sister companies in three other states that captured such savings as were available without further consolidation or merger. Moreover, the savings from the Northwest acquisition did not merely represent more centralization; they represented also a concerted management effort to employ the "best practices" of the collective utility systems.

Mr. Brownell disagreed with Mr. Sommer's position that corporate costs allocated to the Northwest operation should be treated as an offset to the savings. He said the acquisition savings arose within the entire state, not a specific district within the state, and therefore a state-wide analysis was necessary. He testified the company-wide incremental increase in corporate costs had been netted against the acquisition savings. The costs allocated to a particular area within the state, however, do not reflect incremental costs and, therefore, should not be considered an offset to the acquisition savings.

Commission Discussion and Findings. In Cause No. 42029, we considered Petitioner's request to recover an acquisition adjustment related to its acquisition of Northwest. In our final order in that Cause, we found that ratepayer benefits did not exceed the costs of the acquisition premium requested. In Cause No. 42029, Petitioner also asked us to reconsider our decision on the Northwest acquisition adjustment in its Petition for Rehearing and Reconsideration, which we denied. In this case, Petitioner asks us again to consider an acquisition adjustment for Northwest based on its "hub and spoke" concept and reiterated its position about capital and O&M savings. First, we will discuss the hub and spoke concept.

Mr. Eckart testified that the acquisitions of Northwest and United are directly related to solving the problem of small and troubled water utilities because they added many new operating centers (hubs) from which extensions can be made (spokes) to reach small and troubled systems within a reasonable radius. Petitioner suggested that due to the significance of the hub and spoke concept that the issue is not whether Northwest was a troubled utility but whether that acquisition made possible future acquisitions of small and troubled utilities that would not be feasible without the Northwest acquisition. (*Petitioner's Exhibit JEE*, p. 33) We are not convinced. First, there is no new evidence nor was any evidence presented in the last case to indicate Northwest was a troubled utility. Second, we do not agree that the acquisition of Northwest was the cause of the benefits claimed by Indiana-American. It is true that Indiana-American has acquired smaller utilities and integrated them into the Northwest operation. However, we disagree that this acquisition created a new "hub." The evidence presented by the OUCC clearly indicates that Northwest was very active in the consolidation of smaller utilities well before being acquired by Indiana-American. Not only did Northwest display a willingness to step forward, but in the six (6) most recent acquisitions, Northwest did not seek to recover an acquisition adjustment related to those acquisitions. Given the fact that Northwest was a large water utility provider that possessed the technical, financial and managerial ability to acquire small and troubled utilities and frequently utilized that ability before it was acquired by Petitioner, we cannot attribute credit to Indiana-American for creating a new hub to provide this benefit when it is clear that the benefit already existed. Therefore, the answer to the question Petitioner suggests, as to whether the Northwest acquisition made possible future acquisitions of small and troubled utilities that would not be feasible without the acquisition, is no. Thus, we are not convinced that the "hub and spoke" concept discussed by Indiana-American warrants any favorable consideration in our determination about whether the imputed Northwest acquisition adjustment should be included in rates.

Next, we will address the savings Petitioner has reiterated in this case that relate to the Northwest acquisition. Petitioner suggests that we did not consider the Northwest acquisition separately in the last rate case because Petitioner aggregated several acquisitions into one analysis. We do not agree. Before we began our discussion about the Northwest acquisition in our final order in Cause No. 42029, we stated that:

> It is the established policy of this Commission to evaluate acquisitions on a case-by-case basis. <u>In the case of merged operational and management services, they will be separated for purposes of rate consideration insofar as possible.</u> 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.

Ind.-Am. Water Co., Cause No. 42029, 5 (emphasis added). Therefore, it is evident that we did, insofar as possible, consider the Northwest acquisition request independently in Cause No. 42029.

Once again, there appears to be a significant amount of disagreement and controversy over the savings calculation. We note that the average of the seven (7) years of net savings calculated by Mr. Brownell is only $161,051. Even if this amount is correct, when one considers the amount of costs and savings in question, and the controversy surrounding these amounts, this is not a material amount to warrant passing such a significant cost on to the ratepayers. Also, Mr. Brownell calculated total annual savings of $2,789,494 in his calculation of net savings, which is significantly higher than the savings calculated by the OUCC in Cause No. 42029. In that Cause, Mr. Gassert calculated annual O&M savings of $1,375,762. Given the controversy and uncertainty about what level of savings have been achieved, the amount of savings calculated by Petitioner does not provide us with the level of assurance we need to pass on the costs when it is not evident that any net savings will be achieved. We note that the standard we have used to consider acquisition adjustments requires significant and demonstrable savings. Based on the evidence of record here, we cannot conclude with certainty that any savings will be generated if favorable ratemaking treatment is granted. Petitioner's reliance on at best marginal estimated savings to impose a ratepayer funded acquisition adjustment puts the risk that such savings may not occur on the ratepayers. We also note that American is in the process of consolidating its operations in ways that have increased the cost to Indiana-American. Savings projected out several decades under such circumstances are simply not assured.

We also note certain testimony presented by the OUCC in Cause No. 42029 which was included as Public's Exhibit 5, Attachment ECG-1 in this Cause. We believe some of the more important points to consider about the Northwest acquisition adjustment request from that testimony are as follows:

First, the acquisition adjustment does not exist and is not recorded on Indiana-American's books. The acquisition adjustment was created by Petitioner for ratemaking purposes.

Second, income taxes resulting from the sale of NEI's telephone companies were included in the calculated purchase price.

Third, the imputed purchase price was based on book equity and net income. This method of allocation does not consider the condition of the assets when acquired, such as the intake tunnel that cost $50 million to replace. The flaws resulted in an over-allocation of the purchase price for the Northwest acquisition.

Fourth, no consideration has been made by Petitioner to account for the fact that going concern value might properly be considered included in the allocated purchase price and therefore cannot reasonably be relied on to set the fair value.

We believe these points provide additional concerns that support our disallowance of Petitioner's request for favorable rate treatment related to Petitioner's Northwest acquisition adjustment.

Based on our previous review and findings in Cause No. 42029, our finding that Petitioner's hub and spoke concept does not warrant favorable ratemaking treatment, the questionable savings, the material impact to ratepayers, as well as the concerns raised by the OUCC in testimony filed in Cause No. 42029 that have been incorporated into this Cause, we continue to find that ratepayer benefits do not exceed the costs of the acquisition premium requested. Accordingly, and once again, we deny Petitioner's request for favorable ratemaking treatment with respect to its Northwest acquisition.

Because we have denied Petitioner's request to recover an acquisition adjustment related to Northwest Indiana Water, it is not necessary to discuss whether a return should be granted on the original unamortized balance of the imputed acquisition adjustment, the net amortized balance, or whether the annual amortization should be included in rates.

2. Indiana Cities Acquisition Adjustment

The Commission has dealt with the treatment of the purchase price paid by Petitioner to acquire Indiana Cities Water Corporation in three (3) prior litigated rate cases. The first time was in Cause No. 40103, resulting in the 1996 Rate Order. The Commission again considered this issue in the 1997 Rate Order and in the 2002 Rate Order.

Petitioner's total investment to acquire Indiana Cities was $37,072,008. (*1996 Rate Order*, Cause No. 40103, p. 3.) The book value of Indiana Cities' common equity at the acquisition date was $19,659,999. (*Id.*) The $17,412,009 difference between the acquisition cost and the book value was recorded on Indiana-American's balance sheet as an acquisition adjustment. (*Id.*) For accounting purposes, Indiana-American is amortizing the Indiana Cities' acquisition adjustment over a period of forty (40) years.[2] (*1997 Rate Order*, Cause No. 40703, p. 4.) The annual expense relating to this amortization is $467,436. (*Petitioner's Exhibit JEE*, p. 20, line 12; *Public's Exhibit 5*, p. 4.)

Two issues in Cause No. 40103 were (a) whether Petitioner should be allowed to earn a return on the amount of the investment made to acquire Indiana Cities by including the acquisition adjustment in Indiana-American's rate base upon which Petitioner is allowed to earn a return and (b) whether Petitioner should be allowed to recover its investment gradually over time by including the annual amortization of the acquisition adjustment as an allowable expense for ratemaking purposes. Petitioner proposed that the acquisition adjustment be included in its original cost rate base and that the annual amortization expense be reflected "above-the-line" for ratemaking purposes. Petitioner contended that the Indiana Cities acquisition adjustment satisfied the Commission's criteria for favorable ratemaking treatment because the purchase price was reasonable, negotiated at arms length and resulted in substantial cost savings and other benefits.

The Commission did not accept Petitioner's proposed original cost rate base treatment. Instead, it gave "Petitioner authority to recognize 100% of its investment in rates through its fair

[2] The amortization accrued from the time of the acquisition to the issuance of the 1996 Rate Order was deferred so the effective amortization period is 37.25 years, *i.e.*, forty (40) years less the period between the acquisition and the 1996 Rate Order. This is why the amortization expense is $467,436 per year, rather than the amount of $435,300 calculated by Mr. Gassert. (*Public's Exhibit 5*, p. 5, n. 1.)

value rate base," but found none of the annual amortization expense should be treated as a recoverable expense. (*1996 Rate Order*, Cause No. 40103, p. 15.) The Commission stated: "Petitioner can and should be compensated for its investment in the Indiana Cities properties through informed fair value ratemaking by fully recognizing their fair value in [the Commission's] fair value rate base determination." (*Id.* at p. 49.) The Commission explained that it was not allowing above-the-line recognition for the amortization expense because it analogized fair value treatment to an investment in stocks or bonds wherein the investor earns a return on the investment in the form of dividends or interest but does not recover the principal until the end of the investor's holding period. (*Id.* at p. 10.)

In the 1996 Rate Order, the Commission approved a fair value NOI increment of $1,112,482, *i.e.*, the amount the authorized return exceeded the product of the Commission-determined cost of capital and the original cost rate base that did not include the Indiana Cities' acquisition adjustment. (*Petitioner's Exhibit JEE*, p. 14.) The Commission also used an interest synchronization method to determine the interest expense deducted in the income tax calculation by multiplying the weighted cost of debt by the original cost rate base (from which the Indiana Cities' acquisition adjustment was excluded). (*Id.* at pp. 14-15.) The effect of this methodology essentially is to allocate to the shareholder the benefit of the tax deduction for the interest on the debt used to finance the acquisition adjustment. (*Id.*)

In the 1997 Rate Order, the Commission confirmed its position that Petitioner should be compensated for its investment in Indiana Cities through fair value ratemaking. The Commission stated:

> In [Cause No. 40103], 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.

Ind.-Am. Water Co., Cause No. 40703, p. 30. The Commission also found that, due to the savings generated by the acquisition adjustment, recognition of the Indiana Cities' acquisition adjustment should be treated as a "reasonable cost of bringing the property to its then state of efficiency" includible in Petitioner's fair value rate base pursuant to Ind. Code § 8-1-2-6(a). The Commission also stated that "Petitioner would be allowed for ratemaking purposes a return on the acquisition adjustment but not a return of the acquisition adjustment." (*Id.* at p. 40.)

In the 1997 Rate Order, the Commission found a fair value NOI increment of $1,340,279 above what would result from multiplying the cost of capital determination by the original cost rate base excluding the Indiana Cities acquisition adjustment. (*Id.* at p. 46; *Petitioner's Exhibit JEE*, p. 17.) The Commission also reaffirmed use of the interest synchronization method used in the 1996 Rate Order. (*1997 Rate Order*, Cause No. 40703, p. 64.)

The 2002 Rate Order included a fair value increment of $1,282,693 and used the same interest synchronization method as in the prior two (2) orders. (*Petitioner's Exhibit JEE*, p. 19.) In Cause No. 40703, Petitioner and the OUCC disagreed about whether the fair value should be based on the full amount of the Indiana Cities' acquisition adjustment ("gross amount") or the amount net of the accumulated amortization as of the rate base valuation date ("net amount"). Petitioner contended that the findings in the 1996 Rate Order and 1997 Rate Order supported use of the gross amount. Petitioner also asserted that only the gross amount was consistent with the stock and bond analogy adopted by the Commission and its finding about the non-recoverability of the amortization. The OUCC argued that the net amount should be used because it reflects diminishing value over time. In the 2002 Rate Order, the Commission stated that it "agree[d] with the OUCC analysis of this issue." (*2002 Rate Order*, Cause No. 42029, p. 13.)

Petitioner's Position. Petitioner computed a proposed fair value increment for the Indiana Cities' acquisition adjustment by applying its proposed cost of capital to the net amount. (*Petitioner's Exhibit JLC*, p. 10; *Petitioner's Exhibit JLC-1, Sched. 4.*) Petitioner's witness Eckart testified that Petitioner followed the treatment adopted by the Commission in the 2002 Rate Order. Mr. Eckart stated, however, that if the net amount were used, the Commission should allow Petitioner to recover the annual amortization amount as an above-the-line expense. (*Petitioner's Exhibit JEE*, p. 20.) Mr. Eckart also testified that if the fair value increment were calculated on the gross amount, it would be about $280,000 greater. (*Id.*)

OUCC's Position. Mr. Gassert noted that the amortization of the Indiana Cities acquisition adjustment had been discussed and denied by the Commission in Cause No. 40103. Mr. Gassert also noted that despite the denial in Cause No. 40103, Indiana-American was allowed to receive compensation for a portion of the annual amortization in Cause No. 40703. Mr. Eckart acknowledged this on page 18 of his testimony in response to the following quote from our 1997 Rate Order:

> We have not allowed Petitioner to amortize the acquisition adjustment as an above-the-line expense. Moreover, the 1993 acquisition adjustment is included in the fair value rate base but not the original cost rate base to which interest synchronization applies. Therefore, the acquisition adjustment should not be included in the interest synchronization calculation.

Ind-Am. Water Co., Cause No. 40703, at p.120. In response to this quote, Mr. Eckert stated that "[t]his methodology served to offset some of the effect of disallowing any recovery of the annual amortization expense." (*Petitioner's Exhibit JEE*, p. 18, lines 19-20; *Public's Exhibit 5*, p. 39, lines 10-14.) Mr. Gassert concluded, therefore, that in addition to receiving a return on the Indiana Cities' acquisition adjustment, Petitioner has been receiving a good portion of the annual amortization.

Intervenor's Position. Intervenor Industrial Group's witness Michael Gorman, disagreed with Mr. Eckert that the Commission's 2002 Rate Order on the treatment of acquisition expense was inconsistent with the Commission's 1996 and 1997 Orders. Mr. Gorman stated that fair value of an acquisition adjustment will decline over time just as the fair value of the assets that were originally acquired. Consequently, according to Mr. Gorman, reflecting the acquisition adjustment net of accumulated amortization is not inconsistent. Rather, according to Mr.

Gorman, it is necessary in order to state the acquisition adjustment at its test year fair value. (*Industrial Group Exhibit 1*, pp. 33-34.) According to Mr. Gorman, the fair value of an asset declines over time as its remaining life is shortened. He noted that the on-going value of the acquisition is maintained by reinvesting in the utility, but the reinvestment is not tied to the original acquisition premium that Petitioner paid to acquire the companies. (*Id.* at p.35.) Mr. Gorman opined that the fair value of an acquisition adjustment would be overstated if the adjustment is not reduced over time. (*Id.*) Mr. Gorman also testified that the Commission's interest synchronization methodology provides additional revenues to Petitioner by allowing it to earn a full return on the acquisition adjustment grossed up by the tax factor. (*Id.* at pp. 35-36.) In Mr. Gorman's opinion, if the Commission allows Petitioner to amortize above-the-line, then the interest synchronization methodology should be modified to include the debt component relating to the acquisition adjustment. (*Id.* at p. 36.)

Petitioner's Rebuttal In rebuttal, Petitioner's witness Eckart testified that although Petitioner's filing in this Cause followed its interpretation of the 2002 Rate Order, Petitioner believed the use of an amortized approach was inconsistent with prior Commission Orders. (*Petitioner's Exhibit JEE-R*, p. 20-21.) He described the statement in the 2002 Rate Order that the Commission agreed with the OUCC's analysis of this issue as a change from the prior two (2) rate orders. (*Id.* at p. 26.) Mr. Eckart further said that "[c]larification and consistency is needed in order for the Company to make good business decisions and have those decisions result in quality service for the citizens in Indiana." (*Id.* at p. 27.)

Commission Discussion and Findings. In testifying for the OUCC in Cause No. 42029, witness Gassert effectively responded to Petitioner's continued request to earn a return on the unamortized balance of the Indiana-Cities acquisition adjustment. (*See Public's Exhibit 5, Attach. ECG-1.*) Mr. Gassert stated, "In Cause No. 40103, Petitioner requested to collect $72,475,271 over a forty-year period. Without the two changes I discuss, Petitioner would collect $109,593,692 for that same time period. Thus, Petitioner will collect an additional $37,118,421 or 51% more in revenues than it originally requested." (*Id.* at p.28, lines 5-9.) Also during that testimony, Mr. Gassert discussed the Commission's findings in Cause No. 40103. He declared that:

> Clearly, the $1,112,482 fair value increment provided by the Commission is less than the $1,485,244 calculated using Petitioner's interpretation of Cause No. 40103. Therefore, it is clear that the Commission was providing a return on something less than the unamortized $17,412,009 acquisition premium and was possibly using the amortized amount.

Id. at p. 29, lines 17-22.

We conclude that our previous Orders are not inconsistent. Petitioner has never been given a return on its unamortized acquisition adjustment. Further, our position to disallow Petitioner the annual amortization is consistent with our previous Orders where the annual amortization was not included in rates. In fact, our position with respect to granting a return on an acquisition adjustment but no return of an acquisition adjustment is consistent with past practice of this Commission. As can be seen from reviewing Petitioner's Exhibit JLC-2, Schedule 3, "Summary of Acquisition Adjustments," Indiana-American's two (2) acquisition adjustments prior to the Indiana Cities' acquisition are included in rate base but the annual amortization is treated as a below-the-line item. Thus, we conclude that our position to allow a return on the amortized balance of the Indiana-Cities' acquisition adjustment is consistent with our prior orders and is fair and reasonable because we have provided Petitioner with additional compensation by not applying interest synchronization to the Indiana-Cities' acquisition premium.

3. Turkey Creek and Westwood Acquisition Adjustments

The Company did not contest the OUCC's proposed elimination of acquisition adjustments for the Turkey Creek and Westwood acquisitions and, therefore, we will not consider favorable ratemaking treatment with respect to these two (2) acquisitions.

C. Quantification of Original Cost Rate Base

Based on the evidence and the findings made above, the Commission finds that the original cost of Petitioner's water and sewer utility properties used and useful for the convenience of the public is as follows:

ORIGINAL COST RATE BASE

	COMMISSION FINDING	
UTILITY PLANT IN SERVICE		
UTILITY PLANT IN SERVICE	$ 743,339,339	
MISCELLANEOUS REMOVALS FROM RATE BASE	(946,378)	*
E-CIS SOFTWARE (*See* Sect. XI. B. 5.)	659,378	**
CAPITALIZED TANK PAINTING	618,576	
DEFERRED DEPRECIATION	2,394,136	
POST IN SERVICE AFUDC	4,280,607	
TOTAL PLANT IN SERVICE	$ 750,345,658	
ACCUMULATED DEPRECIATION		
UTILITY PLANT IN SERVICE	$ 169,763,405	
MISCELLANEOUS REMOVALS FROM RATE BASE	(304,020)	***
CAPITALIZED TANK PAINTING	423,626	
DEFERRED DEPRECIATION	619,527	
POST IN SERVICE AFUDC	1,018,365	
TOTAL ACCUMULATED DEPRECATION	$ 171,520,903	
NET UTILITY PLANT IN SERVICE	$ 578,824,755	
DEDUCTIONS:		
CIAC	$ 68,021,992	
ACCUMULATED AMORTIZATION OF CIAC	-	
CUSTOMER ADVANCES FOR CONSTRUCTION	43,277,659	
CAPACITY ADJUSTMENT	175,990	
TOTAL DEDUCTIONS	$ 111,475,641	
ADDITIONS		
ACQUISITION ADJUSTMENT (NET)	$ 1,086,259	
LESS: TURKEY CREEK (NORTHWEST) & WESTWOOD (W.LAFAYETTE)	(139,064)	
MATERIALS AND SUPPLIES	1,571,215	
TOTAL ADDITIONS	$ 2,518,410	
TOTAL ORIGINAL COST RATE BASE	**$ 469,867,524**	

Note: The totals marked with *, ** and *** are calculated in the tables below.

UTILITY PLANT IN SERVICE **WATER GROUPS – Public's Exhibit 3, Sch. 1.**	**COMMISSION FINDING**	
Excessive Capacity- Seymour Wells	-	
Excessive Capacity- S. Indiana Pumps	$ 753,378	
Muncie Meters	193,000	
Repl 2 1/2 ton truck- partial support	-	
INS Coating System @ I-65- partial support	-	
INS Lab Equipment- partial support	-	
TOTAL UTILITY PLANT IN SERVICE ADJ.	**$ 946,378**	*
E-CIS CALCULATION (*See*, Sect. XI. B. 5.)		
ORIGINAL COST OF ECIS SOFTWARE	$ 7,326,422	
INDIANA ALLOCATION OF SOFTWARE COST %	9%	
INDIANA ALLOCATION OF SOFTWARE COST	**$ 659,378**	**
ACCUMULATED DEPRECIATION **WATER GROUPS – Public's Exhibit 3, Sch. 1.**		
Excessive Capacity- Seymour Wells	-	
Excessive Capacity- S. Indiana Pumps	$ 232,248	
Muncie Meters	71,772	
Repl 2 1/2 ton truck- partial support	-	
INS Coating System @ I-65- partial support	-	
INS Lab Equipment- partial support	-	
Total	**$ 304,020**	***

D. Update of Prior Fair Value Finding

Petitioner's witness James Cutshaw evaluated Petitioner's proposed fair value increment by recomputing Petitioner's proposed cost of capital after deducting inflation from the cost of its outstanding debt, and multiplying that rate times a fair value rate base determined by updating the fair value finding from Petitioner's last rate order for new additions and inflation. To implement this methodology, Mr. Cutshaw updated the fair value finding in the 2002 Rate Order ($639,949,626) for inflation since the valuation date in the 2002 Rate Order using inflation rate data from the Valuation Edition of the Ibbotson Associates' publication, *Stocks Bonds Bills and Inflation 2003 Yearbook* ("*SBBI 2003 Yearbook*"). (*Petitioner's Exhibit JLC*, p. 12.) This publication is commonly used as a source of data for cost of capital studies. Mr. Cutshaw pointed out that this methodology is consistent with our Order in *PSI Energy, Inc.*, Cause No. 40003, 18; 173 PUR4th 393, 410 (Indiana Utility Regulatory Commission, Date Issued Sept. 27, 1996) and Indiana-American's 1997 and 2002 Rate Orders. To this total, Mr. Cutshaw added net investor-supplied plant additions since the last rate base valuation date to arrive at a total updated fair value estimate of $663,437,626. (*Petitioner's Exhibit JLC*, pp. 12-13; *Petitioner's Exhibit JLC-1*, *Sched. 4*, line 24.) Although OUCC witness Gassert disagreed with Mr. Cutshaw's inflation adjustment procedure, he did not disagree with the updated fair value amount and, in fact, used it in his own analysis. (*Public's Exhibit 5*, p. 21, line 19 through p. 22, line 3.) We shall discuss the issue of how to compute the rate of return applicable to the fair value rate base later.

E. Reproduction Cost New Less Depreciation

Petitioner's Position. A valuation of the reproduction cost new less depreciation ("RCNLD") of Petitioner's utility property as of December 31, 2003, was sponsored by Alan J. DeBoy. (*Petitioner's Exhibit AJD-1 and AJD-2.*) As part of his job responsibilities, Mr. DeBoy has visited and inspected each of Petitioner's operations and their associated facilities. (*Id.* at p. 8, lines 4-7.) Mr. DeBoy expressed the opinion that Petitioner's plant and systems are in a good state of operating condition, well maintained and used to provide utility service to the public. (*Id.* at p. 8, lines 9-12.)

RCNLD represents the cost of reproducing the existing system at present day costs, reduced for the loss in value experienced by the existing system due to wear and tear, obsolescence and lack of utility. (*Id.* at p. 9, lines 2-4.) Mr. DeBoy determined the reproduction cost new ("RCN") of Petitioner's utility property by applying cost trend factors to the original cost by vintage year of the various components of Petitioner's property (excluding land). (*Id.* at p. 9, line 16 through p. 10, line 8.) Mr. DeBoy said Petitioner's accounting records provide the necessary detail for a trended original cost study. (*Id.* at p. 10, lines 8-10.) The primary source for the trend factors used in Mr. DeBoy's study was the *Handy-Whitman Index of Public Utility Construction Costs for Water Utilities*, particularly utilities located in the North Central United States. (*Id.* at p. 11, lines 1-6.) Mr. DeBoy stated that he believed the *Handy-Whitman Indexes* are reasonable to use for estimating RCN because they were developed specifically for that purpose. (*Id.* at p. 12, lines 1-4.) Mr. DeBoy also testified that the *Handy-Whitman Indexes* have been published continuously since 1924 and are well-recognized around the country as suitable for determining the RCN of utility property. (*Id.* at p. 12, lines 20-22.)

Mr. DeBoy determined the RCNLD by deducting from the RCN depreciation necessary to reflect the current condition of the property. (*Id.* at p. 18, lines 12-17.) Mr. DeBoy calculated the percent condition of Indiana-American's property to be 77.12%. (*Id.* at line 18.) This ratio reflects the inverse of the relationship of the depreciation reserve to the cost of the plant. Mr. DeBoy asserted that this method is well accepted and recognized by the Commission and the Courts.

Mr. DeBoy's study quantified the RCNLD of Petitioner's used and useful utility plant in service as of December 31, 2003, to be not less than $1,242,525,436 after adjustment for 77.12% condition (depreciation) as follows:

Indiana-American, excluding Northwest	$ 841,421,166
Northwest	401,104,265
Total	$1,242,525,436 [sic]

Petitioner's Exhibit AJD, p. 18, line 19 through p. 19, line 2 (correct total is $1,242,525,431).

OUCC's Position. The OUCC presented the testimony of Scott A. Bell, Assistant Director of the Public's Sewer/Water/Rates Division, in response to Mr. DeBoy's testimony regarding Petitioner's RCNLD study and to Dr. John A. Boquist's testimony regarding "replacement cost rate base." Petitioner's witness, Dr. Boquist, is the Edward E. Edwards Professor of Finance at the Indiana University Graduate School of Business in Bloomington, Indiana.

Mr. Bell testified that Petitioner has presented a RCNLD study to support a fair value rate base figure in each of its last eight (8) rate cases. (*Public's Exhibit 8*, p. 6, lines 10-12.) He noted that in Indiana-American's last four (4) rate cases (Cause Nos. 42029, 41320, 40703 and 40103), Dr. Boquist provided testimony on fair value rate base and replacement cost rate base values. (*Id.* at p. 6, lines 12-14.) In addition, Mr. Bell acknowledged the Commission has accepted Indiana-American's RCNLD studies into the record as evidence in each of these cases.

However, Mr. Bell pointed out that this Commission has consistently determined that the fair value rate base is not equal to Indiana-American's proposed RCNLD value or its Replacement Cost Rate Base value. (*Id.* at p. 6, lines 15-21.) He created the following table of Petitioner's past eight rate cases to illustrate his point:

Cause No.	Final Order Date	Commission's Determination of Original Cost Rate Base	Petitioner's Proposed RCNLD or "Replacement Cost Rate Base" Value	Commission's Fair Value Rate Base Determination
42029	11/06/02	403,085,800	* 756,281,105	562,680,669
41320	07/01/99	293,003,938	* 492,108,096	No Determination
40703	12/11/97	221,628,031	* 398,701,046	311,804,823
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

* RCNLD value adjusted downward for technological change by Dr. Boquist to determine "Replacement Cost Rate Base."

Id. at p. 6, line 24, though p. 7.

In addition, Mr. Bell testified this Commission has considered RCNLD studies in other utilities' rate cases. However, Mr. Bell testified that this Commission has not equated fair value and RCNLD results in other utility cases. He stated the Commission has "consistently found utilities' fair value rate bases to be significantly less than the RCNLD values." (*Id.* at p. 7, lines 15-16.)

Mr. Bell went on to note that the Commission echoed the OUCC's concerns regarding use of RCNLD studies in prior Indiana-American rate cases. Specifically, Mr. Bell provided the following quote from the Commission's 2002 Rate Order:

> 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.

Ind.-Am. Water Co., Cause No. 42029, p. 28, lines 1-10; cited by *Public's Exhibit 8*, p. 8, lines 1-10.

He also quoted from the Commission's Order in *Northwest Indiana Water Company*, Cause No. 40467:

> We are faced with a concern that plagues all reproduction cost new studies, which is the very real probability that Petitioner's system would not in fact be reproduced in the same fashion today. Efficient planning, efficient construction, advances in technology, shifting demands and location for water and numerous other factors must first accurately be reflected otherwise a reproduction cost new study cannot be said to reflect fair value. Accordingly, while we will take Petitioner's proposed RCNLD into consideration in making our judgment as to what is an appropriate "fair value" for Petitioner's utility plant, we will be fully mindful of the inherent limitations of Mr. Smith's methodology and the theory of reproduction cost new.

Northwest Ind. Water Co., Cause No. 40467, 21-22 (Indiana Utility Regulatory Commission, Date Issued March 26, 1997) (cited by *Public's Exhibit 8*, p. 8, line 11 through p. 9, line 12).

Mr. Bell contended that the Company's plant would not remain the same if it were to be rebuilt today. He cited several Commission cases in which the Commission has expressed concern about using RCNLD studies to determine fair value rate base. Based on these prior Commission rate cases, Mr. Bell concluded that RCNLD studies have not been useful indicators of fair value. Mr. Bell therefore recommended this Commission not grant more weight to Petitioner's RCNLD study than we have in previous rate cases. (*Id.* at p. 9, line 13 through p. 10, line 7.)

<u>Petitioner's Rebuttal.</u> In rebuttal, Mr. DeBoy testified that, even if Petitioner's system would not remain exactly the same if rebuilt today, the RCNLD would not be less than the results presented in his study. (*Petitioner's Exhibit AJD-R*, p. 3, lines 5-15.) In fact, Mr. DeBoy noted that his study was conservative because it did not include the additional cost of working around or dealing with roadways, driveways and other surface improvements as well as underground utilities that would be required today. (*Id.* at p. 2, lines 2-18.) Furthermore, Mr. DeBoy noted that it would have been inefficient if the initial system had been designed and built to accommodate Petitioner's current customer demands. (*Id.* at p. 3, lines 10-12.) He further stated that differences in management practices and management personnel are not relevant because Petitioner's system is designed based on engineering standards and practices. (*Id.*) Finally, Mr. DeBoy responded to Mr. Bell's criticism of reliance on RCNLD studies by noting that Mr. Bell himself relied upon such studies in Cause Nos. 39838, 39839, 39840 and 39841 to determine the RCNLD of four (4) systems now owned by Petitioner. (*Id.* at p. 2, line 20 through p. 3, line 3.)

Commission Discussion and Findings. The Commission has long taken RCNLD studies into consideration in setting rates. We recently noted that "[t]his Commission has routinely accepted RCNLD studies into the record and considered them as evidence in support of Petitioners' fair value." (*South Haven Sewer Works, Inc.*, Cause No. 41903, 2 (Indiana Utility Regulatory Commission, Date Issued June 5, 2002).) In *Northwest Indiana Water Co.*, Cause No. 40467, we responded to arguments of the OUCC similar to those made here by Mr. Bell as follows:

> The OUCC's arguments regarding RCNLD are familiar to us. We recognize that no RCNLD study will achieve absolute perfection. Yet, as we have said many times previously, "[r]atemaking is, at best, an imprecise art." Indiana Gas Co., Cause No. 36816, 49 PUR4th 594, 609 (PSCI 10/27/82). This Commission routinely must rely on estimates which, we recognize, "can only be reasonable approximations." Boone County Rural Elec. Membership Corp. v. Public Serv. Comm'n, 239 Ind. 525, 535; 159 N.E.2d 121, 125 (1959). Accordingly, despite the minor shortcomings identified by the OUCC, we have found the use of the *Handy-Whitman Index* to be reliable in conducting RCNLD studies. Ind. Cities Water Corp., Cause No. 39166 (Indiana Utility Regulatory Commission, Date Issued July 8, 1992); Ind.-Am. Water Co., Cause No. 39215 (Indiana Utility Regulatory Commission, Date Issued May 27, 1992). We have also found that evidence of RCNLD is helpful in the task of determining fair value. See Id.; S. Ind. Gas & Elec. Co. ("SIGECO"), Cause No. 39871, 18 (Indiana Utility Regulatory Commission, Date Issued June 21, 1995).

Northwest Ind. Water Co., Cause No. 40467, p. 21.

Mr. Bell's prior reliance on this methodology also demonstrates its usefulness. Indeed, as a matter of law, "reproduction cost new cannot be disregarded in fixing a valuation for rate making purposes." (*Pub. Serv. Comm'n v. City of Indianapolis*, 235 Ind. 70, 108, 131 N.E.2d 308, 325 (1956).) Reproduction costs take into consideration inflation which the Commission may not ignore. (*Indianapolis Water Co. v. Public Serv. Comm'n*, 484 N.E.2d 635, 640 (Ind. Ct. App. 1985).) We therefore find that a reasonable estimate of the RCNLD of Petitioner's utility plant in service is $1,242,525,436.

F. Replacement Cost Less Depreciation

Petitioner's witness, Dr. John A. Boquist, testified that in economic theory the fair value of property should represent the depreciated replacement cost of the property, i.e., the cost today of similar assets with the same function and service potential. This definition captures the opportunity costs associated with allowing a firm to control its assets for the production of goods and services according to its business strategy. Any strategy which results in a value less than the assets' replacement cost should be abandoned, and the assets dedicated to other opportunities. This valuation concept is consistent with the work of James Tobin, developer of the "Tobin's q ratio," a widely accepted and recognized method of investment analysis which compares the market value of assets to their replacement cost.

Dr. Boquist said that the replacement cost of assets can be affected by technological change. Dr. Boquist testified that, while Mr. DeBoy's RCNLD value already reflects the impact of present day construction practices, to make sure the impact of technological change was not understated in the replacement cost estimate, he asked the Company to make a downward adjustment to Mr. DeBoy's RCNLD computation of 1.347% per year. This is the long-run average annual rate of change in multifactor productivity in the U.S. manufacturing sector during the period of 1948 through 2001 as reported by the U.S. Bureau of Labor Statistics. This adjustment results in an estimate of replacement cost less depreciation as follows:

Indiana-American, excluding Northwest	$605,575,457
Northwest	270,079,469
Total	$875,654,926

Petitioner's Exhibit AJD, p. 19, lines 4-9.

This amount when combined with other components of Petitioner's rate base results in a replacement cost less depreciation value of $882,408,588. (*Petitioner's Exhibit JAB*, p. 61; *Petitioner's Exhibit JAB-6.*) Dr. Boquist testified that this was a conservative estimate of fair value because land has been included at original cost (instead of its current value) and the 1.347% rate for technological change probably exceeds the rate experienced by the water industry. Accordingly, we find the replacement cost less depreciation value to be $882,408,588.

G. Fair Value

Indiana Code § 8-1-2-6 establishes that this Commission shall value a public utility's property at its "fair value." In *Indianapolis Water Co. v. Public Service Commission* (Ind. Ct. App. 1985), the Indiana Court of Appeals confirmed that a utility should be entitled to earn a fair rate of return on the fair value of its rate base. Furthermore, in its determination of "fair value" the Commission may not ignore the commonly known and recognized fact of inflation. (*Indianapolis Water Co.*, p. 640.) In *Indianapolis Water*, the Court of Appeals reaffirmed its holding in *Public Service Commission v. City of Indianapolis,* stating that "reproduction cost new cannot be disregarded in fixing a valuation for rate making purposes." (*Public Serv. Comm'n,* 235 Ind. 108, 131 N.E.2d 325 (1956).) The Court of Appeals expressly stated that this observation is as pertinent today as in 1956. The Court of Appeals has more recently confirmed that the Commission must authorize rates that provide the utility with the opportunity to earn a fair rate of return on the fair value of its property. (*Gary-Hobart Water Corp. v. Office of Util. Consumer Counselor,* 591 N.E.2d 649, 653-654 (Ind. Ct. App. 1992), reh'g denied July 1992; *Office of Util. Consumer Counselor v. Gary-Hobart Water Corp.*, 650 N.E.2d 1201 (Ind. Ct. App. 1995).)

As previously discussed, we will compensate Petitioner for the investment that made the Indiana Cities acquisition possible in the fair value return authorized herein. Such a result is well within the scope of the evidence, which includes quantification of the difference between the purchase prices and book values, the reproduction cost new less depreciation of Petitioner's utility properties, the replacement cost less depreciation of Petitioner's utility properties and an updating of our last fair value finding for inflation and new additions.

Based on the evidence of record, we find that the fair value of Indiana-American's utility property used and useful in the provision of utility service is not less than $663,400,000.

X. FAIR RATE OF RETURN

Having determined the fair value of Petitioner's property, the Commission must determine what level of net operating income represents a reasonable rate of return. This determination requires a balancing of the interests of the investors and the consumers. In *Bethlehem Steel Corp. v. Northern Indiana Public Service Co.*, the Indiana Supreme Court instructs 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." (397 N.E.2d 623, 630 (Ind. App. 1979)(quoting *Bluefield Water Works and Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692 (1923)).) One consideration in evaluating the reasonableness of a utility's return is the utility's overall weighted cost of capital.

A. Cost of Common Equity

Petitioner's Position. Petitioner presented the testimony of Dr. John Boquist on Petitioner's cost of common equity. In his direct testimony Dr. Boquist expressed the opinion that an 11.00% cost of common equity would be reasonable for Petitioner. (*Petitioner's Exhibit JAB*, p. 33, lines 6-14; *See Petitioner's Exhibit JAB-5.*)

In examining the cost of common equity, Dr. Boquist first employed the discounted cash flow ("DCF") model. Dr. Boquist testified that the DCF model stems from the assumption that investors are interested in the expected dividend yield and the future long-run growth in dividends. He said the annual form of the DCF model is simple but has two (2) inherent problems. First, it assumes annual dividends, while virtually all firms pay more frequent quarterly dividends, and quarterly dividends have greater value because they can be put to other profitable uses. Second, the DCF model assumes a single constant growth rate in perpetuity, which is an unrealistic assumption because dividend growth rates change over time and the ability to forecast what will happen to a single company in perpetuity from currently available company-specific data is problematic.

Dr. Boquist stated that he addressed these problems by reformulating the model in two respects. First, he incorporated quarterly dividend payments. Second, he used a two-stage model that reflected company-specific growth rates for the first ten (10) years (the first stage) and a growth rate reflective of the overall economy thereafter (the second stage). Since Petitioner's common stock is not publicly-traded, Dr. Boquist applied his DCF model to the three (3) publicly-traded water companies followed by Value Line Investment Survey ("Value Line") as a sample group.

Current dividends and stock prices for the sample companies were used to determine the current dividend yield. Dr. Boquist converted the current dividend yield to a forward-looking basis by applying his estimate of one (1) year of dividend growth. He used a growth rate in the first stage equal to Value Line's projection of each company's growth in cash flow. Dr. Boquist stated that for the water industry today, particularly given the recent lowering of the tax rate on dividends which encourages dividend increases, estimated cash flow growth best reflects investor expectations for these stocks. For the second stage, Dr. Boquist used a growth rate of 6.32%, the average growth rate of the gross domestic product ("GDP") since 1980. Dr. Boquist pointed out that this rate is virtually identical to the 6.3% estimate of nominal long-term GDP growth used in the *SBBI 2003 Yearbook*. This DCF approach arrived at an unadjusted result of 10.00%. (*Petitioner's Exhibit JAB*, p. 21, lines 1-3.)

Dr. Boquist made an upward adjustment of 1.00% or 100 basis points to the unadjusted DCF result to reflect Petitioner's greater inherent level of risk relative to the proxy group. Dr. Boquist stated that this greater level of risk stemmed from Petitioner's relatively small size, its investment quality, the relatively limited marketability of its securities and its limited service area. In making the adjustment Dr. Boquist considered the current yield spreads between various ratings of utility bonds and between utility bonds and treasury bonds. (*Petitioner's Exhibit JAB-4.*) Dr. Boquist said that investors are currently demanding extra returns to induce them to buy lower quality issues, a situation referred to as a "flight to quality." Dr. Boquist's adjusted DCF result was 11.00%. (*Petitioner's Exhibit JAB-5.*)

Dr. Boquist also used the capital asset pricing model ("CAPM"), which holds that the cost of equity is equivalent to the return on a riskless security plus a risk premium appropriate for the company being analyzed. The risk premium represents the equity risk premium for the entire market (the "market risk premium") multiplied by the beta coefficient ("beta") of the company. The beta measures the responsiveness of a common stock's rate of return to that of the overall market. In applying the CAPM, Dr. Boquist used a beta of 0.633, the average beta of the sample group as reported by Value Line. The market risk premium was represented by the difference between the long-run (post-1926) arithmetic average rate of return on the Standard & Poor's 500 ("S&P 500") and the average long-term government bond income return (interest) for the same period as reported in *SBBI 2003 Yearbook*. Dr. Boquist used as the riskless rate the greater-than-ten (10) year maturity treasury bond yield computed by Merrill Lynch and reported in the Wall Street Journal (the "Merrill Lynch 10+ year treasury index"). Dr. Boquist stated that this index has a par value weighted average maturity of approximately twenty (20) years which matches the maturity used by Ibbotson Associates in calculating the historical treasury bond returns. Dr. Boquist's unadjusted CAPM result for the proxy group was 9.59%. (*Petitioner's Exhibit JAB*, p. 25, lines 20-22; *Petitioner's Exhibit JAB-2*, line 7.)

Dr. Boquist increased this result by 2.06% (206 basis points) to 11.65% to adjust for the small stock risk premium specified in the *SBBI 2003 Yearbook* for companies with an equity market capitalization between $314.2 million and $521.3 million. (*Petitioner's Exhibit JAB*, p. 27, lines 20-21; *Petitioner's Exhibit JAB-2*, lines 8-9.) Dr. Boquist said this adjustment was necessary because Ibbotson Associates uses the large company stocks in the S&P 500 as a proxy for the market. Dr. Boquist cited the *SBBI 2003 Yearbook* which explains that a size adjustment is necessary because "even after adjusting for the systematic (beta) risk of small stocks, they outperform large stocks." (*Petitioner's Exhibit JAB*, p. 30.) Dr. Boquist testified that Ibbotson Associates gives substantial attention to the manner in which this adjustment can be made with their data, and he followed their procedure.

Dr. Boquist testified that it was necessary to use the treasury bond income return (interest) rather than the total return (interest and changes in value) in determining the market risk premium because only the income return is truly riskless to investors. (*Id.* at p. 28.) Dr. Boquist said the arithmetic averages must be used because the purpose is to estimate uncertain future returns, not measure historical performance. He cited a number of authorities supporting this view.

Dr. Boquist testified that a higher recommendation than 11.00% could easily be supported by giving more weight to the CAPM result because the CAPM accounts explicitly for risk relative to the overall market and the DCF model tends to understate the cost of common equity. He noted that the Commission has recognized the understatement inherent in the DCF a number of times, including its Order in *PSI Energy, Inc.*, Cause No. 40003 (Sept. 1996).

Dr. Boquist also discussed the understatement in the required return that will result if the market-derived cost of capital is applied to an original cost (book value) rate base when the market value of stock exceeds book value as is generally the case today. He noted that the average market-to-book ratio of the three (3) sample companies is 2.18, i.e. the average market value of their stock exceeds the book value of their stock by 2.18 times. He suggested some ways of responding to this issue would be to (1) make a market-to-book adjustment to the market-derived common equity models; (2) use the book value of stock, rather than the market value of stock, to determine the dividend yield in the DCF model; (3) use a market value capital structure, rather than a book value capital structure, which would increase the equity ratio and thus the overall weighted cost of capital; and/or (4) use a fair value rate base. Dr. Boquist said he would use the last alternative. This subject will be discussed hereafter.

OUCC's Position. The Public's witness, Mr. Edward Kaufman, Lead Financial Analyst in the OUCC's Rates/Water/Sewer division, used two (2) proxy groups to estimate cost of equity in this Cause. The first ("primary") proxy group was the same proxy group of water companies that Dr. Boquist used. The second ("secondary") proxy group included three (3) additional water companies not used by Dr. Boquist. Mr. Kaufman indicated that both of his proxy groups produced similar results.

Mr. Kaufman used both a DCF model and a CAPM analysis to reach his estimated cost of common equity for Petitioner of 8.75%. Mr. Kaufman's DCF analysis produced a range of 8.52% to 8.57%, while his CAPM analysis produced a range of 7.52% to 9.08%. Mr. Kaufman concluded that Petitioner was similar in size to two (2) of the three (3) companies in Dr. Boquist's proxy group and larger than the three (3) companies that Mr. Kaufman added to make up his secondary proxy group. Based on Petitioner's size compared to the companies in both proxy groups, Mr. Kaufman concluded that a small company risk adjustment was not merited for a company as large as Indiana-American Water Company. In addition, Mr. Kaufman quoted from Mr. John Eckart's testimony in Cause No. 42250, where Mr. Eckart asserted that American Water Works' acquisition by RWE would increase Indiana-American's access to capital markets. Mr. Kaufman also pointed out that in Cause No. 42488 Petitioner's witness Pauline Ahern had recommended a small company risk premium of only 25 basis points for Twin Lakes Utilities (A utility with only 5,000 customers). Mr. Kaufman's cost of equity estimates ranged from 7.52% to 9.08%. Mr. Kaufman then recommended a cost of equity of 8.75%.

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 ("DPS"), 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.

Although Mr. Kaufman relied on Value Line to estimate beta for his cost of equity analysis, his testimony indicates that he reviewed several sources of beta including Merrill Lynch, SmartMoney.com and Yahoo.com. Mr. Kaufman's testimony also indicated that Value Line produced the highest source of beta of all the sources he reviewed.

Mr. Kaufman asserted that an 8.75% cost of equity was reasonable in today's markets. Mr. Kaufman pointed out the forecasted inflation over the next few years was expected to remain low and asserted that lower inflation rates translate directly into lower capital costs. Mr. Kaufman cited to an article by Fama & French (the same analysts Dr. Boquist relied on for his return on replacement cost analysis), supporting a long term expected market return of 8.0% to 8.5%. Next, Mr. Kaufman cited to an article by John Bogle, founder of Vanguard Group, which forecasted a stock market return of 6.0% to 9.0% per year over the next decade. Mr. Kaufman also cited a book by Dr. Jeremy Siegel, *Stocks for the Long Run,* that forecasted a real (before inflation) return for the market of 6.6% to 7.2%. Mr. Kaufman then noted that when current forecasted inflation rates of 2.2% to 2.5% are combined with Dr. Siegel's forecasted market returns, it produces a market return of 8.9% to 9.9%.

Mr. Kaufman commented that since Petitioner was less risky than the overall market, and should have a lower expected return than the overall market, his proposed cost of equity was reasonable and consistent with the market forecasts made by John Bogle, Dr. Siegel and the Fama-French analysis. Finally, Mr. Kaufman cited to an order issued in West Virginia-American's recent rate case where the West Virginia Commission authorized a 7.0% cost of equity.

Mr. Kaufman criticized Dr. Boquist's two-stage DCF analysis. While accepting the theory behind the two-stage DCF model, Mr. Kaufman did not agree with Dr. Boquist's applications. Dr. Boquist's analysis assumes that for the next ten (10) years the dividends for each of the water companies in his proxy will grow at their three (3) to five (5) year forecasted growth rate in cash flow per share. His analysis then assumes that dividends will grow at the average historical growth rate of the United States Gross Domestic Product from 1980-2002, or 6.32%, in perpetuity after that. Mr. Kaufman criticized Dr. Boquist's analysis because he provides no basis to assume that each company in his proxy group will grow at the same rate in its mature stage. There was also no basis to assume that each company in Dr. Boquist's proxy group will reach its mature or a steady stage of growth at the same time. Some if not all of the companies in Dr. Boquist's proxy may have already reached their mature or steady rate of growth. Mr. Kaufman concluded that if one uses reasonable assumptions and tailors a two-stage DCF analysis to the specific conditions for each of the companies in a proxy, a two-stage DCF analysis could have merit. However, according to Mr. Kaufman, Dr. Boquist did not tailor his DCF analysis to be specific for each company and, therefore, Mr. Kaufman does not believe his assumptions are reasonable.

As an example, Mr. Kaufman cited to Dr. Boquist's analysis of one of the water companies used in his proxy group, American States Water. Mr. Kaufman testified that Dr. Boquist's analysis assumes that American States Water's dividends will grow at an average rate of 5.5% for the next ten (10) years and then will somehow increase to an average growth rate of 6.32% for the years 2014 and beyond. Without a company-specific analysis to explain why Dr. Boquist would expect American States Water's dividends to grow in that manner, Mr. Kaufman was unable to accept Dr. Boquist's assumption.

Mr. Kaufman also asserted that water company dividends will grow more slowly than the overall growth rate of the U.S. economy. Water utilities traditionally have relatively high dividend payout ratios, and therefore, low retention ratios. To illustrate, in 2003 California Water (CWT), another proxy company, had a payout ratio of almost 109% (CWT paid dividends of $1.12 per share on earnings of $1.01 per share) and a retention ratio of -9.0%. Mr. Kaufman stated that companies with high payout ratios are by definition retaining or reinvesting a smaller percentage of their earnings back into the company which causes slower earnings growth. Slower earnings growth in turn leads to slower dividend growth. Furthermore, dividend growth cannot indefinitely exceed earnings growth. Therefore, according to Mr. Kaufman, due to their higher payout ratios and lower retention ratios, it is unreasonable to assume that water utility dividends will grow as quickly as the U.S. economy.

Next, Mr. Kaufman stated that Dr. Boquist had overstated his estimate of growth in the U.S. economy. Mr. Kaufman asserted that, even if one accepts the premise that water utility dividends will grow as quickly as the U.S. economy, he believed that Dr. Boquist's analysis overstates the future growth rate of nominal GDP and subsequently overstates forecasted dividend growth for the second stage in his two-stage DCF model. To estimate the future growth rate of the U.S. economy, Dr. Boquist averages the growth rate of nominal GDP over the last twenty-three years (1980-2002). Mr. Kaufman asserted it would be more reasonable to use a forecasted growth rate of GDP than it is to rely on historical data, because the growth rate of nominal GDP and inflation have slowed significantly when compared to the growth rate of nominal GDP and inflation from the early 1980s. Furthermore, both the growth rate of the U.S. economy and the rate of inflation are forecasted to remain low. Thus, in his opinion, Dr. Boquist's reliance on historical nominal GDP overstates forecasted growth in nominal GDP and subsequently overstates his own estimate of dividend growth.

Furthermore, notwithstanding Dr. Boquist's premise that water company dividends will grow as quickly as the U.S. economy and his opinion that it is more appropriate to rely on historical data than it is to rely on forecasted data, Mr. Kaufman still believed Dr. Boquist's analysis overstated the expected growth rate in the U.S. economy and the subsequent forecast of dividend growth. Mr. Kaufman asserted that Dr. Boquist's reliance on historical growth in nominal GDP is based on data for the twenty-three (23) year period from 1980-2002 and seems somewhat subjective. Mr. Kaufman stated it would seem more appropriate to use a ten (10) year average of growth in nominal GDP to match Dr. Boquist's use of a ten (10) year period for the first stage of his DCF analysis. The ten (10) year average growth rate of nominal GDP of the U.S. economy was 5.16% (1993-2002). If Dr. Boquist used a 5.16% growth rate in the second stage of his DCF analysis, it would have reduced his unadjusted DCF estimate of Petitioner's cost of equity by 84 basis points from 10.00% to 9.16%.

Next, Mr. Kaufman emphasized that Dr. Boquist's analysis assumed a dividend stream that does not exist because it assumes dividends will grow each and every quarter. Mr. Kaufman stated that he was not aware of any publicly traded company that raises its dividends on a quarterly basis. By assuming that dividends increase every quarter, Dr. Boquist's analysis inflates the stream of dividend payments that the shareholder will receive. The higher dividend stream will lead to a higher estimated cost of equity. As such, the quarterly version of Dr. Boquist's two-stage DCF model inflates his estimate of Petitioner's cost of equity. Dr. Boquist cites the works of Dr. Ibbotson and Dr. Morin to support his DCF analysis. However, Mr. Kaufman testified that neither Dr. Ibbotson nor Dr. Morin employ a quarterly DCF model in the same manner that Dr. Boquist does in this Cause and that Dr. Boquist's DCF model is his own interpretation and is not directly supported by Dr. Morin or Dr. Ibbotson.

On page 41 of his testimony Mr. Kaufman also quoted from the Commission's Final Order in Petitioner's previous rate case, Cause No. 42029, as follows:

> As we noted in Cause No. 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 two-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 dividends will grow each and every quarter.

Ind.-Am. Water Co., Cause No. 42029, p. 83. Mr. Kaufman claimed that the two-stage DCF model that Dr. Boquist uses in this case suffers from the same flaws that the Commission criticized in Petitioner's last rate case.

Mr. Kaufman also criticized Dr. Boquist's use of forecasted cash flow per share of 7.17% for the first stage in his DCF analysis. Mr. Kaufman pointed out that this was the first time in five Indiana-American rate cases that Dr. Boquist had relied on forecasted cash flow per share in a DCF analysis. Mr. Kaufman then pointed out the change in Dr. Boquist's methodology from ten (10) year historical dividend growth to three (3) to five (5) year forecasted cash flow growth increased Dr. Boquist's estimate of growth (g) by 450 basis points. Next, Mr. Kaufman asserted that, since both Value Line and CA Turner are both forecasting relatively slower growth in dividends over the next five (5) years, he did not believe that using forecasted growth in cash flow was justified. Finally, Mr. Kaufman asserted that it was inappropriate to rely on any single estimator of growth because it ignored relevant information.

Mr. Kaufman also criticized Dr. Boquist's CAPM analysis. Mr. Kaufman stated in the development of his CAPM analysis, Dr. Boquist considered only an arithmetic mean risk premium. Also, Dr. Boquist relied solely upon long-term interest rates. Mr. Kaufman asserted that depending on the period of analysis, either the arithmetic mean risk premium or the geometric mean risk premium can provide reliable cost of equity estimates if combined with the appropriate risk-free rate. An arithmetic mean risk premium is based on short-term (annual) returns, and an arithmetic mean risk premium can be combined with a short term interest rate. The geometric risk premium is a long term measure of returns, and it is appropriate to combine the geometric mean risk premium with longer term interest rates. Mr. Kaufman explained that both methodologies have merit and should be given substantial weight.

Mr. Kaufman also criticized Dr. Boquist's use of bond income returns instead of total returns. On page 26 of his testimony, Dr. Boquist asserted that it is more appropriate to rely on income returns rather than total returns in estimating the market risk premium in his CAPM analysis. Although Mr. Kaufman acknowledged that Dr. Boquist's argument had some merit, he disagreed with his application.

Mr. Kaufman also challenged Dr. Boquist's 206 basis point adjustment to his CAPM analysis and his 100 basis point company-specific risk adjustment to his DCF model. In criticizing Dr. Boquist's 206 basis point adjustment to his CAPM analysis and his use of Dr. Ibbotson's small company adjustment, Mr. Kaufman asserted that these adjustments substantially overstate Petitioner's company-specific risk. As Ibbotson's equity size premium adjustment is based on the theory that smaller companies have earned returns above what would otherwise be predicted by a CAPM analysis, Mr. Kaufman stated he did not believe it is appropriate to directly apply Ibbotson's equity size premium adjustment to a regulated utility like Petitioner. He asserted that regulation decreases the risks faced by Petitioner. For example, Petitioner does not face the same bankruptcy risks that other small companies may face. Mr. Kaufman testified that the Commission supported the view that Ibbotson's micro cap adjustment cannot be blindly applied to utilities:

> We are familiar with the Ibbotson derived 400 basis point small company premium used by Mr. Beatty. The rationale behind this approach is that, all other things being equal the smaller the company, the greater the risk. However, to blindly apply this risk premium to Petitioner is to ignore the fact that Petitioner is a regulated utility. The risks from small size for a regulated utility are not as great as those small companies facing competition in the open market.

South Haven Sewer, Cause No. 40398, p. 30.

Mr. Kaufman also asserted that Ibbotson seems to recognize that its small company adjustment cannot be blindly applied to regulated water companies. The Valuation Edition of Ibbotson's *SBBI Yearbook 2001* provides estimates of industry-specific risk premiums. For the water supply industry, Ibbotson estimates a negative risk premium of 611 basis points. Thus, according to Mr. Kaufman, despite the smaller size of the companies included in the water supply industry, the water industry and the companies included in the water industry are significantly less risky than the overall market.

Mr. Kaufman then criticized Dr. Boquist's 100 basis point adjustment to his DCF model and stated it also overstated Petitioner's company-specific risk. In making his adjustment Dr. Boquist relied on or averaged the spread between A bonds vs. BBB bonds (47 basis points), and the spread between U.S. Treasury Securities and BBB bonds (184 basis points). Mr. Kaufman did not believe it is appropriate to use U.S. Treasury securities to estimate Petitioner's company-specific risk relative to the proxy group. In this analysis Petitioner is being compared to the proxy group. Mr. Kaufman further testified that the companies in Dr. Boquist's proxy have bond ratings ranging from AA- to A+. None of these companies in Dr. Boquist's proxy have a bond rating equal to the full faith and credit of the U.S. Government and, as such, it did not make sense to compare the spreads between BBB bonds and U.S. Treasury securities when comparing Petitioner's company-specific risk relative to the proxy group. Mr. Kaufman testified that Dr. Boquist's analysis assumes that if Petitioner were rated it would have a bond rating of BBB, while the companies in the proxy group have bond ratings from AA- to A+. Thus, Mr. Kaufman claimed that it makes sense to calculate the spreads between BBB versus both AA and A bonds to make a company-specific risk adjustment. While Mr. Kaufman was not in complete agreement that Petitioner would be rated as low as BBB, he agreed that a comparison to AA and A bond yields would have logic, but a comparison to U.S. Treasury securities would not.

Mr. Kaufman pointed out that if Dr. Boquist's use of United States Treasury securities to estimate a company-specific risk adjustment for Petitioner is disregarded, Dr. Boquist's own evidence does not support a 100 basis point adjustment to account for Petitioner's company-specific risk. The average spread between BBB bonds and A bonds is 47 basis points. Thus, according to Mr. Kaufman, even if one assumed Petitioner was rated as low as BBB, Dr. Boquist's analysis would not support a 100 basis point adjustment.

Mr. Kaufman asserted that Dr, Boquist has not provided evidence to support his assumption that Indiana-American would be rated as low as BBB, if it were rated. In fact a review of Indiana-American's most recent debt offerings does not seem to support the contention that Indiana-American's debt would be rated as low as BBB. Finally, the company-specific risk adjustments proposed by Dr. Boquist in this Cause are larger than the company adjustments he proposed in Petitioner's prior rate cases.

Mr. Kaufman's testimony also included a schedule which illustrated the changes in Dr. Boquist's testimonies over the last four Indiana-American rate cases.

Intervenors' Positions. The Industrial Group presented the testimony of Mr. Gorman on rate of return, who recommended that the Commission find Petitioner's cost of common equity to be 9.75%. Mr. Gorman first assessed Petitioner's risk because the allowed rate of return should reflect the investment risk. (*Industrial Group Exhibit 1*, p. 4.) In Mr. Gorman's opinion, the fact that water utilities typically finance their plant with a higher percentage of debt than unregulated companies indicates low operating risk. (*Id.* at p. 5-6.) He noted that Petitioner primarily relies on a subsidiary when issuing its debt. (*Id.*) He also noted that while Petitioner receives the economies of scale by participating in a corporate wide debt issuance program, it also incurs substantial costs. He concluded that both the value and risk reduction of Petitioner's affiliation with its parent company should be recognized in developing the appropriate rate of return. (*Id.* at p. 7.)

Mr. Gorman generally agreed with Petitioner's capital structure, but noted that the retained earnings reflected in its capital structure should be modified to reflect the Commission's approved return on common equity. (*Id.* at pp. 8-9.)

Mr. Gorman used both the DCF and CAPM analyses to derive his recommended return on equity. Mr. Gorman used a single stage annual DCF model using Dr. Boquist's sample group.