He determined the dividend yield by dividing the current annualized dividend, adjusted for next year's growth, by a thirteen (13) week average stock price. He determined the growth rate by averaging various analyst forecasts of earnings growth for the sample companies. A common equity cost rate of 8.6% resulted from this procedure. (*Id.* at pp. 10-13.)

Mr. Gorman opined that his DCF result was reasonable because the yield component was reasonable in light of the utility group's earnings retention and reduction of federal tax on dividend income and in comparison to the projected yield on five-year treasury bonds. He also noted that his growth rate was sustainable because it did not exceed the growth rate of the overall U.S. economy. (*Id.* at pp 13-14.) According to Mr. Gorman, the "U.S. economy growth projection represents a ceiling for a sustainable growth rate for a utility over an indefinite period of time." (*Id.* at p. 14.)

Mr. Gorman also applied the CAPM, using a beta of 0.68, the average of the Value Line betas for the three companies. He developed two market risk premiums, a forward looking estimate and a long term historic average. The forward looking estimate was based on his opinion of the expected return on the S&P 500, less the risk free rate of 6.1%, which was a projection of future long-term treasury bond yields appearing in the February 2004 edition of *Blue Chip Financial Forecasts*. The expected return was based on the arithmetic average of the real S&P 500 return (the return in excess of the inflation rate) from 1926 to 2002 as reported in *SBBI 2003 Yearbook* plus a consensus analyst inflation projection in the January 1, 2004 edition of the *Blue Chip Financial Forecasts*. (*Id.* at p. 16-17.) The second market risk premium was based on the arithmetic average of the S&P 500 total return for the same period as reported in the same volume, less the total return during that period on long-term treasury bonds. (*Id.*) Mr. Gorman's CAPM results were 9.8%, based on the historic risk premium estimate, and 10.5%, based on the prospective market risk premium. (*Id.*)

Based on his analysis, Mr. Gorman recommended that an appropriate return on equity for Petitioner would be 9.75%. (*Id.* at p. 18.) Mr. Gorman noted that the 9.75% would allow Petitioner to maintain the bond rating of its affiliate, American Water Capital Corporation ("AWCC"). (*Id.* at p. 19.)

Mr. Gorman also criticized Dr. Boquist's application of the DCF model, maintaining that an average stock price (rather than a spot price) should be used to calculate the dividend yield; cash flow growth does not necessarily indicate dividend growth; and analyst forecasts, rather than historical averages, should be used to estimate GDP growth in the second stage. Because of these factors, Mr. Gorman believed Dr. Boquist's two-stage DCF result was inflated. (*Id.* at p. 21.)

Mr. Gorman also disagreed with Dr. Boquist's use of a 1% premium as a small company risk premium. Mr. Gorman noted that Petitioner is not a small, stand alone company but rather a subsidiary of one of the world's largest water and wastewater companies. (*Id.* at p. 22.) Removing the 1% risk premium and high growth rate estimates from Dr. Boquist's DCF model would result in 8.6%. (*Id.*)

Mr. Gorman disagreed with Dr, Boquist's market risk premium estimate in the CAPM analysis. Mr. Gorman supported the use of treasury bond total returns, rather than income returns

as the risk free rate in the CAPM because the income return does not measure the actual return investors earn on treasury bonds. Rather, he stated that total annual returns are based on both dividend yields and price changes to bonds. (*Id.* at p. 23.) He noted that since investors cannot invest only in bond income returns, his own method is more accurate than Dr. Boquist's. (*Id.* at 24.) He also opined that a size adjustment for Petitioner should not be made because of the size of its parent company. He also contended that since Petitioner is a water utility, it is less risky than the companies in Ibbotson's eighth decile size category that Dr. Boquist relied upon. (*Id.* at pp. 24-25.)

Mr. Gorman also disagreed with Dr. Boquist's method of estimating a rate of return on the Petitioner's fair value rate base. He stated that method does not measure what investors require to assume the risk of the underlying investment. (*Id.* at p. 26.)

Intervenor Schererville's witness Sommer expressed the opinion that Petitioner's return on equity should be no greater than 10%. (*Intervenor Schererville's Exhibit 1*, p. 17.) Mr. Sommer reasoned that since Dr. Boquist's recommendation of 11.0% was 50 basis points less than his recommendation in Petitioner's last rate case, the Commission's 10.5% finding in the 2002 Rate Order should now be reduced by 50 basis points. Mr. Sommer asserted that in determining the cost of common equity, the Commission should treat Petitioner as less risky and, therefore, as having a lower cost of capital because of its affiliation with RWE AG, its ultimate parent company, which owns the stock of the largest U.S. regulated water utility holding company. (*Id.* at pp. 14-15.)

Petitioner's Rebuttal. In rebuttal, Dr. Boquist criticized Mr. Kaufman's DCF approach, including his failure to adjust for a full year of forward growth in determining the dividend yield. Dr. Boquist said Mr. Kaufman's half-year forward yield procedure was inconsistent with the mathematical derivation of the model, was theoretically unjustified and would result in the investor perpetually being short one half of the expected dividend growth.

Dr. Boquist disputed Mr. Kaufman's failure to give consideration to the quarterly payment of dividends. He said the ability to receive dividends quarterly has value, which increases the stock price and, thus, decreases the dividend yield calculated by Mr. Kaufman. Dr. Boquist pointed out that in *PSI Energy, Inc.*, Cause No. 40003, the Commission found it to be "inconsistent to use a stock price which reflects quarterly dividends in a model which assumes annual dividend payments unless the model is adjusted to reflect the quarterly dividends which lend to the investor expectations which give rise to the stock price." (Cause No. 40003, p. 29 (Sept. 1996).)

Dr. Boquist also criticized Mr. Kaufman's DCF growth rates. Dr. Boquist said the BVPS was a particularly poor indicator of dividend paying ability. Dr. Boquist opined that a more reasonable approach in this case is to use a two-stage quarterly dividend model and employ forecasted cash flow growth as the first stage. He noted that recent changes in the tax treatment of dividends render the historical data suspect.

Dr. Boquist disagreed with Mr. Kaufman's contention that a forecasted GDP growth rate would be more appropriate in the second stage of the two-stage DCF model. Dr. Boquist stated typical GDP forecasts do not encompass a long-term time frame as required for the second stage.

With respect to the CAPM, Dr. Boquist criticized Mr. Kaufman's use of geometric averages to estimate uncertain forward-looking expected returns. Dr. Boquist stated that Mr. Kaufman misinterpreted the 1982 Ibbotson volume, which did not discuss CAPM; in fact, the book never even mentions the CAPM. Dr. Boquist said the quote relied on by Mr. Kaufman is not inconsistent with specifying the use of the arithmetic average in the CAPM.

Dr. Boquist also said Mr. Kaufman failed to match the bond terms used for the risk-free rate with the twenty-year maturity period represented by the Ibbotson data. Dr. Boquist testified that it was incorrect for Mr. Kaufman to use treasury bond total returns as the risk free rate in the market risk premium calculation because they are affected by changes in value. Only the income return is truly riskless. He disputed Mr. Kaufman's position that the fact that the total return is higher than the income return is inconsistent with the theory for using the income return. Total returns reflect price risk from changes in interest rates. Dr. Boquist said it is only logical that the riskless rate as evidenced by the income return would be lower than the risky rate represented by the total return because investors expect compensation for risk.

Dr. Boquist also challenged Mr. Kaufman's view that the CAPM is more controversial and less reliable than the DCF model. He cited sources concerning reliability problems with the DCF model, including Charles F. Phillips, Jr., *The Regulation of Public Utilities* 395-396 (3rd ed. 1993), which describes a number of "theoretical and practical difficulties" with the DCF model, suggesting a degree of precision that does not exist and leaving wide room for controversy and argument. Dr. Boquist also said that Mr. Kaufman's own recommendation implicitly gives more weight to his CAPM results.

Dr. Boquist said Mr. Kaufman is in error in contending that a small stock premium is inappropriate for a regulated utility. A size adjustment is necessary for all small stocks because a small company will have a cost of common equity greater than that of a larger company with an equivalent beta. He pointed out that the *SBBI 2003 Yearbook*, on page 54, provides an example of the application of the CAPM to a small electric utility company which includes the addition of a size premium.

Dr. Boquist made some of the same comments about Mr. Gorman's testimony, particularly concerning unrealistically low DCF growth rates; a single-stage DCF that does not recognize the quarterly payment of dividends; use in the CAPM of treasury bond total returns instead of the truly riskless income returns; and failure to adjust for size in the CAPM. He also disputed Mr. Gorman's contention that analysts' forecasts should be used to estimate GDP growth in the second stage of his DCF model. Dr. Boquist stated that the second stage does not begin for ten years and then extends into perpetuity. The short term GDP forecasts to which Mr. Gorman refers have no relationship to the second stage time period.

Commission Discussion and Findings. There was considerable disagreement among the parties over the mechanics of the DCF model. First, regarding the calculation of the forward dividend yield in the DCF model, Dr. Boquist chose the full-year method, while Mr. Kaufman and Mr. Gorman utilized the half-year method. Second, regarding the estimation of the perpetual growth rate (g), Dr. Boquist chose the three (3) to five (5) year forecasted growth in cash flow per share for the first stage of his DCF model and the nominal growth rate of GNP for the second stage of his DCF model. Mr. Kaufman relied upon ten (10) year, five (5) year and forecasted

growth rates of dividends, earnings and book value per share. Mr. Gorman relied on five (5) year forecasted growth in EPS. We note that while Mr. Kaufman and Mr. Gorman relied on different estimators of growth for their respective DCF analyses, both estimates of growth had very similar results.

The Commission again reaffirms the positions it took in Petitioner's previous rate case, Cause No. 42029, regarding the growth rate and forward dividend yield, where, on page 31, we quoted from our Order in Cause No. 40103:

> This Commission believes that the DCF remains a viable model to aid in our determinations of Petitioner's cost of equity. As stated in our Final Order in Cause No. 40103 pages 40-41:
>
> The Commission has considerable experience with the DCF model for estimating the cost of equity. We are well aware of the advantages and limitations of the various approaches used by each of the witnesses. For example, the half-year method used by the OUCC for calculating the forward yield is the most frequently used approach in this jurisdiction and is rarely a point of contention in DCF analysis. We believe it fairly represents the dividend payments expected and received by investors, while the full-year method employed by Petitioner overstates dividend yield. A recalculation of Petitioner's DCF using the half-year method by the OUCC resulted in a 20 basis point reduction (Sudhoff direct, p. 29). On the issue of deriving growth rates this Commission has sanctioned the use of per share data for earnings, dividends and book value. *Northern Indiana Fuel and Light*, Cause No. 39145, 25 (IURC, Date Issued January 29, 1992). In all cases however, the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis.

Ind.-Am. Water Co., Cause No. 42029, 31 (quoting *1996 Rate Order*, Cause No. 40103, 40-41).

As we stated 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 that dividends will grow each and every quarter.

As we have stated before, this Commission continues to believe that both historical and forecasted earnings, dividends and book value per share data are useful when employing the DCF model. We will be skeptical of any DCF analysis that relies solely on one estimator of growth. This is particularly true when the change in growth estimator significantly increases the estimate of growth during a period of declining capital costs. In this case, Dr. Boquist's change from historical growth in dividends per share to forecasted growth in cash flow per share increases his estimate of growth from 2.83% to 7.17% (an increase of over 400 basis points). This "increase" in growth takes place despite the fact capital costs are lower than they were during Petitioner's previous rate case. Again, we disagree with relying on any single estimator to predict growth. We do not believe that investors will focus on any one estimator of growth and

ignore other relevant information. We disagree with relying solely on either forecasted or historical data in a DCF analysis.

Moreover, we are also specifically concerned about Dr. Boquist's use of cash flow per share to estimate growth in a DCF analysis. Depending on the utility's construction budget, changes in cash flow may not lead to changes in dividend growth. In his direct testimony Mr. Eckart stressed most water utilities will need to increase their construction budgets. When construction needs are high, an increase in cash flow may have little impact on dividend growth.

On a more technical basis, there is a mismatch in time periods. Dr. Boquist uses a three (3) to five (5) year forecast for the next ten (10) years. Dr. Boquist could perform a two-stage DCF analysis with the first stage being five (5) years. In addition, Dr. Boquist argues that investors look for cash flow to pay dividends. (*Petitioner's Exhibit JAB-R*, page 5, line 13.) However, retirement of debt and capital spending are also paid out of cash flow. A review of the Value Line Survey from Dr. Boquist's direct testimony reveals that for all three (3) utilities in his proxy group, capital spending per share exceeded cash flow per share. It follows that an increase in cash flow may not lead to an increase in dividends. Finally, a 7.17% near term forecasted growth rate in dividends per share fails any reality test. Analysts are not forecasting that type of growth in dividends for the water industry. The dividend forecasts presented by the other witnesses in this case forecast lower near-term growth in dividends for the water industry.

When determining a common equity cost rate, the Commission has observed the tendency of some cost of capital models to understate the required return, particularly when used in conjunction with an original cost rate base. As the Commission stated in *Indiana Michigan Power Co.*, "the unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore requires an upward adjustment based largely on the expert witness's judgment." (Cause No. 38728, 116 PUR4th 1, 17-18 (Indiana Utility Regulatory Commission, Date Issued Aug. 24, 1990). See, *PSI Energy, Inc.*, Cause No. 40003, 27 (Indiana Utility Regulatory Commission, Date Issued Sept. 27, 1996) ("We have indicated our own concerns with heavy reliance on the DCF model."). See also, *S. Ind. Gas and Elec. Co.*, Cause No. 40078, 24 (Indiana Utility Regulatory Commission, Date Issued June 21, 1995) ("...the DCF model, heavily relied on by the Public understates the cost of common equity."). These conclusions are borne out once again in this case and must be recognized.

Even though Mr. Kaufman continues to argue that the DCF model is a more reliable model, it would appear that he recognized the understatement inherent in his DCF model because his ultimate recommendation of 8.75% is more consistent with his CAPM results. Mr. Kaufman's DCF analysis results ranged from 8.52% to 8.57%, while his CAPM results ranged from 7.52% to 9.08%.

We also find some of Mr. Kaufman's criticisms of Dr. Boquist to be overstated. For example, Mr. Kaufman criticizes Dr. Boquist for using forecasted cash flow to establish the growth rate in the first stage in his DCF model on the ground that it is inconsistent with prior cases where Dr. Boquist used historical dividend growth. (*Public's Exhibit 6*, p. 55.) But he fails to acknowledge that Dr. Boquist has used cash flow growth in other cases in the past. (*Petitioner's Exhibit JAB-R*, p. 9.) Similarly, Mr. Kaufman seeks to persuade us that Dr. Boquist's use of a company-specific risk adjustment that is different in amount than in some past

cases is inconsistent. (*Public's Exhibit 6*, pp. 56-57.) Yet, Mr. Kaufman himself switched from making a company-specific risk adjustment in Petitioner's last rate case to making none here. (*Compare, 2002 Rate Order*, Cause No. 42029, p. 33 to *Public's Exhibit 6*, pp. 23, 56. *See also* the description of the OUCC's testimony in *1996 Rate Order*, Cause No., 40103, p. 39 and *1997 Rate Order*, Cause No. 40703, p. 34.)

There was also considerable disagreement regarding the CAPM analysis. The OUCC has relied on both the arithmetic and geometric mean to estimate the market risk premium, while Petitioner relied exclusively on the arithmetic mean premium. Petitioner's reliance on the arithmetic risk premium increases his risk premium by more than 150 basis points over the blended risk premium used by Mr. Kaufman.

In past rate cases this Commission has given weight to both the arithmetic and the geometric mean risk premiums. This position was reaffirmed in our 1996 Rate Order, when we stated "[t]he debate over the proper use of the arithmetic and geometric means is one we consider resolved. As we stated in Indianapolis Water Company, Cause No. 39713-39843, each method has its strengths and weaknesses, and neither is so clearly appropriate as to exclude consideration of the other." (*1996 Rate Order*, Cause No. 40103, p. 41.) Also, in the 2002 Rate Order, we stated "...that, while the debate over the proposed use of the arithmetic and geometric means continues, however, each method has its strengths and weaknesses, neither is so clearly appropriate as to exclude consideration of the other." (*2002 Rate Order*, Cause No. 42029, p. 32.)

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

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

We will continue to give both the geometric and arithmetic mean risk premiums substantial weight. Neither the arithmetic nor geometric mean risk premiums should be excluded in favor of the other.

Another area of disagreement in the CAPM analysis is whether the model should use total returns or income returns. We find Mr. Gorman's analysis in this area to be the most persuasive. The income return on Treasury bonds is simply the average of Treasury bond yield quotes over the historical period, and this yield quote does not measure the actual return investors earn by making investments in Treasury bonds. Investors simply cannot invest only in Treasury bond income returns. Rather, investors must take the risk of variations in bond prices before they invest in treasury bonds. Therefore the actual return experienced by investors in Treasury securities is measured by total return, not simply the income return.

We are also mindful, as was the OUCC in this Cause, of the assertions made by Thames Water and Indiana-American during our investigation in Cause No. 42250 of the effect that American's recent acquisition by Thames Water, a subsidiary of RWE AG, would have on Indiana-American ratepayers. In our Order in Cause No. 42250, we recalled the testimony of James McGivern, Managing Director-Americas of Thames Water, that Indiana-American's rates would not be increased as a result of the acquisition; that, to the contrary, Indiana-American's access to capital at reasonable rates should be enhanced by its affiliation with Thames Water and RWE AG, thereby providing long-term benefits to ratepayers in what is an extremely capital intensive industry.

In its testimony in this Cause, the OUCC quoted Indiana-American's President, Mr. Eckart, as testifying in Cause No. 42250 that American's acquisition by Thames Water would increase Indiana-American's access to capital markets. Our Order in Cause No. 42250 also recognized Mr. Eckart's assertion that Thames Water and RWE AG have strong credit quality and large financial resources that are devoted to their subsidiary utility businesses in general and water and wastewater utility businesses in particular. Our Order in Cause No. 42250, therefore, recognized Mr. Eckart's assertion that Indiana-American's affiliation with Thames Water and RWE AG would enhance Indiana-American's ability to meet its financial requirements.

The OUCC and Intervenors have put forth a number of reasons to disallow risk premiums in the calculations used to determine a cost of equity in this Cause. In particular, we agree with the testimony of the OUCC that Petitioner should not be subjected to a downward adjustment because of its subsidiary or otherwise affiliated relationship with American, Thames Water and RWE AG. Likewise, it would not be appropriate to determine Petitioner's cost of equity by delving into American's, Thames Water's or RWE AG's financial requirements or resources. But it is a reasonable conclusion that the benefits of being associated with such large and obviously credit-worthy companies should offset the company-specific risk adjustments that Petitioner has maintained should be applicable in this Cause. The standard financial models that all parties have relied upon to some extent in this Cause, that are useful in determining Petitioner's cost of equity, are based upon calculation of a number of components, including the inclusion or exclusion of a company-specific risk adjustment. The fact of Petitioner's relationship with a large international water company is a reasonable factor to consider in analyzing the applicability of the company-specific risk adjustment component. To be blind to the fact of Petitioner's relationship with a large international water company, when determining the appropriateness of applying a company-specific risk adjustment component to the standard models used to determine a reasonable cost of equity, would be to ignore reality. In addition, it is disconcerting to this Commission that Petitioner gives no recognition in its models for a rate adjustment in this Cause to the financial benefits that it claimed, in Cause No. 42250, its ratepayers would enjoy as a result of the relationship with a large international water company.

The Petitioner recommended a return of 11.00% on equity capital. However, the foregoing discussion of the evidence indicates that Petitioner's recommendation is too high given current levels of capital costs, prevailing economic conditions and because of adjustments made to Mr. Boquist's raw results to reflect Petitioner's increased level of risk relative to that of the proxy group. Petitioner's unadjusted DCF and CAPM results were 10.0% and 9.59%, respectively. These were then adjusted upward to reflect the alleged special circumstances of the Company and resulted in values of 11% for the DCF and 11.65% for the CAPM. The Public

recommended a return on equity capital of 8.75% based on DCF results of approximately 8.5% and CAPM results ranging from 7.52% to 9.08% with no special adjustments. Mr. Gorman recommended a return of 9.75% based on the results of his DCF and CAPM analysis, while Mr. Sommer recommended a return of no more than 10%.

Our review of the evidence indicates that Petitioner's circumstances, as well as economic conditions, have changed significantly since Indiana-American's last rate case. Petitioner's size has significantly increased; its ability to attract capital has improved as a result of being associated with a large international water company; and the cost of capital is substantially below that which prevailed at the time of the Company's last rate case. Taken together, Petitioner is no more risky than the proxy group companies and is less risky than in the past. Ignoring Petitioner's adjustments to its cost of equity estimates establishes a range of 9.59% to 10.0%.

Overall, the evidence does not support a cost of equity as low as the Public recommended. We recognize that capital costs have declined and that the cost of equity should follow suit. However, we have already opined that unadjusted DCF results can understate the cost of equity, and we are mindful of improved economic conditions which will continue to increase the cost of capital over time.

Based on our discussions above, we find the Petitioner's cost of common equity to be 9.25%. This figure is slightly below Petitioner's unadjusted range of results, but compares favorably to the recommended range of results of both the OUCC and the Intervenors of 8.75% to 10.0%. It affords Petitioner an opportunity to earn a pre-tax interest coverage ratio that will preserve an "A" bond rating, is high enough to compensate Petitioner for any marginal risks it faces and anticipates small but continuous increases in the cost of capital in the future.

B. Cost of Capital and Capital Structure

Having determined the cost of equity, we can now determine Petitioner's cost of capital. When a 9.25% cost of equity is incorporated into Petitioner's capital structure as shown below it produces a weighted cost of capital of 7.17%.

Description	Amount	Percent of Total	Cost Rate	Weighted Cost
Long Term Debt	$ 254,659,452	50.47%	6.86%	3.46%
Common Equity	199,979,016	39.64%	9.25%	3.67%
Preferred Stock	420,000	0.08%	6.00%	0.00%
Post-Retirement Benefits, net	2,815,896	0.56%	0.00%	0.00%
Deferred Income Taxes	43,642,668	8.65%	0.00%	0.00%
Job Development ITC-Post 1970	2,833,994	0.56%	7.91%	0.04%
Deferred ITC-Pre 1971	136,821	0.03%	0.00%	0.00%
Customer Deposits	0	0.00%	6.00%	0.00%
Accumulated Depreciation: Muncie Sewer	43,208	0.01%	0.00%	0.00%
Total	$ 504,531,055	100.00%		7.17%

C. Fair Rate of Return and Net Operating Income

Petitioner's Position. In its case-in-chief, Petitioner proposed to determine its NOI by multiplying its cost of capital by its original cost rate base plus its proposed acquisition adjustments. It is not until page 68 of Petitioner's proposed order that it proposes a single fair rate of return of 6.04% that can be applied to a single fair value rate base of $663,400,000. However, the fair rate of return figure does not appear in Petitioner's direct or rebuttal testimony, thus the origin of this figure is unclear. When a 6.04% fair rate of return is multiplied by the fair value rate base of $663,400,000, it produces a NOI of $40,069,360. The Commission notes that this is virtually the same figure which would be produced by multiplying Petitioner's weighted cost of capital by its original cost rate base plus its proposed acquisition adjustments.

Mr. Cutshaw performed a fair value test that he suggested supported Petitioner's proposed NOI. To derive a fair rate of return, Mr. Cutshaw removed the inflation component that he determined was embedded in Indiana-American's long term bonds. So, Mr. Cutshaw derived a rate of return by reducing the interest rate for each issue by the rate of inflation from the year of issuance to the end of 2002. In his direct testimony, Mr. Cutshaw argued that his methodology is appropriate because it will more accurately determine how much of Indiana-American's debt cost represents compensation for inflation. (Tr. p. G-77-78.) Mr. Cutshaw also cites to various Commission Orders to support his contention that inflation should be removed only from the debt portion of the capital structure. After removing the historical inflation from each debt issuance, Mr. Cutshaw derives an inflation adjusted cost of debt of 4.52%. Mr. Cutshaw then uses the adjusted cost of debt to derive an overall fair rate of return of 6.7%. Finally, Mr. Cutshaw concludes that since the NOI that would be produced from multiplying his fair rate of return by Petitioner's fair value rate base is greater than Petitioner's proposed NOI, Petitioner's proposed NOI is reasonable.

In an additional attempt to support the reasonableness of Petitioner's proposed return, Dr. Boquist presented a comparable return on replacement cost study. Dr. Boquist testified that the return of a utility should correspond to the return investors could earn on investments of comparable risk in the unregulated sector. If investors can earn a larger return and bear identical risks or, conversely, earn identical returns with less risk by investing in other industries, they will do so. Failure to recognize this fact would make it difficult for utilities to raise capital on a competitive basis. Dr. Boquist expressed the opinion that Petitioner should be allowed to earn a fair rate of return on the fair value of its property similar to the rate of return which unregulated companies of comparable risk earn on the fair value of their assets. Dr. Boquist performed a detailed study to determine that rate of return.

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

Dr. Boquist replicated the Fama and French study approach by performing a computer analysis of non-regulated firms in the New York Stock Exchange, American Stock Exchange and NASDAQ return files from the Center for Research in Security Prices and the merged COMPUSTAT annual industrial files of income statement and balance sheet data. The time period covered by this study extended from 1976 through 2002. The companies were then partitioned into matrixes for each year based upon the two (2) key Fama and French risk factors. Dr. Boquist then developed a portfolio of comparable companies reflecting the range of ME and BE/ME values for his three (3) proxy companies for each year.

Dr. Boquist then determined the pre-tax rate of return earned by the comparable companies on the depreciated replacement cost of their assets. To determine replacement cost, Dr. Boquist used the techniques described in the work of Lindenberg and Ross, published in the *Journal of Business* in 1981, which prescribes a methodology for estimating replacement cost of a firm's assets from its accounting statements. This method considers price level changes, technological change, real economic depreciation and investment in new plant and equipment. The same 1.347% technological change adjustment used by Dr. Boquist in his determination of Petitioner's depreciated replacement cost was used for the comparable companies. Dr. Boquist testified that he measured before income tax operating profit to eliminate the effects of leverage (the interest of which affects income taxes), the tax strategies some firms employ and tax loss carryforwards and carrybacks available to some companies. From this study, Dr. Boquist determined that the average, annual, pre-tax rate of return on replacement cost for the comparable companies from 1976 through 2002 was 10.6%. (*Petitioner's Exhibit JAB*, p. 57.) He concluded that a rate of return of 10.6% before income taxes on the depreciated replacement cost of Petitioner's property, would be fair and reasonable.

OUCC's Position. The Public used a process similar to that of the Petitioner to estimate an appropriate level of NOI for Indiana-American. The key difference is that the Public did not believe it was appropriate for Petitioner to earn a return on its proposed acquisition adjustment from its merger with Northwest. We considered this matter in a prior section of this Order and concluded that the return on the proposed acquisition adjustment for the merger with Northwest should be denied.

OUCC witness Mr. Gassert disputed Mr. Cutshaw's fair value test. Mr. Gassert showed that the methodology Petitioner used in this Cause to determine the fair rate of return was different than the methods Petitioner had employed in its previous cases. Mr. Gassert criticized Mr. Cutshaw's newest method that reduced the interest rate for each debt issue by the rate of inflation from the year of issuance to the end of 2002. Mr. Gassert noted that not only was this method inconsistent with Commission Orders in Petitioner's previous Causes but it was also inconsistent with the method Petitioner used since it began performing this calculation. Mr. Gassert stated that the purpose of removing inflation from the rate of return is not to remove inflation that is embedded in the cost of debt based on the life of the debt, but to remove the inflation for the time period that is embedded in the fair value rate base. Mr. Gassert then stated that it was necessary to try and match the inflation included in the fair value rate base when removing inflation from the cost of capital to determine a fair rate of return. Since all rate base items contain inflation, it is necessary to remove inflation from the entire capital structure and not just the debt component of the capital structure. Mr. Gassert further opined that, if Indiana-American continues to insist that inflation should be removed from only the debt component, the Petitioner should only inflate assets in its fair value rate base funded by debt to eliminate the mismatch created by Indiana-American.

Mr. Gassert noted that the Commission has consistently recognized that inflation is embedded in the overall weighted cost of capital. Mr. Gassert supported his comment with quotes from previous Indiana-American Orders in Cause Nos. 39595, 40103 and 40703. Mr. Gassert noted that in Cause Nos. 40103 and 40703, when inflation was removed from the debt component, the Commission explained that unfortunately it was forced to take a more conservative approach than it may have taken under different evidentiary circumstances because the evidence on inflation was "meager" in those cases. Next, Mr. Gassert applied the Commission's methodology outlined in Petitioner's rate order from Cause No. 39595 to Petitioner's fair value test. Using the Commission's method, Mr. Gassert estimated that the average inflation in Petitioner's rate base ranged from 3.0% to 4.6%. When Mr. Gassert applied the fair rate of return to Petitioner's fair value rate base, Mr. Gassert concluded that if Petitioner had followed a methodology similar to that outlined by the Commission, its fair value test would have resulted in a NOI substantially lower than the Company's requested NOI level. Mr. Gassert explained that in the OUCC's calculation of Petitioner's NOI, the OUCC did not remove inflation from the overall weighted cost of capital. Mr. Gassert further stated that the OUCC's calculation is consistent with the methodology used by the Commission in Cause No. 39595 and concluded that the OUCC's 5.07% fair rate of return when applied to a fair value rate base of $663,437,626 provided Petitioner's shareholders with a fair and reasonable return.

Through its witness Mr. Kaufman, the Public challenged Dr. Boquist's return on replacement cost analysis. Mr. Kaufman had several concerns regarding Dr. Boquist's Fama-

French analysis. In sum, the key concerns expressed by Mr. Kaufman were that Dr. Boquist's return on replacement cost analysis does not react to changes in capital markets, Dr. Boquist's analysis is based on operating returns while the Fama-French analysis is based on market returns and, lastly, the results of Dr. Boquist's analysis are contrary to the model.

Specifically, Mr. Kaufman asserted that Dr. Boquist's return on replacement cost analysis does not react to changes in market conditions. In models such as the DCF or CAPM, changes in investor expectations are quickly incorporated into expected returns. That is not the case in Dr. Boquist's return on replacement cost analysis. For example, a change in interest rates will impact investor expectations, and the results of both a CAPM and DCF analysis will, in turn, quickly react to reflect the change in investor expectations. Mr. Kaufman stated on page 61 of his testimony that "...during 2003 the yield on "A" Utility bonds decreased by approximately 81 basis points and Dr. Boquist's return on replacement cost analysis fails to either react or incorporate the change in interest rates over the last year into his return on replacement cost analysis."

Next, Mr. Kaufman criticized Dr. Boquist's use of operating returns. The Fama-French analysis assumes that firms in the same grid location will earn similar market returns. Market returns refer to price appreciation plus dividends. Dr. Boquist's analysis is based on net operating profit. Dr. Boquist uses operating income before taxes as his measure of return in estimating his return on replacement cost. While Dr. Boquist's analysis assumes that firms in the same grid location will earn similar operating returns, Mr. Kaufman contended that he presents no evidence to support his opinion that the Fama-French analysis can be extended to include his assumption. Mr. Kaufman agreed that there will be some relationship between market returns and operating returns, but he stated that many other factors will influence market returns that may have little or no impact on operating returns. For example, a change in interest rates will typically have an immediate impact on the market return of a company, but that change in interest rates may not have the same impact on current operating returns. According to Mr. Kaufman, a firm's financial leverage will impact its markets returns, yet Dr. Boquist's analysis specifically intends to remove the impact of financial leverage, as the Petitioner's witness stated on page 54 of his direct testimony, "I sought to obtain a measure of operating earnings of the comparable company group unaffected by leverage (the interest from which affects income taxes)."

Mr. Kaufman asserted that operating returns and market returns are distinct. Companies may have similar market returns, yet have very different operating returns. According to the OUCC, if Dr. Boquist chooses to assert that firms in the same Fama-French grid location will also have similar operating returns in addition to similar market returns, then it is his responsibility to demonstrate that this is the case. Given the lack of support that Dr. Boquist provides in his testimony which demonstrates that the Fama-French analysis can also be applied to operating returns, Mr. Kaufman claimed that such an assumption is not reasonable. Mr. Kaufman asserted, as an example, that in 1999 HJ Heinz Co. had a market return of -27.3%, yet Dr. Boquist estimated an operating return on replacement cost of 21.1%. (*Public's Exhibit 6*, pp. 62-63.)

Mr. Kaufman stated that the results of Dr. Boquist's return on replacement cost analysis produced results that were contrary to the model's predicted results. The Fama-French model

predicts that 1) smaller companies will earn a higher rate of return than larger companies and 2) companies with a higher book-to-market ratio will earn a higher rate of return than companies with a lower book-to-market ratio[3]. In his work papers, Dr. Boquist provides a calculation of returns by grid location for each of the 25 grid locations on his 5 by 5 grid. He does this on a year-by-year basis for each year from 1976-2002 and on a composite basis for all years. Mr. Kaufman provided a schedule that replicates the composite or average results of Dr. Boquist's analysis for all years. (*Public's Exhibit 6, Sched. 4*, p. 3.) Mr. Kaufman also included a copy of Petitioner's work paper that contains the data provided in Schedule 4, page 3. (*Id.* at p. 4.) In his analysis Dr. Boquist separates the companies into quintiles, as measured by market equity, which get larger going left to right (grid locations 1 to 5). Companies are also separated into quintiles as measured by book-to-market ratio with an increasing book-to-market ratio going from top to bottom (grid locations 1 to 5). Thus, companies in grid location (1,1), located in the upper left hand corner, have the smallest market equity and the lowest book-to-market ratio. Conversely, companies in grid location (5,5), located in the lower right hand corner, have the largest market equity and have the highest book-to-market ratio. Under the Fama-French model smaller companies should earn higher rates of return than larger companies, therefore rates of return should increase as one moves horizontally from grid 5 to 1 (right to left). Likewise, under the Fama-French model, where firms with a lower book-to-market ratio should earn lower rates of returns, rates of return should increase as one moves vertically from grid 1 to grid 5 (top to bottom).

Mr. Kaufman then asserted that the figures in Dr. Boquist's analysis did not follow the theory put forth by the Fama-French model. Mr. Kaufman stated that grid location (5,1) located in the upper right hand corner, which contains the largest companies with the smallest book-to-market ratio, shows the highest rate of return (18.04%) when, in fact, the theory dictates it should have the lowest rate of return. According to Mr. Kaufman, under the Fama-French model, the highest rate of return should appear in grid location (1,5) which contains the smallest companies with the highest book-to-market ratio. But, under Dr. Boquist's analysis, grid location (1,5) has one of the lowest rates of return (2.24%).

Additionally, Mr. Kaufman compared the final results of Dr. Boquist's analysis in Cause No. 42029 to the results in a previous Indiana-American rate case, Cause No. 41320. This comparison caused Mr. Kaufman to question the validity of the study's results. According to Mr. Kaufman, although both he and Dr. Boquist disagreed on Indiana-American's cost of equity in Cause No. 42029, both of them estimated a cost of equity in that case that was similar to what each witness estimated in Cause No. 41320. Mr. Kaufman asserted that, despite this fact, Dr. Boquist's estimated return on replacement cost had increased from 7.58% in Petitioner's Cause No. 41320 to 11.88% in Cause No. 42029. According to Mr. Kaufman, between Petitioner's Orders in Cause Nos. 42029 and 41320, Dr. Boquist had increased his estimate of Petitioner's cost of equity by 25 basis points[4] and increased his estimated fair rate of return by 430 basis

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

[4] Dr. Boquist recommended an 11.5% cost of equity in Cause No. 42029 and an 11.25% cost of equity in Cause No. 41320.

points. Mr. Kaufman stated that Dr. Boquist did not explain this dramatic increase in his estimated return on replacement cost during a period where capital costs have remained relatively stable.

Finally, Mr. Kaufman testified that Dr. Boquist performed no review or analysis of his results to test the validity of his study. For example, in his analysis there are approximately 26,375 return on replacement cost estimates from 1990-2002. This sample has an average return of 5.13% and a standard deviation of 28.69%. According to Mr. Kaufman, such a high standard deviation raised concerns, in addition to the concerns he stated previously, and should not be ignored. In his opinion, Dr. Boquist had not demonstrated the validity of his analysis.

Petitioner's Rebuttal. OUCC witness Gassert proposed deducting the average annual inflation rates since 1926 or 1963 from Petitioner's entire cost of capital. Mr. Cutshaw testified in rebuttal that his method is more accurate than Mr. Gassert's because it accounts for the fact that the inflation of concern to the debt investor is the inflation that will occur during the time the debt is outstanding. Mr. Gassert's inflation deduction lacks this correlation because Petitioner's debt has been outstanding for periods much shorter than those used by Mr. Gassert and during a period when inflation was lower than the long-term averages used by Mr. Gassert. Mr. Cutshaw testified that Mr. Gassert's method of deducting inflation from all components of the capital structure is inconsistent with the 1996, 1997 and 2002 Rate Orders. For example, in the 2002 Rate Order the Commission stated that, "[T]his Commission has asserted in previous rate cases that, since the fair value rate base contains inflation that . . . is historic and not prospective inflation, it should be removed from the debt component of the cost of capital to estimate a fair rate of return." (*2002 Rate Order*, Cause No. 42029, p. 39.) Mr. Cutshaw said that Mr. Gassert's proposal created negative cost rates for some capital structure components and resulted in an unreasonable and illogical net operating income when applied to the OUCC's proposed cost of capital.

Mr. Cutshaw argued that Mr. Gassert's proposed methodology produced NOIs that were too low to be credible because it produced a NOI that was below the NOI that would be derived based on original cost rate making. By adjusting for historic inflation in the embedded cost of debt, Mr. Cutshaw also claimed that his own methodology of deducting from each debt issuance the average inflation rate during the period that the issue has been outstanding is better than Mr. Gassert's method. Finally, Mr. Cutshaw maintained that Mr. Gassert's position that inflation should be deducted from all components of the cost of capital is not consistent with prior Commission orders.

In his rebuttal testimony, Dr. Boquist testified that his study was consistent with the Fama-French model. He said Fama-French have employed a 5 by 5 grid in their analysis. Dr. Boquist testified operating returns are a necessary component of fair value ratemaking and are correlated to market returns. Dr. Boquist also argued that the results of his analysis were consistent with the theory of the Fama-French model and that it would be expected for small companies to show relatively lower contemporaneous returns on fair value since the denominator is larger even though small companies generate higher average stock market returns (i.e., dividend and stock price increases) than do large companies. He said his study is company-specific, pointing out that there is no difference in the level of specificity in the study and in Mr.

Kaufman's CAPM results. He also said higher rates of return on replacement costs are to be expected during periods of strong economic growth.

Commission Discussion and Findings. The cost of capital is a percentage which can be converted into an earnings requirement only by applying that percentage to a rate base. In *Duquesne Light Co. v. Barasch,* the United States Supreme Court held that the U.S. Constitution does not require "the adoption of a single theory of valuation.... The Constitution within broad limits leaves the States free to decide what rate setting methodology best meets their needs in balancing the interests of the utility and the public." (488 U.S. 299, 316 (1989).) Indiana has selected the fair value rate base methodology. The Supreme Court described the fair value approach as follows:

> Under the fair value approach, a "company is entitled to ask . . . a fair return upon the value of that which it employs for the public convenience," while on the other hand, "the public is entitled to demand . . . that no more be exacted from it for the use of [utility property] than the services rendered by it are reasonably worth. [*Smyth v. Ames*,] 169 U.S. 466, 547 [(1898)]. In theory the *Smyth v. Ames* fair value standard mimics the operation of the competitive market. To the extent utilities' investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an "above-cost" return, that is, a fair return on the current "market value" of the plant. To the extent utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.

Duquesne Light Co., pp. 308-309. As previously discussed, the Indiana fair value rule is a significant factor in treating the acquisition adjustments at issue in this case. In light of the findings made above, including how the purchase prices served to bring the property to its present state of efficiency and the cost savings that investment made possible, Petitioner should be allowed a return on the net amount of the Indiana Cities acquisition adjustment through fair value ratemaking.

As we did in our 2002 Rate Order, we will use the following standards and criteria to determine a fair rate of return on Petitioner's investment in its utility plant:

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

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

3) Return sufficient to maintain and support the Petitioner's credit [rating];

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

2002 Rate Order, Cause No. 42029, p. 38. One recognized method for evaluating the reasonableness of a utility's allowed return involves investigation of the utility's capital structure. From such investigation, we can develop the overall weighted cost of capital. This

cost of capital may then be considered in determining a fair return. Having previously determined that the fair value of Petitioner's rate base is $663,400,000, it is now our duty to determine a fair rate of return that can be used to calculate a fair dollar return for Petitioner's net operating income.

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

As the Supreme Court of Indiana determined in *Public Service Commission v. City of Indianapolis*,

> The ratemaking process involves a balancing of all these factors and probably others. It involves a balancing of the owner's or investor's interest with the consumer's interest. On the one hand, the rates may not be so low as to confiscate the investor's interest or property. On the other hand, the rates may not be so high as to injure the consumer by charging an exorbitant price for service and at the same time giving the utility owner an unreasonable or excessive profit.

235 Ind. at p. 96, 131 N.E.2d at p. 318. Therefore, the results of any return computation may be tempered by the Commission's duty to balance the respective interests involved in ratemaking. Finally, the end result of this Commission's Orders must be measured as much by the success with which they protect the broad public interest entrusted to our protection as by the effectiveness with which they maintain credit and attract capital.

This Commission has asserted in previous rate cases, insofar as the fair value rate base contains historic inflation, that it is historic inflation and not prospective inflation that should be removed from the cost of capital to estimate a fair rate of return. For example, in the 1996 Rate Order, we explained that "[i]n order to avoid over-compensating Petitioner for the effects of historical inflation, it is necessary to remove the historical inflation component from the costs of capital to derive a fair return." (*1996 Rate Order*, Cause No. 40103, p. 48.) In addition, this Commission determined in *Indiana Michigan Power Company* that

> It is inappropriate to apply to the fair value of Petitioner's used and useful property its weighted cost of capital because the weighted cost of capital contains both historic and prospective inflationary factors. We have accounted for the historic inflationary factors in determining the fair value of Petitioner's property. Therefore, to arrive at a fair return to be applied to the fair value of Petitioner's property the historic inflationary considerations must be removed, lest they be double counted. (emphasis added).

Ind. Mich. Power Co., Cause No. 38728 (1990), p. 28.

On page 21 of his testimony, Mr. Gassert recommended rates of inflation from 3.0% to 4.6% and a fair value range of 3.27% to 4.87%, using the methodology in Cause No. 39595. Mr. Gassert ultimately recommends a fair return of 5.07%. However, Mr. Gassert removed his inflation values from Petitioner's proposed cost of capital of 7.87%. Applying the methodology from Cause No. 39595 to the OUCC's proposed cost of capital of 6.97% and our finding of 7.17% results in ranges of 2.37% to 3.97% and 2.57% to 4.17%, respectively. The use of the Cause No. 39595 methodology in this case yields results that are too low when compared to the OUCC's ultimate recommendation. Petitioner's recommended fair value return appears to be 6.04%. Based on the results of the parties' analyses and their recommendations, we find a range for fair value return to be 5.0% to 6.0%. Based on the evidence, we find 5.38% to be a fair rate of return, and should be approved. When applied to the $663,400,00 fair value rate base, a required NOI level of approximately $35,669,628 is produced. This should adequately compensate Petitioner for the purchase price paid to acquire Indiana Cities.

XI. OPERATING RESULTS UNDER PRESENT RATES

A. Revenues

Petitioner's proposed pro forma annual revenues at present rates originally totaled $135,646,024, and were increased to $137,740,829 on rebuttal. The OUCC's proposed pro forma revenues at present rates equaled $139,532,714. The differences are described and reconciled hereinafter. The resolution of these issues will also have a corresponding impact on certain expenses which vary with the quantity of water delivered and revenues received.

1. Residential Usage Normalization

Petitioner's Position. Petitioner proposed to adjust test year revenues to reflect the normalization of residential customer usage. A usage normalization adjustment would account for potential unusual or unseasonable conditions during the test year which might impact the demand for water. It is derived by comparing the test year usage to some other benchmark over an historical period.

In direct testimony, Bruce I. Tapp, Jr., a Financial Analyst for Indiana-American, conducted a regression analysis in which he examined the trend in consumption over time. He used time as the independent variable and average residential water usage per month as the dependent variable. In conducting this analysis, Mr. Tapp used data from the last nine and one half (9½) years (114 months). (*Petitioner's Exhibit BIT*, pp. 7-10.)

In performing his analysis, Mr. Tapp compared actual test year average residential usage to the model's predicted usage during the test year. As part of his analysis Mr. Tapp used a method he called the Classical Decomposition Multiplicative Model ("CDMM"). The CDMM adjusted residential usage data for seasonality so that it could be used in a regression analysis. (*Id.*)

Based on his analysis, Mr. Tapp concluded that average residential usage was declining. He concluded that actual usage during the test year exceeded his expected/projected usage.

Therefore, Mr. Tapp reduced test-year revenues by $1,734,221 to correct the discrepancy between the actual test-year data and his projected data for the same time period. (*Id.*)

Mr. Tapp testified the Commission had used simple, historical averages in the past, rather than a regression analysis. In explaining his departure from previously employed methodologies, he stated that his methodology using a regression analysis was superior to either a three (3) year average or a five (5) year average because his regression analysis had a mean absolute deviation ("MAD") of .196, while a five-year average and a three-year average had MADs of .221 and .256, respectively. In other words, the average monthly difference or "error" between the actual, historical data and the projected (or averaged) data was lowest (best) for Mr. Tapp's regression analysis and highest (worst) for a three-year average. The MAD for a five-year historical average was in between the MAD for the three-year average and the regression analysis. (*Id.*)

<u>OUCC's Position.</u> The OUCC recommended this Commission make no adjustment to test-year data for usage normalization. The OUCC's witness Edward Kaufman presented testimony disputing the reliability of Mr. Tapp's analysis. (*Public's Exhibit 6*, pp. 70-76.)

Specifically, Mr. Kaufman criticized Mr. Tapp's analysis because Mr. Tapp did not calculate the R^2 value for his regression analysis. Mr. Kaufman explained, "R^2 is the proportion of the total variation in Y explained by the regression of Y on X. Or in layman's terms the R^2 explains the percentage change in the dependent variable (in Mr. Tapp's analysis, water usage) that is explained by the change in the independent variable (in Mr. Tapp's analysis, time [monthly basis])." (*Id.* at p. 71-72.)

Mr. Kaufman explained that calculating the R^2 is an easy way to test the reliability of a regression analysis. Specifically, he noted in his testimony that Mr. Tapp's analysis was performed as a Microsoft Excel document, and Excel gives users the option of having the R^2 of an analysis automatically calculated. (*Id.*)

Mr. Kaufman testified that Mr. Tapp's regression analysis had an R^2 of only .0511 before correcting for autocorrelation (discussed below). Mr. Kaufman explained that this R^2 showed that only 5.11% of the change in average customer usage was explained by the passage time. Mr. Kaufman concluded that an R^2 of only 0.0511 was too low to make a reliable conclusion between time and its impact on water usage. (*Id.*)

In addition, Mr. Kaufman criticized Mr. Tapp's analysis because Mr. Tapp did not correct his results for a statistical bias called "autocorrelation." Mr. Kaufman explained that autocorrelation exists where there is a relationship or correlation between the values of a time series and previous values in the same series. The result is the appearance of a stronger relationship between the dependent and independent variables than actually exists. Mr. Kaufman pointed out that correcting for autocorrelation showed the 5.11% relationship between time and usage shown by Mr. Tapp's analysis was actually overstated. (*Id.* at p. 72, line 7 though p. 73, line 6.)

Mr. Kaufman further disputed Mr. Tapp's analysis by noting Mr. Tapp failed to account for changes in Indiana-American's customer base. Specifically, Mr. Kaufman divided Mr.

Tapp's data into two (2) samples: one prior to the merger with Northwest and United (January 1994 – December 1999) and a second after the merger with Northwest and United (January 2000 – June 2003), and then recalculated Mr. Tapp's regression analysis for the post-merger data. Mr. Kaufman testified that this analysis, using only the post-merger data, shows that average residential monthly usage is increasing and not decreasing. (*Id.* at p. 74, line 13 through p. 75, line 3.)

Mr. Kaufman's testimony included a series of eight (8) graphs that illustrated the low R^2 in Mr. Tapp's analysis and the impact of dividing Mr. Tapp's data into two (2) samples. (*Public's Exhibit 6, Sched. 6.*) Finally, Mr. Kaufman asserted that a MAD, or average error, of 196 gallons per month was so high that it rendered Mr. Tapp's analysis and his subsequent conclusions meaningless. Mr. Kaufman observed that this average monthly error (196 gal.) was nearly as high as Mr. Tapp's entire projected decrease over 9½ years (203 gallons per month). (*Public's Exhibit 6*, p. 75, line 9 through p. 76, line 15.)

Based on Mr. Kaufman's analysis and his criticism of Mr. Tapp's analysis, the OUCC recommended that no adjustment be made based on residential usage.

Petitioner's Rebuttal. In rebuttal, Petitioner's witness, Mr. Cutshaw stated Petitioner would no longer rely on Mr. Tapp's regression analysis, due to "the complexity of the issues that have been raised by Mr. Kaufman[.]" (*Petitioner's Exhibit JLC-R,* p. 5, lines 14-16.) Instead, Mr. Cutshaw offered a new usage normalization adjustment, calculated by comparing a three-year historical average to actual test year data. This change in methodology reduced Petitioner's proposed revenue adjustment from $1.73 million to $1.2 million.

OUCC's Response to Three-Year Average. The Presiding Officers permitted the OUCC to present live testimony at the end of the hearing to respond to Petitioner's new usage normalization adjustment and corresponding new revenue adjustment. The OUCC continued to recommend that the Commission make no revenue adjustment, due to the unreliability of both of Petitioner's proposed methodologies.

The OUCC presented the live testimonies of Edward Kaufman and Utility Analyst Judith I. Gemmecke. Mr. Kaufman reminded the Commission that Petitioner's justification for using a three-year average instead of a five-year average in Cause No. 42029 was that average residential monthly usage was declining at that time. However, Mr. Kaufman reiterated the point from his direct testimony that according to Petitioner's data, average monthly residential usage over the last three and one half (3½) years is in fact increasing, not decreasing. Consequently, the OUCC testified that using an adjustment based on a three-year average was inappropriate. (Tr. pp. H-73–74.)

Mr. Kaufman stated that using a five-year historical average was more appropriate than using Petitioner's three-year average. Mr. Kaufman noted that using Petitioner's proposed three-year average resulted in a downward adjustment to test-year revenues of $1,193,000, while using a five-year average resulted in an upward adjustment to test-year revenues of $214,000. (Tr. p. H-74.)

Mr. Kaufman stated that a five-year average had a lower MAD than the three-year average advocated by Mr. Cutshaw. (Tr. p. H-75.) Mr. Kaufman observed that the three-year average's higher error rate indicated less reliability. (*Id.*) However, Mr. Kaufman stated that the spread of results from all three (3) methodologies (three-year average, five-year average, and regression analysis) demonstrated that estimating average customer usage is imprecise at best. (Tr. pp. H-76-77.) Therefore, Mr. Kaufman concluded that all three (3) methods were unreliable and that none of them should be used. (*Id.*)

Public's witness Ms. Gemmecke also provided live and filed testimony. (Tr. p. H-79-85; *Public's Exhibit 1-A, 1-B, 1-C,* and *1-D.*) In her testimony submitted at the hearing, she claimed that Petitioner has not been consistent in a methodology to determine usage normalization. (*Public's Exhibit 1-D.*) For example, in Cause No. 42029, the Commission allowed Petitioner to use a three-year historical usage average because, in that case, the three-year precipitation average more closely approximated the precipitation average for the previous thirty (30) years. (*Id.*; Tr. p. H-84.)

Ms. Gemmecke testified that in this case, however, the five-year precipitation average more closely approximated the thirty-year precipitation average than did Petitioner's proposed three-year average. Consequently, there was no justification for Petitioner's use of a three-year average. Ms. Gemmecke provided a chart and data to support her position that the five-year average is in fact closer to the thirty-year average than is the three-year average. (*Id.*)

Next, Ms. Gemmecke explained the difference between "weather normalization" and "usage normalization." She explained there are many factors that influence usage other than weather. In response to Petitioner's claim that water conservation has reduced customer usage Ms. Gemmecke explained that there are several other factors that could increase usage. (*Id.*)

Finally, Ms. Gemmecke reiterated the OUCC's position that no usage normalization adjustment was appropriate in this case. However, she stated that, if the Commission felt a usage adjustment was absolutely necessary, the five-year average was superior to the three-year method recommended by Petitioner. (*Id.*)

<u>Petitioner's Rebuttal to Live Testimony.</u> Petitioner's witness Duane Cole provided live rebuttal testimony in response to the Public's live testimony. Mr. Cole claimed that Ms. Gemmecke's analysis of rainfall was irrelevant because her analysis was based upon the entire State of Indiana rather than particular locations where Petitioner serves. He asserted that it is not uncommon in any given month for rainfall amounts within the State of Indiana to vary by as much as ten (10) inches. (Tr. p. H-87.)

Mr. Cole also submitted an analysis of consumption during winter months. (*See Petitioner's Exhibit DDCole-R*; Tr. pp. H-90-93.) He asserted that by analyzing consumption during winter months, many variables of water consumption are removed. (Tr. pp. H-89-90.) Mr. Cole testified that his schedule is consistent with his opinion that the effect of increased conservation efforts is driving base consumption per customer down. (Tr. pp. H-93-94.) Mr. Cole asserted that with declining base consumption per customer, the use of a longer average would drive consumption up to artificially high levels. (*Id.*)

Commission Discussion and Findings. Petitioner, in this case, advocates use of a three-year average for adjusting revenues for residential usage, while the OUCC recommends no usage normalization adjustment. However, during the course of this proceeding, the Commission has been presented with three (3) possible methodologies for adjusting test year revenues based on customer usage. First, Petitioner proposed a $1.73 million decrease to test-year revenues based on a regression analysis. Second, Petitioner proposed a $1.2 million decrease to test-year revenues based on a three-year average of historical usage. Finally, in the event this Commission felt an adjustment was necessary, the OUCC calculated a $214,567 *increase* to test-year revenues based on a five-year average of historical usage. We will address each of these methodologies in turn.

At the close of evidence, Petitioner was no longer relying on Mr. Tapp's regression analysis, nor was Petitioner advocating use of the resulting $1.73 million revenue adjustment. Consequently, we see no reason to accept Mr. Tapp's conclusions, including his proposed revenue adjustment. Furthermore, we find the R^2 of .0511, indicating only a 5.11% relationship between the dependent variable (average monthly usage) and the independent variable (time), insufficient to satisfy Petitioner's burden of proving an adjustment is warranted. In addition, we are troubled by the error rate (MAD) of 196 gallons per month. This seems excessive, given Mr. Tapp's conclusion that residential usage has decreased by only 203 gallons per month over nearly a ten-year period.

However, while we do not accept Mr. Tapp's methodology or proposed revenue adjustment, we cannot ignore portions of Mr. Tapp's testimony which were uncontested and upon which other witnesses relied. Specifically, both the OUCC and Petitioner ultimately repudiated Mr. Tapp's regression analysis, but both the OUCC and Petitioner continued to rely on Mr. Tapp's underlying data. In addition, the MADs Mr. Tapp calculated for each of the three (3) methodologies at issue in this Cause were not part of Mr. Tapp's regression analysis itself and were based on uncontested data.

This brings us to the adjustments based on three-year and five-year averages performed by Mr. Cutshaw and the OUCC, respectively. The error rates expressed as MADs for both the three-year and the five-year averages exceed the error rate for Mr. Tapp's regression analysis. Further, the average error (MAD) for Mr. Cutshaw's three-year average exceeds the average error (MAD) for the five-year average calculated by the OUCC. Consequently, we find the five-year average the more compelling of the two (2) methodologies. However, because both methodologies have higher MADs than Mr. Tapp's regression analysis, which all parties to this Cause have rejected as unreliable, we cannot accept a usage normalization adjustment based on any of these methodologies.

In addition to the above deficiencies in all three proposed methodologies, we have particular concerns about Petitioner's reliance on a three-year historical average. Specifically, we find that Petitioner's justification for reliance on a three-year average inconsistent with this Commission's reasoning in Cause No. 42029. In addition, we find Mr. Cole's testimony and exhibits in support of Petitioner's three-year average troubling in a number of respects.

First, as to our findings in Cause No. 42029, we stated that using a three-year average for a residential usage normalization adjustment was appropriate in that case for the following reason:

> Because weather during the three-year period approximates the thirty-year average, the use of the three-year period appropriately captures this most significant variable for which the usage normalization is an attempt to adjust. We therefore find that Petitioner's proposed three-year average for purposes of usage normalization is appropriate.

2002 Rate Order, Cause No. 42029, p. 41.

However, in this case, only OUCC's witness Gemmecke testified and presented evidence for the record comparing a three-year or five-year average to the thirty-year weather average. She presented data showing that the five-year average more closely matched the thirty-year precipitation average for Indiana than did Petitioner's proposed three-year average. Petitioner provided no historical weather data.

Further, in Cause No. 42029, Mr. Cole testified on behalf of Petitioner in support of using a three-year average. He justified this approach by stating that consumption was declining over time in Indiana-American's service territory. As a result, Mr. Cole argued that limiting historical data to a three-year period was appropriate. We summarized his reasoning as follows:

> [Mr. Cole] explained that usage normalization based upon longer historical averages will overstate revenues since the recent trend in base consumption reflects a more severe decline. If an adjustment is to be made at all, Mr. Cole explained that the period over which the average is to be computed should be shorter rather than longer to avoid including years where the base consumption per customer is higher than it is anticipated to be again, thus overstating normal usage.

Id. at p. 40.

However, in this case usage is not decreasing, according to Mr. Kaufman's testimony. As Mr. Kaufman's testimony and attached schedules show, customer usage in Indiana-American's service territory did decrease from 1994 to 1999, but consumption has actually been *increasing* since Indiana-American's merger with Northwest and United in January of 2000. (*Public's Exhibit 6, Sched. No. 6*, pp. 4-8.) Indeed, if consumption is decreasing over time, as Petitioner contends, it is unclear why the test year, which is the third and final year of Mr. Cutshaw's three-year historical period, is *higher* than the three-year average.

Second, as to Mr. Cole's testimony, we are troubled both by Mr. Cole's general arguments as well as by discrepancies between Mr. Cole's Exhibit DDCole and data submitted in Petitioner's direct testimony.

In live testimony, Mr. Cole attempted to show that residential usage was decreasing over time. In support of this position, Mr. Cole offered Petitioner's Exhibit DDCole, which was a

chart showing consumption during "winter" months (November through March) from 1994 to 2003. However, in presenting data demonstrating a downward trend in consumption, Mr. Cole eliminated all summer months from his review. As he acknowledged on cross-examination, in doing so he did not take into account any trends in consumption that may have taken place during summer months. (Tr. p. H-96.)

We cannot accept an analysis that ignores seven (7) months of the year, rather than attempting to explain inconsistent data. This is especially true in this case, where the OUCC's evidence shows contrary data regarding both consumption and historical weather data.

Even more perplexing, however, are discrepancies between data contained in Mr. Cole's Exhibit DDCole and data on which Mr. Cutshaw relied in generating his three-year average. Below is a chart that reproduces the format, but not the values, of Exhibit DDCole as admitted into evidence during Mr. Cole's live testimony. (*See* Tr. p. H-90.) The values contained in this chart are values we obtained from Petitioner's Exhibit BIT-4, attached to the Direct Testimony of Bruce I. Tapp, and upon which Messrs. Tapp, Kaufman and Cutshaw all relied in performing their analyses. If Mr. Cole had utilized the values used by Messrs. Tapp, Kaufman and Cutshaw in performing their analyses, Exhibit DDCole would appear as follows:

Winter Residential Analysis
Using Data from Petitioner's Exhibit BIT-4, Sched. 1

	JAN	FEB	MAR	APR-OCT	NOV	DEC	Winter Total
1994					5.456	5.358	
1995	5.719	5.374	5.077		5.456	5.416	26.984
1996	5.487	5.529	5.330		5.259	5.217	27.218
1997	5.577	5.541	5.053		5.592	5.126	26.647
1998	5.450	5.200	4.928		5.385	5.052	26.296
1999	5.521	5.218	4.976		5.201	5.078	26.143
2000	**5.401**	**5.327**	**4.871**		**5.015**	**5.101**	25.878
2001	5.393	5.253	4.814		4.535	**5.091**	25.576
2002	4.793	4.978	4.539		**4.916**	**5.068**	23.936
2003	5.767	6.169	5.335				27.255

This chart contains the data which Mr. Cutshaw used to calculate his three-year average. However, only the numbers highlighted in bold match the data contained in Mr. Cole's Exhibit DDCole, which Mr. Cole used in live testimony to justify using Mr. Cutshaw's three-year average. It appears, therefore, that Mr. Cutshaw relied on different data to calculate his three-year average than Mr. Cole used to support the three-year average.

Both Mr. Cutshaw's analysis and Mr. Tapp's analysis are based on the same data contained on Document No. 000029 from Book 2 of Petitioner's Minimum Standard Filing Requirements, which was admitted as Public's Exhibit CX-1 in this proceeding. Further, Mr. Cutshaw agreed (to within $100) to the OUCC's calculation of a five-year average based on this

same data. (Tr. p. G-88-89.) However, Mr. Cole's Exhibit DDCole is based on almost entirely different data, the origins of which are unknown to this Commission.

We are concerned about this discrepancy. At no time in his live, oral testimony did Mr. Cole indicate the data in Exhibit DDCole was any different from that on which the other witnesses relied. Similarly, Mr. Cole offered no analysis or explanation as to the source of this data or what impact this data would have if used in either a three-year or five-year average.

Furthermore, we are concerned about the impact of this inconsistent data on the evidence before us. We note that initially Mr. Cole relied on a "visual review" of the trend in the column of Exhibit DDCole titled "Winter Total" to show that usage was decreasing over time. (Tr. p. H-92-93.) However, a "visual review" of the chart above, using Mr. Cutshaw's and Mr. Tapp's data, shows a less clear and less substantial trend, if any. Conversely, if Mr. Cutshaw had used Mr. Cole's data, which was substantially lower during the winter months of the test year than Mr. Cutshaw's and Mr. Tapp's, Mr. Cutshaw's calculations would have yielded a smaller revenue adjustment in favor of Petitioner, assuming all other data remained unchanged.

In conclusion, we find that no usage normalization adjustment is appropriate in this case. Petitioner proposed a $1.2 million adjustment to revenues based on Mr. Cutshaw's three-year historical average of residential consumption. However, we believe this methodology is not appropriate under the facts of this case. Specifically, Petitioner offered no evidence to establish that weather patterns over the three-year period are in any way comparable to thirty-year averages. In addition, the OUCC, through the testimony of Mr. Kaufman, demonstrated that residential consumption is increasing rather than decreasing. Petitioner attempted to contradict this conclusion through the live testimony of Mr. Cole, but the data on which Mr. Cole relied in attempting to show a decreasing trend in consumption was inconsistent with the data Mr. Cutshaw used to calculate Petitioner's revenue adjustment. No explanation was offered for this discrepancy.

2. Customer Growth

Petitioner's Position. Petitioner's witness Tapp proposed an increase in test year revenues to reflect an increase in Petitioner's residential and commercial customers. (*Petitioner's Exhibit BIT-2, Sched. 1.*) Mr. Tapp calculated his adjustment by determining the change in the number of residential and commercial customers for each of the months from July 2002 through December 2003 and multiplying that change by Petitioner's meter charge. Mr. Tapp also accounted for six (6) months of service charges to the test year for residential and commercial irrigation meters. (*Petitioner's Exhibit BIT*, p. 6, lines 12-18.) Mr. Tapp determined the change in customers for each month and then annualized for the number of months for which the service charge was not accounted for in the test year bill analysis. (*Id.* at lines 18-20.) Mr. Tapp testified his methodology was consistent with the methodology accepted by this Commission in Cause Nos. 39595, 40103, 40703 and 42029. Finally, Mr. Tapp determined the impact of the increased number of residential customers from the Turkey Creek and Westwood acquisitions. This adjustment was determined using the difference between the projected normalized or forecasted usage and actual usage of the customers acquired. Mr. Tapp calculated a projected test year usage for these customers by calculating an average forecasted use from the

residential customers in the district that the acquired customers would be served. Mr. Tapp then multiplied the projected usage through Petitioner's rate blocks.

Mr. Tapp testified that his customer accounting expense adjustment calculated the average cost per bill and multiplied that cost by the number of additional bills related to his customer growth adjustments and his adjustments associated with the additional customers added from the Turkey Creek and Westwood acquisitions. (*Id.* at p. 22, lines 15-20.)

Mr. Tapp also made corresponding adjustments to purchased power, purchased water, and chemical expenses. (*Id.* at pp. 15-21.)

OUCC's Position. OUCC witness Dana Lynn accepted the Petitioner's adjustments to annualize service charges for commercial customer growth that occurred during the test year. However, Ms. Lynn did not accept such an adjustment for residential customer growth.

Instead, the OUCC proposed that Petitioner's residential customer growth adjustment should be calculated for each district by taking the average test year bill by district and multiplying that average by the annualized increase in the number of test year bills. Ms. Lynn calculated the additional revenue expected by district from residential customers added to the system during the test year. She computed an average sales volume for residential customers by district based on test year data. (*Public's Exhibit 3, Attach. DML-7.*) Ms. Lynn testified that her adjustment normalized the growth of Petitioner's residential customer base on a per-bill basis. (*Public's Exhibit 3*, p. 26, lines 22-24.)

The OUCC also adjusted certain operational costs associated with its proposed adjustment. Ms. Lynn stated that a customer accounting adjustment was not needed because Petitioner had already performed the adjustment that would account for the increased bills. (*Id.* at 27, lines 9-10.)

Petitioner's Rebuttal. Petitioner's witness James Cutshaw testified that Ms. Lynn's methodology for calculating the residential customer growth adjustment was unreliable. Mr. Cutshaw noted that Ms. Lynn's use of annualized sales volumes was a methodology the Commission had rejected as not fixed, known and measurable. (*Petitioner's Exhibit JLC-R*, p. 7, lines 15-17.) Mr. Cutshaw claimed Ms. Lynn offered no explanation for why her use of annualized sales volumes was fixed, known and measurable. (*Id.* at p. 8, lines 11-12.) Mr. Cutshaw contrasted Ms. Lynn's proposed methodology with the proposed methodology used by Mr. Tapp to adjust for customer growth. (*Id.* at p. 7, lines 15-17.)

Mr. Cutshaw also identified three (3) other problems with the customer growth adjustment proposed by Ms. Lynn. First, Mr. Cutshaw testified that Ms. Lynn's adjustment only accounted for changes in customers through the end of the test year (June 2003), whereas Mr. Tapp adjusted for changes through the rate base cutoff. Second, Mr. Cutshaw testified that Mr. Tapp's methodology more accurately accounted for additional revenues from the customers added by the Turkey Creek and Westwood acquisitions because the Company prepared a specific calculation for each individual customer based upon their actual usage history since acquisition. (*Id.* at p. 9, lines 19-20.) Ms. Lynn, on the other hand, used average bills for the entire

Northwest and West Lafayette operations, respectively. Finally, Mr. Cutshaw explained that Ms. Lynn included a full year's worth of bills for customers with separate irrigation meter services. (*Id.* at p. 9, lines 21-23.) Mr. Cutshaw testified that such customers typically only activate their irrigation service during six (6) months of the year and that Ms. Lynn's assumptions, therefore, resulted in an inflated allocation of sales revenue to irrigation customers.

Mr. Cutshaw presented a reconciliation of the differences between Ms. Lynn's adjustment and the Company's for residential customer growth:

	Petitioner	OUCC	Difference between Petitioner and OUCC
Customer Growth	$ 393,836	$ 610,832	
Turkey Creek/Westwood	196,629	(included in above)	
Sales-for-Resale		18,725	
	$ 590,465	$ 629,557	$ 39,092

Petitioner's Exhibit JLC-R2.

Mr. Custshaw also criticized the OUCC's methodology used to calculate the adjustments to purchased water, purchased power and chemical expense stating that the proper criteria to use is the change in water sales rather than the change in customers. Lastly, Mr. Cutshaw noted an error in the OUCC's calculation due to incorrect customer numbers. (*Petitioner's Exhibit JLC-R*, pp. 20-24.)

Commission Discussion and Findings. Petitioner complained that a usage adjustment based on an average monthly bill of a customer is not a fixed, known and measurable indication that total usage would increase. However, the Public cited Cause No. 38868 where Petitioner applied the same methodology the Public used in this Cause.

Further, that Petitioner experienced residential customer growth during the test year is undisputed, and this Commission can reasonably expect that this growth will place additional demands on Petitioner's system, resulting in an increase of total water usage. In fact, Petitioner has used the same method the Public used when Petitioner made its revenue adjustments for the customers added as a result of the Turkey Creek and Westwood acquisitions.

Mr. Cutshaw claimed Mr. Tapp's methodology accounted for additional revenues from customers added by the Turkey Creek and Westwood acquisitions based upon each customer's actual usage history since acquisition. However, after a review of Mr. Tapp's testimony, we find that Mr. Cutshaw's representations about Mr. Tapp's calculation are incorrect.

In fact Mr. Tapp used projected data for test year usage of residential customers in each of the entire districts that now serve the Westwood and Turkey Creek acquisitions. Mr. Tapp relied on his CDMM to forecast test year data for the entire districts that serve Westwood and Turkey Creek and used the results of the district forecast (i.e. Northwest and West Lafayette) for test year usage instead of the actual historical usage from the time Westwood and Turkey Creek were acquired by Indiana-American. Thus, Mr. Cutshaw's claim, that Petitioner's method to

account for additional revenues from the customers added from Westwood and Turkey Creek are based on actual usage history since the acquisition, is erroneous.

When discussing the Turkey Creek acquisition in his prefiled testimony, Mr. Tapp explained that projected usage was determined *using normalized usage for the Northwest operation*. (*Petitioner's Exhibit BIT*, p. 13, lines 13-14 (emphasis added).) With the exception of the forecasted step in Mr. Tapp's calculation, Mr. Tapp's and Ms. Lynn's methods are essentially the same. The only difference is that Petitioner used projected *usage*, while the Public used projected *sales*. We see no substantive difference. Further, the Public has consistently applied this method in other cases. For example, in Cause No. 42481, the Public applied this methodology and we found that the Public's adjustments for customer growth were fixed, known, and measurable. (*Morgan Cty. Rural Water Corp.*, Cause No. 42481, 9 (Indiana Utility Regulatory Commission, Date Issued March 31, 2004).) We make the same finding here.

Petitioner raised two (2) additional concerns. First, the Petitioner asserted that the Public did not update its customer growth adjustment through the rate base cutoff. While this is a practice that we have accepted in some past cases, it is not a requirement. Second, the Petitioner claimed that the Public has included a full year's worth of bills for customers with separate sprinkler (irrigation) meter services. However, it appears that if the Public has done this, then so has Petitioner. Ms. Lynn testified that Petitioner had already increased test year expenses for the increased bills based on test year customer growth, thus making no adjustment. If the number of bills the Public projected was different than the number of bills Petitioner projected, then the Public and Petitioner would not have been in agreement on the appropriate customer accounting adjustment, because Petitioner's customer accounting adjustment is also based on projected number of bills. (See *Petitioner's Exhibit BIT*, p. 22, lines 15-20.) However, the OUCC and Petitioner did agree on the customer accounting adjustment, which demonstrates they both relied on the same number of projected bills. (*Public's Exhibit 3*, p. 27, lines 6-10.)

We accept Public's adjustment for changes resulting from residential customer growth and so reject the Petitioner's proposal to exclude Public's customer growth adjustment. We find the Public has adequately demonstrated that customer growth existed during the test year and that total usage will increase; accordingly, the pro forma revenue increase of $610,832 is approved. Regarding corresponding adjustments to operating expenses, we agree with Petitioner's criticism of the OUCC's calculation of the adjustment to purchased water, purchased power, and chemical expense. After taking Petitioner's criticisms into account, the pro forma customer growth increase is $2,290 for purchased water expense; $21,253 for purchased power expense; and $3,375 for chemical expense.

3. Changes in Large Customer Consumption

Petitioner's Position. Petitioner's witness Tapp identified several large customers who, for a variety of reasons, have changed their consumption patterns either during or subsequent to the test year. The total of all such customers resulted in a proposed adjustment to reduce test year revenues by $183,665. (*Petitioner's Exhibit BIT-2, Sched. 1.*, line 22) Mr. Tapp also proposed corresponding adjustments to purchased power, purchased water and chemical expense.

OUCC's Position. OUCC witness Lynn accepted Petitioner's adjustment except for $18,572 associated with Seymour Tubing. She believed that Petitioner's data does not indicate this customer's consumption has materially decreased during the test year, and that Petitioner's support does not warrant a permanent reduction in consumption from Seymour Tubing. (*Public's Exhibit 3*, p. 28, lines 2-10.) OUCC Utility Analyst Margaret A. Stull also proposed corresponding adjustments to purchased power and chemical expense. However, Ms. Stull objected to Petitioner's proposed purchased water adjustment associated with Seelyville and the new penitentiary, on the grounds these customers would not impact purchased water. (*Public's Exhibit 2*, p. 12, lines 5 - 13.)

Petitioner's Rebuttal. Petitioner agreed that Seelyville and the penitentiary would not impact purchased water. With respect to Seymour Tubing, Mr. Tapp testified in Petitioner's case-in-chief that the adjustment is derived from the customer's implementation of water conservation measures and reduced production from levels to which the customer does not anticipate returning. In rebuttal, Petitioner's witness Cutshaw disagreed with Ms. Lynn's comments that Seymour Tubing's consumption is not decreasing. Mr. Cutshaw testified that he reviewed Seymour Tubing's usage for the most recent twelve (12) month period (69,605 CCF), and noted that this is less than Mr. Tapp's projected consumption rate (70,415 CCF). (*Petitioner's Exhibit JLC-R*, p. 5, lines 5-8.) He testified that the Company's adjustment of $18,572 is amply supported and should be utilized in the determination of pro forma revenues.

Commission Discussion and Findings. We accept Petitioner's adjustment for changes in large customer consumption and so reject the OUCC's proposal to exclude the adjustment for Seymour Tubing. We find that Petitioner has adequately demonstrated that Seymour Tubing has decreased its consumption below the test year level; accordingly, the pro forma revenues should reflect the adjustment as proposed by Petitioner. Accordingly, we also find that Petitioner's pro forma adjustments to purchased power and chemical expense should be accepted, though the pro forma adjustment to purchased water should be rejected.

B. Operating Expenses

1. Pro Forma Labor Positions

Petitioner proposed a pro forma adjustment to labor expense in excess of test year labor expenses. Petitioner's witness Cutshaw characterized these extra labor costs as the inclusion of anticipated salary and incentives and anticipated hours of current employees as well as current vacancies and new positions. Most of this upward adjustment in costs was effected through increases to "management fees" Petitioner pays to its affiliates. However, to the extent these management fee adjustments are truly adjustments to Labor Expenses, we address them here. We will discuss each area of labor expense below.

a) Vacant Positions

Petitioner's Position. Petitioner's proposed pro forma adjustment to labor expense included funding for twelve (12) positions which were vacant at the end of the test year (June 30, 2003).

OUCC's Position. OUCC witness Gemmecke testified that Petitioner was seeking an increase of $2,082,496 (13.82% increase) over test year salaries. She testified Petitioner was seeking "full-employment," or inclusion of expense for a full year of salary for employees who only worked part of the year, just as it did in its last rate case (Cause No. 42029). She stated Petitioner was also requesting positions held open during the last four (4) years be funded by its customers. She claimed Petitioner has twelve (12) positions which were not filled as of June 30, 2003, and were still vacant as of January 6, 2004. In addition, five (5) of those twelve (12) positions had been unfilled since before June 30, 2002.

Ms. Gemmecke proposed to reduce Petitioner's pro forma labor expense by excluding the costs of the twelve (12) positions that were vacant during the test year. She stated that each of the positions was vacant or became vacant during the period of August 2000 through June 2003 and remained vacant as of January 6, 2004. (*Public's Exhibit 1,* p. 18.) Further, according to Petitioner's responses to Town of Schererville's data request Q 1.14 (attached as Attachment JIG-2 to Ms. Gemmecke's testimony), each of these positions had been vacant anywhere from six (6) months to three (3) years, as of January 6, 2004. (*Public's Exhibit 1, Attach. JIG-2.*)

Petitioner's Rebuttal. Petitioner, through the testimony of Mr. Cutshaw, agreed to the OUCC's proposed elimination of two (2) of the twelve (12) vacant positions, which are two (2) corporate level employees whose leave dates were May 2003 and June 2003. (*Petitioner's Exhibit JLC-R,* p. 14, lines 1-3.) However, Petitioner's witnesses Duane Cole and James Cutshaw both testified on rebuttal that ten (10) of the positions should remain in labor expense. They argued that three (3) of these ten (10) positions had been filled, and that the Company was actively recruiting for the seven (7) remaining positions. (*Id.* at p. 13, lines 19-23; *Petitioner's Exhibit DDC-R*, pp. 8-10.)

Commission Discussion and Findings. Petitioner has agreed to the OUCC's reduction for two (2) of the twelve (12) vacant positions. Consequently, we remove the costs of "Operations Engineer" and "Financial Analyst" positions, shown at the bottom of Petitioner's Exhibit JIG, Attachment JIG-2, p. 3, from Petitioner's pro forma labor expense. Petitioner has filled three (3) of the remaining ten (10) "vacant" positions with persons hired from outside the company. (*Petitioner's Exhibit DDC-R2*, pp. 1, 17, 20.) Consequently, we allow Petitioner's pro forma adjustment as to these three (3) positions. However, we reject Petitioner's pro forma adjustment for the remaining seven (7) vacant positions. Each of these seven (7) positions is either still vacant or was filled by simply shifting employees from other positions within the company.

Of the seven (7) positions we exclude from Petitioner's pro forma labor expense, two (2) were filled with in-house transfers, thereby leaving two (2) other positions newly vacant. If we were to find these in-house transfers alone were sufficient evidence to support Petitioner's adjustment to test-year expenses, it would open the door to potential double-counting of Petitioner's employees.

As to the remaining five (5) positions at issue, we cannot accept that these positions are necessary for providing utility service, given the length of time they were vacant. The most recently vacated of these positions was March 1, 2003, and it remains vacant. Of these five (5) positions, the position that has remained vacant the longest was vacated on October 26, 2001,

and it remains vacant. While Petitioner's officers have authorized the filling of these positions, the timing and circumstances of these authorizations are suspect.

Specifically, we are troubled by the circumstances under which the ten (10) contested, vacant positions were authorized to be filled. The Commission was made aware through cross-examination of Mr. Cole regarding Exhibit DDC-R2, that the vast majority (eight (8) of ten (10)) of these vacancies were requested to be filled on January 12, 2004, which was the day before Petitioner's Evidentiary Hearing. (Tr. p. E-97-99.) Further, seven (7) of the ten (10) vacancy requests were approved by Mr. Cole and Mr. Eckart on January 13, 2004, the day of the Evidentiary Hearing. Four (4) of the five (5) currently unfilled positions were approved by Mr. Cole on the morning of his testimony. The fifth became vacant on August 31, 2002, but was never requested to be filled until April 5, 2004.

In addition, a review of Petitioner's Exhibit DDC-R2, which is composed of the Job Posting Requests for these vacant positions, shows that nearly all of the "Requested by" and "Manager" signatures were electronic signatures or approvals obtained by telephone. This fact, taken with the fact Mr. Cole approved the requests hours before he was to give sworn testimony in this case, gives an impression that Petitioner rushed to approve hiring for these positions expressly for the purposes of this rate case. The fact that these positions were vacant for such long periods of time (most of them for more than a year) supports this conclusion.

Based on the foregoing, we will allow in rates full annual salaries for the following positions:

District	Vacant Name	Title	Last Held	Request to Fill	Agreed to Fill	Vacancy Filled
John. Co.	Meter Reader	Meter Reader	6/23/2003	1/12/2004	1/13/2004	2/9/2004
Kokomo	Rinker	Utility Specialist	5/31/2003	1/12/2004	1/13/2004	3/22/2004
~~Wabash Valley~~ Mooresville	Jackson, DE	Utility Tech	8/11/2000	1/12/2004	1/20/2004	3/23/2004

Based on the foregoing, we will not allow in rates salaries for the following positions:

District	Vacant Name	Title	Last Held	Request to Fill	Agreed to fill	Vacancy Filled
Warsaw	Dorell AP	F.S.	8/31/2002	4/5/2004	4/5/2004	No
N.W.	Furlow	Field Service	10/4/2002	1/12/2004	1/13/2004	No
N.W.	Townsend R	FSR	3/1/2003	1/12/2004	1/13/2004	No
Corporate	Nitza	Engineer	5/23/2003			
Corporate	Norris, K	unknown	6/6/2003			
Corporate	Maintenance	Maintenance	10/26/2001	1/12/2004	1/13/2004	No
So. Ind.	Satterwhite	Operator	7/6/2001			transfer
John. Co.	Fitter	Fitter	2/28/2002	1/12/2004	1/13/2004	transfer
N.W.	Hamilton	Field Service	3/14/2002	1/12/2004	1/13/2004	No

b) **New Positions**

<u>Petitioner's Position.</u> Petitioner's case-in-chief appeared to involve no increase to Labor Expense for new positions. In fact, Petitioner appeared to be proposing a $1,096,516 decrease to Labor Expense as a result of the elimination of the Customer Service Center in Richmond, Indiana. (*Petitioner's Exhibit WJW*, p. 7.) However, as Petitioner's witness Wolf explained, these expenses were added to the cost Petitioner is billed from its affiliated management company, AWWSC. (*Id.*)

<u>OUCC's Position.</u> OUCC witness Gemmecke testified that Petitioner was seeking an increase of $2,082,496 (13.82% increase) over test year salaries. However, this increase did not appear as an increase to "Labor Expense" because Petitioner was seeking to shift some of these labor costs from Indiana-American to AWWSC, which would then bill Indiana-American "management fees" for those labor expenses. Ms. Gemmecke discussed these pro forma increases as "Labor Expenses," rather than under the heading of "Management Fees." (*Public's Exhibit 1*, p. 4, lines 5-11.)

Ms. Gemmecke testified Petitioner's adjustment to test-year labor expense included the addition of fifteen (15) new positions, including four (4) additional customer service representatives, three (3) dispatchers, six (6) closers, a team leader and a supervisor. (*Id.* at p. 19, lines 4-13.) However, she observed that none of Petitioner's witnesses in Direct Testimony offers an explanation why these positions, above test year expense, were necessary. (*Id.* at lines 20-22.) Consequently, Ms. Gemmecke reduced Petitioner's increase to labor expense by $388,949 for the fifteen (15) additional positions.

Ms. Gemmecke explained that Petitioner had proposed that all of these positions should be paid through management fees in the future. However, she further testified that she had asked Mr. Cutshaw during an on-site visit why AWWSC needed to hire fifteen (15) additional personnel. Mr. Cutshaw informed her that, with the move of Customer Service Center personnel to Alton, Illinois, AWWSC would need to hire local people to handle those functions. (*Id.* at lines 14-18.)

Ms. Gemmecke noted that the Richmond, Indiana Customer Service Center was already performing these functions prior to the move to the Illinois center. (*Id.* at line 19.) Consequently, Ms. Gemmecke concluded that the need to add fifteen (15) positions, in addition to moving customer service operations to Illinois, appeared to contradict Mr. Cole's testimony that centralizing customer service functions would allow Petitioner to take advantage of economies of scale. (*Id.* at p. 19, line 23 through p. 20, line 2.)

<u>Petitioner's Rebuttal.</u> Mr. Cole presented rebuttal testimony opposing Ms. Gemmecke's proposed exclusion of eleven (11) of the new customer service employees. Specifically, he explained the functions of the three (3) dispatchers, six (6) closers, one (1) team leader and one (1) supervisor. He testified that these are positions that are currently being filled. The dispatchers dispatch time critical orders that come from the Alton Customer Satisfaction Center plus perform other duties. Closers have been hired so that all work orders can be closed by the next morning after the work is completed. The team leader and supervisor are already in place. Mr. Cole testified that these positions are not being eliminated as a part of the move to the

Alton Customer Satisfaction Center. Mr. Cole also stated that Petitioner did not increase its number of customer service representatives in Richmond by four (4). (*Petitioner's Exhibit DDC-R*, pp. 6-7.)

Commission Discussion and Findings. With respect to the three (3) dispatchers, six (6) closers, a team leader and a supervisor, none of Petitioner's witnesses, including Mr. Cole, rebutted Ms. Gemmecke's assertion that the functions of these eleven (11) positions had been performed during the test year and costs associated with the performance of this work was already included in the test year expenses. Petitioner bears the burden of proof when advocating expenses in excess of test year, and Petitioner has not met that burden of proof for these eleven (11) positions. The duties carried out by these "new" position titles were the same duties carried out by other personnel during the test year. Consequently, the costs of performing these functions are already included in test year expenses. Permitting Petitioner to adjust test-year expenses for these new positions would result in double-recovery.

Costs related to the four (4) customer service representatives are also denied and are considered within our discussion and findings below regarding the Customer Satisfaction Center. Consequently, we reduce Petitioner's pro forma labor expense by $388,949 for the elimination of these fifteen (15) positions.

c) Wabash District Position

OUCC's Position. The OUCC proposed to eliminate one position in the Wabash District which was double-counted.

Petitioner's Rebuttal. Petitioner agreed that one position had been double counted. Consequently, Petitioner agreed with the removal of $48,262 from Labor Expense.

Commission Discussion and Findings. We find the elimination of $48,262 appropriate.

Commission Discussion and Findings Regarding Labor Expense. For the above reasons, the Commission finds pro forma labor expense, before "shifting" a portion of those costs to management fees, is $16,424,456 or $1,353,835 over the test year. After shifting the labor expenses for customer service and a portion of corporate to management fees, the pro forma direct labor expense is $14,329,245.

2. Incentive Pay Program

Petitioner's Position. Petitioner did not propose a separate adjustment for incentive pay. Instead, Petitioner calculated labor expense to include incentive pay at the percentage of each eligible employee's expensed labor.

OUCC's Position. Ms. Gemmecke proposed to remove all of Petitioner's Annual Incentive Plan ("AIP") from Petitioner's operations and management expense. She summarized her reasons for disallowing this expense as follows:

- The entire variable pay plan can be withheld by the Board if minimum financial goals are not met.

- A large portion of the AIP compensation is based upon financial goals.

- The Merit Pay Plan already encompasses incentives for excellence in performance for the same employees eligible for the AIP.

- A generous pay and benefits plan already exists without the AIP compensation to attract and retain qualified employees.

Public's Exhibit 1, p. 5, line 14 through p. 6, line 2.

Ms. Gemmecke further testified that the requested level of net operating income of $40,071,000 in this case would be short of the required financial goal of $44,982,000 for 2003. (*Id.* at p. 8, lines 6-14; *Public's Exhibit 1, Attach. JIG-15*, p. 2, resp. to Q-283.) Consequently, Petitioner would not need the funds to pay for the incentive payment. Further, she testified that while Petitioner was authorized incentive pay in the last rate case of $411,000, Petitioner had only paid $133,369 in incentive pay as of the date the OUCC prefiled its case-in-chief.

She criticized the calculation of Petitioner's proposed incentive pay for 1) being calculated after the April 2004 Merit Pay increase and 2) being calculated on positions rather than actual eligible employees. Ms. Gemmecke broke down the incentive pay as the portion related to financial goals (56% of total AIP), operational goals (27% of total AIP) and individual goals (17% of total AIP).

Ms. Gemmecke also stated that Petitioner's benefit package is generous. Petitioner has a merit pay incentive which covers the same employees as the AIP covers, and the OUCC has not opposed the merit pay increase. Ms. Gemmecke points out that Petitioner does not keep records on employee turnover which is necessary to determine the extent the incentive compensation has had on retaining employees. She stated the OUCC's position that each element of the incentive compensation (financial, operational, and individual) be paid by the shareholders and not the ratepayers.

Petitioner's Rebuttal. Mr. Eckart responded to many of Ms. Gemmecke's criticisms. (*Petitioner's Exhibit JEE-R*, pp. 2-16.) He explained the basic aspects of the Company's incentive pay program and employee eligibility for the program.

All full-time management, professional and technical employees who are employed as of December 31 or who retire during the plan year may be eligible to receive incentive pay, subject to three "performance" components of the program: financial, operational and individual. The financial component is based upon achieving targeted operating results and net debt. The operational component is based upon achieving targeted results in the areas of customer satisfaction, environmental compliance and health and safety. Lastly, the individual component is based upon the individual employee's performance. Mr. Eckart admitted that the Board does have the discretion to withhold the financial component based upon failure to reach minimum

financial performance; however, he testified that failure to achieve financial goals could not result in the withholding of the other components. (*Id.* at pp. 2-5.)

Mr. Eckart further argued that Petitioner could potentially earn sufficient revenue to meet the requisite financial goals to satisfy the "financial" component of the incentive pay program, noting that the required "operating result" is not synonymous with the "net operating income" granted by this Commission. He explained how the company could yield a higher operating result than the net operating income requested in this case. (*Id.* at pp. 8-9.)

Mr. Eckart responded to Ms. Gemmecke's testimony concerning the portion of incentive pay which is funded by shareholders. He stated that 87% of the annual incentive pay is allocated to operation and maintenance expense. The balance is not capitalized. Thus, Mr. Eckert argued Petitioner's proposal would result in responsibility for financing incentive pay to be split between shareholders and customers. (*Id.* at pp. 15-16.)

Mr. Eckart also disputed Ms. Gemmecke's description of Petitioner's AIP benefits as "very generous." (*Id.* at p. 13.) He disputed Ms. Gemmecke's position that the AIP only benefits Petitioner's stockholders, stating why he believes a financially strong company is to the benefit of both the stockholder and the customer. (*Id.* at pp. 14-15.) In addition, Mr. Eckart testified that an incentive plan payment was made for the plan year 2003 in excess of $500,000. (*Id.* at p. 16.)

Mr. Cutshaw argued that incentive pay should be calculated based on positions in pro forma labor expense rather than persons actually employed during the test year. He opined that all expenses, including incentive pay and other labor-related expenses associated with positions included in pro forma labor expense, should be recovered. (*Petitioner's Exhibit JLC-R*, p. 12-13.)

Commission Discussion and Findings. In the 2002 Rate Order, we approved Petitioner's recovery of a portion of its annual incentive pay. We found significant two (2) criteria by which the recovery of incentive pay is to be judged: (1) a pure profit-sharing plan, which only incents employees to become more profitable is more appropriate for funding solely by the shareholders than a plan which also ties compensation levels to better service to the customers; and (2) a plan which causes compensation to exceed levels which are reasonably necessary for the utility to attract its workforce should be disallowed as an unnecessary expense. In addition, we found it significant that Petitioner's plan was funded only in part through rates.

As we review Petitioner's incentive plan, we find these criteria are still satisfied. Petitioner's plan is not a pure profit-sharing plan. Rather, significant components of annual incentive pay are derived solely from operational goals, which relate to customer service, environmental compliance, and health and safety, and from individual goals which are based upon the individual employee's performance. Furthermore, Mr. Eckart demonstrated that Petitioner's incentive program does not cause total compensation to exceed levels which are reasonably necessary to attract the workforce. To the contrary, the at-risk component of pay is necessary for Petitioner's employees to receive the average pay commanded in the marketplace. The only evidence offered to the contrary related to the all-encompassing Bureau of Labor Statistics information, which is not tailored to Petitioner's workforce including degreed, licensed and highly trained people. Mr. Eckart further demonstrated that Petitioner's compensation

package is well within the mainstream for that offered in the industry. Finally, Mr. Eckart demonstrated that a portion of the plan is proposed to be funded through rates, and a portion proposed to be funded by shareholders. Accordingly, as we found in Cause No. 42029, we find that Petitioner's incentive pay should be recoverable through rates, and we reject Ms. Gemmecke's and Ms. Stull's proposed adjustment.

3. Pension Expense

Petitioner's Position. Petitioner proposed an adjustment to test year pension expense which converts to the use of the Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 87 ("FAS87"). Previously, Petitioner has reflected pension expense based upon the contribution to the pension trust fund required under the Employee Retirement Income Security Act ("ERISA"). The difference between the two (2) methodologies is that FAS87 is essentially a current year estimate of pension costs being accrued for currently employed, eligible employees and existing retirees. The ERISA method fluctuates based upon the value of the investments in the pension trust fund, and is therefore more directly influenced by short-term fluctuations of the financial markets. Petitioner's witness Wolf explained that the FAS87 level is a long-term measure that is relatively stable from year to year, while the ERISA contribution level is a short-term measure that may fluctuate significantly from year to year. Mr. Wolf testified that the conversion to the FAS87 expense method accomplishes two (2) important objectives: (1) less fluctuation in cost and resulting impact to the company and its rates for service, and (2) minimizing the impact of the increase in pension cost in this case since the pro forma expense is $132,000 less than what the pro forma amount would be if the ERISA method were used.

There are two components to Petitioner's proposed adjustment to reflect the change from ERISA to FAS87. First, the Company proposes to amortize the deferred pension assets accumulated under the ERISA method over ten (10) years. Second, the adjustment reflects an increase in the pro forma FAS87 expense over the test year ERISA contribution level. The pro forma FAS87 level was calculated based upon a six (6) year average of Petitioner's projected FAS87 expense for the years 2003 to 2008. The projection for this period was prepared by Towers Perrin, one of the world's largest global management consulting and actuarial firms. The total adjustment to test year expense, including both the average pro forma level and the amortization of the deferred amount is $1,686,130. (*Petitioner's Exhibit WJW-1, Sched. 2.*)

OUCC's Position. The OUCC did not oppose Petitioner's proposed conversion to FAS87, the amortization of the deferred amount or the computation of the pro forma level of FAS87 expense. The OUCC's proposed pension expense adjustment is identical to Petitioner's. (*Public's Exhibit 1, OUCC Sched. 4*, p. 1.) OUCC witness Gemmecke's testimony as initially prefiled specifically agreed with Petitioner's proposed adjustment. (*Public's Exhibit 1*, p. 24.) Ms. Gemmecke excluded this testimony from the version which was actually offered and received into evidence at the evidentiary hearing; nevertheless, she testified that she personally prepared her testimony as it was originally prefiled and was careful to assure that it accurately reflected her opinions. (Tr. p. D-18-19.) Given that the OUCC included Petitioner's proposed pension expense adjustment in its schedules, we are left to conclude that the OUCC has no objection to Petitioner's request.

Intervenors' Positions. Both the Industrial Group and the Town of Schererville opposed Petitioner's proposed pension expense adjustment. Mr. Gorman noted that the ERISA pension expense reflects the minimum annual cash contribution the Petitioner normally makes to the pension trust fund. He explained that the FAS87 pension expense is an accrual expense recorded on a company's financial statements. (*Industrial Group's Exhibit 1*, p. 27.) Mr. Gorman disputed Mr. Wolf's contention that the FAS87 pension expense is more stable. He noted that Petitioner's FAS87 pension expense was a negative amount in the calendar years 2000 and 2001 compared to the $1.8 million positive expense accrual projected for the test year. (*Id.* at p. 28.) Mr. Gorman also noted that Petitioner's test year pension expense was based on a 2002 actuarial study which assumed that the long-term return on the trust fund assets would be 9%. According to Mr. Gorman, the 2002 projected return understates the actual return on stock investments during 2003. He provided an example that the S&P 500 has increased over 35% from January 2003 to January 2004. Consequently, he concluded that this increase in the value of the trust fund assets will lower the Petitioner's FAS87 pension expense when it is updated in 2004. Therefore, Mr. Gorman opined that the support for Petitioner's requested pension expense under FAS87 for the test year is already stale and probably overstates what the Petitioner's pension expense will be when the study is updated. (*Id.* at 29.) Mr. Gorman recommended that the Commission be consistent with its past ratemaking treatment of pension expense by continuing to use the ERISA pension expense method and allow Petitioner to include $677,000 as pension expense, which was the amount incurred for the test year.

Intervenor Town of Schererville offered the evidence of its witness Sommer who divided the $2.2 million adjustment increase into its three (3) components: losses, change in methodology and retired Northwest Indiana executives. The evidence thereafter offered by witness Sommer was a rejection of all three components. Witness Sommer rejected the recovery of the loss component of the $2.2 million pension adjustment, equaling $471,897 per year. The basis for witness Sommer's rejection of this pension loss recovery can be summarized as an objection to charging Petitioner's ratepayers who lost their own pension funds; the likelihood that with market changes, Petitioner will actually over-collect on these losses; and a belief that good regulatory policy is not served by such recovery. Witness Sommer's rejection of the change in methodology component of this $2.2 million increase is a rejection of $1,683,288. Witness Sommer's rejection can be summarized as being based on calculations which are wrong and, thus, not fixed, known and measurable. Finally, witness Sommer rejected the recovery of the third component, equaling $34,236, relating to retired former executives of Northwest Indiana, which is part of Petitioner's acquisition of Northwest Indiana.

Petitioner's Rebuttal. Mr. Wolf first disputed Mr. Gorman's testimony on the relative volatility of FAS87 and ERISA for purposes of computing annual pension expense. He introduced an exhibit which shows the ERISA level goes from zero for the year 2001 to in excess of $4 million for the year 2005 and then down to $1.3 million for 2008. (*Petitioner's Exhibit WJW-R2.*) During the same time period, the FAS87 cost fluctuates from $0.6 million in 2001 to a lower peak of $2.4 million in 2004. The overall average of ERISA from 2003 to 2008 is much higher at $2.6 million per year as compared to the $1.9 million average for FAS87 in those same years.

He also disputed Mr. Gorman's opinions based upon recent market gains. It is the use of FAS87 which is intended to mitigate the effects of short-term fluctuations in capital markets. As

a result, he testified that short-term unrealized investment gains or losses will not have a significant impact from one year to the next on the valuation but will have an average impact over longer periods of time. (*Petitioner's Exhibit WJW-R*, p. 10.)

Mr. Wolf further stated that Mr. Sommer is not relying on the correct information for purposes of his criticisms of the salary increase rate assumed by Towers Perrin in its valuation. He testified that a simple comparison to recent actual labor cost changes on a Company-wide basis is an apples-to-oranges comparison. Mr. Wolf testified that selection of the salary increase rate assumption for actuarial valuation of the pension plan requires more complex analysis of the salary of a pool of employees over the course of their entire careers than simply using recent labor cost changes which can be influenced by any number of factors that could vary from year to year. He testified that pension valuation depends upon the wage increases for a particular group of employees over the span of their respective careers. While wage rates may increase on average by 3% in one year, the increase for a particular employee over the span of his/her career is usually higher due to seniority, merit increases and promotions. (*Id.* at pp. 11-12.) Mr. Wolf quoted the comments to FAS87, which he testified reveal that Mr. Sommer is not considering the pertinent data for purposes of his criticism. Comment 46, FAS87, states that, "[a]ssumed compensation levels shall reflect an estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion and other factors." (*Id.* at p. 13, lines 14-17.) Mr. Wolf further presented surveys conducted by Towers Perrin and Watson Wyatt, two nationally recognized actuaries, which show that Petitioner's wage rate assumptions are at the low end of the mainstream. (*Petitioner's Exhibit WJW-R3* and *WJW-R4.*)

Commission Discussion and Findings. We find that Petitioner's proposed pension expense adjustment should be partially accepted. While Mr. Gorman criticized the move from ERISA to FAS87, the evidence is unrebutted that pension expense will be lower and less volatile over the ensuing years if this change is made. In addition, no other actuarial valuation was presented which would produce a level of pension expense different from that presented by Petitioner. Pensions are valuable rights which are offered to employees, many times as a result of collective bargaining.

However, the Commission believes the loss component of the pension adjustment should not be accepted. Both Schereville's witness Sommer and Industrial Intervenor's witness Gorman objected to the recovery of this pro forma adjustment. Witness Sommer specifically notes that providing this adjustment to Petitioner's operating expenses will, in essence, force Petitioner's ratepayers who lost their own pension investments to cover this loss. We note that Petitioner's witness Wolf acknowledges that Petitioner is seeking to recover additional funds from ratepayers who themselves suffered pension losses (see Transcript, B-99). Mr. Sommer goes on to point out that there is no good regulatory policy served by allowing recovery of this past loss. Finally, Mr. Sommer points out that the market in which Petitioner's pension was invested, which caused pension losses to historically occur, has more recently recovered and Petitioner, on a pro forma basis, will potentially be overcompensated if this loss is allowed as part of Petitioner's revenue request. Accordingly, we find that Petitioner's proposed pension expense adjustment, less the loss component, should be accepted.

4. Depreciation Expense on Contributions in Aid of Construction

OUCC's Position. Mr. Gassert requested that the Commission revisit its practice of allowing the recovery of depreciation expense on contributions in aid of construction ("CIAC") because this allegedly proliferates troubled utilities which have an eroding or negative rate base. He further testified that allowing depreciation expense on CIAC encourages larger utilities to overinvest. Further, he testified that allowing a recovery of depreciation on CIAC causes customers to pay more than one time for the same plant.

Petitioner's Rebuttal. Mr. Cutshaw testified that Mr. Gassert is requesting the Commission to reverse a long-standing policy allowing depreciation expense on CIAC. Mr. Cutshaw cited the Commission's Orders in Cause No. 37182 dated December 7, 1983, and in Cause No. 39595 dated February 2, 1994. In the latter order, the Commission said that "the customers and the company benefit from the Commission's current practice of allowing depreciation on contributed property." Mr. Cutshaw testified that depreciation expense on CIAC provides additional internally generated funds to cover at least a part of replacement cost and that this results in lower external financing requirements, a factor which is particularly important for Indiana-American. Mr. Cutshaw explained that the Commission found this is the reason which supports recovery of depreciation expense on CIAC and has specifically rejected Mr. Gassert's argument that the Commission should change its policy to align with other jurisdictions. The Commission has noted that "Indiana has a broader perspective" which "provides that depreciation rates should be designed to provide the amounts reasonable and necessary to maintain the property in an operating state of efficiency corresponding to the progress of the industry," and that this "policy on CIAC depreciation better accomplishes this objective without adverse effect on the customer." (*Petitioner's Exhibit JLC-R*, pp. 31-32.)

Mr. Cutshaw testified that while depreciation on CIAC may create issues for small troubled utilities, Indiana-American does not encounter the same issues because of its size. Mr. Cutshaw explained that in the case of smaller utilities facing prospects of negative or eroding rate base, the OUCC would be free to argue that depreciation expense should not be recovered on CIAC in those particular circumstances. Mr. Cutshaw testified that in the case of larger utilities with growing demand for capital improvements, depreciation on CIAC continues to provide a low cost source of internally generated funds.

Commission Discussion and Findings. We commence our consideration of Mr. Gassert's request by reviewing our findings in *Indiana-American Water Co.*, Cause No. 39595:

> [OUCC witness] Mr. Effron's position would require a change in the Commission's policy regarding CIAC. Presently, we allow water utilities to recover depreciation on contributed property, but (a) the accumulated CIAC balance is deducted from the Company's original cost rate base and (b) the balance of CIAC is not reduced when the contributed property is retired. Under our present methodology, CIAC is an ever increasing amount and continues to be deducted from rate base long after the property represented thereby is retired . . .

* * * *

> We do not agree with Mr. Effron's contention that replacements of contributed property, like replacements of other property, are not explicitly financed by depreciation expense included in the cost of service. Mr. Salser demonstrated that depreciation expense recoveries, including depreciation on CIAC, are internally generated funds used to finance replacements of property. Over time the contributed property will need to be replaced and the replacement costs will be many times more than the original cost of the property. The Commission's current policy of allowing the recovery of depreciation on the contributed property provides to the Company additional internally generated funds to cover at least a part of the replacement cost. This directly results in lower external financing requirements and is particularly important for Petitioner at this time because, as both Mr. Hargraves and Mr. Salser noted, the Company is facing significant financing requirements over the next five years.
>
> *Accounting for Public Utilities* states that the ratemaking treatment for depreciation on CIAC varies from jurisdiction to jurisdiction. Mr. Effron contends we should change our policy to align with jurisdictions which do not allow recovery of such depreciation on the theory that the purpose of depreciation is only to recover the cost of property. However, Indiana law has a broader perspective than that promoted by Mr. Effron. Ind. Code § 8-1-2-19 provides that depreciation rates should be designed to provide the amounts reasonable and necessary to maintain the property in an operating state of efficiency corresponding to the progress of the industry. We think our policy on CIAC depreciation better accomplishes this objective, without adverse affect on the customers. The FERC and FCC regulations which require that contributed property be written off to utility plant are neither comparable nor appropriate for water utilities.
>
> We believe the customers and the Company benefit from the Commission's current practice of allowing depreciation on contributed property. We find Mr. Effron's proposal to change this policy should be rejected.

Ind.-Am. Water Co., Cause No. 39595, p. 22-23 (Indiana Utility Regulatory Commission, Date Issued Feb. 2, 1994); 150 PUR4th 141, 158-59.

As we indicated previously, we are not averse to reconsidering our existing policies and practices; however, we depart from such practices only after very careful consideration convinces us that new evidence or circumstances warrant a change. We believe as a general matter that stability and predictability in regulatory policy is desirable. We do not change course simply to side with the majority. While the positions of other state commissions may be of interest, this Commission is duty-bound to make its own independent decisions on what is best for Indiana.

Reviewing Mr. Gassert's positions, we see a familiar refrain to the arguments we have already rejected. The only argument he has made which we have not previously considered is that the growing CIAC balance can lead to eroding rate base and thereby create troubled utilities. While we recognize the problems a negative rate base may cause with respect to small, thinly

capitalized utilities, we would be better served to address those concerns in a particular case involving such a utility. Such is not the case with Indiana-American. Indiana-American continues to have a growing demand for capital improvements, and depreciation on CIAC continues to serve the purpose of providing internally generated funds at a significantly lower cost of capital than would otherwise be available. Our findings in Cause No. 39595 continue to apply with equal force to Petitioner's position today. Also, depreciation on CIAC does not force customers to pay for the asset twice. The developer initially pays for the asset, and the customer thereafter pays rates to recover depreciation expense which supply the capital to replace the asset, thus reducing the need for external funding and associated cost. If we were to reverse our practice, the customers would still pay rates to recover depreciation on the replacement asset after it is placed in service, and they would be forced to pay the higher cost of external funding needed for the replacement. We find that in the current case we should continue our practice of allowing depreciation on CIAC and, therefore, reject Mr. Gassert's proposal.

5. Customer Satisfaction Center and E-CIS Project

As noted in our earlier discussion of the Petitioner's Rate Base, the OUCC's proposal to exclude the E-CIS project from rate base sufficiently relates to Petitioner's conversion to the Alton Customer Satisfaction Center to merit our consideration of both issues in this section of our Order.

Petitioner's Position. Petitioner testified that the Customer Satisfaction Center is a nation-wide customer service call center located in Alton, Illinois. This center will be open twenty-four (24) hours a day, seven (7) days a week. Petitioner states that customers will be provided with a high level of service in dealing with billing questions, scheduling service orders, establishing new service and locating convenient payment sites. Petitioner advised that once Indiana-American converts to the Illinois CSC, it will close its Indiana customer service center located in Richmond, Indiana.

Petitioner claimed that the new Customer Satisfaction Center would cost slightly more to Petitioner's customers, but it would provide new services and technologies that are not currently provided. Petitioner claimed these new services and technologies would come at a lower cost than if Richmond were to offer these services on its own. Petitioner said that the new center would use a leading edge Interactive Voice Response ("IVR") system that would pave the way for web-based interaction that would allow customers to access their accounts and pay bills online. The new IVR allows for "automatic call distribution" software to ensure an even distribution of in-bound calls and an "expert agent selection" software that will allow a customer call with a particular question to automatically be transferred to a representative, who has received specific training in that area.

Petitioner also testified that the other benefits of the Alton CSC related to human resources management. Petitioner explained that the CSC will utilize an "automatic call monitoring" software to evaluate the effectiveness of call handling and associate responsiveness to inquiries and a "workforce management" software to collect data from all of the new technologies to provide resource forecasting and scheduling to predict staffing needs. (*Petitioner's Exhibit DDC*, pp. 14-17.) Petitioner's witness Wolf disclosed that, according to Petitioner's analysis, the closing of the Richmond Customer Service Center and the move to the

Alton CSC will cause a net increase in test year expense of $91,840. This amount did not include the costs associated with the E-CIS software, which the OUCC considered to be a cost associated with the move.

Petitioner's witness James Cutshaw filed supplemental testimony and updated Petitioner's proposed rate base to include $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-1-UA*, line 21, column 2.) In his supplemental direct testimony, Mr. Cutshaw alleged that E-CIS replaces an outdated Electronic Data Inquiry System ("EDIS") software program. He claimed that the EDIS program does not provide the functionality needed to effectively respond to increased customer demands for more detailed billing information nor does it allow for improved processes in handling customer inquiries. He explained that EDIS is not Windows-based and is not functionally compatible with other software packages and programs currently utilized. Also, Mr. Cutshaw said EDIS was not designed to support the current security threats related to network and internet technologies, does not provide a database to allow for resolution of data discrepancy issues and does not provide scalability to support "large water company" information needs. Mr. Cutshaw testified that with E-CIS, customer data is arranged more logically on the inquiry and input screens, allowing for more efficient access to customer data and more timely responses to customer inquiries. With the new software, customer bills will provide more detail regarding the nature and type of charges being billed. Mr. Cutshaw claimed that under EDIS, this level of detail was either unavailable or cost prohibitive due to the extensive reprogramming that would have been required to provide it.

Mr. Cutshaw testified that E-CIS was placed in service on March 8, 2004, and satisfies the definition of "major project" for purposes of the MSFRs. Petitioner testified that it utilized an approved depreciation accrual rate of 5.54% to compute the depreciation expense relating to the capitalized E-CIS costs. (*Petitioner's Exhibit JLC-U*, pg. 9.)

OUCC's Position. OUCC witness Dana Lynn stated that Petitioner's proposed net increase of $91,840 shown on page 7 of Mr. Wolf's testimony greatly understates Petitioner's true cost to participate in American's Customer Satisfaction Center initiative. Ms. Lynn noted that Petitioner has not included the $282,528 in amortization expense associated with the $1,345,305 of deferred costs it has recorded on its balance sheet related to the CSC. In addition, Petitioner has not included the return and depreciation it has requested on AWWSC's $6.2 million Orcom E-CIS software ($194,360), which is associated with the CSC. Ms. Lynn noted that if Petitioner would have calculated depreciation expense correctly, Petitioner's customers would be made to pay an additional $1,249,764 in depreciation expense and $592,174 in return. (*See Public's Exhibit 3, DML Sched. 1*, page 2.) In sum, Ms. Lynn determined that Indiana-American's ratepayers would pay an additional annual amount of $2,318,826 for the E-CIS conversion and Alton CSC transfer, after considering the additional depreciation expenses, return on investment and the higher operational cost of $194,360 as acknowledged by the Petitioner. ($2,318,826 = $282,528 + 194,360 + $1,249,764 + $592,174.) Thus, according to the OUCC, Petitioner substantially understated the true cost of its participation in the Alton CSC.

While Petitioner included $346,185 for depreciation expense, associated with the E-CIS software, the OUCC calculated $1,249,764 as the expense. Ms. Lynn explained her belief that there was a discrepancy between Petitioner's number and the $1,249,764 calculated by the

OUCC because Petitioner multiplied the E-CIS software costs by its old depreciation accrual rate for its Mainframe Computer Software account of 5.54%. In the Commission's Final Order, in Cause No. 40703, the Commission approved an increased depreciation accrual rate for Petitioner's Mainframe Computer Software account to 20%. Ms. Lynn stated that if Petitioner would have applied the correct accrual rate in its updated schedules, the depreciation alone would cost Indiana-American's ratepayers an additional $1,249,764 over the next five (5) years.

Ms. Lynn disagreed that AWWSC'S computer software should be recorded as Utility Plant in Service, and she asserted that Petitioner's proposed adjustment requests the Commission to approve $6,248,821 in Petitioner's rate base for software it does not need. Ms. Lynn testified that American is consolidating several subsidiaries, including Indiana-American, to the Alton CSC. The $6.2 million represents Indiana-American's portion of the total software cost that will be used by the CSC in Alton, Illinois. Indiana-American's Customer Call Center in Richmond, Indiana already operates on an EDIS. According to Ms. Lynn, it is not advantageous for Indiana-American to participate in AWWSC's Customer Satisfaction Center, and the E-CIS software is not necessary for the Richmond customer service center to continue its operations.

Ms. Lynn noted that the OUCC asked Petitioner to provide a copy of the contract to purchase and develop the Orcom E-CIS software for the Alton CSC. Petitioner provided a copy of an agreement with addendums between AWWSC and Orcom Systems, Inc., which was entered into evidence during the OUCC's cross-examination of Mr. Eckart. (*Public's Exhibit CX-2.*) Ms. Lynn noted that Indiana-American was not a party to this agreement and does not own the software rights. Ms. Lynn argued that the ratepayers of the State of Indiana should not be made to pay either a return on or of an investment that the utility does not own or, as explained further below, for costs associated with an unregulated affiliate's venture that does not accrue any quantifiable benefits to the utility or its customers.

Ms. Lynn stated that the additional cost to Indiana-American's ratepayers, if the Petitioner is allowed to recover in rates its move to the CSC in Alton, Illinois, is over $2.3 million per year. Ms. Lynn provided the following table based on the OUCC's analysis to illustrate the adjustments that would be necessary if the Commission were to accept Petitioner's proposal to participate in American's CSC:

OUCC UPDATED	Customer Service Increase/(Decrease)
Labor	$ (1,007,762)
Purchased Power	(17,471)
Management Fees	2,384,726
Group Insurance	(263,031)
Customer Accounting	(23,684)
General Office	(552,303)
Miscellaneous (($240,878) + $282,528)	41,650
401 (k)	(2,600)
Depreciation Expense	1,249,764
Return on Software	592,174
General Taxes	(82,637)
Net Change	**$ 2,318,826**

Public's Exhibit 1, Attach. Nos. 9 and 10.

Ms. Lynn noted that, while Petitioner did not provide any work papers to support the proposed cost increase for its participation in the Alton CSC, in Cause No. 42043 the Petitioner did provide the OUCC a discovery request response that reflected a pay back period of 115.44 months ($1,791,486 estimated implementation costs/$186,231 project savings x 12 months) for Indiana-American's participation in American's customer call center for an annual saving of $186,231 per year. (*Public's Exhibit 3, Attach. No. 4.*) However, Ms. Lynn added that Petitioner's payback calculation is flawed since it failed to include the Orcom Software cost of $6,248,821 and the amortization of the implementation cost of $282,528. She stated that after these costs are included, there are no annual savings. Therefore, there will never be a payback on this investment. Ms. Lynn stated that once Petitioner recognized there would be no payback to participate in this joint venture, it should have abandoned the program.

Ms. Lynn testified that it is neither necessary nor reasonable for Indiana-American to participate in American's initiative to consolidate its subsidiary customer call centers, noting that Indiana-American has a customer call center located in Richmond, Indiana that is open Monday through Friday, from 7:30 a.m. to 6:30 p.m., and provides quality service. Ms. Lynn also noted that Indiana-American did not perform any analysis or studies that would support the need to transfer its customer service operations to Illinois. In response to an OUCC Data Request, Mr. Cole admitted that "No studies have been done in regard to incorporating the services provided at the Customer Satisfaction Center in the Richmond Call Center due to our inability to justify the level of expense this would generate." (*Public's Exhibit 3*, p. 11, lines 4-15.)

Ms. Lynn also advised that the "Business Case Review" American relied upon to move forward with the customer satisfaction center contained information specifically addressing Indiana-American. Ms. Lynn added that only two (2) comparisons were made in the "Business Case Review" of the Richmond Call Center and the Alton CSC. The first compared average handle time and the second was the abandonment rate. If Indiana transferred to Illinois, the

review shows that the average handle time is projected to decrease from 7:16 minutes to 5:00 - 5:30 minutes, but the abandonment rate will increase from 2% to between 5% and 5.5%. American failed to complete the comparisons for the availability of consumer service representatives ("CSRs"), the cost per call or the quality of service.

Ms. Lynn observed that Indiana-American had already attained economies of scale and centralized its Customer Service Center in Richmond. Ms. Lynn added that Petitioner's witness, Mr. Cole had testified in Cause No. 42029 that its Richmond customer service facility has provided customer inquiry handling capabilities for all of Indiana-American since 1994. Mr. Cole also testified that a cost saving of $651,000 had been realized as a result of the centralized customer service center. Finally, Mr. Cole testified that Indiana-American improved its quality of service by improving its efficiency of handling and processing customer inquiries through implementation of Indiana-American's EDIS and automated service order preparation. On pages 54 and 55 of his testimony in Cause No. 42029, Mr. Cole extolled the strengths of its efforts by stating the following:

> The first example would be our implementation of Indiana-American's Electronic Data Inquiry System ("EDIS") and automated service order preparation within the acquired operations [has] resulted in a more efficient method for responding to customer inquiries. With the EDIS system in place, customers can call from anywhere in the State of Indiana into our Richmond facility utilizing a toll free number and discuss their problems or concerns with a customer service representative. A service order will then automatically print out in the location in which the work needs to be done. This will improve the efficiency of handling and processing customer inquiries....We've also made available Xpress Cheque, an automatic bill paying service, to all customers with the acquired operations as well.

Thus, Ms. Lynn asserted, Indiana-American's ratepayers have already paid for and received high quality customer service from a relatively modern system. (*Id.* at p. 11.)

Describing how AWWSC charged Indiana-American for the Alton, Illinois implementation costs, Ms. Lynn noted that AWWSC charged Indiana-American an allocated portion of its implementation costs based on the number of customers that Indiana-American had on a particular date. To date, this allocation was $7,594,126 ($1,345,305 + $6,248,821). Ms. Lynn further testified that the method that AWWSC used to allocate these costs will cause Indiana ratepayers to subsidize efficiency improvements for other states. Ms. Lynn noted that the CSC is just one instance where the OUCC has found this subsidy to occur. This method of allocation causes Indiana ratepayers to subsidize the inefficiencies that exist in other states. Based on the "Business Case Review" American expects to save over $31 million system-wide in a five (5) year period, or over $6 million annually. Thus, while some of American's subsidiaries operating in other states will share in the $6 million projected annual savings, Indiana-American ratepayers are expected to pay an additional $2.3 million every year. Ms. Lynn concluded that it is unreasonable to request Indiana-American's customers to pay significantly more so Petitioner's affiliates can attain a savings. (*Id.* at pp.12-13.)

Ms. Lynn also provided a schedule analyzing information contained in AWWSC's request for a proposal to receive bids on its implementation study for the Customer Satisfaction Center. As shown by that schedule, several states have more than one customer call center. Ms. Lynn reiterated the fact that Indiana-American's ratepayers paid to have its customer call center centrally located in Richmond less than ten (10) years ago. Further analysis also shows how efficient its call associates are when handling customers. Ms. Lynn testified that the associates located in Richmond are more efficient than any of AWWSC's existing call centers in its five largest states, and the Richmond call associates exceed the mean average of customers handled per associate by more than 25%. (*Id.* at p. 14.)

Ms. Lynn also noted that customers will incur additional costs if Indiana-American retires its assets associated with the Richmond call center before they are fully depreciated. This is because the undepreciated cost will remain in accumulated depreciation. Ms. Lynn observed that AWWSC has not shared any of its projected cost savings with Indiana-American. Instead, Indiana-American has been made to pay more than $8 million in implementation costs.

Ms. Lynn testified that the Commission should not include any of the implementation costs in Indiana-American's rates, noting that this is not truly Indiana-American's initiative but an affiliated company's initiative. It may be more economical for other sister companies to participate in American's CSC initiative but these economies of scale should not be achieved on the backs of Indiana ratepayers. The OUCC recommended removal of $6,248,821 from rate base for the software cost and claimed Petitioner should not be allowed to recover the amortization of the $1,345,305 deferred costs. Thus, Ms. Lynn removed the annual amount of $282,528 from miscellaneous expense.

Ms. Lynn also expressed concern that more implementation costs might apply. Ms. Lynn noted that Petitioner has testified that it is still transitioning to the Alton CSC. In Cause No. 42043, Petitioner responded to the OUCC's discovery that its share of American's $17,811,898 implementation cost was $1,791,486 or 10.06%. In this Cause, Petitioner responded to OUCC discovery that the implementation costs for American's CSC have increased to $18,393,677. Thus, Indiana-American could in a subsequent rate case be allocated an additional $505,099 (($18,393,677 x 10.06%) – $1,345,305)) in implementation costs before American completes its transition. Ms. Lynn asserted any additional implementation costs associated with the CSC in Alton, Illinois should likewise be denied. (*Id.* at p. 15.)

Ms. Lynn concluded that Petitioner should not be permitted to recover costs recorded to Utility Plant that were not necessary. She added that the E-CIS software is not being used for Indiana-American's operations at its Richmond facilities, but that it is only necessary for participation in AWWSC's CSC. Ms. Lynn stated that Petitioner has not shown quantifiable benefits to its Indiana customers resulting from its participation in the Alton CSC. Based on the testimony provided by the OUCC, Ms. Lynn stated that Petitioner's proposed increase in management fees associated with its participation in AWWSC's Customer Satisfaction Center should be denied. The following reflects the OUCC's elimination of Petitioner's pro forma adjustments reflecting the test year cost associated with the Richmond, Indiana customer call center.

OUCC Update	Customer Service Increase/(Decrease)
Labor	$ 1,007,762
Purchased Power	17,471
Management Fees	(2,384,726)
Group Insurance	263,031
Customer Accounting	23,684
General Office	552,303
Miscellaneous	240,878
401 (k)	2,600
General Taxes	82,637
Net Change	**$ (194,360)**

Public's Exhibit 1, Attach. Nos. 9 and 10.

Ms. Lynn noted the foregoing adjustment is based only on the accounts that Petitioner identified as its customer satisfaction center adjustments. The OUCC adjusted for the amortization costs, depreciation expense and rate base costs associated with American's CSC in separate adjustments. (*Id.* at pp.16-17.)

Petitioner's Rebuttal. Petitioner claims that the Commission should view the purchase and development of the E-CIS software as a separate project from the conversion costs to the Alton CSC. Petitioner testified that the decision to convert to the E-CIS software was made well before the decision to consolidate all of American's affiliated utilities' call centers into one centralized location. Thus, in rebuttal, Petitioner's witness Eckart disputed Ms. Lynn's views that the E-CIS project is a cost of converting to the CSC. Mr. Eckart testified that a decision to replace EDIS with E-CIS was made in 1996. Mr. Eckart further stated that the E-CIS decision pre-dated consideration of a national call center, which did not begin until the Fall 1998. Mr. Eckart said that the acquisition of E-CIS was not a result of Petitioner's conversion to the Alton CSC because it would have occurred regardless of that fact. *(Petitioner's Exhibit JEE-R*, pp. 29-30.)

Petitioner also submitted the rebuttal testimony of A. Joseph Van den Berg, a principal with Deloitte Consulting, LLP, on the issues raised by Ms. Lynn. Mr. Van den Berg is the Strategy and Operations and Customer Relationship Management Lead Partner for the Energy and Utilities Practice within Deloitte. Mr. Van den Berg stated he is familiar with the Alton CSC from prior engagements and has toured the facility. In connection with his review of Ms. Lynn's testimony, Mr. Van den Berg claimed he undertook extensive data collection, including interviews with Indiana-American, Alton CSC and AWWSC personnel in various roles. (*Petitioner's Exhibit AJV-R*, pp. 1-6.)

Mr. Van den Berg first disputed Ms. Lynn's opinion that E-CIS was unnecessary. He repeated Mr. Cutshaw's supplemental testimony in his discussion about EDIS not being capable of various requirements that occur in today's computing environment. In particular, he stated that EDIS suffered from the inability to handle security challenges and threats resulting from an

expanded network and Internet uses, the lack of a detailed database to allow for data discrepancy resolution and the inability to continue to scale to Indiana-American's growing customer needs. (*Id.* at p. 7, lines 20-23; *Petitioner's Exhibit JLC-U*, p. 8, lines 4-7.) Mr. Van den Berg testified that there was no consistency among the operating companies on EDIS and, as a result, the utilities were operating six (6) versions of EDIS out of three (3) data centers. He testified that not only was the network of systems complicated to maintain, but enhancements made in one location could not be shared in others. He said that continuing the use of EDIS would require extensive enhancements. Mr. Van den Berg testified that Indiana-American had studied the issues surrounding the inabilities of the EDIS system since the mid-1990s and had been planning to replace its EDIS software for some time. (*Petitioner's Exhibit AJV-R*, p. 8.) Mr. Van den Berg testified that it was not until after some states had already initiated the implementation of E-CIS that, rather than incurring the cost to expand multiple versions of E-CIS, management made the decision to implement a single platform on a basis that was cost effective for Petitioner and its utility affiliates. (*Id.* p. 8, lines 6-12.)

Mr. Van den Berg also repeated Mr. Cutshaw's position that E-CIS is more sophisticated, consistent and user-friendly than EDIS. Mr. Van den Berg testified E-CIS was Windows-based and has a graphical user-interface as opposed to the mainframe, "green-screen" approach of EDIS. This allows E-CIS to be compatible with other packages and programs currently in use and supports enhanced real time reporting. (*Id.* at pp. 9-10; *Petitioner's Exhibit JLC-U*, pp. 7-8.)

Mr. Van den Berg also asserted the superiority that E-CIS will have in viewing customer account information and the planned internal website resources. Mr. Van den Berg testified that E-CIS has many more billing capabilities and allows users to personalize the customer's experience. For example, bill due dates of individual customers can be easily changed, a feature lacking in the old software. Also, more time is allowed for personnel to review bills and correct mistakes before mailing. E-CIS also provides the ability to generate detailed bills that itemize every component of the total bill amount. (*Petitioner's Exhibit AJV-R*, pp. 10-11; *Petitioner's Exhibit JLC-U*, pp. 7-8.)

Relying on a survey of twenty (20) utility companies included in *Chartwell's 2002 CIS Report*, Mr. Van den Berg asserted that it would have cost Petitioner $5.9 million to $7.5 million to upgrade its existing EDIS program. (*Petitioner's Exhibit AJV-R*, p. 12, lines 1-4.) However, according to Mr. Van den Berg, EDIS was in need of replacement and not just an overhaul. Mr. Van den Berg estimated that a full Customer Information System ("CIS") implementation would cost a company of Petitioner's size between $8.04 million and $29.48 million. (*Id.* at lines 19-22.) Mr. Van den Berg said this includes, but is not limited to, expenditures on vendors, consultants and integrators for hardware, software and services; payroll costs, overtime pay, bonuses, and temporary staffing; project space and training facilities; and amounts for extended capabilities, such as bill production, change management, and data warehousing. Based on his analysis, Mr. Van den Berg came to the same conclusion as stated by Mr. Cole in his testimony that, given his cost projections, replacing EDIS on its own was not Petitioner's best option. Rather, as Mr. Cole testified, by joining with the other utility subsidiaries of American in the cost of a modern CIS, the new E-CIS program could be implemented at a much lower cost than for Petitioner to do so by itself. (*Id.* at pp. 13-14; *Petitioner's Exhibit DDC*, p. 17.)

Mr. Van den Berg also disputed Ms. Lynn's testimony that the cost to Petitioner of the E-CIS software should not be included in Petitioner's rate base because Petitioner allegedly does not own the software rights. He noted that the Orcom contract was signed by AWWSC to make E-CIS available to American's utility subsidiaries, including Petitioner, at cost. He said AWWSC was acting on behalf of American's utility subsidiaries as a result of a decision of the utilities' Presidents. Mr. Van den Berg said that this was further demonstrated by Petitioner's payment directly to Orcom of its share of the initial payment. (*Petitioner's Exhibit AJV-R1.*) Instead of taking on by itself all the capital costs and risks associated with implementing a new CIS, Petitioner was able to benefit from the leveraging of existing assets, systems and processes within the American organization. Mr. Van den Berg testified that by implementing the software package through AWWSC, Petitioner was able to achieve substantial customer benefits at a lower cost than creating a duplicative system owned solely by Petitioner. (*Id.* at pp. 13-14.)

Mr. Eckart testified that the decision to implement E-CIS was separate and distinct from the decision to combine all call center operations at the Alton CSC, which was affirmed by Mr. Van den Berg. Both also testified that Petitioner made the E-CIS decision in the mid-1990s before the process of evaluating a national call center had begun. Petitioner's decision to "go live" on E-CIS at the time of moving to the CSC was based upon a desire to minimize training and other change management costs. Mr. Van den Berg said that the Richmond Call Center could have operated with E-CIS and, likewise, the EDIS system could have been used by the Alton CSC. In Mr. Van den Berg's opinion, neither would have been the best course of action. (*Id.* at p. 15; *Petitioner's Exhibit JEE-R*, pp. 29-30.)

Mr. Van den Berg testified that today's customers have expectations that are driven by industry standards for customer service, and that the Alton CSC is a state-of-the-art facility that is capable of meeting these standards. He testified that the costs incurred by Petitioner in transitioning to the Alton CSC are reasonable and in line with industry averages required to implement such a system or to upgrade an existing system to the same level and quality as that offered by the Alton CSC. (*Petitioner's Exhibit AJV-R*, p. 17.)

Mr. Van den Berg reiterated the prefiled testimony of Mr. Cole that the Alton CSC operates twenty-four (24) hours per day, seven (7) days per week. He also stated that the CSC provides an IVR system that offers many advantages over the system at the Richmond facility, such as allowing customers to complete more self-service transactions, supporting automatic call distribution and computer telephony integration and enabling skill based routing. Further, an effective IVR paves the way for web-based information access and self-service transactions, such as for meter reads, service turn on/offs and customer surveys. Mr. Van den Berg noted the CSC also supports automatic call monitoring which, Mr. Van den Berg stated, greatly enhances the quality assurance process by allowing managers to record and review telephone interactions. Further, the CSC has the ability to handle call volume smoothing, which will allow greater control over staffing. (*Id.* at pp. 19-22; *Petitioner's Exhibit DDC*, pp. 15-16.) Mr. Van den Berg also testified that a great enhancement in the Alton CSC is its bilingual capabilities. (*Petitioner's Exhibit DDC*, p. 15.) He noted that according to the United States Census Bureau, the Hispanic population in Indiana grew by nearly 120% from 1990 to 2000, and many of the areas with the greatest Spanish-speaking population are served by Petitioner. (*Petitioner's Exhibit AJV-R*, p. 22.)

Mr. Van den Berg disagreed with Ms. Lynn's contention that the Richmond facility would continue to be adequate on a going forward basis. While the Richmond facility may have been offering an acceptable level of service, Mr. Van den Berg testified that the Richmond facility was beginning to outgrow its capabilities and lagging behind the requirements of centers in today's customer service landscape. (*Id.* at pp. 22-23.) Mr. Van den Berg cited testimony received at the Jeffersonville Field Hearing in this Cause to demonstrate how the CSC was responsive to customer expectations. There, a customer complained about the inability of customer service representatives to access complete real-time customer service information after normal business hours. The customer was left with the impression that Petitioner is not "consumer-friendly." (*Petitioner's Exhibit AJV-R3*, p. 30.) Mr. Van den Berg explained that, since Petitioner has completed its transition to the CSC, all calls are logged real-time in a central location to which all customer service representatives have access. Further, customers are able to call and speak to a customer service representative twenty-four (24) hours a day, seven (7) days a week. Calls are routed automatically to an agent with the proper expertise to resolve the issue. Finally, customers not fluent in English will still be able to communicate about their needs.

Mr. Van den Berg estimated the cost for Petitioner to upgrade the Richmond facility to the level of service now provided at the Alton CSC. Mr. Van den Berg testified that, excluding a new CIS, Petitioner could expect to incur costs in the range of $2.7 million to $5.5 million for such upgrades, an amount significantly greater than its share of the one-time implementation cost of the Alton CSC of $1,345,305. (*Petitioner's Exhibit AJV-R*, p. 26.) Mr. Van den Berg also compared the annual cost in terms of return, depreciation and amortization of his estimates for both upgrading the Richmond facility and implementing a new CIS to the annual revenue requirement for E-CIS and the Alton CSC as quantified by OUCC witness Lynn. Mr. Van den Berg's analysis showed that Petitioner's E-CIS and CSC costs were significantly less than the go-it-alone alternative. (*Petitioner's Exhibit AJV-R4*.)

Mr. Van den Berg also believed Ms. Lynn's position that the CSC costs should have been directly charged to each participant, rather than allocated, should not be considered. Mr. Van den Berg said the cost allocation was made in accordance with the service company agreement on file with the Commission since 1989. This agreement provides that common costs incurred by AWWSC that cannot be related exclusively to one utility shall be allocated to American's utility subsidiaries based on the number of customers. Mr. Van den Berg said that the CSC was developed jointly among the operating companies and the allocation of costs was consistent with the treatment of other comparable costs and fair for all the utilities. Mr. Van den Berg noted that regardless of whether some companies may have experienced a bigger leap in their customer care operations than others, Petitioner achieved both cost savings and an increased level of service by participating in the CSC. (*Id.* at pp. 27-29.)

With respect to the E-CIS project depreciation rate issue, Petitioner's witness Cutshaw responded in rebuttal that Petitioner had proposed use of a 5.54% rate because it would have less of a rate impact. However, he stated that Petitioner does not oppose the OUCC's position that the 20% depreciation accrual rate should be used to determine depreciation expense for the E-CIS project. (*Petitioner's Exhibit JLC-R*, p. 26-27.)

Commission Discussion and Findings. As mentioned earlier in the rate base section of this Order, we believe there is enough of a relationship between the acquisition of the E-CIS software and the consolidation of customer services in Alton, Illinois to discuss these two issues jointly in this portion of the Order. We also note that as much evidence relevant to these issues was elicited during cross-examination as was presented in the parties' prefiled testimony.

Petitioner requested we approve the return on and of $6,248,821 related to the purchase and development of the E-CIS software. In addition, there is $194,360 in increased operating costs caused by Indiana-American's participation in the Alton CSC. Petitioner also seeks $282,528 in amortization costs of the $1.3 million deferred asset balance associated with the conversion to the Alton Customer Satisfaction Center. The OUCC recommended that the $6,248,821 associated with the E-CIS software be disallowed and removed from its 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. In addition, the OUCC recommended that the Commission accept its $194,360 downward adjustment to offset the increased O&M costs that is embedded in Petitioner's management fee adjustment for the Customer Satisfaction Center.

Sufficient evidence was presented to lead us to conclude that Petitioner's decision to upgrade its EDIS software to Orcom's E-CIS was made prior to the decision to consolidate its customer service functions in Illinois. What is at issue, however, are the costs and the need associated with (1) the decision to abandon the Richmond, Indiana consolidated customer service center and move to an out-of-state, multi-state consolidated service center and (2) the acquisition of an upgraded customer billing/service database that has expanded significantly in cost. In the initial three-year contract (1996-1999) between American and Orcom, Orcom agreed to develop E-CIS software that would be able to "go live" at eight (8) sites, of which Richmond, Indiana was one; Petitioner witness Eckart stated that "going live" meant the Orcom Customer Information System was installed and being used in the production of bills. (Tr. at E-14.) Indiana-American's portion of the cost to design and implement the software was 9% of the total $7.3 million cost.

Whether the OUCC should have known or not, we derive from the cross-examination testimony of Ms. Lynn that the Public was not readily aware that the upgrade to E-CIS was not limited to the initial Orcom contract. According to testimony and rebuttal evidence from Petitioner witnesses Eckart and Van den Berg, the initial American-Orcom contract for E-CIS serving eight (8) utilities was supplemented by an October/November 2000 contract between American and Accenture (formerly Anderson Consulting). (Tr. F-18, line 22 through F-19, line 4.) As we understand Petitioner's testimony, the initial Orcom "piece" of the E-CIS upgrade comprises only about 10% of the total work (and cost) needed to effect the E-CIS upgrade and application in the context of the consolidated customer service center. According to Petitioner, the cost of the second contract to develop and implement the E-CIS for the Alton CSC is $71,416,845. (Tr. D-49, line 21; E-69 lines 1-3.) The only contract in evidence, however, is American's 1996 through 1999 contract with Orcom.

After entering into the initial American-Orcom contract but prior to American's decision to cause Indiana-American to convert to Alton, a decision was made to include twenty-two (22)

utility locations, including Petitioner, to participate in the Alton CSC and to implement the E-CIS software for all participating utilities. Mr. Van den Berg testified that, dissatisfied with Orcom's customization work, the Petitioner entered the supplemental contract with Accenture for the purpose of developing a single instance of E-CIS for the Alton CSC. (Tr. F-22, lines 5-12.) The total cost of developing and installing the E-CIS software rose from $7,326,422 to $71,416,845. (Tr. D-49, line 21; E-69 lines 1-3.) And, though there are now twenty-two (22) installation locations using E-CIS, instead of eight (8), Indiana-American is expected to pay roughly the same percentage of the allocation: 9% of $71,416,845, instead of 9% of $7,326,422.

Putting the cost issue aside momentarily, we find that Petitioner presented sufficient justification for the need to upgrade to the E-CIS database. In his rebuttal testimony, Mr. Van den Berg explained the need for the E-CIS database, the benefits to be derived by Petitioner's customers and the advantages it offers over the EDIS database being replaced. According to Mr. Van den Berg, when compared to EDIS, the E-CIS software is more compatible and easily adaptable to other programs or packages used by Indiana-American, is user-friendly and allows employees to generate more sophisticated and "real time" reports. (*Petitioner's Exhibit AJV-R*, pp. 9-10.) He stated that the EDIS system used at the Richmond, Indiana service center could not "handle security challenges and threats resulting from expanded network and Internet uses, lack[ed] a detailed database to allow for data-discrepancy resolution" and could not be enhanced to meet "growing customer needs" because it lacked space to accommodate new computer code. (*Id.* at pp. 8-9.) With the E-CIS system in place, Mr. Van den Berg claimed that customers would benefit by receiving additional billing information (i.e., detailed usage, separated fixed charges), having the capability to select a different payment date and receiving accurate statements since Indiana-American employees would have additional time to correct billing errors before the statements are mailed. (*Id.* at p. 10.)

The question still remains, however, as to the amount of costs to allow for the software upgrade. First, we are unable to determine with any specificity the identity of the additional products and/or services that caused the total price to increase from $7,326,422 to $71,416,845. In addition, other than the testimony that Indiana-American's parent allocated the cost based on its percentage of the total customers served, Petitioner has not satisfactorily explained why it is more expensive for Indiana-American to go live with E-CIS as one (1) of twenty-two (22) companies with which to share the costs, than it would have been as one (1) of only eight (8). Petitioner witness Van den Berg acknowledges that providing software for twenty-two (22) utilities, many subject to different sets of regulations, would be more costly than providing the service for eight (8) utilities. However, we would expect some economies of scale since the Petitioner is now sharing the cost with almost three (3) times the number of participants originally proposed. Instead, Petitioner is expected to pay roughly the same percentage of a much greater expense. Also, we note the recent trend of Indiana-American to speak of attaining economies of scale within the state only to subsidize smaller American utilities by paying shared costs through a suspect allocation method; a method which does not credit economies of scale reached by the individual utilities. Since the evidence is not sufficient either to justify the Petitioner's requested expense or to reconcile the discrepancy of cost allocation, we find the most reasonable cost to allow Indiana-American is the allocation of $659,378 (9% of $7,326,425) as agreed to in the initial, three-year Orcom contract as the E-CIS was planned to be developed and implemented before the decision to include Indiana-American in the Illinois CSC.

With respect to the move from the customer service center in Richmond to Alton, Illinois, we believe the OUCC has presented compelling reasons to find that the move was imprudent and not reasonably necessary. First, the OUCC discovered that the Petitioner failed to perform any studies regarding the transfer of the Richmond center's services to the Alton CSC before the transition occurred and, by the time the Petitioner secured an expert to testify about general customer services at Richmond, the Richmond center had ceased being Indiana-American's customer call center. Second, the OUCC testified that the cost to Petitioner's ratepayers for Petitioner to participate in the consolidated customer service center would be approximately $2.3 million additionally each year. Petitioner had filed testimony in Cause No. 42029 that suggests that 88.28% of Indiana-American's customers were very satisfied with the detailed information contained on their bills when compared to other utility bills. Third, the Public also offered evidence that suggests that the Richmond call associates were very effective in handling its customer's needs. Fourth, when Petitioner surveyed its customers about the overall quality of service received from the call associates located at the Richmond facility, Mr. Eckart testified that 84.49% of Indiana-American's customers were satisfied with the overall quality of service received from the water company's customer call associates located in Richmond. Furthermore, Mr. Eckart testified that an 85% satisfaction rating from these surveys was Petitioner's goal:, stating that an 85% rating would mean Petitioner had achieved "world class" service. Thus, Richmond's Customer Service Center was considered "world class" based on the customer survey results provided as Public's Exhibit CX-4.

The OUCC also recalled testimony from Petitioner in Cause No. 42029 that the centralization of Indiana customer services in Richmond resulted in economies of scale. Petitioner stated in this Cause that, by consolidating service centers for all American companies in Illinois, economies of scale can be captured because the Petitioner can provide all the new services it described at a much lower cost than it would have incurred to provide them by itself. We believe that Petitioner's rebuttal evidence is not sufficient to allow such a conclusion. We believe that Petitioner gained its economies of scale when it centralized its customer service functions into one call center in Richmond, Indiana less than ten (10) years ago when Petitioner estimated a savings of over $650,000 annually as a result of the consolidation. Moreover, the Public demonstrated that with or without the inclusion of the E-CIS software in its analysis, there would never be a payback to Petitioner for its participation in American's Alton CSC initiative.

We conclude that the Richmond center was providing adequate service to Indiana-American's customers who, for the most part, have been satisfied with the level of service provided by the Richmond center. Petitioner's evidence in this proceeding is insufficient to demonstrate the necessity to move and consolidate Indiana's customer service functions into a national customer service center. We find it appropriate, therefore, to limit this expense to the amount already reflected in Petitioner's rate base for the Richmond Customer Service Center.

We also share the concern expressed by the OUCC that Petitioner is asking its customers to subsidize other states' inefficiencies. The OUCC testified that according to the "Business Case Review," American expects to save approximately $6 million each year over the next five (5) years as a result of establishing the Alton Customer Satisfaction Center, but Indiana-American is expected to pay $2.3 million each year. As a result, some of Petitioner's inefficient affiliates will share in the savings, while Indiana customers are expected to pay more. Indiana

customers benefited from the efficient customer service center in Richmond and should not now be financially penalized so that a consolidated grouping of efficient and inefficient affiliates can produce a savings for the parent company.

While we accept as a general concept that consolidations and shared services can result in greater benefits and efficiencies, we will review any such request separately and with an eye toward the impact on Indiana ratepayers. Within any such review we expect complete and substantial justification for the anticipated benefits and efficiencies.

Finally, Petitioner has openly recognized, even prior to this Cause, that the establishment of a consolidated call center could lead to the elimination of jobs in Indiana. Nonetheless, it is disturbing that what we find to be an imprudent decision to establish a consolidated call center, with respect to Indiana customer service needs, is exacerbated by the elimination of forty-seven (47) customer service jobs in Richmond, Indiana.

6. Purchased Power

Petitioner's Position. Petitioner proposed an increase to pro forma purchased power costs of $259,376 to reflect an increase in electric costs paid to Cinergy. Petitioner's witness Tapp testified that Cinergy had filed for a 16.1% rate increase that was anticipated to be effective in early 2004. (*Petitioner's Exhibit BIT*, p. 18, lines 20-23.)

OUCC's and Intervenor's Position. The OUCC and Intervenor Schererville opposed Petitioner's adjustment to pro forma purchased power costs attributable to the Cinergy rate proceeding. OUCC witness Ms. Stull testified that the adjustment was not fixed, known or measurable because Cinergy's rate case proceeding was still being litigated before the Commission. (*Public's Exhibit 2*, p. 16, lines 1-6.)

Petitioner's Rebuttal. Petitioner alleged that it appeared evident the Commission would grant a rate increase in some amount to Cinergy. Petitioner's witness Cutshaw testified that the proposed orders filed in the Cinergy proceeding showed that the OUCC was recommending an across-the-board increase of 4.2%, while Cinergy was now proposing an overall increase of 11.2%. (*Petitioner's Exhibit JLC-R*, p. 21, lines 16-18.) Mr. Cutshaw assumed the Commission should, at a minimum, adjust Petitioner's pro forma power costs to reflect the smallest rate increase being proposed in the Cinergy rate proceeding. (*Id.* at lines 18-20.) Mr. Cutshaw stated that this would result in an adjustment of $67,665. (*Petitioner's Exhibit JLC-R8.*)

Commission Discussion and Findings. On May 18, 2004, we issued our order in the Cinergy rate proceeding, Cause No. 42359, and granted an 8.36% rate increase. This increase is now fixed, known and measurable. Accordingly, we find that test year purchased power costs should be increased by $134,682.

7. Purchased Water

Petitioner's Position. Petitioner's witness Tapp testified that due to the addition of a new plant in Newburgh, Petitioner's demand for purchased water from the City of Evansville's

municipal utility had diminished by an estimated 58%. (*Petitioner's Exhibit BIT*, p. 17, lines 3-8.) The costs saved by reduced demand were offset somewhat by an anticipated rate increase for Evansville for the water Petitioner still purchases. (*Id.* at lines 8-13.) The Commission had not issued an order in the Evansville rate proceeding at the time Mr. Tapp's prefiled testimony was submitted, so Mr. Tapp presumed that the entire increase requested by Evansville would be granted by the Commission. Adjusting for the reduced demand and increased cost, Mr. Tapp claimed a negative purchased water adjustment for Newburgh of $12,822 was warranted.

OUCC's Position. At the time that the OUCC submitted its case-in-chief, the Commission had issued an order in the Evansville's rate proceeding. OUCC witness Stull testified that the final order issued by the Commission in that proceeding had adopted a rate increase of 15.38% and recommended that this be used to calculate the Newburgh purchased water adjustment. (*Public's Exhibit 2*, p. 13, lines 9-15.) Ms. Stull accepted Petitioner's estimate of the decreased volumes it will purchase from Evansville. (*Id.* at lines 15-19.) Accepting Ms. Stull's methodology would result in a decrease to test year purchased water expense of $28,671.

Intervenor's Position. Intervenor, Town of Schererville, advocated allowing no expense for the cost of purchased water from the City of Evansville. Schererville's witness Sommer testified that the final order in the Evansville rate proceeding specifically found that the City of Evansville was not going to be selling any water to Petitioner. (*Intervenor Schererville's Exhibit 1*, p. 18, lines 11-16.)

Petitioner's Rebuttal. Petitioner accepted the OUCC's adjustment for purchased water costs in Newburgh. (*Petitioner's Exhibit JLC-R*, p. 19, lines 17-20.) Petitioner disagreed, however, with the Town of Schererville's proposal to allow no expense for the cost of purchasing water from Evansville. Mr. Cutshaw testified that regardless of what may have been said in the Evansville rate order, Petitioner was still a customer of Evansville, and should be able to recover the prudent purchased water costs it is reasonably anticipated to incur. (*Id.* at p. 20, lines 7-9.) Mr. Cutshaw testified that actual purchases for the most recent twelve (12) months totaled 41,535 thousand gallons. (*Id.* at lines 5-7.)

Commission Discussion and Findings. All parties agree that Petitioner has constructed a new water treatment plant in Newburgh and that this plant is included in Petitioner's rate base. What is in dispute is how much, if any, water will continue to be purchased from the City of Evansville. In our Final Order in Cause No. 42176 ("Evansville Order"), we recognized that Petitioner would continue to be connected to Evansville and may need to use Evansville as a "backup" source of water supply. (*Evansville Mun. Water Works Dept.*, Cause No. 42176, p. 9-10 (Indiana Utility Regulatory Commission, Date Issued Feb. 18, 2004).)

That being said, this Commission intended the term "backup" to be used in the sense of an emergency source of supply and that purchases would be infrequent and difficult to predict or budget. Indeed, in that case we rejected a request to adjust Evansville's revenues because "any amount that Indiana-American may or may not purchase in the future is not fixed, known and measurable and therefore would not properly be included in [Evansville's] adjusted test year operating revenues." (*Id.* at p. 10.)

We found in the Evansville Order that future Indiana-American purchases from Evansville were not fixed, known and measurable. Nothing in the record of this Cause leads us to disturb that finding. Accordingly, test year should exclude any purchased water costs from Evansville, and pro forma purchased water expense should be decreased by $68,202.

8. Insurance

a) Group Insurance

Petitioner's Position. Petitioner made adjustments for current group insurance costs and costs associated with post-retirement benefits other than pensions ("PBOP"), i.e., Statement of Financial Accounting Standards No. 106 ("FAS106"). Petitioner proposed an increase over test year of $503,075 for group insurance and a decrease of $522,562 for PBOP, for a net decrease of $19,487. Petitioner further reduced test year expenses by shifting certain positions in customer service and corporate to AWWSC, which were offset by increases to "management fees" paid by Petitioner to AWWSC.

OUCC's Position. The OUCC made adjustments consistent with its proposed labor adjustments, including the exclusion of certain vacant and new employment positions and updating the costs for an increase in premiums less the portion paid by the employee. The OUCC accepted Petitioner's adjustment for PBOP/FAS106 costs. The OUCC proposed an increase over test year of $383,826 for group insurance and a decrease of $522,562 for PBOP, for a net decrease of $138,736. The Public also recognized Petitioner's shifting of costs to management fees, as was discussed in the labor portion of this Order. (*See* Sect. XI. B. 1. Pro Forma Labor Positions.)

Petitioner's Rebuttal. Mr. Cutshaw testified that the originally proposed adjustment to PBOP was in error. He stated the pro forma amount should have been $2,043,667, not $1,271,240 as originally filed. Mr. Cutshaw changed the adjustment from ($522,562) to $249,886. Petitioner accepted Ms. Gemmecke's adjustment reflecting group insurance rates effective January 1, 2004, and employee contributions. (*Petitioner's Exhibit JLC-R*, pp. 14-15.)

Commission Discussion and Findings. Petitioner originally requested a decrease of $522,562 to test year PBOP expenses. The Public and Intervenors made no changes to this adjustment to test year expenses. However, Petitioner on rebuttal stated its adjustment was in error and the correct adjustment to test year expense would be an *increase* of $249,866, rather than the originally proposed *decrease* of $522,562.

We find no justification for Petitioner's disparate treatment of pension expense and PBOPs. With the pension expense, Petitioner calculated a six-year pro forma average pension (FAS87) expense. (*Industrial Group's Exhibit 1*, p. 28, lines 11-12.) However, with the PBOP (FAS106) calculation, Petitioner did not calculate an average. Instead, Petitioner took only the 2004 amount of $28,400,000 to calculate Indiana-American's share of the expense.

Mr. Wolf explained the reasoning behind the pension expense average, saying, "[a] six (6) year average was used because recent declines in the financial markets are causing significant

increases in pension costs over the period. Using the average mitigates the short-term impact of recent events." (*Petitioner's Exhibit WJW*, p. 12, lines 1-4.) The same factors of market fluctuation are relevant in determining FAS106 expense as for FAS87 expense. Consequently, we see no justification for Petitioner to treat FAS106 differently.

The Commission finds pro forma group insurance costs to be $112,664 above the test year amount of $4,258,549, before shifting costs to management fees. The amount shifted to management fees is $417,056, consistent with our findings for labor expense.

b) Other Insurance

Petitioner's Position. Petitioner adjusted test year insurance other than group expense by annualizing the current premiums for each type of coverage, including general liability, auto liability and workers' compensation. (*Petitioner's Exhibit BIT*, p. 22, lines 1-4.) This adjustment resulted in an increase in test year expense of $124,458. (*Petitioner's Exhibit BIT, Sched. 6*, p. 1.)

OUCC's Position. OUCC witness Margaret Stull proposed several adjustments increasing test year insurance other than group expense by $14,938. According to the OUCC, Petitioner overstated auto insurance expense by $89,364 and overstated liability insurance by a net $19,714. (*Public's Exhibit 2, Attach. MAS-13.*) Ms. Stull also proposed to eliminate the amortization of retrospective insurance premiums in the amount of $153,264. Ms. Stull noted that Petitioner did not provide any explanation or support as to what these insurance premiums related or how they would benefit future periods and, therefore, warrant multi-year amortization. (*Public's Exhibit 2,* page 18, lines 12-20.)

Petitioner's Rebuttal. Petitioner accepted the adjustments to auto insurance and liability insurance. However, Petitioner opposed the proposed exclusion of the retrospective premiums.

In rebuttal, Petitioner's witness Cutshaw provided a summary of the affected policies and copies of supporting invoices. (See *Petitioner's Exhibit JLC-R9.*) He argued that the retrospective payments are a "true-up" of premiums for prior year policies that Petitioner is paying over a set policy period. Mr. Cutshaw further claimed that the amounts reflected by the Company were incurred in the test year and will be incurred beyond the adjustment period provided in the Prehearing Conference Order in this case. (*Petitioner's Exhibit JLC-R*, p. 24, lines 10-15.) Mr. Cutshaw alleged that retrospective premiums have been accepted by the OUCC and approved by the Commission in Petitioner's last four rate cases (Cause Nos. 42029, 41320, 40703 and 40103). (*Id.* at lines 20-24.)

Commission Discussion and Findings. First, we find that the insurance adjustments for auto insurance and liability insurance, which were accepted by Petitioner, should be approved.

Second, as to retrospective premiums, we have reviewed our rulings in Petitioner's four (4) previous rate cases and do not see any specific mention or acceptance of retrospective insurance premiums as stated by Petitioner in its rebuttal testimony.

That being said, we do not think that there is enough information on the record to disallow these retrospective insurance premium expenditures. We will allow these costs to be included in test year for this rate case, but emphasize that this issue is not closed to future examination in subsequent cases. Indeed, we encourage a more thorough investigation of these costs by the OUCC in Petitioner's next rate case.

9. Internal Audit

OUCC's Position. Ms. Lynn reduced Petitioner's management fee expense by $56,572 for the Internal Audit Division of an affiliated company. She based her adjustment on Petitioner's response to OUCC Data Request No. 3, Question 51, in which Petitioner stated that the Internal Audit Division had not performed an internal audit for Petitioner in over three (3) years. (*Public's Exhibit* 3, p. 32.)

Petitioner's Rebuttal. Petitioner's witness Wolf testified that Petitioner and its ratepayers receive benefits from the American Internal Audit department because the department does more than direct internal audits. (*Petitioner's Exhibit WJW-R*, p. 2, lines 9-10.) He stated that, in addition to performing periodic internal financial audits, the Internal Audit department assists with the annual independent audit performed by PricewaterhouseCoopers (thereby reducing audit fees allocated to Petitioner), performs reviews of Information Technology Services processes and procedures, reviews SCADA system security and administers Petitioner's Code of Ethics. (*Petitioner's Exhibit WJW-R*, p. 2, lines 11-21.)

Commission Discussion and Findings. We reviewed Public's Exhibit 3, Attachment DML-11, which contained the complete question and answer to the discovery question the Public relied upon as its basis for the adjustment:

Q-51: Please describe any and all internal audits, review, cost/benefit analyses, assessments or evaluations ("audits") of any aspect of Petitioner's operations performed in the last three years. Also, please state who performed the audit, the length of the document and whether the audit is complete.

Response: . . . .Without waiver of its objections, Indiana-American states that it has no internal audits for the referenced period. Indiana-American further states that it prepared comprehensive planning studies during the referenced period. Such studies were prepared under the supervision of Alan J. DeBoy. Copies of the comprehensive planning studies will be made available for inspection at its corporate office.

We note that this data request by the OUCC was not just a request for the internal audits that had been performed. Certainly, Mr. Wolf's rebuttal on this subject claims that the affiliated company's Internal Audit division performed audit tests for Indiana-American and a review of Indiana-American's corporate-wide Information Technology Services processes and procedures.

However, despite being clearly within the scope of the OUCC's request, no reference to, or documentation of these "internal audits, review, cost/benefit analyses, assessments or evaluations" was provided to the OUCC. Indeed, beyond Mr. Wolf's passing assertion of their existence in his rebuttal testimony, there is no documentation whatsoever of these activities in the record of this case. (*Petitioner's Exhibit WJW-R*, p. 2, lines 16-21.)

We note that under the Commission's procedural rules, discovery is designed to be self-executing, and parties should be able to rely on the completeness of other parties' responses. (*See*, 170 IAC § 1-1.1-16 (2000).) Furthermore, Indiana courts have addressed the issue of inferences that may be drawn from a party's failure to provide evidence within that party's exclusive control, as follows:

> In Indiana, the exclusive possession of facts or evidence by a party, coupled with the suppression of the facts or evidence by that party, may result in an inference that the production of the evidence would be against the interest of the party which suppresses it. . . . The rule not only applies when a party actively endeavors to prevent disclosure of facts, but also when the party "merely fails to produce available evidence."

Porter v. Irvin's Interstate Brick & Block Co., Inc., 691 N.E.2d 1363, 1364-65 (Ind. Ct. App. 1998)(quoting *Morris v. Buchanan*, 220 Ind. 510, 44 N.E.2d 166, 169 (1942)).

Clearly, Petitioner's records are within Petitioner's exclusive control. Furthermore, OUCC witness Lynn appropriately raised questions regarding the purposes for which Petitioner was billed by its affiliate's Internal Audit division. Therefore, without documentation of these management fees Petitioner paid to its affiliate's Internal Audit division, we may infer that these fees are properly counted as expenses in the provisioning of utility service. Consequently, we find that Petitioner should reduce its test year management fees by $56,572 for its affiliates Internal Audit Division.

We will incorporate this reduction into Petitioner's adjustment for management fees in Section XI. B. 16.

10. Employee Investment Plan

<u>OUCC's Position.</u> OUCC witness Judith Gemmecke challenged the amount of Petitioner's adjustment for 401(k) expense, the Employee Investment Plan ("EIP") and temporary employment services. (*Public's Exhibit 1*, p. 22, lines 2-17.) Ms. Gemmecke objected to the inclusion of the EIP in rates because the Internal Revenue Service had not issued a determination letter qualifying the contributions to the plan as deductible for tax purposes and, if the plan is found not to be deductible, the company will be able to recover all contributions made. (*Id.* at lines 10-13.) Consequently, Ms. Gemmecke asserted the EIP expense was not fixed in time or known to occur because the company may be able to reclaim the money put into the EIP accounts. (*Id.* at lines 14-16.)

Petitioner's Rebuttal. Mr. Cutshaw disagreed with Ms. Gemmecke, testifying that Petitioner's contributions to the EIP are fixed, known and measurable. (*Petitioner's Exhibit JLC-R*, p. 17, line 16 through p. 18, line 6.) Mr. Cutshaw testified that delays in obtaining a determination from the Internal Revenue Service are not uncommon and attached Petitioner's Exhibit JLC-R7, a copy of a letter from Petitioner's law firm opining that the EIP qualifies for special tax treatment, to his testimony. (*Id.* at lines 20-23.) Mr. Cutshaw noted that the EIP replaced Petitioner's Employee Stock Ownership Plan ("ESOP") which has been included in Petitioner's recoverable expenses for many years. (*Id.* at p. 17, line 23 through p. 18, line 1.) Although the tax deductibility of the contributions is not yet resolved, Mr. Cutshaw argued that Petitioner has made and continues to make contributions to the EIP and that these payments are fixed, known and measurable. (*Id.* at p. 18, lines 1-6.)

Commission Discussion and Findings. We have previously noted that "[t]his Commission is bound in making adjustments to a standard that those adjustments must be sufficiently fixed, known and measurable, and therefore likely to occur, for ratemaking purposes." (*Indiana Gas Company, Inc.*, Cause No. 38080, 86 PUR4th 241, 255 (IURC September 18, 1987).) Ms. Gemmecke's challenge to Petitioner's contributions to the EIP is not that those contributions cannot be determined with sufficient specificity, but instead goes to the likelihood of the expenses' occurrence. While the IRS may not yet have determined that the EIP will qualify for tax benefits, Petitioner has established that it is likely that the plan will receive a favorable ruling from the IRS. We therefore reject the OUCC's proposal to remove the cost of Petitioner's contributions to the EIP from its expenses.

11. Maintenance Expenses

Petitioner's Position. Petitioner's witness Tapp proposed an adjustment for certain maintenance items to be completed during the twelve-month adjustment period. He itemized each of the maintenance efforts, which included:

(1) Southern Indiana: well cleaning, parking lot sealing, chlorine maintenance, easement maintenance and printing;

(2) Richmond: parking lot sealing and valve maintenance and repairs;

(3) Seymour: painting and sector cleaning;

(4) Shelbyville: residuals removal and painting;

(5) Wabash Valley: well cleaning and generator maintenance; and

(6) Warsaw: well cleaning

The total proposed adjustment is $270,100.

OUCC's Position. OUCC witness Stull excluded all of the proposed pro forma adjustments from Petitioner's maintenance expenses. (*Public's Exhibit 2*, p. 19, lines 21-23.) Ms. Stull testified that these additional costs were requested in addition to the test year maintenance expense ($2,620,679), but the Petitioner did not adequately support the need for this amount with schedules or work papers. (*Id.* at p. 21, lines 8-11.)

Petitioner's Rebuttal. In rebuttal, Petitioner's witness Cole disagreed with the Public's proposal to exclude all pro forma adjustments to the Company's maintenance expenses. He explained that a decision was made to reduce the Company's maintenance in 2003 by more than $300,000 in the areas of well cleaning, residuals removal and other areas. He explained that this was done because the maintenance could be briefly delayed without impacting water quality and because the Company was anticipating budgetary constraints. (*Petitioner's Exhibit DDC-R*, p. 10, lines 15-17.) Mr. Cole further explained that continued delivery of water supply and delivery of service requires the reinstatement of maintenance that was curtailed in 2003. For example, the well cleaning, included in the $270,000 adjustment, commenced in March 2004 and will be completed in May 2004 in preparation for upcoming water demands in Summer 2004. All of the other delayed maintenance will be completed during the adjustment period. (*Id.* at p. 10, line 18 through p. 11, line 2.)

Commission Discussion and Findings. We find that the OUCC's proposal to omit all adjustments to the Petitioner's maintenance expense should be rejected. The Petitioner has sufficiently explained why the test year maintenance expenses were reduced in 2003 and why it is necessary to reinstate maintenance expenses that have been curtailed. We further find that these expenses are required for the Petitioner's continuous provision of quality service to Indiana customers and that this amount should not be excluded.

12. Regulatory Expenses

Petitioner's Position. Petitioner proposed to amortize its estimated regulatory expense over a thirty-month period, resulting in a proposed adjustment to increase the test year level by $65,268. (*Petitioner's Exhibit JLC-3, Sched. 3.*)

OUCC's Position. The OUCC agreed with Petitioner's thirty-month amortization period but proposed an adjustment to increase test year regulatory expenses by only $51,268. (*Public's Exhibit 2*, p. 10, lines 21–22.)

OUCC witness Stull evaluated the support provided by Petitioner for the various types of estimated regulatory expenses it was proposing, including legal fees and consultant fees for a cost of capital study and a cost of service study. Ms. Stull determined that the support provided was reasonable and agreed with Petitioner's estimated costs for these expenses. However, Petitioner did not provide any support for its estimates of customer notification costs and other miscellaneous expenses. Consequently, Ms. Stull compared Petitioner's estimates in this case to costs incurred in its prior rate case and determined that customer notification expenses appeared reasonable but that other miscellaneous expenses did not. (*Id.* at lines 17-20.) Ms. Stull requested, through an on-site data request, further details regarding Petitioner's estimate of other miscellaneous costs but she received no response. (*Id.* at lines 11-17.) Based upon the limited information available to the OUCC, Ms. Stull recommended that Petitioner's miscellaneous regulatory expense be reduced from $45,000 to $10,000, the level of expenses incurred in Petitioner's prior rate case for this category of costs. (*Id.* at lines 9-11.)

Petitioner's Rebuttal. Petitioner claimed that the miscellaneous expense estimate of $45,000 was reasonable. (*Petitioner's Exhibit JLC-R*, p. 15, lines 10-24.) In fact, Mr. Cutshaw alleged that the costs incurred as of the time his rebuttal testimony was filed had actually

exceeded Petitioner's original estimate by $12,000. (*Id.* at p. 16, lines 1-3.) Mr. Cutshaw also provided the support for the expenses included in this category as Petitioner's Exhibit JLC-R5 and explained the costs that had been incurred. The explanation Mr. Cutshaw offered as to why the supporting information for other miscellaneous regulatory expense was not provided to the OUCC was that the request was overlooked.

Mr. Cutshaw further claimed that total estimated regulatory expense had increased. The costs for customer notification had increased by $24,000 from the previous estimate. Further, he claimed that Petitioner had not originally anticipated retaining Mr. Van den Berg to testify and that the cost of service study and associated discovery were underestimated by approximately $12,500. Mr. Cutshaw did not discuss the status of expenditures related to legal costs or the cost of capital study.

Commission Discussion and Findings. It appears that some of the documents supporting Petitioner's miscellaneous regulatory expenses were not provided until its rebuttal evidence was filed. We are, again, concerned with Petitioner's lack of responsiveness to the OUCC. Nonetheless, we accept Petitioner's proposed pro forma regulatory expense as requested in its case-in-chief but do not accept the increased costs presented in Petitioner's rebuttal testimony. These expenses should have been presented in Petitioner's case-in-chief. Because they were not, the OUCC and Intervenors were not given adequate opportunity to review these additional costs. Further, no update was provided for legal costs, which is a substantial portion of the overall costs, or for the cost of capital study.

While Petitioner has presented evidence that certain categories of expense have increased in the intervening period between the filing of Petitioner's direct and rebuttal testimonies, we have only estimates as to the remaining expenses. Consequently, we have insufficient evidence to determine with any degree of certainty that the overall level of regulatory expense has increased. Consequently, we find Petitioner's test year regulatory expense adjustment should be limited to the amount requested in Petitioner's case-in-chief, $65,268.

13. General Office Expenses

OUCC's Position. The OUCC proposed an adjustment to reduce Petitioner's general office expense by $54,907, by removing the amortization of a prior period short-term line-of-credit fee which did not appear to be a recurring expense. (*Public's Exhibit 2*, p. 23, lines 3-9.) The OUCC also proposed to eliminate from this category of expense $4,146 for a meter restocking fee which it believed was not reasonably necessary. (*Id.* at lines 10-14.)

Petitioner's Rebuttal. Petitioner accepted the disallowance of the meter restocking fee but submitted evidence that the short-term line-of-credit fee was recurring. Petitioner's witness Wolf alleged that the fee is incurred on an annual basis to maintain a syndicated line-of-credit used to provide short-term financing for Petitioner's borrowing needs. Mr. Wolf testified that the fee was incurred and paid in August 2003 to continue the line of credit. (*Petitioner's Exhibit WJW-R*, p. 17, lines 5-15.)

Commission Discussion and Findings. The basis for the OUCC's proposed adjustment to general office expense was that the fee attributable to short-term debt expense was nonrecurring. Petitioner provided testimony demonstrating that this fee was in fact recurring. Based on Petitioner's testimony, we find that the OUCC's proposed adjustment to remove $54,907 of short term debt fees should be rejected.

14. Taxes

a) Property Tax

Originally there was considerable disagreement by Intervenor Schererville with the calculation of pro forma property taxes. Petitioner originally proposed an adjustment to increase test year expense by $2,466,662. (*Petitioner's Exhibit WJW-1-U, Sched. 4.*) This amount was calculated using the most recent assessed values and most recent property tax rates available. Intervenor witness Sommer opposed the adjustment because he believed the effect of the recent statewide reassessment would produce significantly lower property tax rates in the Northwest district. By the time of the final hearing, updated property tax rates were available for all counties where Petitioner has taxable property with the exception of Clark County. With the new rates, Petitioner recomputed its pro forma property taxes and reduced the proposed adjustment by $2,302,851. (*Petitioner's Exhibit WJW-1-L, Sched. 2.*) We approve the Petitioner's adjustment as no party opposed the recalculated pro forma property taxes.

b) Utility Receipts Tax

Both Petitioner and the OUCC made an adjustment for utility receipts tax based upon their respective calculations of pro forma revenues. However, OUCC witness Gemmecke reduced taxable receipts by the amount of pro forma wholesale sales. On rebuttal, Petitioner's witness Cutshaw agreed with Ms. Gemmecke's exclusion of such revenue from the calculation. The Commission is in agreement with this calculation methodology and has applied the same in determining the utility receipts tax.

c) Income Tax

OUCC's Position. The OUCC proposed one adjustment to Petitioner's method of calculating state income taxes. Ms. Gemmecke has deducted parent company interest as well as synchronized interest as tax-deductible interest expense. She states that interest expense is a proper business deduction to both federal and state taxable income. Indiana state tax begins with federal taxable income, which includes the deduction for interest expense.

Petitioner's Rebuttal. Petitioner opposed Ms. Gemmecke's proposal to treat any parent company interest expense as tax deductible for state income tax purposes. (*Petitioner's Exhibit WJW-R*, p. 25, lines 6-10 and lines 18-22.) As explained by Mr. Wolf, the allocation to Petitioner of a share of its of parent company interest expense in the federal income tax calculation was made in accordance with the procedure set forth in the Commission's Supplemental Order On Remand dated September 16, 1981, in Muncie Water Works Company, Cause No. 34571. (*Id.* at lines 10-18.) As explained in that Order, the parent company interest allocation is intended to reflect for ratemaking purposes the benefits of Petitioner joining in a

consolidated federal income tax return. For this reason, the Order in Cause No. 34571 did not allocate parent company interest in the state income tax calculation. (*Id.* at lines 18-20.) Mr. Wolf testified that Petitioner does not file a consolidated state income tax return and, therefore, derives no benefits from the parent company interest. (*Id.* at lines 18-22.)

Commission Findings. We accept Petitioner's methodology to calculate pro forma state income taxes. The OUCC's proposal to deduct parent company interest in the state income tax calculation is rejected. We rejected this same proposal from the OUCC in our Supplemental Order on Rehearing in Cause No. 38880. (*Ind.-Am. Water Co.*, Cause No. 38880 (Indiana Utility Regulatory Commission, Date Issued Nov. 28, 1990).) We noted in that Order that "the Commission's calculation of state income taxes in the [34571] Order did not treat the parent company interest as tax deductible for state income tax purposes." (*Id.* at p. 7.) This conclusion is likewise valid in this proceeding because Petitioner does not file a consolidated state income tax return.

15. GIS Expenses

OUCC's Position. Ms. Stull proposed to reduce miscellaneous expense by $40,180 to remove the accrual of costs for "GIS" services. (*Public's Exhibit 2*, p. 28, lines 14-16.) Ms. Stull also indicated that Petitioner accrued $50,000 for GIS services during the test year but had reversed $9,820 of this accrual in March 2003. (*Id.* at lines 19-22.) Ms. Stull concluded that the remaining $40,180 accrued for GIS services was either not necessary for the test year or should have also been reversed and that miscellaneous expense was, therefore, over-stated. (*Id.* at p. 28, line 19 through p. 29, line 2.)

Petitioner's Rebuttal. Mr. Wolf testified that it would be inappropriate to remove the accruals recorded to miscellaneous expense for GIS services. Mr. Wolf explained that Ms. Stull incorrectly assumed that Petitioner's reversal of a portion of these costs meant that the remaining amount should be disallowed. Mr. Wolf testified that the partial reversal was a result of a change in Petitioner's accounting for this expense. Petitioner has historically handled these expenses by first accruing them to a liability account and then processing invoices against the accrual. (*Petitioner's Exhibit WJW-R*, p. 18, lines 20-22.) Mr. Wolf testified that Petitioner ceased accruing the cost in March 2003 and reflected this change by adjusting the liability account to zero and crediting $9,820 to expense. (*Id.* at p. 18, line 23 through p. 19, line 4.) Mr. Wolf stated that the Petitioner had actually incurred $73,573 in expenses to this contractor, but had only booked $47,190 as a result of this accounting change. (*Id.* at p. 19, lines 4-6.)

Commission Discussion and Findings. According to the testimony of Mr. Wolf, the accrual process was streamlined during the test year and this accrual does, in fact, represent actual expenses incurred by Petitioner. Petitioner has explained the changes and demonstrated that these costs are not being counted twice. Consequently, we disallow the OUCC's adjustment.

16. Management Fees

Petitioner's Position. Petitioner proposes to increase management fees from test year amounts of $5,361,157 to a pro forma amount of $10,130,448. This increase consists of a 4%

increase in the labor portion of management fees, the annualized cost of a Vice President of Finance position plus a shifting of costs from direct expenses and of certain Indiana-American corporate personnel.

OUCC's Position. We previously accepted the OUCC's adjustment to eliminate $56,572 of charges for internal audits which were not performed. (*See*, Sect. XI. B. 9. Internal Audits.) This expense is an allocation from AWWSC. Ms. Stull made additional adjustments for non-recurring expenses related to a cancellation fee and a legal settlement. Ms. Stull also eliminated certain costs that the OUCC alleges provide no material benefit to ratepayers, including investor relations, lobbying costs, charitable contributions and a public relations contract. In addition, she made an adjustment for a three-year maintenance agreement which was fully expensed within the test year. Ms. Stull had concerns regarding management fees, stating she could only conduct a limited review and that information was difficult and time-consuming to obtain. Ms. Gemmecke confirmed that source documents for management fees were not as forthcoming as desired. In addition, she remarked that office rental expense, which is being shifted from a direct corporate expense to a management fee expense, is for excessive space. She also made adjustments for the elimination of incentive pay (paid through management fees). Finally, Ms. Gemmecke made adjustments to labor and benefits expenses which have an impact on the dollar amounts being shifted to management fees. Mr. Pettijohn, while not proposing an adjustment, commented on the amount of research and development charges which were being allocated to Indiana-American through management fees.

Petitioner's Rebuttal. Petitioner agreed to part of Ms. Stull's adjustment for lobbying expense, but also disagreed in part. Petitioner's witness, Mr. Wolf voiced his disagreement with the disallowance of $13,894 from the Corporate Communications Department, as this department helps prepare press releases and speeches. (*Petitioner's Exhibit WJW-R*, p. 4.) Mr. Wolf also categorizes the research and development charges as the American Water System Research Program and membership in AWWARF.

Commission Discussion and Findings. Petitioner is slowly moving its direct expenses to its service company where costs for all its affiliates are accumulated and then allocated as management fees. AWWSC is the hub of all accounting, administration, engineering, financing and customer service functions and most management functions. The only direct management salaries are those in the positions of management for each water treatment/delivery system. In addition, the AWWSC acts as a flow-through entity for charges from the Belleville Lab and the Customer Satisfaction Center.

Petitioner disputes neither the OUCC's elimination of charitable contributions, investor relations or certain lobbying expenses, nor the adjustments for non-recurring items or the maintenance agreement contract. Petitioner goes to great lengths describing the benefits of the Corporate Communications Department, but the OUCC has not eliminated the costs of this department; instead it has eliminated the costs related to a particular vendor that provides public relations services for Petitioner. Petitioner provided no evidence in rebuttal to show that this vendor's activities provided any material benefit to ratepayers, so we find that these costs should be eliminated.

Petitioner also discussed at length the benefits of the government affairs department. The standard for including these types of expenses in rates has been whether the expenditures provide a specific, material benefit to the ratepayers. Petitioner has failed to demonstrate any such benefit, so we find that these costs should be eliminated.

As a result, total management fees allowable in rates equals $8,992,386.

17. Other Expenses

Petitioner's Position. Petitioner includes several adjustments under this heading. Adjustments to test year expense included the labor-related costs of the 401(k) and Employee Investment Plan (*see,* Sect. XI. B. 10.), the "Call Before You Dig" program, the write-off of deferred expenses from the Shared Services Initiative and an increase of security expenses. Petitioner filed supplemental testimony on February 20, 2004, to reflect the determination in our December 30, 2003 Order on security costs in Cause No. 42029. The adjustment for security expense will be discussed separately below. (*See,* Sect. XI. B. 18.) Petitioner then shifts some of the miscellaneous expenses to management fees.

OUCC's Position. OUCC witness Gemmecke challenged the amount of Petitioner's adjustment for 401(k) expense, the EIP and temporary employment services. The amount of 401(k) expense is tied to the pro forma labor expense recommended by the OUCC in this Cause. Ms. Gemmecke makes an additional adjustment to eliminate temporary employment services which were included in the test year. This was done because full-employment was allowed in labor expense.

OUCC witness, Margaret Stull agreed with Petitioner's adjustment removing a one time write-off of costs associated with the Shared Services Initiative. She also agreed with the adjustment to annualize costs associated with the "Call Before You Dig" program. Ms. Stull made additional reductions to test year miscellaneous expense for charitable contributions, advertising costs, community relations expense and lobbying expenses. Ms. Stull provided a detailed listing of items included in her adjustments. Corrected testimony was submitted by Ms. Stull on April 15, 2004, wherein she adjusted her advertising expense reductions in light of Petitioner's rebuttal testimony on this subject. In addition, Ms. Stull made adjustments to reverse accrued expenses recorded during the test year where no actual expenses were recorded to off-set these reserves during the test year. The adjustment to reverse GIS contract services is discussed under Operating Expenses, GIS Expense. (*See,* Sect. XI. B. 15.) The OUCC agreed with the shifting of costs from Indiana-American's miscellaneous expense to management fees, however, due to some of the adjustments indicated above, the amount of reduction to miscellaneous expense varies from that proposed by Petitioner.

Petitioner's Rebuttal. Mr. Wolf discusses the miscellaneous expense adjustments of advertising expense, accrued expense and lobbying expense. He does not agree with the full amount of Ms. Stull's exclusion of advertising cost. He states that part of the $54,508 in advertising expenses that Ms. Stull reduced in test year level of expense did provide a benefit to the ratepayers. He indicated that $7,691 of cost was incurred for hydrant flushing notification

and $17,809 was incurred for employment classified ads. Later in his rebuttal testimony he states his belief that lobbying expense provides a material benefit to the ratepayer.

Commission Discussion and Findings. There are a variety of issues which have been placed in "Other Expenses." We will discuss each adjustment that was contested by either party.

401(k) Expense. Both Petitioner and the OUCC propose an increase in 401(k) expenses. This expense is directly tied to the findings under labor expense. Consistent with the findings in labor expense, we now find the increase to test year 401(k) expense to be $45,403, and the amount of costs shifted to management fees is $2,600 for customer service associates and $19,063 for Indiana-American corporate employees who will be employees of AWWSC on a pro forma basis.

Advertising. While Mr. Wolf did not detail which invoices he believed had a benefit to ratepayers, he did testify as to amounts for hydrant flushing notification and employment advertising, thus leaving $29,008 which Petitioner did not contest removing from test year expenses to obtain a pro forma amount of advertising expense. The OUCC corrected its testimony and schedules to reflect the same. The Commission now finds test year advertising to be overstated by $29,008 for pro forma expense.

Charitable Contributions. The OUCC proposed adjusting test year expenses to eliminate charitable contributions for ratemaking purposes. This adjustment was unopposed by Petitioner. Consequently, the Commission accepts the OUCC's adjustment.

Community Relations. The OUCC proposed adjusting test year expenses to eliminate items related to Community Relations. This adjustment was unopposed by Petitioner. Consequently, the Commission accepts the OUCC's adjustment.

Lobbying Expense. The OUCC proposed the removal of lobbying expenses from Operations and Maintenance expenses for ratemaking purposes. Petitioner opposed the removal, stating that some of the expense was for the lobbying efforts of a membership trade association. As we have found in previous orders for this company, lobbying expenses are not includable in rates unless they can be found to have a specific, material benefit to the ratepayers which can be expected to occur during the period in which the rates being considered are applied. Petitioner did not provide evidence regarding any specific, material benefit to ratepayers and, therefore, the Commission finds the OUCC's adjustment should be approved.

Accrual Reversals. The OUCC has proposed excluding amounts recorded on Petitioner's books from the accrual of customer survey costs. Petitioner did not rebut this adjustment. Consequently, the Commission finds the OUCC's adjustment relating to the customer survey accrued expense should be approved.

18. Security Costs

Petitioner's Position. Petitioner adjusted test year expenses to include $1,918,070 for security costs. (*Petitioner's Exhibit JLC-3-U, Sched. 4.*) This amount included annual amortization of deferred security costs in the amount of $572,742 and $1,345,328 of on-going

annual expenses. Deferred security costs are being amortized over a five (5) year period. Petitioner's witness Cutshaw testified that these amounts were based upon the Commission's December 30, 2003 Order on Security Costs in Cause No. 42029. (*Petitioner's Exhibit JLC-U*, p. 5, lines 20-24 through p. 6, lines 1-6.)

OUCC's Position. OUCC witness Margaret Stull asserted that it is not clear from the Order issued in Cause No. 42029 what security costs have been approved by the Commission to be recovered by Petitioner. Due to confidentiality issues, the Order does not provide specifics regarding the composition of the costs approved, what or whether deferred costs can be recovered, or over what period these deferred costs should be recovered. (*Public's Exhibit 2*, p. 25, lines 14-23.) Since the hearing on this issue in Cause No. 42029, Petitioner's annual costs have decreased steadily from approximately $1.8 million to $1.3 million. In Cause No. 42029, Petitioner requested total annual security costs of $2,454,027, and the Commission approved $2,062,871. If the Commission did not intend for Petitioner to recover all of its current or deferred costs or intended for Petitioner to recover deferred costs over a longer period of time, then Petitioner would be over-recovering these costs based on its current test year adjustment. (*Id.* at p. 26, lines 9-15.) The OUCC alleged that it did not make an adjustment to Petitioner's pro forma expenses because there was insufficient information on which to base an adjustment, but did ask the Commission for clarification on this issue. (*Id.* at p. 27, lines 1-5.) The OUCC also expressed concern that, if the Commission has not approved recovery of all of the deferred costs, there is an issue of retroactive ratemaking. (*Id.* at p. 26, lines 18-22.)

Petitioner's Rebuttal. Mr. Cutshaw maintained that the Commission's Order on Security Costs authorizes it to amortize deferred costs. Mr. Cutshaw based his opinion on the fact that the Order adopted a revenue requirement that was greater than Petitioner's annual current on-going security expenditures identified and because of the language in the Order's first ordering paragraph stating that the revenue requirement is without carrying charges. (*Petitioner's Exhibit JLC-R*, p. 18, lines 25-29.) Mr. Cutshaw alleged that this language would not be necessary if the Commission was not approving the regulatory asset created by the deferral of security costs incurred prior to the Order. Mr. Cutshaw also argued that allowing amortization of the deferred security costs does not represent retroactive ratemaking if full recovery of these expenses in future revenues is anticipated. (*Id.* at p.19, lines 6-13.)

Commission Discussion and Findings. We first address the retroactive ratemaking issue raised by the Public. Security measures benefit the ratepayers at the time they were expensed and going forward. The Commission hereby clarifies that the amortization of the deferred security expenses over a five (5) year period is authorized consistent with our December 30, 2003 Order in Cause No. 42029.

With regard to Petitioner's proposed level of security expenses in this proceeding, we notice that the annual expense has decreased from $2,062,871 in Cause No. 42029 to the proposed $1,918,070. No other party offered evidence contradicting this amount. We find that the proposed amount is reasonable and should be authorized.

XII. NET OPERATING INCOME AT PRESENT RATES

Based upon the evidence and the determinations made above, we find that Petitioner's adjusted operating results under its present rates are as follows:

	Total Company	Water Groups	Wabash	Total Sewer	Northwest
Operating Revenue	$139,380,203	$88,529,107	$1,865,785	$294,229	$40,641,293
O & M Expense	52,219,786	31,763,606	923,379	278,877	15,606,943
Depreciation	21,748,977	15,661,330	307,339	18,938	4,531,314
Amortization	422,740	351,991	3,292	1,224	52,698
Other Taxes	16,224,846	7,852,813	154,878	14,442	7,487,584
State Income Tax	3,106,091	2,126,055	29,531	(2,731)	789,876
Federal Income Tax	10,315,740	7,078,790	91,390	(12,514)	2,612,823
Total Operating Expenses	104,038,180	64,834,585	1,509,809	298,236	31,081,238
Net Operating Income	$35,342,023	$23,694,522	$355,976	($4,007)	$9,560,055

	Mooresville	Warsaw	West Lafayette	Winchester
Operating Revenue	$1,564,389	$2,248,099	$3,412,019	$825,284
O & M Expense	673,334	951,508	1,621,555	400,584
Depreciation	218,803	308,509	560,904	141,840
Amortization	2,590	2,921	6,583	1,441
Other Taxes	132,858	178,233	325,478	78,563
State Income Tax	36,442	56,503	58,546	11,870
Federal Income Tax	123,962	191,225	192,794	37,272
Total Operating Expenses	1,187,989	1,688,899	2,765,860	671,570
Net Operating Income	$376,400	$559,200	$646,159	$153,714

In summary, we find that with appropriate adjustments for ratemaking purposes, Petitioner's annual net operating income under its present rates for water and sewer service would be $35,342,023. We have previously found that the fair value of Indiana-American's utility property is approximately $663,400,000, and that 5.38% is a fair rate of return, resulting in a NOI level of $35,669,628. A return of $35,342,023 represents a rate of return of 5.33% on the fair value rate base. Based on the evidence, we find that 5.33% is not a reasonable return and, therefore, we find that Petitioner's present rates are insufficient.

XIII. AUTHORIZED RATE INCREASE

Based on the evidence presented in this proceeding, we find that Petitioner should be authorized to increase its rates and charges to produce additional operating revenue of $564,801, resulting in total annual revenue of $139,945,004. This revenue is reasonably estimated to allow Petitioner the opportunity to earn net operating income of $35,669,628 as follows:

	Total Company	Water Groups	Wabash	Total Sewer	Northwest
Operating Revenue	$139,945,004	$91,061,068	$1,967,065	$314,857	$38,739,937
O & M Expense	52,224,577	31,785,081	924,238	279,052	15,590,817
Depreciation	21,748,977	15,661,330	307,339	18,938	4,531,314
Amortization	422,740	351,991	3,292	1,224	52,698
Other Taxes	16,233,302	7,890,722	156,394	14,752	7,459,117
State Income Tax	3,153,640	2,339,211	38,057	(995)	629,807
Federal Income Tax	10,492,142	7,869,587	123,022	(6,072)	2,018,980
Total Operating Expenses	104,275,376	65,897,922	1,552,342	306,899	30,282,733
Net Operating Income	$35,669,628	$25,163,146	$414,723	$7,958	$8,457,204

	Mooresville	Warsaw	West Lafayette	Winchester
Operating Revenue	$1,503,374	$2,058,158	$3,459,305	$841,254
O & M Expense	672,816	949,897	1,621,956	400,720
Depreciation	218,803	308,509	560,904	141,840
Amortization	2,590	2,921	6,583	1,441
Other Taxes	131,944	175,389	326,187	78,802
State Income Tax	31,305	40,512	62,527	13,215
Federal Income Tax	104,906	131,902	207,562	42,260
Total Operating Expenses	1,162,364	1,609,130	2,785,719	678,278
Net Operating Income	$341,010	$449,028	$673,586	$162,976

XIV. COST OF SERVICE STUDY AND SINGLE TARIFF PRICING

Petitioner's Position. Kerry A. Heid, an independent rate consultant, conducted Petitioner's Cost of Service Study ("COSS") using the American Water Works Association's ("AWWA's") Base-Extra Capacity Method to allocate costs of service to customers. Mr. Heid testified that under the Base-Extra Capacity Method, the costs are allocated to cost functions according to the design and operation of the water system: base, extra capacity, customer and direct fire protection costs. Those functionalized costs are then allocated to the different classes of Petitioner's customers according to their usage and demand characteristics. These classes are: residential, commercial, industrial-large, industrial-other, public authority, sales for resale, private fire protection and public fire protection.

As a result of the COSS, Mr. Heid designed rates that recover revenues from each customer class which closely match the cost of providing service to each customer class. Mr. Heid conducted his study on a company-wide basis and not on a regional or district operational basis. Such approach resulted in a unified set of rates for each customer class statewide known as Single Tariff Pricing ("STP"). Petitioner is moving toward this goal of STP in phases, as authorized in our 1997 Rate Order and subsequent Orders. Prior to our 1997 Rate Order, Petitioner had thirteen (13) separate water rate schedules exclusive of the later acquired Northwest, United Water and other smaller systems. The Wabash district was excluded from the STP movement for a period of five (5) years, which expired in this proceeding. The original United Water system consisted of four (4) separate rate schedules. In this proceeding, Petitioner is proposing two (2) water groups in addition to Wabash, Northwest and United Water. Petitioner proposed to move the Wabash, Northwest and United systems closer toward STP in this proceeding.

OUCC's Position. In testifying for the Public regarding Petitioner's COSS, Scott Bell recommended that Petitioner:

(1) allocate the "Capitalized Tank Painting" by Allocation Factor 4 rather than allocation Factor 9 to be consistent with the allocation of "Distribution Reservoirs and Standpipes." Similarly, he recommended that "Accumulated Amortization-Tank Painting" be allocated by Allocation Factor No. 4.

(2) use capacity factors for Maximum Day and Maximum Hour for the residential customer class of 250 and 325 respectively, instead of 275 and 350 as proposed by Mr. Heid.

(3) correct the Equivalent Hydrant Ratios that were used to calculate the Equivalent Hydrant Units in its next COSS. (*Public's Exhibit 8*, p. 16.)

Intervenor's Position. Ernest Harwig, a consultant in the field of public utility regulation, testified on behalf of the Industrial Group. Mr. Harwig differed with Mr. Heid on the classification of two (2) items with respect to the Northwest District: reservoir costs and purchased power expenses. Mr. Harwig recommended that the reservoir costs are more appropriately classified as Maximum Day Extra Capacity costs and that all purchased power

expenses should be classified as Maximum Day and Maximum Hour Extra Capacity costs. Mr. Harwig argued that if the total volume of a particular source of supply is the only factor to be considered then all source of supply would be classified with the Base-only factor. Hence, the Base-Maximum Day classification is more appropriate and accurate.

With respect to the reservoir costs, Mr. Harwig opined that sources of supply are capable of meeting both total annual volume and Maximum Day Demands. As for the power expenses, Mr. Harwig asserted that pumps must have adequate capacity and be in sufficient number to deliver water during peak periods as well during non-peak periods. With respect to these two items, Mr. Harwig suggested that Mr. Heid use the Maximum Hour-All Allocation Factor No. 4 rather than the Base-only factor.

Mr. Harwig finally recommended that, if Petitioner is granted the rate increase it seeks, the Commission should approve Petitioner's single tariff rates for the Northwest District and not phased-in rates, since the Northwest District was impacted the most by the most recent rate increase in Cause No. 42029 and those customers have not yet benefited from STP.

Petitioner's Rebuttal. In his rebuttal testimony, Mr. Heid accepted all of Mr. Bell's recommendations except for one recommended modification to the Equivalent Hydrant Ratio. Mr. Heid testified that Petitioner would agree to change the Equivalent Hydrant Ratio in its next COSS as recommended by Mr. Bell unless Petitioner can demonstrate that such a change would not be in the public interest. If such a demonstration can be made, Mr. Heid suggested that the Company retain the flexibility needed to implement the correct factors in a phased, or other, approach.

With regard to Mr. Harwig's testimony on behalf of the Industrial Group, Mr. Heid did not accept Mr. Harwig's recommendations and explained that following such recommendations would result in more costs being allocated to residential customers and fewer costs allocated to industrial customers. In refuting Mr. Harwig's arguments, Mr. Heid testified that the primary criterion in designing reservoirs is the total volume, which is affected by the surface area of the reservoir, watershed drainage area and expected rainfall. Mr. Heid asserted that none of these factors is related to the Maximum Day Demands, and the reservoir is capable of meeting maximum day demands only because of its total volume. Mr. Heid clarified, however, that reservoir intake structures are designed to handle maximum day flows and that he classified those in his Study on Maximum Day Extra Capacity costs.

Mr. Heid also disagreed with Mr. Harwig's suggestion that all purchased power costs should be classified as Maximum Day or Maximum Hour Extra Capacity. (*Petitioner's Exhibit KAH-R*, p. 10.) However, Mr. Heid did not reject the idea that it may be appropriate for part of such expenses to be allocated as Maximum Day or Maximum Hour Extra Capacity. Mr. Heid also noted that, in responding to Data Request Question No. 5(a), Mr. Harwig acknowledged that he only reviewed the tariffs of three (3) of the seventeen (17) electric utilities that serve Indiana-American. (*See Petitioner's Exhibit KAH-R2.*) Mr. Heid observed that Mr. Harwig, therefore, did not quantify the amount of Indiana-American's electric power costs that were actually billed pursuant to demand charges.

Commission Discussion and Findings. We have previously authorized Petitioner to move toward STP. While we affirm herein the benefits to be derived from STP, we also note that we examine the Company's approach in each case based on the evidence that supports the proposed move toward common rates. Accordingly, our original STP authorization does not constitute an automatic approval of every proposal to move further toward common rates.

In the current case, Petitioner has proposed further movement toward STP for its existing rate groups and has also initiated the process of aligning the rate structures of the above mentioned operations acquired following the 1999 rate case with the rate structures of the existing groups. Because the Wabash, Northwest, Mooresville, Warsaw, West Lafayette, and Winchester operations had not formerly been included in the derivation of the STP rates, it was necessary to establish several new rate groups. The addition of these new districts into the STP calculation also created some disparate results within some of the existing rate groups, with some groups moving closer toward STP rate levels while other groups moved away from STP rate levels. Such results are not unexpected given the relative significance of the six (6) districts that have been added. In Petitioner's next general rate proceeding we anticipate that all groups will make a consistent move toward STP. No party filed testimony opposing Petitioner's rate design proposals. Therefore, we approve the Petitioner's proposed rate design, subject to our revenue requirement findings.

Except for the Equivalent Hydrant Ratio issue, Mr. Heid accepted all of the Public's recommendations. We accept Mr. Heid's suggestion regarding the Equivalent Hydrant Ratio. As to the concern expressed by Mr. Harwig with respect to the reservoir costs allocation, we find that Mr. Harwig did not demonstrate how a reservoir designed to meet the total volume sales would fail to meet Maximum Day Demand according to the criteria described by Mr. Heid. We agree with Mr. Heid that the reservoir intake structures must be classified as Maximum Day Extra Capacity costs since these structures handle the transmission of the Peak Demand from the reservoir to the customers.

Concerning the purchased power expenses argument, we note that Mr. Heid, at least theoretically, did not reject the possibility that at least part of this expense could be classified as Maximum Day or Maximum Hour Capacity costs. However, no evidence has been provided by Mr. Harwig quantifying what, if any, amount should be allocated to the Maximum Day or Maximum Hour costs. Therefore, we find that Mr. Heid's allocation should be accepted.

Therefore, in this Cause, we find that Petitioner's COSS is sound. Petitioner's use of the Base-Extra Capacity method is consistent with previous Cost of Service Studies conducted by Indiana-American and has been accepted by this Commission in past proceedings. Where appropriate, Petitioner has followed the methodology as found in the AWWA manual.

XV. DEPRECIATION STUDY

OUCC's Position. Harold L. Rees, Principal Utility Analyst for the OUCC, testified that Petitioner:

(1) conducted its last full book depreciation study with data ending December 31, 1995;

(2) has experienced substantial growth in its plant including the purchase of several utility properties resulting in the depreciable plant being tripled since the last study; and
(3) has made many substantial additions of new technology plant, which would increase the remaining lives of certain facilities. (*Public's Exhibit No. 7*, pp. 3-4.)

Mr. Rees recommended that Petitioner:

(1) prepare a new depreciation study to be filed in a separate procedure prior to filing its next rate case;
(2) use the depreciation rates previously authorized if the addition of depreciable plant is no more than $10 million from acquisitions; and
(3) within thirty (30) days of this Order, file with the Commission and the OUCC, a report on whether it is maintaining in its records the type of plant data needed for an equal life group ("ELG") depreciation study. (*Id.* at p. 15.)

Petitioner's Position. James Cutshaw testified that Petitioner is not opposed to preparing a new depreciation study. However, Mr. Cutshaw expressed concern about the time frame suggested by the Public, citing that this would restrain Petitioner's ability to file a new rate case prior to completing the depreciation study. Mr. Cutshaw pointed to the substantial growth in Petitioner's plant due to recent acquisitions which, because of the detailed and costly record keeping needed for ELG studies, would require even more resources and time devoted to classifying and reviewing data in preparing the study.

Mr. Cutshaw also disagreed with the limitations on depreciation rates for plants under $10 million added by future acquisitions. Mr. Cutshaw opined that the Commission should continue to follow its past and current practice of setting depreciation rates based on the outcome of reviewing depreciation studies. Also, Mr. Cutshaw did not accept Mr. Rees' final recommendation that Petitioner file a report within thirty (30) days, detailing its ability to file an ELG study.

Commission Discussion and Findings. Both Petitioner and the Public agree as to the need for a new depreciation rates study. We find it reasonable that Petitioner should file a depreciation case prior to filing its next rate case, and that such depreciation case be filed reasonably far enough in advance of the next rate case to allow updated and approved depreciation rates to be used in the next rate case. In addition, Petitioner should, within thirty (30) days of the date of this Order, file a report stating whether it is maintaining the detail to support the ELG method, but no other demonstration need be made at this time. We also find it is inappropriate to issue a blanket order regarding depreciation rates in future acquisitions and will continue to address this issue as a part of such acquisitions on a case-by-case basis.

XVI. COMMISSION ORDER

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

1. Indiana-American Water Co., Inc. is hereby authorized to adjust and increase its rates and charges for water and sewer utility service by approximately 0.4% in accordance with the Findings herein, which rates and charges shall be designed to produce total annual operating revenues of $139,945,004 which, after annual operating expenses of $104,275,376, are expected to result in annual net operating income of $35,669,628.

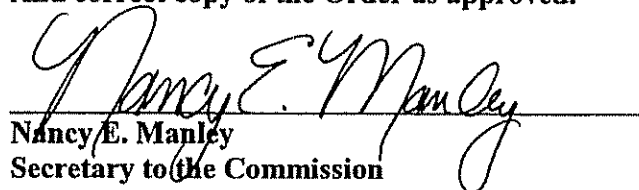
2. Petitioner shall file new schedules of rates and charges with the Gas/Water/Sewer Division of the Commission on the basis set forth in Finding No. XIII of this Order. Such new schedules of rates and charges shall be effective upon filing and approval by the Gas/Water/Sewer Division and shall apply to water and sewer usage from and after the date of approval.

3. Petitioner shall file a depreciation case and ELG report in accordance with our determinations in Finding No. XV of this Order.

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

MCCARTY, LANDIS, RIPLEY, AND ZIEGNER CONCUR; HADLEY ABSENT:
APPROVED: NOV 18 2004

I hereby certify that the above is a true
And correct copy of the Order as approved.



Nancy E. Manley
Secretary to the Commission