KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2015-00418
COMMISSION STAFF'S FOURTH REQUEST FOR INFORMATION

Witness: John Wilde

5. List and provide a copy of each state utility regulatory commission decision or opinion in which the ratemaking treatment of a reserve created to meet the requirements of (Financial Accounting Standards Board Interpretation No.) FIN 48 is discussed. This listing should include the name of the state commission, case number, case style, and date of decision or opinion.

Response:

Neither American Water nor Kentucky-American Water has compiled information on FIN 48 as requested outside of actions of commissions regulating other members of the American Water Group, which represents our base of knowledge on the subject. Kentucky-American Water did not attempt to filter or categorize these commission actions based on the comparability of the facts and circumstances in those cases to those of Kentucky-American Water with respect to FIN 48. Variances in facts and circumstances surrounding the FIN 48 discussion can make it difficult to do "an apples to apples" comparison of the regulatory treatment between different utilities and/or different commissions.

American Water Utility	Case	Order Date	State Commission
Indiana	44022	06/6/2012	Indiana Utility Reg. Com.
Tennessee	10-00189	04/27/2012	Tennessee Reg. Authority
New Jersey	WR15010035	09/11/2015	NJ Board of Public Utilities
New York	11-W-0200	03/20/2012	NY Public Service Com.
Iowa	RPU-2013-0002	02/28/2014	Iowa Utilities Board
Missouri	WR 2015-0301	05/26/2016	Mo. Public Service Com.
Maryland	9372	05/26/2015	Md. Public Service Com.
California	A.13-07-002	04/09/2015	Ca. Public Utilities Com.
Hawaii	2010-0313	11/21/2011	Hawaii Public Utilities Com.
Illinois	11-0767	09/19/2012	Illinois Commerce Com.
Pennsylvania	R-2013-2355276	12/19/2013	Pa. Public Utility Com.
Virginia	PUE-2011-00127	12/12/2012	Va. State Corp. Com.
West Virginia	15-0676-W-42T	02/24/2016	W.Va. Public Service Com.

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN WATER COMPANY, INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER AND SEWER UTILITY SERVICE AND FOR APPROVAL OF NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO	)	CAUSE NO. 44022 APPROVED: JUN 06 2012

ORDER OF THE COMMISSION

Presiding Officers:
Carolene Mays, Commissioner
Jeffery A. Earl, Administrative Law Judge

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FINAL ORDER

On May 2, 2011, Indiana-American Water Company, Inc. ("Petitioner," "Indiana-American," or "Company") filed its Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements ("Petition") with the Indiana Utility Regulatory Commission ("Commission"), seeking authority to increase its rates and charges for water and sewer utility service and for approval of new schedules of rates and charges applicable thereto. Petitioner's notice of its intent to file in accordance with the Commission's rules on minimum standard filing requirements ("MSFRs") was given pursuant to 170 IAC 1-5.

Pursuant to notice and as provided in 170 IAC 1-1.1-15, the Commission held a Prehearing Conference at 11:00 a.m. on June 9, 2011, in Hearing Room 224, 101 West Washington Street, Indianapolis, Indiana. Proofs of publication of the notices of the Prehearing Conference were incorporated into the record and placed in the official files of the Commission. Petitioner, the Indiana Office of Utility Consumer Counselor ("OUCC"), the Town of Schererville ("Schererville"), and the City of Crown Point ("Crown Point") participated at the Prehearing Conference. On June 16, 2011, the Commission issued a Prehearing Conference Order in this Cause. The following parties filed petitions to intervene, which the Commission granted: Schererville; Crown Point; the Indiana-American Industrial Group ("Industrial Group"); the City of West Lafayette ("West Lafayette"); and ArcelorMittal Burns Harbor LLC ("ArcelorMittal").

Pursuant to notice published as required by law, the Commission convened an Evidentiary Hearing at 9:30 a.m. on August 22, 2011, in Hearing Room 222, 101 West Washington Street, Indianapolis, Indiana. The hearing continued on August 23, 26, and 30. Proofs of publication of the notice of the hearing were incorporated into the record and placed in the official files of the Commission. During the Evidentiary Hearing, Indiana-American presented its case-in-chief and offered its witnesses for cross-examination. In addition, the Commission took administrative notice of the following Orders: *Indiana-American Water Co.*, Cause No. 43899, 2010 Ind. PUC LEXIS 355 (IURC Oct. 14, 2010) ("Preapproval Order"); *Indiana-American Water Co.*, Cause No. 43680, 2010 Ind. PUC LEXIS 155 (IURC April 30, 2010) ("2010 Rate Order"); *Indiana-American Water Co.*, Cause No. 43187, 2007 Ind. PUC LEXIS 293 (IURC Oct. 10, 2007) ("2007 Rate Order"); *Indiana-American Water Co.*, Cause No. 42520, 2004 Ind. PUC LEXIS 351 (IURC Nov. 18, 2004) ("2004 Rate Order"); *Indiana-American Water Co.*, Cause No. 42029, 2002 Ind. PUC LEXIS 432 (IURC Nov. 6, 2002) ("2002 Rate Order"); *Indiana-American Water Co.*, Cause No. 40703, 1997 Ind. PUC LEXIS 429 (IURC Dec. 11, 1997) ("1997 Rate Order"); and *Indiana-American Water Co.*, Cause No. 40103, 1996 Ind. PUC LEXIS 126 (IURC May 30, 1996) ("1996 Rate Order").

Pursuant to Ind. Code § 8-1-2-61(b), The Commission held public field hearings on: August 17, 2011, in the City of West Lafayette; August 18, 2011, in the City of Gary, the largest municipality in Petitioner's service area; and August 29, 2011, in the City of Jeffersonville. At each hearing, members of the public provided oral and written testimony, which the Presiding Officers admitted into the Record.

The Evidentiary Hearing continued from December 5-8, 2011. The OUCC and Intervenors presented their respective cases-in-chief and offered their witnesses for cross-examination. In addition, Petitioner presented its rebuttal evidence and offered its rebuttal witnesses for cross-examination. In addition, the Commission took administrative notice of the following Orders: *Indiana-American Water Co.*, Cause No. 43991, 2011 Ind. PUC LEXIS 128 (May 11, 2011) ("Warsaw AFUDC Order"); *Dep't of Waterworks of the Consolidated City of Indianapolis*, Cause No. 43645, 2011 Ind. PUC LEXIS 30 (IURC Feb. 2, 2011); *Bd. of Dirs. for Utils. of the Dep't of Pub. Utils. of the City of Indianapolis*, Cause No. 42767, 2007 Ind. PUC LEXIS 254 (IURC Aug. 29, 2007); *Bd. of Dirs. for Utils. of the Dep't of Pub. Utils. of the City of Indianapolis*, Cause No. 39066, 1992 Ind. PUC LEXIS 168 (IURC Jun. 10, 1992); *Muncie Water Works Co.*, Cause No. 34571, 1981 Ind. PUC LEXIS 246 (Pub. Serv. Comm'n of Ind. Sept. 16, 1981) ("Muncie Remand Order"). The Commission also took administrative notice of Indiana-American's Report of Financing filed on November 4, 2010, in Cause No. 43767 and the direct testimony of Gregory T. Guerrettaz on behalf of Crown Point filed on October 27, 2009, in Cause No. 43680.

Having considered the evidence presented in this proceeding and the applicable law and being duly advised, the Commission finds:

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

2. <u>Petitioner's Characteristics</u>. Indiana-American, a subsidiary of the American Water Works Company, Inc. ("American Water"), is a public utility corporation organized under the laws of the State of Indiana and is engaged in the provision of water utility service to the public in and around numerous communities and counties throughout the State of Indiana. Petitioner also provides sewer utility service in Wabash and Delaware Counties. Petitioner has charter power and authority to engage in the business of providing such water and sewer utility service. Petitioner renders water and sewer utility service by means of utility plant, property, equipment, and related facilities owned, leased, operated, managed, and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution, and sale of water for residential, commercial, industrial, public authority, and sale-for-resale purposes, for the provision of public and private fire service, and for the provision of sewer service. Petitioner provides utility service to approximately 284,600 customers.

3. <u>Existing Rates</u>. Petitioner's existing basic rates and charges for water and sewer service were established pursuant to the 2010 Rate Order. Subsequently, the Commission approved a Distribution System Improvement Charge ("DSIC") in *Indiana-American Water Co.*, Cause No. 42351 DSIC 6, 2010 Ind. PUC LEXIS 361 (IURC Oct. 20, 2010). As a result, Petitioner's current rates are approximately 3% higher than those approved in the 2010 Rate Order.

4. <u>Relief Requested</u>. Petitioner originally requested a 10.48% rate increase. Prior to the

August 22 hearing, Petitioner filed supplemental direct testimony and exhibits, reflecting the updated rate base permitted by 170 IAC 1-5-5(3)(B) and Paragraph 2 of the Prehearing Conference Order, and revised its request to a 9.76% rate increase. Petitioner also proposed to continue its transition to single tariff pricing ("STP"), by moving the Warsaw and West Lafayette districts from the Area Two tariff rate to the Area One tariff rate. The Mooresville, Winchester, and Wabash districts would remain in the Area Two tariff rate. Petitioner proposed to further reduce the differential between the Area One and Area Two Commodity Charges and to move the eight remaining municipalities that have not yet adopted ordinances pursuant to Ind. Code § 8-1-2-103 to fire protection surcharges by meter size in lieu of directly billed hydrant charges. Finally, Petitioner requested approval of a 10% depreciation rate for American Water's Business Transformation Project ("BT")

5. **Test Year.** As provided in the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and pro forma operating revenues, expenses, and operating income under present and proposed rates is the twelve (12) months ended December 31, 2010, adjusted for changes that are fixed, known, and measurable for ratemaking purposes and that will occur within twelve (12) months following the end of the test year. The financial data for this test year, when adjusted for changes as provided in the Prehearing Conference Order, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

6. **Overview.** Alan J. DeBoy, President of Indiana-American, provided an overview of Petitioner's case and identified the most significant drivers of the need for a rate increase. Mr. DeBoy stated that three major categories of changes have occurred since Petitioner's last general rate case: 1) Indiana-American has added substantial capital additions that are not reflected in Petitioner's DSIC, which impact the necessary after-tax return and depreciation expense; (2) Indiana-American's customers are using less total water, which has caused Petitioner's pro forma revenues to be significantly below what was authorized by the 2010 Rate Order and DSIC 6; and (3) higher cost of equity.

7. **Petitioner's Rate Base.**

A. **Original Cost.** In its case-in-chief, Petitioner first presented its utility plant in service balances as of December 31, 2010. Petitioner updated those balances to the June 30, 2011, actual balances pursuant to 170 IAC 1-5-5(4). Petitioner also updated its rate base to reflect one major project referred to as the Warsaw Water Treatment Plant ("Warsaw WTP"), which was identified in the Petition and was also the subject of the Preapproval Order. Estimates of Petitioner's investment were included in Petitioner's case-in-chief and the amount to be included in rate base does not exceed such estimates. Monthly investment updates were filed and the Warsaw WTP was declared to be used and useful at least ten business days before the final evidentiary hearing. The cost of the Warsaw WTP was more than one percent of Petitioner's proposed rate base.

Petitioner proposed a net original cost rate base as of June 30, 2011, adjusted for the cost of the Warsaw WTP, of $731,882,581.

OUCC Witness, Mr. Charles Patrick, proposed to exclude the post-in-service Allowance for Funds Used During Construction ("AFUDC") and deferred depreciation costs related to the

Warsaw WTP from rate base. OUCC Witness, Ms. Margaret Stull proposed a net original cost of $730,834,216. The OUCC also raised concerns regarding Indiana-American's Capitalization Policy.

(1) **Warsaw WTP Deferred Depreciation and Post-in-Service AFUDC.**

(a) **Petitioner's Position.** Petitioner included pro forma adjustments to its original cost rate base, updated on June 30, 2011, for deferred depreciation and post-in-service AFUDC related to the Warsaw WTP in the amounts of $525,079 and $523,286, respectively. These amounts include the estimated accruals through the anticipated date of this Order.

(b) **OUCC's Position.** Mr. Patrick proposed to exclude from rate base the deferred depreciation and post-in-service AFUDC amounts proposed by Petitioner. Mr. Patrick contended that these amounts exceed the estimated costs stated in Petitioner's case-in-chief with respect to the project and include costs incurred after the cutoff date under the MSFRs. He stated that the total cost included in Petitioner's rate base for the Warsaw WTP was $26,348,365, which is in excess of the $25.3 million estimate provided in Petitioner's case-in-chief. He asserted that only costs incurred through November 17, 2011, (ten business days prior to the December 5, 2011 hearing) may be included in rate base, and only to the extent that the total costs of the major project do not exceed the estimate provided in Petitioner's case-in-chief. Mr. Patrick stated that Indiana-American is not precluded from continuing to record deferred depreciation and post-in-service AFUDC related to the Warsaw WTP as approved by the Commission in the Warsaw AFUDC Order and can still capitalize the costs to be included in rate base in its next rate case.

(c) **Petitioner's Rebuttal.** Mr. Gary VerDouw responded that Petitioner did include the estimates of the post-in-service AFUDC and deferred depreciation for the Warsaw WTP in its case-in-chief. Mr. VerDouw then explained that Mr. Patrick's position is inconsistent with the Stipulation and Settlement Agreement ("Settlement") approved in the Warsaw AFUDC Order. There, Petitioner sought authority to continue the accrual of post-in-service AFUDC and to defer depreciation on the Warsaw WTP until such time as a rate order is issued including the project in rate base and providing recovery of depreciation expense. Petitioner entered into a Settlement in that case, which provided that Petitioner should be authorized to: (1) record such post-in-service AFUDC and deferred depreciation as a regulatory asset in Account 186, Miscellaneous Deferred Debits; (2) amortize the regulatory asset over the estimated remaining service life of the improvements, commencing on the date of the first rate order; and (3) include the amortization as a recoverable expense and include the unamortized portion of the regulatory asset in Petitioner's rate base for ratemaking purposes.

Mr. VerDouw described Mr. Patrick's position as seeking to imply the word "subsequent" or "ensuing" in the last sentence as a modification to the phrase "rate cases" such that Petitioner would be authorized to accrue the post-in-service AFUDC and to defer depreciation until the first rate order including the plant in rate base; to commence amortization of the regulatory asset on the date of the issuance of the first rate order including the plant in rate base (this case); but only to include the amortization of the regulatory asset as a recoverable expense and unamortized balance of the regulatory asset in rate base in "subsequent or ensuing rate cases."

Mr. VerDouw noted those words do not appear anywhere in the Warsaw AFUDC Order or the Settlement, and they are inconsistent with the relief sought in that case. He stated Petitioner is required to commence amortization of the regulatory asset on the date an order is issued in this Cause, but under Mr. Patrick's view, Indiana-American would not be permitted to commence recovery of the amortization until its next rate case. He pointed out, however, that in Petitioner's next rate case, it would only be permitted to earn a return on the unamortized balance. According to Mr. VerDouw, Mr. Patrick's interpretation results in Petitioner forever being denied recovery of a return of or a return on the portion of the regulatory asset which is amortized between the date of an order in this Cause and the date of an order in Petitioner's next rate case.

Mr. VerDouw contends that this result is illogical. He further noted that in Petitioner's last rate case, it treated the London Road and West Lafayette improvement projects in the same manner as in this case, which is to include in net original cost rate base the amount of the deferred asset to be accumulated between the in-service dates and the anticipated order date. He stated neither the OUCC nor any intervenor objected to this treatment, which was ultimately approved by the Commission. At the time of the Settlement in Cause No. 43991, there was thus already a practice for dealing with this issue, and Mr. VerDouw asserted that Mr. Patrick's new interpretation is inconsistent with that practice.

Mr. VerDouw stated that the inclusion of the Warsaw WTP deferred depreciation and post-in-service AFUDC amounts does not violate the rate base cutoff. He cited to the MSFR requirement that the major project be in service by the cutoff of November 17, 2011. Petitioner filed a Verified Certification of In-Service Date on October 12, 2011 stating that the Warsaw WTP was placed in service on September 30, 2011, thus satisfying the in-service requirement of the MSFRs. Mr. VerDouw testified that there is nothing in the rule that indicates the anticipated level of the ensuing regulatory asset cannot be projected to the date of the Commission Order. He stated Mr. Patrick's interpretation would mean a utility could never recover a return of and a return on the portion of a related regulatory asset that is amortized between rate cases, which Mr. VerDouw contends is unreasonable.

(d) Commission Discussion And Findings. In Cause No. 43991, Petitioner and the OUCC entered into a Settlement, which addressed the accounting treatment and recovery of AFUDC and deferred depreciation related to the Warsaw WTP. The Settlement provides that Petitioner may "continue the post-in-service accrual and capitalization of AFUDC and to defer depreciation ... until the date of issuance of a rate order or orders fully including such Improvements in Petitioner's rate base and including depreciation expense thereon in Petitioner's recoverable operating expenses ...." *Warsaw AFUDC Order*, 2011 Ind. PUC LEXIS 128, at *21. In accordance with the Settlement, the Commission authorized Petitioner to:

> record such post-in-service AFUDC and deferred depreciation as a regulatory asset in Account 186, Miscellaneous Deferred Debits; to amortize such regulatory asset over the estimated remaining service life of such Improvements, such amortization commencing on the date of the first rate order including such

> Improvements in Petitioner's rate base and including depreciation expense thereon in Petitioner's recoverable operating expenses; and to include such amortization as a recoverable expense and to include the unamortized portion of the regulatory asset in Petitioner's rate base in rate cases.

Id., at *19.

The language of the Settlement and the Warsaw AFUDC Order clearly anticipate that the regulatory treatment of AFUDC and deferred depreciation will span multiple rate cases. Petitioner may include in rate base in this Cause only the level of deferred depreciation and AFUDC accrued through the November 17, 2011 major project cut-off date. The portion of the regulatory asset accrued between November 17, 2011, and the effective date of this Order will not be included in Petitioner's rate base until Petitioner's next base rate case. This treatment is consistent with the rate base cutoff date in the MSFR rule.

Therefore, Petitioner's proposed deferred depreciation and post-in-service AFUDC are reduced by $426,459 and $416,217, respectively. Petitioner's rate base shall include $205,689 for deferred depreciation and post-in-service AFUDC related to the Warsaw AFUDC Order.

(2) Capitalization Policy.

(a) OUCC's Position. Mr. Patrick expressed concern regarding Petitioner's capitalization policy. He stated that during the OUCC's field audit, Mr. VerDouw indicated assets with a value of $1,500 or more were capitalized without taking into effect the useful life or economic value. Petitioner then provided a copy of its capitalization policy, which indicated that assets are not only capitalized based on original cost equal to or greater than $1,500 but also on whether the asset is trackable and is expected to have a useful life greater than one year. In light of this discovery response, Mr. Patrick voiced a concern that items may have been expensed that meet the capitalization policy and may have been included in rate base.

(b) Petitioner's Rebuttal. In his rebuttal testimony, Mr. VerDouw indicated he had subsequent discussions with Ms. Stull of the OUCC regarding the capitalization policy and provided a copy of the capitalization policy to the OUCC during discovery. The capitalization policy clearly states that Petitioner takes into account useful life or economic value of the assets.

(c) Commission Discussion and Findings. Based on the testimony of Mr. Patrick and Mr. VerDouw, we find that Petitioner's capitalization policy requires that the useful life and economic value of an asset be taken into consideration in addition to the original cost equal to or in excess of $1,500 when determining whether the asset is capitalized. Further, we find no evidence in the record suggesting that this policy was not applied correctly or that items were improperly included in rate base.

B. Original Cost Rate Base. Based on the evidence presented and the findings and conclusions above, the original cost of Petitioner's water and sewer utility properties used and useful for the convenience of the public is as follows:

Utility Plant in Service	**Commission Finding**
Plant in Service	$1,169,706,967
Warsaw WTP Plant	25,049,505
Capitalized Tank Painting	161,558
Deferred Depreciation	3,929,634
Post-In-Service AFUDC	5,805,542
Less: Retirements	1,645,378
Total Plant in Service	**$1,203,007,827**
Accumulated Depreciation	
Utility Plant in Service	$304,641,774
Capitalized Tank Painting	140,017
Deferred Depreciation	1,311,865
Post-In-Service AFUDC	2,128,216
Less: Retirements	659,072
Total Accumulated Depreciation	**$307,562,800**
Net Utility Plant in Service	**$895,445,027**
Deductions	
Contributions in Aid of Construction	$106,438,609
Customer Advances for Construction	60,456,340
Capacity Adjustment – Somerset	195,857
Total Deductions	**$167,090,806**
Additions:	
Acquisition Adjustment (Net)	$446,751
Materials and Supplies (13 Month Average)	1,988,437
Total Additions	**$2,435,188**
Net Original Cost Rate Base	**$730,789,409**

C. Reproduction Cost New Less Depreciation.

(1) **Petitioner's Position.** Petitioner's Witness Stacy Hoffman sponsored a study and analysis of the Reproduction Cost New ("RCN") and Reproduction Cost New Less Depreciation ("RCNLD") of the Company's utility plant and equipment used in providing service to the public. Mr. Hoffman expressed the opinion that Indiana-American's plant and systems are in a good state of operating condition, are well maintained, and are used to satisfy the Company's responsibility to provide safe and reliable water utility service.

RCNLD refers to the estimated cost of reproducing existing facilities at current costs, adjusted for the loss in service value (depreciation) reflected in their current condition. The calculation of RCNLD is a two-step process. Mr. Hoffman first determined the cost of constructing, purchasing, or manufacturing new property substantially the same as the old property, using costs at or about the time of the study. This is the RCN portion of the study. The second step is to determine the percent condition of the property. Percent condition measures the amount of the property's service value that has not been lost due to physical depreciation. The percent condition is then multiplied by the RCN, resulting in the RCNLD, which is a net cost recognizing both the current costs of reproducing the property and the loss of service value of the existing property due to depreciation in the form of wear and tear, obsolescence, and lack of utility.

Mr. Hoffman testified that the purpose of a RCNLD study is to assess the cost to reproduce the existing utility plant in service based on current material and equipment prices and current construction and wage levels. The original cost of a well-planned facility is representative of its value at the time of construction, but the original cost of plant constructed in the past is generally not representative of the RCN or RCNLD due to changes in unit costs caused by inflation and changes in construction practices.

Mr. Hoffman indicated that he used the Trended Original Cost method, as opposed to the Unit Price method, to determine the RCN of Petitioner's property. According to Mr. Hoffman, the Trended Original Cost method is significantly less costly to perform than the Unit Price method and produces a reasonable result. The Company's accounting records provide the necessary detail about original cost by account, sub-account, and vintage year for a Trended Original Cost study. In Mr. Hoffman's opinion, the Trended Original Cost method is reasonable and appropriate for determining the RCN of Indiana-American's property. Mr. Hoffman further compared the results of the RCN against his knowledge of construction costs in the Indiana area and concluded that the index data is valid and reasonable.

The primary source of the trend factors used in Mr. Hoffman's study was the *Handy-Whitman Index of Public Utility Construction Costs for Water Utilities located in the North Central United States* ("Handy-Whitman Indexes"). Mr. Hoffman stated that he also used an index published by the U.S. Bureau of Labor Statistics for some accounts. Mr. Hoffman believed that the Handy-Whitman Indexes are reasonable to use for estimating RCN because are designed for that purpose. Mr. Hoffman indicated that the Handy-Whitman Indexes have been published continuously since 1924 and are well-recognized around the country as suitable for determining the RCN of utility property. Further, Mr. Hoffman noted that, for many years, Petitioner has calculated the RCN of its utility property using the Trended Original Cost method and the Handy-Whitman Indexes and has found the result to be a reasonable and conservative estimate of the cost to reproduce the property at current price levels. Mr. Hoffman's study included land at its original cost because of the expense of obtaining separate land appraisals. Mr. Hoffman stated that he believes this is a conservative assumption of land costs.

Mr. Hoffman determined the RCNLD by deducting depreciation necessary to reflect the current condition of the property from the RCN. Mr. Hoffman calculated the percent condition of Indiana-American's property to be 73.94%. This ratio reflects the complement of the depreciation reserve divided by the utility plant in service on June 30, 2011. Mr. Hoffman's study quantified the RCNLD of Petitioner's used and useful utility plant in service on June 30, 2011, as not less than $2,098,677,432. Mr. Hoffman stated that his valuation does not include materials and supplies, capitalized tank painting, post-in-service AFUDC, or deferred depreciation.

Mr. Hoffman's study also includes a calculation of the Trended Cost Adjusted for Technological Change. He explained that even though the Handy-Whitman index already captures the effects of technological change through the years, he made a further adjustment based on changes in productivity through the years. Mr. Hoffman's productivity adjustment factor was calculated using historical data from the Bureau of Labor Statistics ("BLS") Major Sector Productivity Costs Index for Output per Hour for Nonfarm Business ("OHNFB") which is available from 1947 through 2010. The 2011 OHNFB was estimated by multiplying the 2010 OHNFB by the sum of one plus the 10 year compounded annual growth rate ("CAGR") of the OHNFB for the ten year period from 2001 through 2010. Because OHNFB is not available prior to 1947, the 64-year CAGR of the OHNFB from 1947 through 2010 was used to estimate the productivity factor for the period from 1884 through 1946. The resulting productivity factor and corresponding adjustment in the RCN for productivity are shown in respective columns in Petitioner's Exhibit SSH-1 as "Sum of Trended Cost Adjusted for Productivity." As shown in Mr. Hoffman's study, the total Trended Cost Adjusted for Technological Change amount is $1,191,340,954. Mr. Hoffman computed the weighted average age of plant and equipment in the study based on the RCNLD values, arriving at a weighted average age of 14 years.

(2) **OUCC's Position.** Mr. Patrick recommended that the Commission give no more weight to Petitioner's RCNLD study than it has given the studies offered in Petitioner's past rate cases. He noted that Mr. VerDouw did not use the RCNLD Study to determine Petitioner's fair value rate base.

(3) **Commission Discussion and Findings.** "This Commission has routinely accepted RCNLD studies into the record and considered [them] as evidence in support of Petitioners' fair value." *South Haven Sewer Works, Inc.*, Cause No. 41903, 2002 Ind. PUC LEXIS 221, at *5 (IURC June 5, 2002). Our supreme court recognized that RCNLD is one of several reasonable valuation methods that can be used in determining fair value, stating:

> [T]he courts will not limit the Commission to any one or more methods of valuation, be it prudent investment, original cost, present value, or cost of reproduction. This court has held that cost of reproduction depreciated is a proper item to be considered under the statute in arriving at a fair value figure.

Pub. Serv. Comm'n of Ind. v. City of Indianapolis, 131 N.E.2d 308, 318 (Ind. 1956).

In *Indianapolis Water v. Pub. Serv. Comm'n*, the court explained that a fair value determination by the Commission is not an either/or proposition between original cost and reproduction cost, but derives from consideration of all legitimate value factors. 484 N.E.2d 635, 638-640 (Ind. Ct. App. 1985). Therefore, there are a number of legitimate valuation methods that the Commission should consider in determining fair value, one of which is the RCNLD method. "[R]eproduction cost new less depreciation cannot be disregarded in fixing a valuation for rate making purposes." *Indianapolis Water*, 484 N.E.2d at 640 (quoting *City of Indianapolis*, 131 N.E.2d at 325 (Emmert, J., concurring)). The court indicated that this observation is as pertinent today as in 1956. *Id.* at 640. We will give appropriate weight to the RCNLD of Petitioner's utility plant for purposes of our fair value finding.

D. Update of Prior Fair Value Finding. Mr. VerDouw updated the fair value finding from the 2010 Rate Order for inflation that has occurred since the valuation date and for net investor supplied plant additions that would not have been included in that fair value finding. To implement this methodology, Mr. VerDouw updated the fair value finding from the 2010 Rate Order – $945,522,592 – for inflation of 2.1% through June 30, 2011, based on the annual inflation taken from Ibbotson SBBI 2011 Classic Yearbook Market Results for Stocks, Bonds, Bills, and Inflation 1926-2010 as published by Morningstar ("Ibbotson Yearbook"). Mr. VerDouw then added the net investor funded plant additions since the 2010 Rate Order to arrive at a total updated fair value estimate of $1,126,503,364. Mr. VerDouw noted that this procedure is consistent with the procedure used by the Commission in Petitioner's 1996 Rate Order, the 1997 Rate Order, the 2002 Rate Order, the 2004 Rate Order, and the 2010 Rate Order. No party submitted any evidence in opposition to Mr. VerDouw's testimony, methodology, or calculations.

Although the Commission accepts Mr. VerDouw's methodology for calculating the updated prior fair value, it is clear Mr. VerDouw made a calculation error in his inflation adjustment. We adjusted the fair value finding from the 2010 Rate Order of $945,522,592 for inflation of 2.1% through June 30, 2011. The results is in an adjusted fair value of $985,651,516. The net investor-funded plant additions from the 2010 Rate Order through the November 18, 2011 rate base cutoff are $66,234,254. Adding these two amounts, the Commission finds that Petitioner's updated fair value is $1,051,885,770.

E. Ultimate Fair Value Finding. Ind. Code § 8-1-2-6 establishes that this Commission shall value a public utility's property at its fair value. In *Indianapolis Water*, the Indiana Court of Appeals confirmed that a utility should be entitled to earn a fair rate of return on the fair value of its rate base. 484 N.E.2d at 638-640. Further, in its determination of fair value the Commission may not ignore the commonly known and recognized fact of inflation. *Id.* at 640. The Court of Appeals has more recently confirmed that the Commission must authorize rates that provide the utility with the opportunity to earn a fair return on the fair value of its property. *Gary-Hobart Water Corp. v. Ind. Util. Reg. Comm'n*, 591 N.E.2d 649, 653-54 (Ind. Ct. App. 1992); *Office of Util. Consumer Counselor v. Gary-Hobart Water Corp.*, 650 N.E.2d 1201 (Ind. Ct. App. 1995). Based on the evidence of record, we find that the fair value of Indiana-American's utility property used and useful in the provision of utility service is not less than $1,051,885,770.

8. Fair Rate Of Return.

A. Cost of Common Equity.

(1) Petitioner's Position. Mr. Paul R. Moul, Managing Consultant of the firm P. Moul & Associates, presented Petitioner's cost of equity recommendation. Mr. Moul testified that 11.5% is a reasonable return on equity ("ROE") cost of equity for Petitioner.

Mr. Moul discussed the risks facing the water utility industry generally and Indiana-American specifically. He noted that the business risk of water utilities has been strongly influenced by water quality concerns, regulations promulgated by the Environmental Protection Agency ("EPA"), and federal statutes. Water companies have experienced increased water treatment and monitoring requirements and escalating costs in order to comply with increasingly stringent regulatory requirements and must now also address potential threats from terrorists. Mr. Moul indicated that the Company is engaged in a continuing capital expenditure program that is necessary to meet the needs of its customers and to comply with various regulations. Mr. Moul indicated that the Company's total capital expenditures over the next five years will represent approximately 43% of the utility plant in service, net of contributions, on December 31, 2010.

In addition, Mr. Moul testified that Petitioner has been faced with a sustained decline in the average use per residential customer, which has contributed to Petitioner not realizing actual sales as compared with the billing determinants used to set rates. The high fixed costs of water utilities make earnings vulnerable to significant variations when usage fluctuates with weather, the economy, and customer conservation efforts.

For purposes of his analysis, Mr. Moul used average market data from a proxy group of eight water companies (the "Water Group"). The use of average data, rather than individual company data, helps to minimize the effect of extraneous influences on an individual company. According to Mr. Moul, the companies in the Water Group have the following characteristics: they are listed in the "Water Utility Industry" section (basic and expanded) of the Value Line Investment Survey; their stock is publicly traded; and they are not currently the target of a publicly-announced merger or acquisition.

Mr. Moul compared Indiana-American's financial data with that from the Water Group. Mr. Moul stated that the Company has a higher degree of capital intensity than the Water Group, it has somewhat more financial risk, its equity returns display more variability, its returns were lower, and its creditor protection (i.e., interest coverages) was weaker. He further stated that the Company has very substantial construction requirements for the future. Based on his analysis, Mr. Moul concluded that the Water Group provides a conservative basis for measuring the Company's cost of equity.

Mr. Moul relied on four measures in analyzing the Company's cost of equity: the Discounted Cash Flow ("DCF") model, the risk premium model, the Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings approach.

(a) DCF Analysis. Mr. Moul stated that the DCF methodology requires the use of an expected dividend yield to establish the investor-required cost of equity. For purposes of his analysis, Mr. Moul used the six-month average dividend yield of 3.30% for the Water Group, which he stated reflects current capital costs while avoiding spot yields. Mr. Moul then adjusted the six-month average dividend yield to reflect growth in dividends during the initial investment period and quarterly dividend payments to arrive at an adjusted dividend yield of 3.42% for the Water Group.

As to the appropriate growth rate, Mr. Moul opined that all relevant growth rate indicators using a variety of techniques must be evaluated when formulating a judgment of investor expected growth. He stated that negative growth rates reflected in historical data provide no reliable guide to gauge investor expected growth for the future and thus should not be given any weight when formulating a composite growth rate expectation. Mr. Moul testified that although ideally historical and projected earnings per share and dividends per share growth indicators would be used to provide an assessment of investor growth expectations for a firm, the circumstances of the Water Group mandate that greater emphasis be placed on projected earnings per share growth. He opined that projections of future earnings growth provide the principal focus of investor expectations and represent a reasonable assessment of investor expectations.

Mr. Moul provided projected earnings per share growth rates taken from analysts' forecasts compiled by I/B/E/S/First Call, Zacks, Morningstar, and Value Line. He testified that a five-year investment horizon associated with the analysts' forecasts is consistent with the DCF model. He testified that earnings per share growth provides the principal focus of investor expectations and is consistent with the recommendations of Professor Myron Gordon, the foremost proponent of the DCF model in rate cases. Mr. Moul indicated that the forecasts of earnings per share growth provide a range of growth rates from 6.63% to 9.62%. He concluded that his use of an investor-expected growth rate of 7.00% is a conservative representation of the analysts' growth rate forecasts.

Mr. Moul made two adjustments to his DCF results, a leverage adjustment and a flotation cost adjustment. Mr. Moul stated that a leverage adjustment is necessary if book values are used to compute the capital structure ratios. He stated that if regulators rely on the results of the DCF, which are based on the market price of the stock of the companies analyzed, and use those results in computing the weighted average cost of capital with a book value capital structure, those results will not reflect the degree of financial risk associated with the book value capital structure. His leverage adjustment is computed with the return for an unleveraged company plus the additional return to reflect the risk associated with having senior debt and preferred stock in the capital. Based on his calculation, Mr. Moul concluded that the appropriate leverage adjustment for the Company was 1.02%.

Mr. Moul testified that a flotation cost adjustment is computed to recognize the cost of issuance when additional common equity is issued. This is to compensate for the underwriting discount and issuance expenses associated with the issuance of new common stock. Mr. Moul utilized a flotation cost adjustment of 0.23% in his DCF model, which, when combined with an adjusted dividend yield of 3.42%, a projected growth rate of 7.00%, and a leverage adjustment of 1.02%, results in a rate of return for the Company of 11.67%.

(b) <u>Risk Premium Analysis</u>. Mr. Moul stated that in a risk premium analysis, the cost of equity capital is determined by corporate bond yields plus a premium to account for the fact that common equity is exposed to greater investment risk than debt capital. Mr. Moul used a long-term public utility debt cost rate of 5.75%, which he opined was a reasonable estimate of the prospective yield on long-term A-rated public utility bonds. Mr. Moul stated that his long-term cost rate of 5.75% is supported by the Moody's Index and the Blue Chip forecasts. He noted that the historical yields for A-rated public utility debt during the twelve months ended February 2011 have ranged from 5.01% to 5.84%.

Mr. Moul determined the prospective yield on A-rated public utility debt by using the Blue Chip Financial Forecasts along with the spread in the historical yields noted above. He testified that the Blue Chip is a reliable authority and contains consensus forecasts of a variety of interest rates compiled from a panel of banking, brokerage, and investment advisory services. Because Blue Chip stopped publishing forecasts of yields on A-rated public utility bonds in early 1999, he combined the forecast yields on long-term Treasury bonds published on March 1, 2011, and a yield spread of 1.00%, which he opined was a reasonable spread for the yield on A-rated public utility bonds over Treasury bonds. Mr. Moul also provided Blue Chip's long-term forecasts of interest rates, which he stated further supported the use of a 5.75% yield.

Mr. Moul stated that he calculated the equity risk premium by comparing the market returns on utility stocks and the market returns on utility bonds. He used the S&P Public Utility Index for the purpose of measuring the market returns for utility stocks, which he stated is reflective of the risk associated with regulated utilities and reduces the role of judgment in establishing the risk premium for public utilities. To develop an appropriate risk premium, Mr. Moul averaged the results for the S&P Public Utilities by averaging the midpoint of the range shown by the geometric mean and median and the arithmetic mean. He explained that this procedure was employed to provide a comprehensive way of measuring the central tendency of the historical returns.

Based on this analysis Mr. Moul determined that a reasonable risk premium for the S&P Public Utilities in this case is 6.23%. Mr. Moul stated that differences in risk characteristics must be taken into account when applying the results for the S&P Public Utilities to the Water Group including size, market ratios, common equity ratio, return on book equity, operating ratios, coverage, quality of earnings, internally generated funds, and betas. Mr. Moul opined that these differences indicate that 5.50% represents a reasonable common equity risk premium in this case and is reflective of the lower risk of the Water Group compared to the S&P Public Utilities. Using this risk premium together with the prospective yield for long-term public utility debt and his flotation adjustment, Mr. Moul's risk premium approach provided a cost of equity for Petitioner of 11.48%.

(c) <u>CAPM Analysis</u>. Mr. Moul stated that three components are necessary to compute the cost of equity in a CAPM analysis: a risk-free rate of return; the beta measure of systematic risk; and the market risk premium. For the beta, Mr. Moul initially considered the Value Line betas. However, because the betas must be reflective of the financial risk associated with the rate setting capital structure that is measured at book value, Mr. Moul testified that a leverage adjustment similar to that utilized on the DCF model would be necessary. He used the Hamada formula to un-leverage and re-leverage the Value Line betas for the common equity ratios using book values. Mr. Moul calculated a leveraged beta of 0.89 for the Water Group associated with book value capital structure.

For the risk-free rate, Mr. Moul employed the yields on 20-year Treasury bonds using historical data. For forecasts, Mr. Moul used the yields on 30-year Treasury bonds that are published by Blue Chip. Mr. Moul summarized the various yields and determined that a 4.75% risk-free rate of return would be appropriate for CAPM purposes, as it considers not only the Blue Chip forecasts but also the recent trend in the yields on long-term Treasury bonds.

Mr. Moul derived his market premium from the SBBI Classic Yearbook and the Value Line and S&P 500 returns. For the historically based market premium he used the arithmetic mean. Mr. Moul acknowledged that the Commission has expressed its preference for considering both the arithmetic mean and the geometric mean and stated that if that approach is to be taken, much more weight should be placed on the arithmetic mean because it is the correct measure in the single-period model specification of the CAPM. Mr. Moul indicated that the market premium as taken from these sources is 6.86%.

Mr. Moul testified that an adjustment must be made to the CAPM result relating to the size of the company or portfolio for which the calculation is performed. Mr. Moul explained that as the size of a firm decreases, its risk and, hence, its required return increases. He stated that the Water Group has an average market equity capitalization of $1,423 million, which would make it a low-cap portfolio. While Mr. Moul noted that this low-cap market capitalization would indicate a size premium of 1.98%, he used a more conservative size adjustment of 1.20%, which represents the mid-cap adjustment.

Based on a 4.75% risk-free rate of return, the leverage adjusted beta of 0.89 for the Water Group, the 6.86% market premium, the 1.20% size adjustment and the flotation cost adjustment developed previously, the cost of equity resulting from Mr. Moul's CAPM analysis is 12.29%.

(d) Comparable Earnings Analysis. Mr. Moul testified that he performed this analysis because regulation is a substitute for competitively driven prices and the returns realized by non-regulated firms with comparable risks provide useful insight into a fair rate of return. He selected non-regulated companies from the Value Line Investment Survey that have six categories of comparability designed to reflect the risk of the Water Group. Mr. Moul stated that Value Line provides a comprehensive basis for evaluating the risks of the comparable firms. He used both historical realized returns and forecasted returns covering a ten-year period (5 historical years and 5 projected years) in order to cover conditions over an entire business cycle.

Unlike with the DCF or CAPM approaches, Mr. Moul indicated that a leverage adjustment was not necessary when using the Comparable Earnings method because it can be applied directly to the book value capitalization, avoiding the potential misspecification with the other models. Mr. Moul stated that the results from the Comparable Earnings approach suggest a reasonable cost of equity for Petitioner of 12.40%, representing the average of the historical and forecast median rates of return for the comparable earnings group.

Based on his application of a variety of methods and models, Mr. Moul opined that the cost of common equity for the Company in this case is 11.50%. He further opined that it is essential that the Commission employ a variety of techniques to measure the Company's cost of equity because of the limitations/infirmities that are inherent in each method.

(2) OUCC's Position. Mr. Edward R. Kaufman, CRRA, a Senior Analyst with the OUCC, presented testimony regarding Petitioner's cost of equity. Mr. Kaufman used both DCF and CAPM analyses to estimate Petitioner's cost of equity at 8.6%. He did not conduct risk premium or Comparable Earnings analyses. Mr. Kaufman's DCF models produced a range of estimates from 8.40% to 9.45%, and his CAPM analysis produced a range of estimates from 7.71% to 7.95%. Mr. Kaufman stated that a cost of equity of 8.6% results in a weighted cost of capital of 6.47%, as shown by Ms. Stull. Mr. Kaufman explained that the difference between his and Mr. Moul's cost of equity estimates is the result of inputs to the various models, adjustments that Mr. Moul made to his models, and the weight given to each of the models.

Mr. Kaufman testified that Petitioner's cost of debt since its last rate case has declined by almost 50 basis points from 6.96% to 6.52%. He stated that the decrease in Petitioner's cost of equity since its last rate case is illustrated by the decline in the beta of his water company proxy group from 0.793 to 0.722. Mr. Kaufman testified that inflation influences interest rates and interest rates influence the cost of equity. He stated that for the past several years interest rates have been at historically low levels, and interest rates have further declined during the past few months. Mr. Kaufman provided several examples that showed that relevant interest rates had declined. For example, he testified 30-year US Treasury yields declined from 4.19% to 3.37%. Mr. Kaufman also noted that 10-year US Treasury bonds hit a record low of 1.91% on September 9, 2011. He explained that lower interest rates translate directly into a lower cost of equity and long-term capital costs are as low or are lower today than they have been during most of the last 50 years.

Mr. Kaufman explained that he generally accepted and used Mr. Moul's Water Group, but he also included Artesian Resources in his proxy group. On cross examination Mr. Moul agreed Artesian Resources meets his screening criteria but was not covered by Value Line at the time Mr. Moul filed his testimony. Mr. Kaufman divided the proxy group into two categories for purposes of his DCF model: (1) the "Value Line proxy group" consisting of four out of the five water companies covered by Value Line's Standard Universe; and (2) the "AUS proxy group" comprising the same eight companies used in Mr. Moul's analysis, plus Artesian Resources. Mr. Kaufman stated that his AUS proxy group did not have the same level of data as for his Value Line proxy group, and therefore, he gave it less weight. He stated that it was not necessary to divide the companies into two proxy groups for purposes of his CAPM analysis because he had the same level of detail (beta) for all nine companies.

Mr. Kaufman used a traditional single stage DCF model for his Value Line proxy group, and used both historical and forecasted growth rates of earnings per share, dividends per share, and book value per share from Value Line. He estimated a growth rate of 5.21% for his Value Line proxy group. For his AUS proxy group, Mr. Kaufman used a single stage DCF model, using forecasted growth rates of earnings per share from Value Line, Yahoo.com (which relies on I/B/E/S Thomson Financial), and Morningstar to determine an estimated growth rate of 5.96%.

In both single-stage DCF analyses Mr. Kaufman eliminated zero and negative growth rates, consistent with the 1996 Rate Order, although he did not believe that investors completely ignore these growth rates. He did not eliminate low positive growth rates as he explained that low growth rates are not ignored by investors. Mr. Kaufman explained that he also did not eliminate high positive growth rates. He stated that his growth rate of 5.21% is supported by a Value Line chart titled "A Long-term Perspective," which provides average growth rates in earnings per share, dividends per share, and book value per share.

Mr. Kaufman asserted that short- to intermediate-term forecasts can lead to unreasonably high estimated growth rates in a DCF analysis, and should not be mechanically incorporated into a DCF analysis. To support his claim, Mr. Kaufman cited a 2003 article published in the

National Regulatory Research Journal of Applied Regulation, which stated that no utility can sustain a growth rate over the long run that exceeds the growth rate of the economy. Mr. Kaufman further cited a 2003 Wall Street Journal article as indicating that analysts' forecasts are potentially biased upwards due to possible financial incentives. Along with the Wall Street Journal article Mr. Kaufman also cited to two articles by McKinsey Quarterly to further support his opinion that analyst forecasts were bullish. Mr. Kaufman concluded that both the potential for analyst bias and the intermediate term nature of analyst forecasts of earnings per share may make these estimates potentially unreliable. Mr. Kaufman asserted that, even assuming no analyst bias, unsustainable growth rates should be adjusted or given reduced weight.

Mr. Kaufman stated that a two-stage DCF model allows one to give appropriate weight to short-term or intermediate-term forecasts in earnings per share to estimate the cost of equity. Mr. Kaufman then described the mechanics of the 2-stage DCF model. He explained that it is reasonable to use a forecasted growth rate of the U.S. economy as a long-term sustainable growth. To determine this growth rate, Mr. Kaufman used a forecasted growth rate presented by Mr. Moul of 4.75%. He also consulted a number of sources that provide forecasted real growth and forecasted inflation to support his use of Mr. Moul's 4.75% forecasted growth in the U.S. economy or GDP.

Mr. Kaufman next explained the mechanics of his two-stage DCF analysis. He indicated that he used inputs from Mr. Moul's single stage DCF analysis to produce an estimated cost of equity based on a two-stage DCF analysis. He used a dividend yield of 3.42%, a near term dividend growth rate of 7.0%, and the long-term EPS growth rate of 4.75% to produce an estimated cost of equity of 8.71%. Mr. Kaufman explained that he used his 2-stage DCF model as a check to the results of his single stage DCF analysis, and that he gave significantly more weight to his single stage DCF analysis for his Value Line proxy group because it was the most consistent with prior Commission decisions.

Mr. Kaufman then presented the results of his CAPM analysis. He indicated that the CAPM is typically more controversial and less reliable than the DCF model, and that different applications of CAPM may cause vastly different cost of equity estimates. He testified that he believes a geometric mean is a better approach to determine the risk premium than an arithmetic mean, but stated that his CAPM analysis considers both geometric and arithmetic mean risk premiums. To support his position, Mr. Kaufman cited to the 1982 Ibbotson Yearbook. Mr. Kaufman noted that more recent versions of the Ibbotson Yearbook advocate the use of only the arithmetic mean but provide no explanation for this change. He also cited to several articles and texts that recommended using the geometric mean rather than the arithmetic mean. Mr. Kaufman explained that the Commission has consistently given weight to both arithmetic mean and geometric mean risk premiums, for example in Petitioner's most recent rate case, Cause No. 43680.

Mr. Kaufman stated that he also developed a forecasted risk premium in addition to his risk premium based on historical data because the expected risk premium is below the historical averages. Based on his review of a number of articles that provided a range of forecasted market risk premiums from a low of 1.5% to a high of 5.25%, Mr. Kaufman stated that his CAPM analysis used a forecasted risk premium of 5.25%. He noted, however, that the historical risk premium is only 5 basis points lower (5.20%) than his forecasted risk premium of 5.25%. Mr.

Kaufman testified that the cost of equity based on his CAPM analysis using a historical risk premium ranged from 7.71% to 7.91%, and the cost of equity based on his CAPM analysis using a forecasted risk premium ranged from 7.75% to 7.95%.

Mr. Kaufman's cost of equity models produced a range of equity estimates of 7.71% to 9.45% with a midpoint of 8.58%. Mr. Kaufman explained that giving weight to models consistent with past Commission orders produced a range of equity estimates of 7.71% to 8.44% with a midpoint of 8.08%. Mr. Kaufman recommended a cost of equity above the high end of his range. Based on his DCF and CAPM analyses, Mr. Kaufman recommended a cost of equity of 8.60%. He explained that there was no need to adjust the results of his proxy group's cost of equity to make it applicable to Indiana-American as he believed Indiana-American has a similar business and financial risk to the companies in the proxy group. Mr. Kaufman discussed industry sources supporting a view that his proposed cost of equity of 8.6% is reasonable in today's markets. Mr. Kaufman indicated the Duke CFO survey, the Schwab Center for Financial Research, an article from Portfolio Solutions and J.P. Morgan, all predicted long run stock returns below 8.6%. Mr. Kaufman noted that Petitioner's proposed annual expense for its Pension and OPEBs assumes a long-term return on large capitalization equities of 8.85%. Mr. Kaufman argues that if an 8.85% forecasted return on large capitalization equities is appropriate to determine Petitioner's Pension/OPEB expenses, then it is also appropriate to help estimate its cost of equity, especially for models that rely on an estimate of market returns.

Mr. Kaufman next expressed his concerns regarding Mr. Moul's cost of equity analysis. First Mr. Kaufman briefly discussed why, despite Mr. Moul's comments, the business risk of the water industry remains low. Mr. Kaufman's testimony included Mr. Moul's response to OUCC Discovery Request 03-001 that showed each water company in Mr. Moul's proxy group (rated by S&P) had a business risk of "Excellent." "Excellent" is S&P's highest – i.e. least risky – rating.

Mr. Kaufman commented on Mr. Moul's DCF model. He explained that Mr. Moul's reliance on intermediate term forecasts for earnings per share results in a growth rate that is unrealistically high. Mr. Kaufman explained that Mr. Moul's reliance on forecasted growth rates for his DCF analysis was improper, as these estimates are not long-term (perpetual) estimates and may overstate cost of equity. These estimates are made typically for only three to five years. Three to five year estimates are likely to be optimistic and overstate long-term growth, and they do not necessarily represent a reasonable long-term growth estimate. He stated that in a single-stage DCF model, it is necessary to use a growth rate that is sustainable over the long run as the equation used in the DCF model assumes an infinite time frame.

Mr. Kaufman then explained how using Mr. Moul's inputs in a 2-stage DCF analysis would reduce the results of a DCF analysis by 170 basis points. Mr. Kaufman also disputed Mr. Moul's use of the FERC language stating that the 2-stage DCF model should only be used if the forecasted growth in EPS is at least 2 to 3 times higher than forecasted GDP. Mr. Kaufman explained that in a setting where parties are disputing adjustments as small as 23 basis points (Mr. Moul's flotation cost adjustment), he did not believe we needed to wait until an intermediate term forecasted growth rate exceeded the long-term growth rate by 2-3 times to justify using multiple growth rates.

Mr. Kaufman next discussed his concerns with Mr. Moul's leverage adjustment. He disagreed that the difference between market and book value creates a need to adjust the results of a DCF analysis and therefore asserted that Mr. Moul's leverage adjustment is unnecessary. He pointed out that Mr. Moul provided no numerical analysis to support his argument that a leverage adjustment is necessary when a utility's market-to-book ratio is different from 1.0 and most jurisdictions do not use Mr. Moul's adjustment. Mr. Kaufman testified that the leverage adjustment proposed by Mr. Moul has the effect of rewarding utilities when market-to-book ratios are high and penalizing utilities when market-to-book ratios are low. Mr. Kaufman asserted that if Mr. Moul had applied his leverage adjustment directly to American Water in Petitioner's last rate case, it would likely have led to a negative leverage adjustment.

Mr. Kaufman next criticized Mr. Moul's CAPM analysis, which Mr. Kaufman explained contained an improper leverage adjustment, overstated the risk premium, and included unnecessary adjustments for size and for flotation costs. Mr. Kaufman disagreed with Mr. Moul's sole use of an arithmetic mean calculation and stated a historical risk premium should be based on both geometric and arithmetic mean calculations. Mr. Kaufman explained that ignoring the geometric mean overstates expected returns. Mr. Kaufman pointed out that the SEC requires mutual funds to report historical earned returns using a geometric mean calculation and that the Commission has consistently given weight to both the geometric and arithmetic mean. Mr. Kaufman also challenged Mr. Moul's second historical risk premium, which improperly used bond income returns instead of bond total returns. Mr. Kaufman explained that investors who buy long-term bonds earn total returns, not income returns. Mr. Kaufman cited the 2005 Rate Order to support his criticism of Mr. Moul's reliance on income returns to estimate the market risk premium.

Mr. Kaufman disagreed with Mr. Moul's 7.37% forecasted risk premium because Mr. Moul's source data was overly optimistic. Mr. Kaufman stated that Mr. Moul's forecasted market risk premiums resulted from market forecasts of 12.47% and 11.76%, both of which dramatically exceed the historical market return. In particular, Mr. Kaufman explained the inherent unreliability of the Value Line Price Appreciation Potential data and the flaws in using First Call's 9.85% 5-year growth estimate as a substitute for a sustainable, long-term growth rate.

Mr. Kaufman next took issue with Mr. Moul's size adjustment, stating that it is not appropriate to directly apply the Ibbotson Yearbook's equity size premium adjustment to regulated water utilities. He stated that regulation decreases the risks faced by Petitioner and the companies in Mr. Moul's Water Group and those companies do not face the same bankruptcy risks that other small companies may face. He also stated that the Commission's Order in Cause No. 40398 determined that the Ibbotson Yearbook's small cap adjustment cannot be directly applied to utilities. Mr. Kaufman also cited articles by Business Valuation Alert and by Annie Wong, supporting his conclusions. For the same reasons he disagreed with the leverage adjustment proposed in Mr. Moul's DCF analysis, Mr. Kaufman disagreed with the leverage adjustment that Mr. Moul made to his CAPM analysis. He noted that Mr. Moul did not cite any jurisdictions that accepted his leverage adjustment for a CAPM analysis.

Mr. Kaufman testified that Mr. Moul's risk premium model overstates the risk premium, uses a forecasted interest rate that exceeds the current interest rate and includes an unnecessary adjustment for flotation costs. Mr. Kaufman explained that Mr. Moul's use of median returns, which exceed both the arithmetic and geometric mean returns, further reduced the reliability of Mr. Moul's model. Mr. Kaufman stated that this approach inflates the expected return for the S&P Utility Index and deflates the expected return for Public Utility Bonds. Mr. Kaufman agreed with the 2010 Rate Order and disagreed with Mr. Moul's argument that there was no need to update his risk premium analysis for 2008, 2009, and 2010 data in this case. Mr. Kaufman testified that if Mr. Moul's risk premium model was updated to include 2008, 2009, and 2010 data, it results in an unadjusted risk premium of only 4.02%. Mr. Kaufman further testified that if Mr. Moul's risk premium model is adjusted to give equal weight to arithmetic and geometric means, and no weight to median returns, it would result in a premium of 3.25%.

Mr. Kaufman did not agree with Mr. Moul's use of forecasted interest rates in his CAPM and risk premium analyses. He explained that a purchaser of long-term debt is effectively making a forecast, and therefore the purchase price produces a yield that the investor is willing to accept over the life of the debt. He further explained that a forecast of increasing interest rates is also a forecast of declining bond prices, and that if a potential purchaser expected the price to decrease, that would be reflected in the current purchase price. Mr. Kaufman surmised that a current yield is already a forward-looking yield over the investment horizon. Mr. Kaufman explained that if a risk premium of 3.25% was added to the current yield on "A" utility bonds of 4.55%, it would produce an estimated cost of equity of 7.8%. Mr. Kaufman testified Mr. Moul's proposed cost of equity for his risk premium model of 11.48% exceeds the average actual return earned for the S&P Public Utility Index from 1928-2010 of 8.36% and that given today's historically low interest rates it is counterintuitive for this model to produce an estimated cost of equity well in excess of the historical returns.

Mr. Kaufman expressed concerns over Mr. Moul's Comparable Earnings approach. He explained that Mr. Moul's analysis does not exclude outliers, nor did Mr. Moul screen his proxy group for dividends or percentage of long-term debt. Mr. Kaufman further explained that a company with little or no long-term debt or that does not pay significant dividends is not comparable to either Indiana-American or Mr. Moul's Water Group. Mr. Kaufman expressed concern that historical returns do not react to changes in market conditions, and so the comparable earnings methodology can produce increasing returns during periods of declining capital costs. He noted that the Commission disregarded the results of Mr. Moul's Comparable Earnings analysis in the 2010 Rate Order.

As to Mr. Moul's flotation cost adjustment, Mr. Kaufman asserted that Petitioner has not justified the need to recover flotation costs in this case. He noted that the Commission has typically allowed utilities to recover measurable and reasonable flotation costs when the utility has recently incurred or expects to incur flotation costs in the near future. Mr. Kaufman stated that because Mr. Moul is proposing a generic flotation cost adjustment not based on actual costs incurred by Indiana-American or by American Water on behalf of Indiana-American, a flotation cost adjustment should not be included in Indiana-American's authorized cost of equity.

Mr. Kaufman explained that his proposed cost of equity is reasonable. He testified that Petitioner's actuarial study assumes the S&P 500 will earn a return of 8.85%, the average historical return of the S&P Public Utility Index from 1928-2010 is only 8.36% the Third Quarter 2011 Duke Survey of CFO's forecasts a 10-year mean for the S&P 500 of 6.5% and the Schwab Center for Financial Research forecasted a long-term (20 year) annual rate of return for large-cap stocks of 7.9%. Mr. Kaufman discarded the lowest result and calculated that the three remaining diverse sources produced an average return of 8.37%. Mr. Kaufman noted that because Petitioner is less risky than the market, his proposed return of 8.6%, which exceeds the average return of 8.37%, is reasonable and should be approved by the Commission.

(3) **Industrial Group's Position.** Mr. Michael Gorman, a consultant and Managing Principal with the firm of Brubaker & Associates, Inc., sponsored testimony recommending a 9.40% ROE. Mr. Gorman opined that based on the data he reviewed and the analysis he performed, Indiana-American's cost of common equity is no higher than it was in the Company's last rate case, and that his 9.40% return is reasonable. Mr. Gorman also noted that current market conditions, in which utility bond yields are 90-100 basis points lower than they were prior to the 2010 Rate Order, suggests that the Company's current market cost of equity is well below the 10.0% cost of equity approved in that Order.

Mr. Gorman stated that Indiana-American's own analysis supported a lower cost of common equity than in the Company's prior rate case. In that case, Mr. Moul recommended an ROE of 12.0%, but, in this case, is only recommending an ROE of 11.50%. Mr. Gorman compared that 50 basis point reduction to his own recommendation, which is 50 basis points lower than the 9.9% return he proposed in the Company's last rate case. He explained that these comparable reductions indicate that Indiana-American's cost of common equity is lower today than at the time of the last rate case.

Mr. Gorman utilized five models to estimate Indiana-American's cost of common equity: (1) a constant growth DCF model using analyst growth data; (2) a Sustainable Growth DCF model; (3) a Multi-Stage Growth DCF model; (4) a risk premium analysis; and (5) a CAPM.

Mr. Gorman testified that he relied on two proxy groups, Mr. Moul's Water Group and a proxy group that consisted of ten gas utilities, to estimate Indiana-American's current cost of capital. He explained that it was necessary to rely on the gas proxy group in addition to the water proxy group for several reasons. First, the gas proxy group's securities were more widely followed than water utility stocks, and provide a more robust estimate of the market cost of equity. Second, market participants consider the investment risk of water and gas utilities to be comparable as is evidenced by the practice of S&P credit reports, which typically combine the two types of utilities in reports to investors. Third, the asset mix, capitalization, and operations of the two types of utilities are very similar because they are dependent on large main investment and operations, infrastructure replacement and upgrades, and compliance with local, state, and federal regulations. For these reasons, Mr. Gorman opined that reliance on the two proxy groups provided a better risk proxy of Indiana-American than the Water Group alone. Mr. Gorman also opined that Indiana-American's financial risk is reasonably comparable to both the water and gas proxy groups.

Mr. Gorman testified that he measured the Company's investment risk by relying on the bond rating of American Water and its financing subsidiary, American Water Works Capital Corporation ("AWC"), as a proxy for Indiana-American's bond rating. He also relied on Indiana-American's stand-alone capital structure to measure the investment risk of the Company relative to that of the two proxy groups.

Mr. Gorman explained that it is appropriate to use American Water and AWC's bond ratings as a proxy because AWC obtains its credit standing though affiliation with Indiana-American and American Water's other operating affiliates. Mr. Gorman further explained that American Water is structured to mitigate operating risks and financial risks by consolidating utility operations within its holding company structure. Mr. Gorman opined this reduced Indiana-American's financial and operational risks by eliminating small company risk and by opening access to markets for bond issuances that likely reduce the cost of borrowing. Mr. Gorman also stated that because ratepayers pay for the risk reductions through shared services fees, they should receive the benefits of the corporate structure through reduced capital costs.

In his constant growth DCF model, Mr. Gorman relied on the average of the weekly high and low stock prices of the proxy groups over a 13-week period ending September 23, 2011. Mr. Gorman opined that in his judgment, the use of the 13-week average stock price is a reasonable balance between the need to reflect current market expectations and the need to collect sufficient data to smooth out aberrant market movements. Mr. Gorman stated that he relied on two sources of growth for his constant growth DCF model. In his first constant growth DCF analysis, Mr. Gorman relied on a consensus of professional security analyst's earnings growth estimates as a proxy for investor consensus dividend growth rate expectations. Specifically, Mr. Gorman averaged growth rates estimates from Zacks, SNL Financal, and Reuters to calculate average growth rates of 7.25% and 4.54% for the water and gas proxy groups, respectively. Using these growth rates, Mr. Gorman calculated average constant growth DCF rates of 10.77% and 8.43% for the water and gas proxy groups, respectively. Mr. Gorman concluded that the constant growth DCF return for the water proxy group in not reasonable and represents an inflated ROE for Indiana-American at this time. Mr. Gorman opined that the 7.25% growth rate is far too high to be a reasonable or reliable estimate of a long-term sustainable growth rate, as required in the constant growth model. Mr. Gorman testified that the 7.25% growth rate exceeds the projected growth rate of GDP. Mr. Gorman stated that the consensus of published economists is that GDP will grow at a rate of no more than 4.9% over the next five to ten years. Mr. Gorman stated that GPD growth projection represents a high-end sustainable growth rate for a utility because utilities cannot indefinitely sustain a growth rate greater than that of the overall economy. Mr. Gorman concluded that the constant growth DCF model relying on consensus analysts' growth rate estimates for the water proxy group does not produce a reasonable estimate of Indiana-American's cost of equity. Mr. Gorman also stated that the constant growth DCF return of the gas proxy group is slightly below a reasonable long-term sustainable growth estimate.

Mr. Gorman next discussed his sustainable growth DCF model. Mr. Gorman indicated that in this DCF study he used the internal growth rate methodology, which is tied to the percentage of earnings retained in the company. He testified that by using the internal growth rate model the sustainable growth rates for the Water Group were in the range of 6.51% (average) and 6.81% (median); and the sustainable growth rates for the gas proxy group were in the range of 5.98% (average) and 5.59% (median). Based on these sustainable growth rates Mr. Gorman developed an estimated average return of 9.85% for the Water Group and 9.92% for the gas proxy group.

Mr. Gorman testified a limitation of the constant growth DCF model is that it cannot reflect the rational expectation that a period of high and/or low short-term growth can be followed by a change in growth to a rate that is more reflective of a long-term sustainable growth level. For that reason, he performed a multi-stage growth DCF analysis that reflects three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of years six through ten; and (3) a long-term growth period starting in year 11 through perpetuity. For the short-term growth period, Mr. Gorman relied on the consensus analysts' growth projections used in his constant growth DCF model. For the transition period, Mr. Gorman reduced or increased the growth rates by an equal factor to reflect the difference between the analysts' growth rates and the GDP growth rate. For the long-term growth period, Mr. Gorman assumed the growth of each company in the proxy group would converge to the maximum sustainable growth rate for a utility company, or the consensus analysts' projected growth rate for GDP of 4.9% starting in year 11. The 4.9% projected GDP growth rate used by Mr. Gorman reflects the midpoint of consensus GDP growth rate projections published in the latest issue of *Blue Chip Economic Indicators*, which range from 5.1% to 4.7% over the next 5 and 10 years, respectively.

Mr. Gorman testified that his average multi-stage growth DCF ROEs were 8.96% for the Water Group and 8.71% for the gas proxy group. Based on the results of all three DCF models, Mr. Gorman found a reasonable range for the DCF returns to be 9.90%, rounded from 9.87%, to 9.00%, rounded from 9.02%, with a midpoint estimate of 9.50% rounded from 9.45%. Mr. Gorman opined that this midpoint is conservatively high because it gives some weight to the unreasonably high results derived for the water proxy group in the constant growth rate DCF model using analysts' growth rates.

Mr. Gorman stated that his risk premium model is based on the principle that investors require a higher return to assume greater risk. Mr. Gorman testified that his model is based on two estimates of equity risk premium. First, he estimated the difference between the required return on utility common equity investments and Treasury bonds with the difference being the risk premium. Mr. Gorman testified that the common equity required returns he used were based on regulatory commission authorized returns for gas utility companies. The second risk premium method utilized by Mr. Gorman is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields.

In both estimates, Mr. Gorman used the time period of 1986 through the second quarter of 2011, which he selected because during that time, public utility stocks consistently traded at a premium to book value. Mr. Gorman stated that the time period was selected to draw accurate results concerning contemporary market conditions. Mr. Gorman stated that reliance on a relatively long period of time where stock valuations reflect premium to book value is an indication that the authorized ROEs and the corresponding risk premiums supported investor expectations and provided utilities access to equity markets under reasonable terms. He further stated that the time period selected is long enough to smooth out market movements that might distort equity risk premiums. Mr. Gorman testified that the period he used is a generally accepted period to develop a risk premium analysis using "expectational" data and, therefore, does not require consideration of very long historical time periods.

Mr. Gorman testified that based on his analysis, the average indicated equity risk premium over Treasury bond yields has been 5.09% with three-quarters of the results falling in a range of 4.15% to 5.93%. Mr. Gorman also testified that the average indicated equity risk premium over contemporary Moody's utility bond yields was 3.67% over the period 1986 through the second quarter of 2011, with the results primarily falling in the range of 3.04% to 4.43%.

Mr. Gorman stated that the equity risk premium should reflect the relative market perception of risk in the utility industry today. To gauge that risk, he reviewed utility bond yield spreads for "A" rated and "Baa" rated utility bonds over Treasury bond yields for 2008, 2009, and 2010. Mr. Gorman testified that in 2010 the yield spreads had declined to 1.21% and 1.71% for "A" and "Baa" rate utility bonds, respectively. Mr. Gorman stated that these spreads over Treasury bond yields are now lower than the 30-year average spreads of 1.59% and 1.99%, respectively. Mr. Gorman also compared the 13-week average "A" rated utility bond yield of 4.82% with the current Treasury bond yield of 3.79%, and found the yield spread of 1.03% to be lower than the 1.59% 30-year average yield for "A" rated utility bonds. Mr. Gorman also compared the 13-week average "Baa" rated utility bond yield of 5.34% with the current Treasury bond yield, and found the yield spread of 1.55% to be lower than the 1.99% 30-year average yield for "Baa" rated utility bonds. Mr. Gorman opined that these reduced yield spreads are clear evidence that the market considers the utility industry to be a relatively low risk investment and that utilities continue to have strong access to capital.

In performing his risk premium analysis, Mr. Gorman added a projected long-term Treasury bond yield of 4.2% to his estimated risk premium over Treasury yields. Using the projected 30-year bond yield of 4.2% and the Treasury bond risk premium of 4.15% to 5.93%, Mr. Gorman produced an estimated common equity return in the range of 8.35% to 10.13%, with a midpoint of 9.24%. Using his utility equity risk premium of 3.04% to 4.43% and the 13-week average yield of 5.34% on "Baa" rated utility bonds, Mr. Gorman produced an estimated cost of equity in the range of 8.38% to 9.77%, with a midpoint of 9.08%. Mr. Gorman therefore testified that his risk premium analyses produce an estimated cost of equity in the range of 9.08% to 9.24%, with a midpoint estimate of 9.16%, rounded to 9.20%.

Mr. Gorman testified that a CAPM analysis is based on the theory that the market required rate of return for a security is equal to the risk free rate, plus a risk premium associated with the specific security, and explained that the risk associated with a specific security is expressed as "beta". To determine the risk free market rate, Mr. Gorman relied on the 4.2% projected 30-year Treasury bond yield he used in his risk premium analysis that was derived from Blue Chip Financial Forecasts projections. To determine the beta, he used the average Value Line beta estimates of 0.74 and 0.68 for the water and gas proxy groups, respectively. Mr. Gorman also relied on a historical market risk premium of 6.0%. He derived this historical risk premium using Morningstar data from 2006 through 2010, which estimated the arithmetic average of the achieved total return on the S&P 500 of 11.90% and the total return on long-term Treasury bonds of 5.9%. Mr. Gorman also produced a forward-looking risk premium estimate that he derived by estimating the expected return on the market (represented by the S&P 500) and subtracting the risk-free rate. Mr. Gorman calculated a forward-looking risk premium of 7.0%. Mr. Gorman stated that his average market risk premium of 6.5% is consistent with Morningstar's analysis, which produces a market risk premium in the range of 6.0% to 6.7%. Although Mr. Gorman disagreed with some assessments made by Morningstar, he used Morningstar's 6.7% risk premium conclusion to demonstrate the reasonableness of his own market risk premium estimates.

Using these inputs, Mr. Gorman's CAPM analysis produced estimated returns of 9.16% for the Water Group and 8.76% for the gas proxy group. Mr. Gorman gave greater weight to the high end of this range, first, because it was reasonably close to the results of his risk premium analysis and, second, because the beta for water utilities appears to be higher than that for the gas utility proxy group. Therefore, as a conservative estimate, Mr. Gorman opined that based on his CAPM study an ROE for Indiana-American in this proceeding would be 9.16%, rounded to 9.20%.

Based on all his cost of equity models, which ranged from 9.20% to 9.50%, Mr. Gorman recommended an overall ROE for Indiana-American of 9.40%, which is the mid-point of 9.35% rounded up. Mr. Gorman opined that with Indiana-American's proposed capital structure and his recommended ROE, Indiana-American's financial credit metrics are supportive of an investment grade bond rating.

Mr. Gorman next responded to Mr. Moul's recommended cost of common equity of 11.50%. He stated that Mr. Moul's use of adders in his various models is unreasonable and inflates his estimated return for Indiana-American. Mr. Gorman further testified that Mr. Moul's proposed ROE is excessive, and that with reasonable and appropriate adjustments to Mr. Moul's own analyses, his studies would support an ROE of 9.26%.

With respect to Mr. Moul's DCF analysis, Mr. Gorman stated that at a minimum Mr. Moul's proposed flotation cost and leverage adjustments should be rejected. Mr. Gorman opined that even with these adjustments removed, however, Mr. Moul's DCF result is inflated because it relies on a growth rate estimate of 7.00%, which is too high to be a reasonable estimate of long-term sustainable growth, and because Mr. Moul's yield adjustment to reflect quarterly compounding of dividend payments does not accurately estimate a utility's cost of capital.

Mr. Gorman stated that Mr. Moul's leverage adjustment is erroneous for several reasons. Mr. Gorman testified that Mr. Moul's contention that the adjustment should be made for differentials in financial risk, depending on a review of either book value or market value capital structure, is erroneous. Mr. Gorman explained that Mr. Moul's adjustment is flawed because he does not compare Indiana-American's market value capital structure to the market value capital structure of the Water Group, and that, therefore, there is no basis for Mr. Moul to conclude that Indiana-American's leverage is greater than the proxy companies based on market value capitalization. Mr. Gorman concluded that Mr. Moul's proposed leverage risk adjustment is unfounded. Mr. Gorman also pointed out that Mr. Moul's own risk comparison of Indiana-American to the Water Group shows that the book value capital structure risk of each proxy group company is reasonably comparable to the book value capital structure risk of Indiana-American.

Mr. Gorman disagreed with Mr. Moul's flotation cost adjustment because it does not clearly identify and provide recovery of prudent and reasonable cost expense incurred by Indiana-American. Mr. Gorman stated that the flotation cost adjustment should be rejected because it is not based on Indiana-American's actual and verifiable flotation expenses, but rather on other publicly traded companies' flotation expenses. Mr. Gorman concluded that there is no means to verify the reasonableness of the proposed flotation adjustment, nor the appropriateness of applying it to Indiana-American's rates, because Mr. Moul provided no evidence of the Company's actual flotation costs.

Mr. Gorman expressed concern with the growth estimate included in Mr. Moul's DCF estimate. He noted that Mr. Moul correctly places emphasis on the projected three- to five-year growth rates from I/B/E/S First Call, Zacks, Morningstar, and Value Line but stated that the 7.00% growth rate selected by Mr. Moul is unreasonable and substantially exceeds a rational outlook for a long-term sustainable growth rate for utility stock. Mr. Gorman emphasized that a constant growth rate DCF model, as used by Mr. Moul, requires a growth rate that can be sustained indefinitely. Mr. Gorman reiterated his belief that rational estimates of long-term sustainable growth rates cannot exceed GDP and stated that Mr. Moul's contrary belief is against the weight of academic, regulatory, and investment practitioner outlooks. Mr. Gorman argued that the 7.00% growth rate used by Mr. Moul, which exceeds the long-term projected GDP growth rate, cannot be sustained over the long-term. Mr. Gorman testified that a rational utility investor would not believe Mr. Moul's growth projections because they imply a utility can sustain growth rates that exceed the long-term growth of the economy in which it sells its services. Mr. Gorman stated that this is simply not rational.

Mr. Gorman rejected Mr. Moul's adjustment to the dividend yield to reflect quarterly compounding of dividends. Mr. Gorman explained it is not a cost to the utility and therefore compound return is not paid to the utility's investors. Mr. Gorman testified that only the utilty's cost of common equity capital should be included in the authorized rate of return. He further stated that if the dividend reinvestment return is included in the authorized ROE, then investors will actually receive the dividend reinvestment twice, once through the ROE, and a second time when dividends are received and reinvested.

Mr. Gorman stated that his primary issue with Mr. Moul's risk premium analysis is his equity risk premium of 5.50%, which Mr. Gorman opined is arbitrary and has not been shown to be appropriate for Indiana-American. Mr. Gorman stated that Mr. Moul's projection is not based on an independent assessment or market participation projection. Rather, Mr. Moul's projection is based on estimated returns over various periods between the S&P Public Utility Index and utility bond yields, which led Mr. Moul to conclude that the S&P Public Utility Index equity risk premium over prevailing utility bond yields was 6.23%. He then reduced that figure to 5.50% to derive an equity return for the Water Group. Mr. Gorman stated that the failure to rely on observable and verifiable market factors to adjust the equity risk premium eliminates the usefulness of Mr. Moul's risk premium estimate. Mr. Gorman testified, however, that if an appropriate equity risk premium for Indiana-American were used, Mr. Moul's analysis would produce a risk premium return in the range of 8.79% to 10.18%, with a midpoint of 9.48%.

Mr. Gorman expressed concerns with Mr. Moul's CAPM analysis similar to Mr. Moul's DCF model. Mr. Gorman did not agree with Mr. Moul's leverage adjustment, flotation cost adjustment, or "small size" adjustment. Mr. Gorman also stated that Mr. Moul's market risk premium of 6.86% is excessive. Mr. Gorman explained that Mr. Moul's size adjustment and his leverage adjustment to the beta should be rejected for a variety of reasons. Mr. Gorman testified the leverage adjustment was unnecessary because projections of leveraged risk are based on book value, not market leverage value. Further, Mr. Gorman testified that the beta adjustment ignores systemic risk factors that distinguish Indiana-American's systemic risk from that of the proxy group, and that Mr. Moul's application of the adjustment is erroneous. Mr. Gorman testified that Mr. Moul applies the leverage adjustment to the already adjusted Value Line beta, which makes Mr. Moul's further adjustment redundant and unreasonable.

Mr. Gorman also concluded that Mr. Moul's small size adjustment was flawed. Mr. Gorman stated that Mr. Moul's proposal relies on "mid-cap" deciles to adjust Indiana-American's ROE, but testified the Morningstar study used by Mr. Moul shows that companies in the mid-cap deciles have beta estimates of 1.13, which Mr. Gorman explained represented a significantly greater risk than the Water Group. Mr. Gorman testified the adjustment should, therefore, be rejected because it is not based on companies with comparable risk to Indiana-American.

With respect to Mr. Moul's market risk premium, Mr. Gorman testified that it was derived by averaging Mr. Moul's historical market risk premium with his prospective market risk premium of 7.37%. Mr. Gorman recommended rejecting Mr. Moul's prospective market risk premium because Mr. Moul did not provide any detail underlying his projected market return. Mr. Gorman updated Mr. Moul's CAPM analysis to remove the flawed adjustments and the prospective market risk premium and derived a CAPM return estimate of 9.45%.

Finally, Mr. Gorman responded to Mr. Moul's Comparable Earnings analysis. Mr. Gorman stated that Mr. Moul's analysis does not measure the appropriate return to use to ensure that Indiana-American is fairly compensated and that the ratepayers are not charged an excessive rate of return. Mr. Gorman also testified that Mr. Moul's analysis is not based on companies that have been shown to have risk comparable to that of Indiana-American, and that the book ROE cannot be considered a comparable "accounting" return appropriate to set Indiana-American's rates. Mr. Gorman noted that the companies used by Mr. Moul are non-regulated, and he opined that it is not reasonable to estimate an appropriate book ROE for Indiana-American from book ROEs for non-regulated companies in part because differences in regulatory accounting principles can produce higher book ROEs for regulated companies compared to non-regulated companies. In light of the problems with Mr. Moul's comparable earnings model, Mr. Gorman recommended that it should be disregarded.

(4) **Schererville's Position.** Town of Schererville witness, Mr. Theodore J. Sommer testified that Petitioner's ROE should be 9.75%. He explained that he believes an ROE of 9.75% would provide a reasonable and fair rate of return in the current proceedings. Mr. Sommer supported his opinion by comparing the Company's current proposal to its proposed ROE in its last three rate cases and to the ROE authorized by the Commission in those cases, which averaged 9.75%.

Mr. Sommer also pointed out that Indiana-American filed rate cases and received orders from the Commission in 2004, 2007, and 2010. He noted that the Company also sought and successfully implemented a DSIC in the fall of 2010. Mr. Sommer opined that the Commission should consider the frequency with which Petitioner seeks increased rate relief and also should consider the time period over which these current rates will likely be in effect. Mr. Sommer suggested that Petitioner's history indicates that the rates that flow from this particular proceeding will in reality only cover a very short window of time. Mr. Sommer further supported his ROE by pointing out a material drop has occurred in the cost of debt for Petitioner since its last rate case. This in turn suggests to Mr. Sommer that a drop in risk for this Petitioner has occurred, which would translate into a drop in the cost of equity.

(5) <u>Crown Point's Position</u>. Crown Point Witness, Mr. Gregory T. Guerrettaz, conducted DCF and CAPM analyses, and determined that 8.75% is a fair ROE for Petitioner. Mr. Guerrattaz testified that the cost of debt capital has substantially decreased since Petitioner's current 10% ROE was authorized, thus warranting an ROE lower than 10%. Mr. Guerrattaz noted that Petitioner's witnesses testified that Indiana-American has been able to reasonably attract capital from the market place at its current authorized ROE of 10%. Mr. Guerrattaz also explained that the supportive traditional regulation in Indiana, Petitioner's past successive base rate increases approximately every two years, and its ability to regularly adjust rates for significant transmission and distribution projects through the DSIC all help to protect and maintain cash flow and reduce risk. Next, Mr. Guerrattaz noted the attractiveness to investors of Petitioner's regulated water utility return and that American Water's equity enjoys a relative safe-haven-investment position during these turbulent, economic recessionary times.

Mr. Guerrettaz testified his proposed reduction in ROE from 10% to 8.75% is a reflection of the overall lower returns nationwide and the material decrease in the cost of debt. He noted that 10- and 30-year Treasury interest rates have declined by 1.78% and 1.54%, respectively, since Petitioner's last rate case and are projected to decrease further to 1.55% and 0.90%, respectively. He pointed out that reducing Petitioner's current ROE by the average of the historical and projected declines yields an ROE of 8.56%.

In addition, Mr. Guerrettaz relied on his application of DCF and CAPM analyses in reaching his proposed 8.75% ROE. Mr. Guerrettaz explained that his analysis differs from Mr. Moul's in that he has not included the leverage, flotation, and size adjustments in his cost of equity analysis. Mr. Guerrettaz used the same proxy group as Mr. Moul; however, Mr. Guerrettaz used a stable growth rate model in his DCF analysis while Mr. Moul used a two-stage growth model. Mr. Guerrettaz's DCF analysis concluded that the cost of equity ranged from 7.4% to 10.57%, with a simple average of 8.74%.

Mr. Guerrettaz also described his CAPM analysis. He pointed out that American Water enjoys a low financial assessment of risk, or beta, of .65, substantially below the average risk beta of 1.0. Mr. Guerrettaz's CAPM analysis employed the same betas as Mr. Moul. Mr. Guerrettaz explained that he gave weight to both the geometric and arithmetic mean risk premiums. His CAPM analysis yielded an arithmetic mean ROE of 7.93% and a geometric mean ROE of 6.75%. Mr. Guerrettaz concluded that an 8.75% ROE would be reasonable and would allow Petitioner to remain financially healthy.

(6) <u>Petitioner's Rebuttal</u>. In rebuttal, Mr. Moul testified that there is nothing in the testimony of Mr. Kaufman or Mr. Gorman that causes him to change his recommendation that the Commission find the Company's cost of common equity is 11.5%. Mr. Moul noted that both Mr. Kaufman and Mr. Gorman recommended an ROE that would be the lowest return by a significant margin of any state in which American Water will have continuing operations. He further stated that he is unaware of the Commission ever finding a cost of common equity for any public utility as low as the cost of common equity recommended by Mr. Kaufman in this case. He opined that if the Commission were to set the Company's cost of equity below 10%, the financial community would become extremely concerned because such a return level is not sufficient to sustain utility operations or attract capital at a reasonable cost. He stated that volatility experienced in the capital markets in recent months confirms that equity investments are still perceived as being extraordinarily risky. As a measure of stock market volatility, Mr. Moul referred to the Chicago Board Options Exchange Volatility Index, which showed an average from July 1, 2011, through October 17, 2011, of 36.53, which is similar to the average annual index during the financial crisis. Mr. Moul opined that this level of risk of common stocks does not support the extraordinarily low equity returns suggested by Messrs. Sommer, Gorman, and Kaufman.

Mr. Moul referred to the AUS Utility Report's tabulation of authorized returns for the water utility proxy group, which averaged 10.06%. He explained that returns below these levels would not fulfill investor expectations. He stated that Janney Montgomery Scott, a major investment firm that closely follows the water utility industry for investors, ranks water companies and their respective regulatory commissions. The Commission is rated at the middle of the states that receive scores on water issues from Janney Montgomery Scott, which uses the ROE granted in rate case decisions as the foremost category considered in its ranking system. In its scoring system, Janney Montgomery Scott uses a 10.25% baseline return for ranking commissions with points added or deducted for returns that vary from the base. Janney Montgomery Scott deducts the maximum points for returns below 9.5%. Mr. Moul stated that the returns proposed by Messrs. Kaufman and Gorman, if accepted by the Commission, would provide a signal to the investment community of unsupportive regulation for Indiana water utilities.

In response to Mr. Sommer's testimony that the Company's ROE should be reduced from the 10% set in the Company's last case, Mr. Moul stated that Mr. Sommer's "fairness" and "balancing of interests" arguments are subjective and are not a substitute for the returns necessary to retain capital in the Company and obtain new capital. Mr. Moul explained that the frequency of the Company's rate cases is dictated by its large capital expenditures and unless internally generated funds increase to match those expenditures, rate increases are a necessary consequence of large new capital infusions (both debt and equity) into the Company. With respect to Mr. Sommer's argument that the availability of the DSIC to the Company should reduce the ROE, Mr. Moul stated investors already factor in the benefits of DSIC into their return expectations, given that the DSIC mechanism is prevalent in the water utility industry.

Mr. Moul testified that there is some consensus among the experts concerning the group of water companies that could be used to measure the cost of equity. He noted that both Mr. Gorman and he used the same eight-company Water Group in their analyses. He further noted that Mr. Kaufman also used these same companies, but added, in some instances, Artesian Resources to his group. Mr. Moul opined that Artesian's two classes of common stock, one of which does not have voting rights, presents a highly unusual situation that warrants exclusion of Artesian from his Water Group. He also noted that Mr. Kaufman has segmented his water group, but that there is no need to do so. Mr. Moul disagreed with the exclusion of American Water from Mr. Kaufman's smaller four-company group, because the cost of equity for American Water is particularly relevant given that it is the parent company of Indiana-American. Mr. Moul stated that Mr. Gorman also submitted a secondary group of natural gas utilities, but that there is no need to consider gas companies as there are an adequate number of water companies.

Mr. Moul then described some of the limitations of the DCF models employed by Mr. Kaufman and Mr. Gorman. Mr. Moul stated that the "Gordon" form of the DCF model is not without its limitations because many of the assumptions that must be made to utilize this model are simply not realistic. These include constant and infinite growth and the assumption that earnings per share, dividends per share, book value per share, and price per share will all appreciate at the same constant rate absent any change in dividend payout and price-earnings multiple. He testified that the Gordon model does not account for, or reflect changes in, the variables that are common characteristics of the equity market. Indeed, according to Mr. Moul the evidence shows that these steady-state (i.e., constant growth) conditions represent unrealistic assumptions of investor expectations. Mr. Moul stated that this is shown by the dividend payout ratios calculated from the forecasts by Value Line for the water companies, which are forecast to decline in the future. Mr. Moul opined that with the forecasted trend of lower payout ratios, the use of dividend growth by Mr. Kaufman is particularly inappropriate for DCF purposes. As to the issue of book value per share growth, which Mr. Kaufman also presents, stocks do not trade at a constant market-to-book-ratio, thereby limiting the usefulness of this measure of growth.

Mr. Moul next discussed the financial variables that should be given the greatest weight when assessing investor expectations. Mr. Moul stated that he agreed generally with the Commission's preference for considering a variety of sources in the development of the DCF growth rate and that he has presented all of the variables that the Commission enumerated in the 2002 Rate Order. However, Mr. Moul believed that there is no justification for giving each of these variables equal weight. Mr. Moul testified that if a specific variable must be emphasized, then it is necessary to substantiate the reason for giving additional emphasis to that variable. He noted that the theory of DCF indicates that the value of a firm's equity (i.e., its share price) will grow at the same rate as earnings per share. Hence, the theory of DCF indicates earnings growth should be emphasized. Mr. Moul stated that dividends per share growth should not be emphasized because the payout ratios for the water companies are forecasted to decline. He also stated that book value cannot be emphasized because market-to-book ratios do not remain constant. Retention growth would likewise be inappropriate because it merely provides the individual components that cause book value per share to change. Therefore, Mr. Moul testified that in order to reflect investor expectations within the limitations of the DCF model, earnings per share growth, which is the basis of capital gains yield and the source of dividend payments, must be given primary emphasis.

Mr. Moul recognized that Mr. Kaufman removed negative rates from his growth analysis, but stated that Mr. Kaufman's mechanical averaging of the remaining growth rates does not conform to the specification of the DCF model he discussed previously. Mr. Moul opined that Mr. Kaufman has been inconsistent in his selection of variables in his DCF growth analysis. For example, Mr. Kaufman's constant growth form of the DCF model used earnings per share, dividends per share, and book value per share and gave each variable one-third weight. Yet when selecting his first-stage growth rate in his two-stage DCF, Mr. Kaufman used only earnings per share growth, thereby giving it 100% weight. Likewise, Mr. Kaufman gave one-half weight to historical growth in his constant growth DCF model, but gave 0% weight to historical growth in the first-stage growth rate of his two-stage DCF model. Mr. Moul stated that it must be recognized that in developing a forecast of future earnings growth an analyst would first apprise himself/herself of the historical performance of a company. Hence, there is no need to count historical growth rates a second time, because historical performance is already reflected in analysts' forecasts, which reflect an assessment of how the future will diverge from historical performance.

Mr. Moul testified that Mr. Kaufman's 5.17% growth rate for the Value Line group is much too low. Mr. Moul stated that Mr. Kaufman failed to acknowledge that the magnitude of the growth rates cannot be assessed in isolation, but rather must be viewed in the context of the dividend yields because investors' expectation of growth must by synchronized with the price that is used for the dividend yield calculation. He noted that the fundamentals for water companies are different today than they were in 2003, when the NRRI article relied on by Mr. Kaufman was published. Mr. Kaufman also cited to the position of Steven G. Kihm that public utilities will grow significantly less than the economy as a whole. Mr. Moul asserted that this assumption is unrealistic because if Mr. Kaufman were correct, then the contribution of public utilities to growth in the overall GDP would continually decline, yet Mr. Moul was aware of no evidence supporting that notion. In fact, Mr. Moul stated that the evidence is to the contrary, indicating that utilities have contributed a relatively stable percentage relative to all industries to the GDP. This means that long-term growth for utilities cannot be significantly smaller than the growth of other corporations. Mr. Moul therefore concluded that it is unrealistic to believe that second-stage growth for utilities is capped at the GDP growth rate.

Mr. Moul next discussed Mr. Kaufman's two-stage DCF model. Mr. Moul stated that Mr. Kaufman's claim that the forecast growth rates in DCF models are unreasonably high disregards the information that is actually being used by investors in making their investment decisions. He also noted that Mr. Kaufman's criticism of analysts' forecasts is inconsistent with his presentation of analysts' forecasts in his DCF analysis. Mr. Moul opined that what is important is what investors actually use in their decisions regarding the purchase, sale or holding of stocks. The bottom line, according to Mr. Moul, is that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF model to have any meaning as a representation of investors' required returns. Otherwise, the DCF result will be mis-specified, which is the case with Mr. Kaufman's result.

Mr. Moul explained that Mr. Kaufman's two-stage model adds complexity to the DCF and opens its application to further manipulation. He stated that Mr. Kaufman has understated the first-stage growth rate and that by including the Zacks forecasts, which Mr. Kaufman employed in the Company's prior rate case but omitted in this case without justification, the first stage growth rate is 6.31%. Mr. Moul asserted that use of a second-stage growth rate based on GDP is inappropriate in this case. Using the 6.31% first stage growth and 5.7% forecast growth in corporate profits (discussed below in response to Mr. Gorman's multi-stage DCF), Mr. Moul calculated a two-stage DCF result for Mr. Kaufman's inputs of 9.38%. Using Mr. Moul's 7.0% growth rate, the result is 9.53%. Both of these results are significantly higher than the 8.50% and 8.71% that Mr. Kaufman calculated.

Mr. Moul next discussed Mr. Kaufman's CAPM analysis. He stated that Mr. Kaufman presents a variety of CAPM calculations that are simply not credible because they provide returns that are either lower than or nearly equal to the cost of the Company's debt. Mr. Moul opined that any cost of equity calculation that provides a result that nearly equals the yield on a public utility bond is unreliable. Mr. Moul agreed that the Value Line betas used by Mr. Kaufman can be used as a starting point in the analysis, but maintained that they must be unlevered and re-levered for the same reasons indicated with regard to the DCF, i.e., for the leverage difference between the market and book value capitalization. Mr. Moul stated that the Hamada formula that he used to leverage-adjust the betas is merely an extension of the Modigliani and Miller formula that he used in the DCF calculation.

Mr. Moul stated that the arithmetic mean should be used to the exclusion of the geometric mean in the CAPM, and that the theory of the CAPM requires this choice. He testified that the arithmetic mean provides the correct representation of all probable outcomes and has a measurable variance, unlike the geometric mean used by Mr. Kaufman which consists merely of a rate of return taken from two data points. Mr. Moul stated that, contrary to Mr. Kaufman's testimony, the Ibbotson Yearbook carefully explains the rationale for using the arithmetic means in a single period model, such as the CAPM. Mr. Moul stated that there is no relevance to Mr. Kaufman's reference to a twenty-five-year-old article that does not even discuss the CAPM because the current Ibbotson Yearbook is very clear on this point. Mr. Moul opined that because the geometric mean does not fulfill any role in determining the market premium component of the CAPM, it certainly should not be given 50% weight but rather should be discounted to the greatest extent possible.

Mr. Moul criticized Mr. Kaufman's use of a constant 5.25% market premium in relation to Treasury bond yields as being well off the mark. When combined with Mr. Kaufman's risk-free rates of return, Mr. Kaufman has postulated total market return of 9.2% to 9.4%. Mr. Moul opined that a 9.2% to 9.4% overall return for the market is unreasonable given that it is less than or equal to the DCF return that Mr. Kaufman calculates for his AUS water proxy group which is less risky than the total market.

Mr. Moul then defended his adjustment to the CAPM to compensate for the risk associated with small size. He stated that Mr. Kaufman's arguments revolve around a statement by the Commission in a 1997 sewer rate case and articles published in 1999 and 1993. As to the Commission order, Mr. Moul indicated that it seemed troubled by the large 400 basis point size adjustment. In this case, Mr. Moul used a 1.20% midcap size adjustment, even though a larger 1.98% low cap adjustment was justified. He believed that his conservative approach to the size adjustment satisfies the Commission's concerns in the sewer case Mr. Kaufman cites, as well as the 1999 article. As to Mr. Kaufman's reliance on the 1993 *Wong* article, Mr. Moul noted that the article employed data going back into the 1960s. Mr. Moul stated that enormous changes have occurred in the utility industry since the 1960s that have fundamentally changed the utility business. Mr. Moul opined that the conclusions in the *Wong* article do not invalidate the additional risk associated with small size. Moreover, Mr. Moul pointed out that the Wong article erroneously used betas to reach its conclusion because beta is not designed to measure the influence of size on a company's risk.

Mr. Moul then responded to Mr. Kaufman's criticism of the risk premium approach and in particular Mr. Moul's use of median values and arithmetic means. He testified that medians are a well accepted measure of central tendency that can be found in any basic statistics textbook. He noted that Mr. Gorman correctly used the arithmetic mean in his application of the CAPM.

Mr. Moul defended his Comparable Earnings approach, stating that the Comparable Earnings approach satisfies the comparability standard established in the *Bluefield* decision and reflects the view of the financial community that the regulatory process must consider the returns that are being achieved in the non-regulated sector to ensure that regulated companies can effectively compete in the capital markets.

Mr. Moul responded to Mr. Gorman's testimony. He stated that he had some of the same issues that he discussed concerning the testimony of Mr. Kaufman, such as ignoring the element of flotation costs, the adjustment that is necessary to make the DCF cost rate applicable in the rate-setting context, and the size adjustment to the CAPM. He first addressed Mr. Gorman's testimony that American Water's bond rating is a reasonable proxy for Indiana-American's bond rating and that American Water is a reasonable risk proxy for Indiana-American. Mr. Moul explained that Indiana-American's interest coverage ratios are significantly below those of the companies in the proxy group and lower interest coverage ratios make a company's debt riskier. He explained that since debt instruments are more secure than equity, the fact that Indiana-American has lower interest coverage ratios means that its cost of equity is necessarily higher. He stated that although Indiana-American may be able to access the debt markets through American Water at cheaper rates than it would attract on its own, this does not mean that Indiana-American's risk is equal to that of American Water. Mr. Moul disagreed that Indiana-American has a higher interest coverage ratio than the proxy group.

Mr. Moul responded to Mr. Gorman's conclusion that Indiana-American's customers should receive the benefits of American Water's larger size due to their affiliation with American Water. He stated that the economies of scale provided by American Water Works Service Company, Inc. (the "Service Company") would suggest that services obtained from the Service Company would be available at lower costs to Indiana-American, and that an enhanced level of expertise is available from the Service Company. Accordingly, Mr. Moul disputed Mr. Gorman's assertion that without adjusting the cost of equity, customers do not receive the benefits of the American Water affiliation although they pay the costs.

Mr. Moul stated that Mr. Gorman's DCF results in several instances that are simply not credible. For example, he indicated that DCF results of *negative* 1.16% for Middlesex Water cannot possibly provide a reliable measure of its cost of equity. In addition, the numerous DCF returns below 9% shown on Industrial Group Exhibit MPG-5 are outside the range of reasonable returns. Mr. Moul testified that Mr. Gorman's use of a two-stage DCF approach essentially contradicts Mr. Gorman's own testimony, and depresses his DCF results by approximately two percentage points (e.g., 10.77% to 8.96%) for the Water Group. Mr. Moul disagreed with Mr. Gorman's concerns about analysts' forecasts and the results of his constant growth DCF model. Mr. Moul reiterated that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF model to have any meaning as a representation of investors' required returns. Mr. Moul testified that Mr. Gorman's sustainable growth form of the DCF does not provide a reasonable cost of equity in this case. He stated that there are serious limitations in this approach. Mr. Moul opined that book value per share growth, or its surrogate retention growth, does not represent the proper financial variable to be considered when selecting the DCF growth component because utility stocks do not typically trade at book value.

Mr. Moul stated that there are specific problems with the sustainable growth method proposed by Mr. Gorman. He observed that Mr. Gorman's input values were taken from Value Line reports and represent forecasts covering the period 2014-2016. Thus, Mr. Gorman's projections are for a very specific period and have not been shown to be sustainable beyond that point. Further, Mr. Gorman's approach to sustainable growth ignores investors' expectations for 2011-2013 and the growth that will occur during that period. Mr. Moul commented on Mr. Gorman's assertion that analysts' growth rates for water companies are abnormally high. He stated that there are several reasons that explain the current analysts' growth forecasts for water utilities and that growth rates cannot be viewed in a vacuum. Mr. Moul explained that high growth stocks often have low dividend yields and vice versa and that the combination of growth and yield, which is determined from the price, provides the DCF cost of common equity rate.

Mr. Moul stated that there are objective measures that could be used to determine whether or not to employ a two-stage DCF. He explained that FERC has set forth specific criteria to be applied when deciding whether to employ the two-stage DCF model: (i) a dividend payout ratios analysis; (ii) an assessment of electric utilities relative to other industries; and (iii) whether analysts' forecasts were two to three times greater than GDP growth. Mr. Moul found that the dividend payout ratios of the water utilities do not approach the 20%-30% levels for other, mostly non-regulated industrial companies, where the two-step DCF model has been used. Thus, based on criteria employed by FERC, Mr. Moul stated that application of a two-stage growth rate in the DCF analysis is unsupported.

With respect to the technical aspects of Mr. Gorman's proposed two-stage DCF, Mr. Moul again criticized his assumption of a 200-year investment horizon. Mr. Moul testified that when the FERC uses a two-stage DCF model for natural gas pipelines, it weighs the analysts' growth rate (i.e., first-stage growth) two-thirds (66.7%) and second-stage growth one-third (33.3%) in the case of corporations. Additionally, FERC's application of the two-stage model removes the additional complexity that exists by inserting, as Mr. Gorman did, transitional growth for years 6 through 10. Mr. Moul stated that if Mr. Gorman had employed FERC's methodology, his two-stage DCF result would be 11.06%, after removing the anomalous results for Middlesex Water.

Mr. Moul expressed his concerns regarding the CAPM application by Mr. Gorman. He stated that Mr. Gorman properly used the arithmetic mean market premium of 6.7% from the Morningstar study, but then neglected to incorporate forecasts of market returns in the development of his market premium. Mr. Moul testified that forecasts of market returns are necessary to comply with the "ex ante" specification of the CAPM, as market models of the cost of equity are a reflection of the forward-looking nature of investor return expectations. Mr. Moul noted that those returns average 15.56%, thus producing a market premium of 11.36%, which is considerably higher than the 6.7% or the alternative 6.5% market premiums used by Mr. Gorman.

Mr. Moul next commented on Mr. Gorman's risk premium approach. He opined that, for a variety of reasons, this type of risk premium study provides only limited evidence of the cost of equity. He observed that the historical periods selected by Mr. Gorman are arbitrary, and that by shortening his time period progressively higher risk premiums would result when using the yields on Treasury bonds and utility bonds. For example, Mr. Moul stated that the five year average 2007 through 2011 period, and the ten-year average 2002 through 2011 period indicates that the risk premium would be higher than Mr. Gorman's averages. He pointed out that this type of risk premium study also mixes "authorized gas returns" on book value with market-determined yields based on Treasury bonds and utility bonds, and thus employs non-comparable variables and does not provide a reliable measure of the risk premium. Mr. Moul testified that there is a potential for mismatch of time frames between Mr. Gorman's tabulation of the "authorized gas returns" and the yield on Treasury bonds and utility bonds. He explained that this failure arises because there is a time lag between the development of the evidentiary record in a rate case proceeding and the issuance of an order by a regulatory agency, unlike the yield on Treasury bonds and utility bonds, which are measured after-the-fact.

Mr. Moul also testified that there is no telling how the "authorized gas returns" may have been influenced by regulatory policy or political factors. He explained that a regulatory agency may employ the "authorized gas returns" as a tool to reflect policy decisions in other rate-setting areas such as interim rates, rates collected subject to refund, use of historical or future test periods, use of average or year-end rate bases, various procedures to calculate depreciation, allowances or disallowances of certain operating costs, and a host of other regulatory practices. Moreover, Mr. Moul asserted that it is well known that regulatory agencies have used the "authorized gas returns" as a means of accomplishing certain goals, such as rewarding or penalizing management performance, and thus it is impossible to determine whether these "authorized gas returns" in fact represent investor-required returns for the time periods in which those decisions were rendered. Given all of the unknown factors that influence "authorized gas returns," he opined that Mr. Gorman's approach employs an unsuitable benchmark to measure the equity risk premium. Using the yields on utility bonds and Treasury bonds proposed by Mr. Gorman, Mr. Moul stated that the cost of equity would be 10.01%.

Mr. Moul noted that Mr. Gorman's CAPM analysis also failed to include the flotation cost adjustment and neglected to adjust the beta for the financial risk adjustment associated with the differences in market capitalization and book value capitalization. He stated that the beta used by Mr. Gorman was taken directly from Value Line without the necessary modification to synchronize it with the book value capitalization. He further stated that Mr. Gorman failed to include the size adjustment, which is indicated to be 1.20% and would bring his CAPM result to 10.59% with flotation costs.

Petitioner's witness James I. Warren, a tax partner in the law firm of Winston & Strawn, LLP, responded to Mr. Kaufman's characterization of Petitioner's income tax position and the impact, if any, on the cost of equity. He first disputed that Petitioner's position is unique, given the advent of bonus depreciation and the change in method most utilities have elected with regard to the repairs deduction. He then clarified that the income tax position impacts the overall cost of capital, and that this impact is fully reflected in the capital structure by including deferred taxes at zero cost. He explained that to suggest that it also impacts the cost of equity is to double-count deferred taxes.

Mr. DeBoy testified that Petitioner must increase the replacement rate of its distribution system. The current rate of replacement (0.7% which calculates to a lifespan of 143 years) is beyond the expected useful life of water mains. He testified that it is critical the Commission approve a reasonable ROE because the Commission's finding will be applicable in future DSIC filings.

(7) **Commission Discussion and Findings.** The record contains a number of different methods of estimating Petitioner's cost of common equity, resulting in cost of equity recommendations ranging from 8.60% to 11.50%, with an average of 9.60%. We recognize the cost of common equity cannot be precisely calculated and estimating it requires the use of judgment. Due to this lack of precision, the use of multiple methods is desirable because no single method will produce the most reasonable result under all conditions and circumstances.

In the 2010 Rate Order, the Commission concluded Indiana-American's cost of equity was 10.00%. 2010 Ind. PUC LEXIS 155, at *145. Yields on 30-year U.S. Treasury bonds began falling just prior to the 2010 Rate Order, from a high of 4.84% in April 2010 to a low of 3.53% in August 2010. Since then, yields steadily climbed to 4.76% in February 2011, but began to fall after S&P downgraded U.S. sovereign debt. The Commission questioned Mr. Moul regarding the Treasury yield, and he indicated that Treasury yields have declined since his initial testimony and have remained around 3%. As Mr. Gorman pointed out, a similar downward trend has occurred for "A" and "Baa" utility bonds: yields on "A" bonds have decreased 1.02% and yields on "Baa" bonds have decreased 0.88% from April 2010 to September 2011. While not an exact correlation, there is a positive relationship between cost of equity and interest rates. Based on the general downward trend since Petitioner's last rate case, the Commission believes it would be unreasonable to find that Petitioner's cost of equity is higher than 10%.

Similarly to his analysis in Cause No. 43680, Mr. Moul's analysis here suffers from the use of an unusually high growth rate (7.00%) and a high market premium (6.86%). In addition, Mr. Moul's analyses used leverage adjustments, flotation cost adjustments, and small company adjustments. In Cause No. 43680, we found that these adjustments were inappropriate, and we reiterate that finding here. For example, in the 2010 Rate Order, when discussing flotation costs we stated: "The Commission will only allow such an adjustment when it is based on verifiable actual costs so that the reasonableness and appropriateness of the costs may be examined." 2010 Ind. PUC LEXIS 155, at *140. In this Cause, Petitioner again did not produce evidence of actual costs. In fact, Mr. Moul stated these costs are not traceable because the costs are not pushed down to the subsidiaries when American Water issues equity.

However, the Commission agrees with Mr. Moul that in this Cause the market-based models such as CAPM and risk premium produced unusually low results. For example, using a risk free rate of 4.00%, a beta of 0.74, and an equity risk premium of 5.25% yields a cost of equity of 7.89% in the CAPM, which is too low to be reasonable. Similarly, the risk premium model using a current yield on "A" rated utility bonds of 4.55% and the equity risk premium of 3.95%, produces a cost of equity of 8.50%, which is also too low to be reasonable.

With respect to DCF analyses, the Commission has considerable experience with the DCF model for estimating the cost of equity, and is well aware of the advantages and limitations of the various approaches used by each of the witnesses. The Commission believes that both historical and forecasted earnings and dividends and book value per share data are useful when employing the DCF model. Petitioner's DCF analysis yielded an average cost of equity, when the leverage and flotation cost adjustments are removed, of 10.42%: Mr. Kaufman's range was 8.4% to 9.45%, with an average of 8.925%: Mr. Gorman's average was 9.5%: Mr. Guerrettaz's average was 8.74%.

When comparing the Parties' ROE proposals from Cause No. 43680 to those in this Cause, each of the Parties has proposed a lower cost of equity than in Cause No. 43680: Indiana-American – 0.5%; Schererville – 0.25%; Industrial Group – 0.5%; OUCC – 0.65%. In addition, Indiana-American's cost of debt has declined by 0.44% from 6.96% in Cause No. 43680 to 6.52% in this Cause. As a result, we believe that a decrease in Petitioner's ROE from the 10% authorized in the 2010 Rate Order, is warranted. Based on our discussion above, the Commission finds that a reasonable range for Petitioner's cost of equity is 9.50% to 10.00%, and we conclude that a 9.70% ROE equity is fair and reasonable.

B. Deferred Taxes.

(1) OUCC's Position. Mr. Ralph Smith, Senior Regulatory Consultant at Larkin & Associates, testified on income tax issues for the OUCC. Mr. Smith noted that American Water implemented a major tax accounting change for repairs deductions on its federal income tax return for tax year 2008, which affected Indiana-American by reducing its federal taxable income. Mr. Smith noted the decrease in taxable income reduced the Company's current taxes payable while increasing deferred income tax expense and the accumulated deferred income tax ("ADIT") liability. Mr. Smith explained that the increase in the Company's accumulated deferred income tax liability represents an increase to the ADIT component of the capital structure. However, the total income tax expense remained unchanged. The increase in deferred income tax expense is debited to deferred income tax expense and credited to ADIT, which is a balance sheet liability account. Mr. Smith explained that, for ratemaking purposes, the ADIT balance is treated as a component of non-investor supplied funds (similar to a government non-interest bearing grant) and is reflected at zero cost in the capital structure. Mr. Smith's testimony indicated that on Petitioner's 2008 federal income tax return, substantial amounts of income tax savings were realized by claiming repairs deductions using the new tax accounting method. He added that the actual income tax savings realized by the Company from the repairs deduction tax accounting method change represents a source of capital to the Company and should therefore be reflected in the capital structure.

Mr. Smith noted that Indiana-American's response to OUCC Data Request 43-017 stated the total amount of repairs deductions claimed by the Company on its 2008 through 2010 tax returns was $79,322,471. Mr. Smith argues, however, that Indiana-American's evidence does not fully reflect the normalized amount of tax savings resulting from the repairs deductions. Mr. Smith stated that the ADIT balance proposed by the Company is understated by approximately $9.247 million.

Pursuant to Financial Accounting Standards Board Interpretation No. 48 ("FIN 48"), Petitioner evaluated its uncertain tax position and established a liability under FIN 48 for financial reporting purposes. Mr. Smith noted that during the test year, the Company accrued relatively small amounts of interest on its uncertain income tax positions – $13,044 for 2009 and

$19,408 for 2010. The FIN 48 interest is for accrual accounting only and has not been paid. The FIN 48 interest represents the net carrying costs that Indiana-American recorded in those years for the portion of the repairs deductions under the new tax accounting method that it views as an uncertain tax position.

Mr. Smith explained that the FIN 48 account balance should either be treated as zero cost capital or as capital with interest associated with it, and, if the latter, the best measurement of that interest cost is the FIN 48 interest that the Company has actually recorded on its books. Mr. Smith testified that treating the FIN 48 balance as zero cost capital is consistent with the Company's financial accounting for it, where the Company is required under Generally Accepted Accounting Principles ("GAAP") to record interest expense on the FIN 48 liability if it believes that it's going to be subject to an interest assessment by the IRS.

Based on information Petitioner provided in discovery, Mr. Smith estimated the FIN 48 liability on June 30, 2011 to be $9.247 million and he recommended that this amount be included in Petitioner's capital structure at zero cost, or, alternatively, with a cost based on the related FIN 48 interest that has been recorded by the Company during the test year. He testified that this Commission has not adopted FIN 48 for regulatory purposes and that the Commission should decline to do so now as this would unnecessarily increase utility rates by failing to fully reflect deferred income taxes for the actual tax benefits that have been claimed on the tax returns. He testified that the Company has not paid taxes with respect to the FIN 48 amounts and has benefited from these uncertain tax positions. As a result, the tax savings realized from the uncertain tax positions should be viewed similarly to a grant from the federal and state government. If the uncertain tax positions ultimately are resolved in the Company's favor, it will have had the use of this money at zero cost. If the position is ultimately disallowed, Mr. Smith testified that the Company will have to pay the taxes with interest. He also testified that it is likely the ultimate outcome of the uncertain tax position will be resolved somewhere in the middle, where the Company will have the use of part of the savings but not all. He explained that under no scenario would it be fair or appropriate to charge ratepayers the overall rate of return by failing to reflect the significant source of funds as additional ADIT or non-investor provided capital in the capital structure.

(2) <u>Petitioner's Rebuttal</u>. Mr. James Warren testified in rebuttal to Mr. Smith's proposed FIN 48 adjustment to the capital structure. He provided a summary of tax normalization and the timing differences that cause income tax expense for accounting purposes to differ from income taxes paid in any given year as reported on the tax return. He described the difference between two types of government loans made through the tax code. The first type is an ADIT cost-free loan and the second is a non-cost-free non-ADIT loan. The ADIT loan is what results from the timing differences inherent in normalization. The utility claims accelerated depreciation on its tax return and, by virtue of that fact, reduces its tax liability. The reduction in the utility's tax liability gives rise to the ADIT loan. Mr. Warren testified that, indeed, the Congressional purpose in enacting accelerated depreciation was to extend ADIT loans to businesses. The repayment of the loan is accomplished by filing future tax returns that reflect incremental taxable income because there is less tax depreciation. Because the loan is repaid to the government by the filing of future tax returns, there is no interest associated with it. It remains interest free as long as it is outstanding and this is the reason why deferred taxes are reflected in the capital structure at zero cost. He described the non-ADIT loan as arising when the utility claims a deduction on the tax return to which it ultimately is not entitled. In that event, the deduction will reduce its tax liability for that particular year and thereby creates a government loan. Once the deduction is disallowed, the utility will have to pay back the loan immediately with interest. This second type of loan is not a part of a Congressional subsidization scheme. Interest will accrue from the date the utility files its tax return. There is no period during which such a loan is interest-free.

Mr. Warren explained that the purpose of FIN 48 is to make order out of chaos. FIN 48 prescribes the way in which companies must analyze, quantify, and display the consequences of tax positions that are technically uncertain. The tax law is exceedingly complex and contains many provisions that are subject to more than one interpretation, and business transactions can frequently be viewed in more than one way. FIN 48 prescribes a single standard, a single process, and a single disclosure regimen for uncertain tax positions taken by a taxpayer. The taxpayer must identify all of its "tax positions," and must evaluate the degree of uncertainty of each one. The evaluation process is extremely rigorous and results in a determination of the amount of tax that more likely than not must be paid to taxing authorities in connection with uncertain tax positions. FIN 48 does not permit this amount to be reflected as ADIT. In short, the FIN 48 amount represents the incremental quantity of tax that the Company and its auditors have concluded will most likely be owed with respect to previously filed tax returns. These amounts will be payable with interest when they are assessed if the tax position is ultimately disallowed by the IRS.

Mr. Warren testified that all companies with publicly traded securities must comply with FIN 48. Because of the adverse earnings implications of designating amounts as FIN 48 amounts, no company has an incentive to designate a larger FIN 48 amount than FIN 48 requires. He testified that a FIN 48 balance represents amounts that experts have determined will likely have to be paid to the taxing authorities with interest and should not be reflected as ADIT. Otherwise, ratepayers will see a reduction in the weighted overall cost of capital that the FIN 48 process has concluded is neither real nor sustainable. He testified that while admittedly it is not absolutely certain that all of the loans identified as FIN 48 amounts will be payable, it is even less likely that those loans will be interest-free.

Mr. Warren testified that the Commission should encourage the Company to take uncertain tax positions because if, contrary to the expectations of the experts, the Company is able to prevail in the assertion of an uncertain tax position, at that point the loan would be characterized as an ADIT loan and customers would enjoy incremental zero-cost capital in the next rate proceeding. Consequently, it is in the customers' best interests for the Commission to encourage such positions. Mr. Warren also took issue with the amount of the FIN 48 balance reflected by Mr. Smith. He testified that the FIN 48 balance at the end of 2010 was estimated at that time, and it was subsequently trued-up to reflect the tax returns as filed for 2008 and 2009. The corrected amount was $6.7 million. He also explained that because the Company has a net operating loss carryover ("NOLC"), some portion of the uncertain deduction claimed on the Company's tax return did not produce any cash – those deductions merely increased the NOLC. The Company recorded this failure to actually defer any tax as a debit in its ADIT account. The amount of the debit was $0.75 million. He testified that the current FIN 48 balance should be $5.95 million.

(3) **Commission Discussion and Findings.** To fully understand the FIN 48 issue it is important to review normalization tax accounting. Timing differences between financial reporting and tax accounting, such as those created by accelerated depreciation and the repairs method change, are normalized for ratemaking purposes and the difference held (either as a credit or debit) in ADIT as zero cost capital. In the Muncie Remand Order, the Commission defined "permanent differences" as differences (such as income from government securities, which is exempt from federal tax) "applicable to a given tax period whose tax consequences will never reverse over time." 1981 Ind. PUC LEXIS 246, at *14. The Commission defined "timing differences" as differences (such as accelerated depreciation) "applicable to a given tax period but whose tax consequences will reverse themselves in subsequent tax periods." *Id.*

The Commission went on to state:

> The concept or principle which recognizes and accounts for the timing differences between the periods in which transactions affect taxable income and the periods in which such transactions affect the determination of pre-tax book income is known as comprehensive inter-period tax allocation, or commonly referred to as "normalization", and is a form of accrual accounting by which the tax expense liability is recorded in the proper taxable period even though actual cash payment therefor will not occur until later taxable periods.
>
> The difference between such amount of tax expense liability recorded and actual cash tax payments for any given taxable period results from timing difference adjustments, such as accelerated depreciation, to taxable income and the deduction of investment tax credits.
>
> The use of timing difference adjustments, such as accelerated depreciation, to taxable income reduces the actual tax liability for any given taxable period, but such reduction is not of a permanent nature so as to result in a tax avoidance or permanent tax "savings." In subsequent taxable periods, over the life of the capital asset which was the basis for such timing difference adjustments, the actual tax liability will increase due to the lesser amount available as a tax deductible expense.
>
> When the tax consequences of such timing difference adjustments are "normalized", for rate-making purposes, the difference between the actual tax liability, taking advantage of such adjustments, and the larger amount of what the tax liability would have been without such adjustments is deferred and recorded in deferred tax reserve accounts. Thereby, the deduction of expenses to determine income tax expense, for rate-making purposes, is as if the timing difference adjustments to taxable income had not been made. In later years, over the life of the asset, when the deduction to taxable income decreases due to the larger deduction in the earlier years of the asset, a proportionate amount of the deferred tax reserve, attributable to the capital asset, is applied so as to reduce the recorded tax expense liability for rate-making purposes.

* * * *

> The use of normalization accounting principles permits an entity to equalize the tax consequences resulting from timing difference adjustments, such as accelerated depreciation, to taxable income and investment tax credits, associated with capital assets, over the useful life of the assets, and consequently, when such normalization is utilized for rate-making purposes, the present and future utility customers share such tax consequences equally over the life of the assets that are used to provide the utility service.

Id., at *15-19. Both of the expert tax witnesses in this proceeding were in agreement that normalization is the appropriate regulatory treatment of timing tax differences such as those that are created by accelerated depreciation and the repairs method change.

With that background, we now address the ratemaking treatment for the FIN 48 balance, which represents the "uncertain" portion of the repairs deductions taken by the Company. In 2008, the Company changed its tax accounting method for repairs. For the test year, the only "uncertain" tax position, and the only item for which Indiana-American has recorded a FIN 48 reserve, is for repairs deductions. According to Petitioner's accounting records, the FIN 48 balance on December 31, 2010 was $9.449 million.

Petitioner asserts that the "uncertain" portion of its repairs deductions should have no effect on its regulatory capital structure. The OUCC argues that repairs deductions result in non-investor supplied capital that should be recognized in the capital structure either as zero cost capital (similar to other ADIT) or as a form of non-investor supplied capital that requires an interest cost.

The money resulting from the lower income taxes that resulted from the repairs deductions claimed by the Company is available for any use to which the Company wants to put it, and is therefore similar to other sources of non-investor supplied capital. Ignoring this source of non-investor supplied capital altogether as Indiana-American advocates is not reasonable. Reflecting the full impact of the repairs deductions, including the "uncertain" portion as non-investor supplied capital is reasonable since the Company has the use of that money and can use it for any use that it wishes.

We conclude that the balance of Indiana-American's FIN 48 account on December 31, 2010, $9,448,727, shall be included in its weighted cost of capital.

C. **Overall Weighted Cost of Capital.** Based on these findings and after giving effect to the ROE we authorized above, we find that Petitioner's capital structure and weighted cost of capital is as follows:

Description	Amount	Percent Of Total	Cost Rate	Weighted Cost
Long Term Debt	$ 313,596,520	43.77%	6.52%	2.86%
Common Equity	301,014,743	42.01%	9.70%	4.08%
Preferred Stock	210,000	0.03%	6.00%	0.00%
Post Retirement Benefits, net	2,513,672	0.35%	0.00%	0.00%
Deferred Income Taxes	88,314,099	12.33%	0.00%	0.00%
FIN 48 Liability	9,448,727	1.32%	0.00%	0.00%
Job Development ITC-Post 1970	1,247,384	0.17%	8.08%	0.01%
Deferred ITC-Pre 1971	36,633	0.01%	0.00%	0.00%
Accum. Depreciation-Muncie Sewer	62,889	0.01%	0.00%	0.00%
Total	**$ 716,444,667**	**100.00%**		**6.95%**

D. Fair Rate of Return and Net Operating Income.

(1) Petitioner's Position. Mr. Moul provided an analysis by which the Commission can derive a fair return on fair value based on the Commission's procedure in Cause No. 43624 where we reduced the cost of equity by the prospective rate of inflation that is reflected in the cost of equity. Mr. Moul reduced the Company's 11.50% cost of equity by a prospective rate of inflation of 2.35% based on the difference between the nominal yield on 20-year Treasury bonds and the corresponding yield on inflation-indexed Treasury bonds having a similar maturity. A rate of return of 6.80% is indicated when the cost of equity is adjusted for prospective inflation and Mr. Moul opined that a return of 6.80% on the Company's fair value rate base would be fair and reasonable.

Mr. VerDouw explained how the Company arrived at its proposed net operating income. Consistent with how this Commission has dealt with the acquisition adjustment resulting from the acquisition of Indiana Cities Water Corp. ("Indiana Cities AA"), Mr. VerDouw computed a net original cost return based on the weighted cost of capital, and to that he added a fair value increment derived from applying the weighted cost of capital to the remaining unamortized balance of the Indiana Cities AA. This produced a requested authorized net operating income of $57,969,265. Mr. VerDouw then conducted reasonableness tests as applied to the Company's request. Mr. VerDouw conducted his analysis independently of Mr. Moul's. He started with the updated fair value finding from Petitioner's last litigated rate case. He then computed three different fair rates of return on that fair value, based on the Commission's high end, low end and ultimate finding of fair rate of return from the 2010 Rate Order. The first fair rate of return calculated by Mr. VerDouw corresponds to the upper end of the range of fair returns found by the Commission in Cause No. 43680. This rate of return was calculated by deducting historical inflation from the weighted cost of debt over the weighted average life of Petitioner's utility plant in service. Mr. VerDouw used an average age of plant weighted by the original cost of approximately 14 years as provided by Mr. Hoffman in his direct testimony. Utilizing the inflation rate of 2.4% from the Ibbotson Yearbook for the years 1996 through 2010 and deducting that from the weighted cost of debt produced a fair rate of return of 6.72% and a required net operating income of $75,701,026.

Mr. VerDouw's second test computed the fair rate of return in the same manner that the Commission computed the low end of its range in Cause No. 43680, which is to remove historical inflation from the overall weighted cost of capital. This produced a rate of return of 5.40% and a required net operating income of $60,831,182.

Mr. VerDouw's third test was derived from an approximation of the point between the two ends of the range found in Cause No. 43680. In the 2010 Rate Order, the fair value range was 5.03% on the low end to 6.40% on the high end, or a total spread of 137 basis points. The Commission determined Indiana-American's fair value rate of return was 5.32%, which is 29 basis points above the low end of our fair value range. Mr. VerDouw, employed the same methodology to calculate a fair rate of return of 5.69%, which is 29 basis points above the low end of 5.40% as calculated in Mr. VerDouw's second reasonableness test. This produces a required net operating income of $64,098,041.

(2) **Industrial Group's Position.** The only opposing witness to submit evidence on fair return on fair value was Mr. Gorman, who testified that the fair return on fair value should be approximately equal to the amount produced by net original cost rate base and weighted average cost of capital.

(3) **Petitioner's Rebuttal.** Mr. VerDouw testified that Indiana is a fair value jurisdiction and that, as applied to Indiana-American, Mr. Gorman's argument that the authorized return should be the same using an original cost rate base and a fair value rate base is inconsistent with the fair value ratemaking applied to the Indiana Cities AA, which has been approved in several litigated rate cases, most recently in Indiana-American's last rate case when the Commission rejected Mr. Gorman's arguments against it. He further noted that no party, including Mr. Gorman, submitted any testimony challenging any of the reasonableness tests presented in Mr. VerDouw's direct testimony.

(4) **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 Supreme Court held that the U.S. Constitution does not require the adoption of a single theory of valuation. 488 U.S. 299, 316 (1989). "The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." *Id.* 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." … 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.

Id. at 308-309 (quoting *Smyth v. Ames*, 169 U.S. 466, 547 (1898)).

As we have in previous rate orders, 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.

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 $1,051,885,770 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.

As our supreme court determined *City of Indianapolis*,

> The ratemaking process involves a balancing of all these factors and probably others; a balancing of the owner's or investor's interest with the consumer's interest. On the one side, the rates may not be so low as to confiscate the investor's interest or property; on the other side 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.

131 N.E.2d at 318. Therefore, the results of any return computation may be tempered by the Commission's duty to balance the respective interests involved in ratemaking. The end result of the 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 allow utility's to maintain credit and attract capital.

This Commission has asserted in previous rate cases, insofar as the fair value rate base contains historical inflation, that it is historical inflation and not prospective inflation that should be removed from the cost of capital to estimate a fair rate of return. Mr. VerDouw determined the inflation rate by calculating the historical inflation over the weighted average life of Indiana-American's plant in service, which according to Mr. Hoffman was approximately 14 years. According to the Ibbotson Yearbook, the historical inflation rate for the years 1996 through 2010 was 2.40%.

Using the 2.40% historical inflation rate to remove inflation values from Indiana-American's overall cost of capital yields a fair value rate of return of 4.55% (6.95% - 2.40%). Removing inflation from Indiana-American's cost of debt and plugging the new cost of debt into the capital structure yields a fair value rate of return of 5.90%. Accordingly, the range for Petitioner's fair value rate of return is 4.55% - 5.90%. Based on the evidence presented, the Commission finds the fair value rate of return is 4.897%. When this is applied to Indiana-American's fair value rate base of $1,051,885,770, the result is a net operating income of $51,509,986.

9. Operating Results Under Present Rates.

A. Revenues. Petitioner's proposed pro forma annual revenues at present rates on June 30, 2011, totaled $194,244,778. The OUCC's proposed pro forma revenues at present rates equaled $197,722,414. The OUCC accepted Petitioner's proposed adjustments for Bill Analysis Reconciliation, Unbilled Revenue, DSIC Normalization, and Normalization of the 43680 Rate Increase. Petitioner accepted on rebuttal a portion of the OUCC's proposed adjustments for test-year customer growth and late fee revenues. The remaining differences as well as issues raised by other parties are discussed below.

(1) Test-Year Customer Growth Normalization.

(a) Petitioner's Position. Petitioner proposed to normalize residential and commercial revenues to reflect changing customer counts during the test year and for the rate base update period of January 1 through June 30, 2011. Mr. VerDouw explained that these adjustments are consistent with the treatment ordered by the Commission in Cause No. 43680. He calculated the monthly increase or decrease in residential and commercial customers for each of the months from January 2010 through June 2011 using actual increases/decreases by month in customer accounts from January 2010 through December 2010, and budgeted increases/decreases in customer accounts from January through June 2011. He explained that the change in customers was calculated by month and annualized for the number of months for which the service charge was not accounted for in the test-year bill analysis. In addition, Mr. VerDouw calculated an adjustment for annualization of monthly volumetric usage for increases/decreases in test-year residential and commercial customers by month using the average test-year monthly consumption by District for a residential or small commercial customer. The calculation for service charge and volumetric adjustment was made up or down, depending on whether or not the number of residential and commercial customers went up or down over the period. Using the methodology described above and with respect to those changes in customer counts occurring during the test year, Mr. VerDouw derived an annualization adjustment that increased test-year revenues by $54,405 for changes in residential customer counts and decreased test-year revenues by $700,044 for changes in commercial customer counts during the test year.

(b) OUCC's Position. For those customers added during the test year, Ms. Stull used Mr. VerDouw's methodology to normalize revenues for additional customers with three changes. First, she applied the rates approved in Cause No. 42351 DCIS 6, consisting of a 3.16% increase in both the base monthly charges and the volumetric rates in calculating her test-year customer growth adjustment. Second, she used both block one rates and block two rates in calculating commercial customer growth during the test year. Finally, she used thousands of gallons rather than hundreds of cubic feet ("ccf") in her presentation of the adjustment for test-year customer growth. Based on these revisions, Ms. Stull recommended an increase in residential revenues of $29,043 and a decrease in commercial revenues of $633,015.

(c) Petitioner's Rebuttal. In rebuttal, Mr. VerDouw disagreed with Ms. Stull's inclusion of the DSIC surcharge because it over-counts the effects of DSIC 6. He stated that his adjustment to annualize the DSIC 6 revenue requirement in Petitioner's case-in-chief was for the full amount of the revenue authorized by DSIC 6. He explained that the Commission approves an annual DSIC revenue requirement that is reconciled to ensure no more or no less than that annual revenue requirement for the approved DSIC is collected. Accordingly, if customers use less than anticipated, the under-collection will be recovered in the subsequent DSIC. If Petitioner collects more in revenues than the authorized level, then the over-collection will flow back to customers in the subsequent DSIC. He stated the proper adjustment is for the full amount of the authorized DSIC revenues and therefore Ms. Stull is incorrect in her assumption that DSIC revenue should be applied to the customer growth normalization adjustment. As a result, Mr. VerDouw's proposed adjustment remains an increase to test-year residential growth revenues of $54,405.

Mr. VerDouw agreed with Ms. Stull's methodology regarding the application of more than one volumetric rate block to determine the dollar value of the change in commercial accounts. He re-calculated his original commercial growth volumetric adjustment for the test year following Ms. Stull's methodology, wherein he looked at the average account usage per district and determined if any of the average usage was greater or less than 20 ccf, which is the top end of the first volumetric rate block. If the average account usage per district was less than 20 ccf, he calculated the volumetric dollar adjustment by taking that average usage times the appropriate volumetric rate (Area One or Area Two tariff) for the first rate block. If the average account usage per district was more than 20 ccf, Mr. VerDouw calculated the first 20 ccf times the appropriate volumetric rate (Area One or Area Two tariff) for the first rate block, then took the remainder of the usage at the appropriate volumetric rate for the second rate block. By applying a lower volumetric rate for any average usage by district volumetric amounts over 20 ccf, Mr. VerDouw's adjustment for commercial test-year customer growth normalization changed from a proposed decrease of $700,044 to a revised proposed decrease for commercial test-year customer growth normalization of $414,383.

(d) Commission Discussion and Findings. We find that Ms. Stull's recommended additional adjustment for DSIC 6 revenues should be rejected. Petitioner has already adjusted for a full 12 months of DSIC revenues. We find that Ms. Stull's proposed adjustment to account for more than one volumetric block should be accepted, but we accept Mr. VerDouw's calculation on rebuttal. Mr. VerDouw's analysis of the impact of the rate structure was more detailed. The total combined residential and commercial growth pro forma adjustment for changes in customers added during the test year is a decrease of $359,978.

(2) Post-Test-Year Customer Growth.

(a) Petitioner's Position. Mr. VerDouw sponsored an adjustment to normalize residential and commercial revenues to reflect changing customer counts with respect to monthly service charge billings for the rate base update period of January 1 through June 30, 2011. Mr. VerDouw stated in his direct testimony that this post-test-year adjustment to service charge revenue only is consistent with 2010 Rate Order. The total adjustment is an increase of

$392,106 for residential and $1,664 for commercial, for a combined total increase of $393,770.

(b) OUCC's Position. Ms. Stull proposed an additional adjustment to post-test-year growth using the same methodology as her adjustment for test-year customer growth. Ms. Stull included a base-charge component, a volumetric component, and the DSIC 6 surcharge and applied the block one and block two rates in calculating commercial customer growth in the post-test-year period. Her volumetric component was based on average post-test-year consumption data provided by Petitioner in discovery. Ms. Stull's post-test-year customer growth adjustment amounted to an increase in residential revenues of $1,013,253 and an increase in commercial revenues of $694,552.

(c) Petitioner's Rebuttal. Mr. VerDouw testified that he followed the same methodology in calculating the post-test-year change in residential and commercial counts by month as Petitioner used in Cause No. 43680, which was approved in the 2010 Rate Order. Mr. VerDouw testified that although Petitioner has added more customers following the test year, it is not actually selling more water. He stated that despite having more residential and commercial customers in 2011 than in 2010, Petitioner's total water sales to residential customers in the first nine months of 2011 were below the total water sales to residential customers in the first nine months of 2010. Further, total sales volumes to all customer classes are lower in 2011 than 2010. During the first nine months of 2011, total sales are 25.495 MG compared to 26.120 MG for the first nine months of 2010, a decline of 2.4%. He stated weather cannot be the explanation for this decline, because the summer months of 2011 have been particularly hot and dry. Mr. VerDouw asserted Ms. Stull's volumetric adjustment based on customer growth is therefore not fixed, known, and measurable and should be rejected.

(d) Commission Discussion and Findings. The Commission has a long history of accepting a customer growth adjustment for the service charge portion of the bill because only that portion was found to be fixed, known, and measurable. *See 2010 Rate Order*, 2010 Ind. PUC LEXIS 355, at *193-194. This is especially true when there is an increase in the number of customers but a decline in total consumption. *Id.*, at *194. Here, Petitioner again reported an increase in the number of customers since the close of the test year but a decrease in sales – a decline in total sales volumes of 2.4% during the first nine months of 2011. Therefore, we conclude that Petitioner's Post-Test-year Customer Growth pro forma adjustment is $392,106 for residential customers and $1,664 for commercial customers, totaling $393,770.

(3) Late Fee Revenues.

(a) OUCC's Position. Pursuant to 170 IAC 6-1-13(B)(2), Petitioner began assessing late fees to delinquent bills in February 2011. Ms. Stull proposed an adjustment to account for pro forma late fee revenues. Ms. Stull calculated late fee revenues recorded in February through July of 2011 as a percentage of total operating revenues recorded during the same period. She then averaged the percentage of late fees to total operating revenues over the six months to arrive at a rate of 0.6497% and applied this to pro forma present rate revenues to yield a pro forma late fee revenue amount of $1,260,844.

(b) Petitioner's Rebuttal. On rebuttal, Mr. VerDouw agreed that an adjustment needs to be made for the addition of late payment fees, but proposed two changes to

Ms. Stull's adjustment. First, Mr. VerDouw testified that approximately $10,000 per month of the late payment fee ($120,000 per year) is currently being charged to two large municipal customers. Indiana-American has learned that its billing cycle did not close at a time that was conducive to these customers being able to approve the claim before the due date. Mr. VerDouw explained that Indiana-American has modified its billing cycles to fit with these customers' claims approval schedules and has waived the previously charged late payment fees. He expressed his belief that, in the future, both customers will be making payments by the due date. Accordingly, Mr. VerDouw proposed reducing Ms. Stull's adjustment by $120,000 for those two accounts.

Second, since late payment fees are assessed only on Indiana-American's slowest paying customers, Mr. VerDouw opined that, based on his experience and a limited bad debt analysis he conducted, Indiana-American will collect far less of the late payment fees than are actually assessed – and the write-off will be far more than the uncollectible rate of 1.1772% that is currently being proposed for this case. He explained that bad debt expense is calculated as a percentage of total operating revenues. All accounts that become uncollectible and therefore drive the bad debt expense percentage will be delinquent accounts against which the late fee is assessed. As a result, the bad debt percentage would necessarily be a higher bad debt percentage when one just looks at accounts that become delinquent and subject to the late payment fee. He analyzed a snapshot to determine what percentage of accounts recoverable went from current to past due. These are accounts to which the late payment fee would apply. He then compared those accounts receivable to Petitioner's bad debt expense for the prior month, since by definition all bad debts generated the prior month would have become delinquent in this time frame. The percentage of bad debts to accounts becoming delinquent was approximately 11%, but Petitioner reduced the amount to 10% for its proposed adjustment. He proposed that Ms. Stull's late payment fee adjustment less the $120,000 adjustment proposed above for billing cycle changes be further reduced by 10%, to account for late payment fees that are assumed to not be collected by Indiana-American. Mr. VerDouw's proposed changes to Ms. Stull's adjustment for late payment fees would reduce her adjustment by $234,084, thus adjusting revenue by $1,026,760 to account for late payment fees.

(c) <u>Commission Discussion and Findings</u>. In future cases, accounting for late payment revenues will be a much simpler task, since Petitioner will have a full 12 months of actual data. In this case, we must estimate as best we can the impact on Petitioner's revenues from implementing the late payment fee provided by our rules. Ms. Stull used the data available at the time of her filing (late fee revenues recorded from February through July 2011) to estimate the annual percentage of late fee revenues to total operating revenues and applied this percentage to Petitioner's pro forma present rate revenues to calculate a pro forma late fee revenue amount of $1,260,844. Mr. VerDouw testified that Petitioner has worked with two municipal customers to address the cause of their late payments, making future late payments unlikely. We agree with Mr. VerDouw that it is appropriate to reduce Ms. Stull's pro forma late fee revenue by $120,000.

Mr. VerDouw also proposed an adjustment to Ms. Stull's pro forma late fee revenue amount to account for the fact that Petitioner will not actually receive all late fees charged. Mr. VerDouw looked at data for the month of March, 2011, which revealed that 10.7996% of Petitioner's collectable late fees had slipped to an age of 31-60 days. As a result, Petitioner proposed a 10% reduction to the pro forma late fee revenue adjustment to account for uncollectable late fees. As stated above, because we do not have a full year of actual data, we must estimate as best we can what the actual impact of collected late fees will be on Petitioner's revenues. Both Ms. Stull and Mr. VerDouw made estimates using limited data in an attempt to reach a reasonable pro forma late fee revenue adjustment. We accept the Parties' methodologies and Mr. VerDouw's late fee revenue adjustment. Thus, we find that Petitioner's pro forma late fee revenue adjustment is $1,034,513.

(4) **Declining Usage Adjustment.**

(a) **Petitioner's Position**. Petitioner's Witness, Mr. Gary A. Naumick sponsored an adjustment to revenues to reflect a declining usage trend by Petitioner's residential customers over the last ten years. Petitioner's proposed declining usage adjustment is based on Mr. Naumick's analysis regarding water usage trends by Indiana-American's residential customers and shows a continuing annual decline of 769 gallons per customer per year, or approximately 2.1 gallons per customer per day ("gpcd"). This relates to an approximate annual rate of decline of 1.32% per year at present customer usage levels. Mr. Naumick testified that the decline is attributable to several key factors, including the increasing prevalence of more efficient plumbing fixtures within residential households, the conservation ethic of customers, conservation programs, and price elasticity. He explained that the Energy Policy and Conservation Act of 1992 mandated the manufacture of water efficient toilets, showerheads, and faucet fixtures and the more recent Energy Independence & Security Act of 2007 has established high efficiency standards for dishwashers and clothes washers, which will further impact indoor water usage and could perpetuate and further accelerate the downward trend. Overall, Mr. Naumick stated that with all other factors being equal, a typical residential household in a new home constructed in 2011 would use 35% less water for indoor purposes than a non-retrofitted home built prior to 1994. He also stated that as customer awareness and interest in the benefits of conserving water and energy continues to increase, customers may decide to replace a fixture or appliance even before it has broken or further reduce consumption by changing their household water use habits in other ways.

Mr. Naumick's analysis is based on monthly residential water sales recorded in January through April for each of the last ten years. He explained that studying usage in the winter months helps reveal underlying trends in indoor (or "base") usage, largely independent of discretionary usage (such as lawn and landscape irrigation, car washing, filling swimming pools, etc.). He explained that the ten-year time period was utilized for his analysis because it is long enough to adequately study the underlying trend, while also providing a reasonable reflection of the most recent trends and demographics. In order to calculate the usage per customer trend, Mr. Naumick performed a four-step calculation. First, monthly water sales data were recorded and divided by the number of customers to yield the average usage per customer. Next, winter consumption (January through April) was calculated in gallons per customer per month for the years 2001 through 2010. A "best-fit" linear regression trend line was then created using the 10 year winter usage per customer history. Finally, in order to apply the trend in "base" usage to the full-year usage by customers, Mr. Naumick calculated what portion of consumption is constant throughout the year (and therefore is considered to be baseline indoor usage) versus the amount of increased usage that occurs during the discretionary summer usage period. This was done by calculating the daily usage per customer during winter months versus the daily usage per customer for the entire year. The results show that 92.0% of residential usage is considered base usage. The winter trend was then applied to the full-year consumption. As noted above, Mr. Naumick's analysis shows that residential usage per customer is declining at a rate of 769 gallons per customer per year, or 2.1 gallons per customer per day. Mr. VerDouw then calculated the effects of twelve months of this decline, corresponding to the adjustment period of 2011, and computed an adjustment that decreased revenues by $861,090.

Mr. Naumick testified that the trend exhibited by Indiana-American is very similar to the trends being experienced by other American Water companies in other states and across the industry. He referred to the 2010 Water Research Foundation ("WRF") report, which indicated that many water utilities across the United States and elsewhere are experiencing declining water sales among households. The report further stated that a pervasive decline in household consumption has been determined at the national and regional levels. He testified that not only does he expect the declining usage trend to continue in the future, but could, in fact, accelerate as a result of water efficient fixtures and conservation actions by utilities, such as Indiana-American's Wise Water Use Plan.

Mr. Naumick noted that certain water efficiency initiatives being undertaken by Indiana-American impact residential water usage. He observed that currently, there is an economic disincentive to Indiana-American to sell less water in its service territories, but expressed Indiana-American's desire to work with the Commission to overcome this disincentive and fully unlock the benefits of resource preservation.

(b) OUCC's Position. Mr. Jon Dahlstrom opposed Petitioner's declining usage adjustment. Mr. Dahlstrom explained that for ratemaking purposes, Mr. VerDouw's schedule assumes a prospective decline in customer usage that translates into an $861,090 revenue requirement. Mr. Dahlstrom specifically took issue with Mr. Naumick's failure to consider alternative causes for a decline in usage, the accuracy of the data, and whether the data actually shows a continuing downward trend in usage.

Mr. Dahlstrom noted that, while Mr. Naumick listed items that could potentially influence customer use (e.g. the introduction of water efficient appliances, housing age and stock, appliance saturation, and remodeling), during cross-examination by the OUCC, Mr. Naumick acknowledged that Indiana-American has not performed any studies as to the particular causes of any trend indicated by his study. Mr. Dahlstrom noted that Mr. Naumick based his analysis on one factor – the passage of time. He explained that, because numerous factors might cause customer use to vary, it is nearly impossible to isolate just one of these items (time) and rationally argue this one item provides fixed, known, and measurable justification and support for the proposed adjustment.

Mr. Dahlstrom explained that, to represent a period not influenced by outdoor usage, Mr. Naumick's analysis was done using one point for each winter period (January – April). Mr. Dahlstrom indicated that he analyzed the four winter months in each of the ten years and noted a large variability within each year and from year to year. He considered the large variability not indicative of base load use. Rather, Mr. Dahlstrom considered that variability to suggest the existence of many variables driving customer use each and every month within the 10 year period on which Mr. Naumick based his analysis.

Mr. Dahlstrom also expressed doubt about the accuracy of the information relied on by Mr. Naumick. Mr. Dahlstrom noted that adjustments were made to the Indiana-American sales and customer count historical data prior to Mr. Naumick running his regression analyses, but no reason for the changes was given. For example, Mr. Dahlstrom noted, during one two-year period Indiana-American added customers to the customer count in each month of the period, but there was no corresponding adjustment made to consumption during these same months. In another example, Indiana-American moved a large quantity of sales from April 2010 to May 2010. The magnitude of the move increased May 2010 sales by 35% and decreased April 2010 sales by 20%. Mr. Dahlstrom noted that because Mr. Naumick's analysis was based on January through April consumption, changes to any of these months would change the results of his analysis. Mr. Dahlstrom explained he had no opinion about the appropriateness of such a change in the data. But he did note that such a change would have the effect of decreasing the winter usage for 2010 and thereby increasing the declining use results in Mr. Naumick's analysis. Mr. Dahlstrom suggested that such a change should call into question the data inputs for prior years.

Mr. Dahlstrom expressed other concerns about the compilation of the inputs Mr. Naumick considered. Mr. Dahlstrom noted that the residential usage was based on historical data compiled by Indiana-American in due course, but added that Mr. Naumick is unable to speak to whether any changes have occurred in how Indiana-American compiles the data or verifies the accuracy of the data. Mr. Dahlstrom added that, like most water utilities, Indiana-American does not read its meters for every customer on the same day every month of every year. For example, customers in the Northwest District are scheduled to be read every other month. Thus, Mr. Dahlstrom concluded, there is nothing in Mr. Naumick's analysis to establish that each four month period in each year included the same number of days for the customers as a whole. Mr. Dahlstrom stated that Mr. Naumick's study made no allowance for the fact that from year to year there may be variations in the number of days in December included in the so called "winter" month readings. For instance, conditions in December and January may result in delayed readings in a given year that would skew the results in Mr. Naumick's methodology.

Mr. Dahlstrom noted that even a one-day difference can affect the results of the data. He explained that if a typical day's usage is 150 gallons, one fewer day of recorded usage for the average customer during the "winter" months would explain more than half of the annual decline projected by Mr. Naumick. Thus, Mr. Dahlstrom noted, a difference in two days would exceed the "trend" observed by Mr. Naumick.

Mr. Dahlstrom stated that Mr. Naumick does not appear to acknowledge any margin of error in his inputs. But the errors and variances that seem likely lead him to conclude that the trend line observed by Mr. Naumick is not a sufficiently reliable basis upon which to recommend a revenue requirement that deviates from the test year. He concluded the adjustment to revenues proposed by Mr. Naumick does not meet the fixed, known, and measurable standard.

Mr. Dahlstrom also noted that Mr. Naumick chose the four months he selected to "isolate base, non-discretionary usage." Mr. Dahlstrom did not agree that this goal was necessarily accomplished. Mr. Dahlstrom reviewed the per customer usage for those months and observed a variation among the months that was inconsistent with this theory. Mr. Dahlstrom reasoned that if such usage is truly non-discretionary, one might expect there to be less variation in average gallons used per customer from month to month, within each year. Mr. Dahlstrom stated that this could be explained by variations of when the meters are read from month to month or reductions in usage due to vacationing. Mr. Dahlstrom added that neither of these explanations adds an element of reliability to Mr. Naumick's reliance on these winter months.

Mr. Dahlstrom added that Mr. Naumick's decision to ignore the usage per customer for the entire year does not give a full picture of what is happening to residential use and may skew any results. For instance, Mr. Naumick's analysis, which looks only at the four "winter" months, indicates a decline in per customer use from 2009 to 2010. But looking at the year in its entirety, per customer use increased from 2009 to 2010. Mr. Dahlstrom noted that, while Mr. Naumick's analysis is designed to address a particular trend and is not designed to capture changes in non-discretionary use, its application may lead to customers paying more in rates to address declining usage when usage on a per customer basis may in fact be increasing.

Mr. Dahlstrom added that the theory behind Indiana-American's adjustment to test-year operating revenues is to allow it to meet its revenue requirement by offsetting the decline it projects in its revenues. Therefore, he questions Indiana-American's decision to justify the revenue adjustment by looking only at sales on a per customer basis, and not overall residential sales for Indiana-American. Mr. Dahlstrom asserted this selected methodology fails to take into account Indiana-American's sales growth from the addition of new customers, which would offset a decline in per customer usage. For instance, Indiana-American added 2,544 customers in the first 6 months of 2011. If you multiply this by an average monthly consumption for 2011 and then multiply this amount by 12 months, you arrive at usage of approximately 135 million gallons in additional sales for the first 6 months of 2011 due to new customer growth. Mr. Dahlstrom added that an annualized amount of customer growth would yield much larger results. Mr. Dahlstrom stated that if there were declining use losses in 2011, this sales growth would offset those estimated losses.

Considering the calculations Indiana-American made to arrive at the baseload percentage, Mr. Dahlstrom said the calculation can also be affected by the period of time chosen. He noted Mr. Naumick chose to look at a period of ten years in his analysis. However, a shorter period, such as five years, yields results that may be more representative of current conditions. Mr. Dahlstrom explained that the AWWA's M1 manual recommends the most recent 5-year period for calculating Capacity Factors. Using this same 5-year period in calculating a baseload factor is consistent in this case. Results for the individual years on Petitioner's Exhibit GAN-3 vary widely from 86% to 96% adding to the concern that this average is not representative of today's conditions.

Mr. Dahlstrom expressed other concerns with the 92% baseload factor chosen. Mr. Dahlstrom explained that after running his 10-year regression analysis on baseload data, Mr. Naumick, calculated a 708 gallon annual trend decrease in baseload usage, Mr. Naumick then divided this trend result by 92%, and mistakenly increased the annual trend amount to 769 gallons. Mr. Naumick's analysis calculated the impacts on his winter baseload amount over time. Dividing his results by 92% mistakenly applies his declining baseload result to non-baseload demand (the 8% discretionary demand above 92% baseload). There is no need to divide the results by 92% because Mr. Naumick is only addressing winter baseload sales, not annual total sales in his analysis. This mistaken overstating of the results is another concern Mr. Dahlstrom expressed in his testimony.

Mr. Dahlstrom addressed the likelihood of the trend Mr. Naumick described continuing into the next decade. He said that it is possible that extending Mr. Naumick's data points into the next ten years may reflect what will happen, but it also may not. Mr. Dahlstrom stated that is one of the problems of basing revenues on a projected, unknown amount. Mr. Dahlstrom said that the important question is whether it is sufficiently certain that we will see the level of usage projected by Mr. Naumick during the life of the rates established in this rate case, which is approximately two years.

Mr. Dahlstrom noted that Indiana-American ran more than one analysis for its adjustment and the different studies had widely varying results. Mr. Dahlstrom explained that Indiana-American ran two different analyses on the January-April winter baseload data, one for ten years and one for five years. The result of the 10-year analysis was a projected annual trend decrease of 769 gallons. The result of the 5-year analysis was a projected annual trend decrease of only 244 gallons. He noted that Mr. Naumick testified on the witness stand that he had added the January-June 2011 data to his original analysis and he again came up with different results. Mr. Dahlstrom explained these substantially differing results support his position that the decline in usage for the next two years as predicted by Petitioner is too speculative.

Mr. Dahlstrom attached to his testimony copies of Mr. Naumick's 5-year and 10-year graphs and noted that they show a visible change in the slope of the line between the 10-year graph and the 5-year graph. Mr. Dahlstrom added that this suggests a leveling off of the rate of decline over the last ten years. Mr. Dahlstrom also noted the substantial difference in slope between the 5- and 10-year regression formulas shown on Mr. Naumick's spreadsheet, which Mr. Naumick provided in response to OUCC Data Request No. 01-007. Mr. Dahlstrom considered this too to support the leveling off in the rate of decline.

To explain the leveling off, Mr. Dahlstrom ran linear regression analyses for first 5-year and second 5-year periods used in Mr. Naumick's analyses. He explained that a comparison of these results indicates the declines in customer use had been more pronounced in the past, but those declines have now leveled off and will continue to level off when compared to Mr. Naumick's results. In addition, to more thoroughly investigate these inconsistencies, Mr. Dahlstrom ran a non-linear regression analysis of Mr. Naumick's winter month data over the same 10-year period. Mr. Dahlstrom's non-linear regression analysis shows this same trend of declining use leveling off in the most recent years.

Mr. Dahlstrom explained that, while Mr. Naumick's regression analysis calculated a decline of 769 gallons per year, the ten years included in Mr. Naumick's study did not consistently show actual decreases from year to year. Mr. Dahlstrom noted that looking at the months relied on by Mr. Naumick in his analysis, three of the nine year to year comparisons show an increase in per customer baseload use. Moreover, two of the last four comparisons of baseload use showed increases from year to year. Mr. Dahlstrom said this shows that the correlation in Mr. Naumick's analysis is not strong and impugns the study's ability to project a decrease or increase in the relatively short period between rate cases. Mr. Dahlstrom also noted Indiana-American will have the opportunity to adjust to any changes in per customer use in each rate case it files.

In addition, Mr. Dahlstrom also noted Mr. Naumick did not take into account potential growth in sales to Indiana-American's commercial, industrial, and sale-for-resale customers, which may offset the decline in residential use. Mr. Dahlstrom noted that a Value Line article on American Water, published July 22, 2011, stated that declines in residential water usage should slow and we look for more growth of the company's commercial and industrial water segments. Mr. Dahlstrom added that an article by Mary Ann Dickerson, President and CEO of the Alliance for Water Efficiency, published in Water Efficiency magazine indicated that water use is going down in the residential sector indoors, but going up outdoors.

Mr. Dahlstrom indicated these articles underscore the many challenges analysts face when trying to forecast what will happen to water use in the future. Considering this issue to be complex, he added that we cannot simply look at one aspect in isolation, as Mr. Naumick did in his study. Mr. Dahlstrom suggested that before the Commission establishes expectations of water utilities receiving increases in their revenue requirements, these complexities need to be better understood and more certainty established.

Based on the foregoing, Mr. Dahlstrom recommended the Commission not allow Petitioner's proposed $861,090 revenue adjustment.

(c) West Lafayette's Position. West Lafayette Witness, Mr. Otto W. Krohn also opposed Petitioner's declining usage adjustment on the basis that Mr. Naumick's analysis lacks sophistication and is unsuitable for ratemaking purposes. Mr. Krohn contended that Mr. Naumick's analysis lacked thoroughness in that it did not include a "t-test" to test the statistical significance of the slope of the regression equation or an "f-test" to test the statistical significance of the regression equation as a whole. He further stated that Mr. Naumick's regression equations are time-series regressions that do not capture cyclical or counter-cyclical trends, the effects of changes in direction of the data, or changes in the rate of change over time. As such, Mr. Krohn asserted that these regressions must be tested for possible non-linear trends and for autocorrelation and that it is unclear whether these tests were performed. Mr. Krohn testified that the R^2 value for the regression equation estimating Mr. Naumick's 10-year trendline is low and does not demonstrate a direct correlation between water usage and time. He also suggested that Mr. Naumick's analysis is oversimplified because it does not specifically address changes in weather, income, general economic conditions, employment status, household composition, and community demographics as factors potentially affecting residential customer water usage. Finally, Mr. Krohn stated Petitioner has not offered sufficient information to establish that average monthly water usage by its residential customers will not level off or even increase in the next several years.

(d) Crown Point's Position. Mr. Guerrettaz also opposed Petitioner's declining usage adjustment. First, he testified that the declining residential use adjustment is not justified or necessary because Petitioner already files a base rate case approximately every two years and receives DSIC rate adjustments on a regular, ongoing basis. He explained that, in traditional Indiana regulation, increases and decreases in operating revenues are captured with each rate case. Given that Petitioner files a base rate case every two years, plans to continue doing so, and receives regular and ongoing DSIC adjustments, Mr. Guerrattaz stated that regulatory lag is already minimized and he sees no need to impose this pro forma adjustment in rates for a hypothetical estimate of what decline in residential sales may or may not occur.

Second, Mr. Guerrettaz pointed out that the proposed adjustment focuses only on possible residential sales decreases. It does not address other customer class sales and revenue to the Petitioner, which he testified may offset any decrease in residential sales. Similarly, he testified that Mr. Naumick's analysis does not take into account the impact of weather on water sales, particularly during the summer months. He testified that Mr. Naumick's Exhibit GAN-3 shows there have been periods where increased summer usage more than offset any perceived decline in residential usage. He testified that increases in customer base between rate cases can also offset any perceived decline in residential sales.

Third, Mr. Guerrettaz testified that it is not reasonable for customers, who voluntarily engage in water conservation or pay for more efficient plumbing fixtures and appliances, to have the savings they expected to enjoy reduced or eliminated by a declining usage adjustment. He pointed out that the customer utility bill savings to be achieved by high efficiency appliances is one of the reasons people choose to buy high efficiency appliances and to install low flow fixtures. Mr. Guerrattaz opined that the declining usage adjustment could discourage people from voluntary conservation and purchasing efficient appliances.

Fourth, Mr. Guerrettaz testified that Petitioner's declining usage adjustment is not fixed, known, and measurable. He testified that it is not fixed that the estimated decline in sales will occur in the twelve months following the test year. He testified the projected reduction is not known, with certainty, to occur. He testified that the projected reduction is not reasonably measurable or subject to accurate quantification for ratemaking purposes. He testified "Mr. Naumick can't accurately predict floods, droughts, or economic changes, and thus, cannot now accurately measure the direct impact of each on future sales levels. In addition, he testified there is no showing of dire need or unusual circumstances that warrant the proposed non-traditional accelerated recovery of possible future sales declines that otherwise would be reflected in the revenue update in Petitioner's next biennial rate case.

Finally, Mr. Guerrettaz testified that Petitioner is uncertain of the number of days in its billing data. He took issue with the number of billing days utilized by Mr. Naumick in his analysis. He characterized the data used in Mr. Naumick's analysis as inaccurate and questioned the reliability of the analysis as a result.

(e) Petitioner's Rebuttal. Petitioner's Witness, Mr. VerDouw, explained that the declining usage adjustment is fixed, known, and measurable and is not a "projection" as suggested by Mr. Dahlstrom. He stated that Mr. Naumick used ten years of historical residential usage data to develop a relationship between residential customer usage and time to produce an adjustment to Test-year residential customer water usage based on a fixed, known, and measurable historical ten-year trend. He compared this adjustment to an adjustment to test-year expenses for known and measurable increases in Purchased Power expenses. He explained that the fact that Mr. Naumick's adjustment is calculated using statistical modeling, whereas a Purchased Power Expense adjustment is made using a revised rate tariff and spreadsheet, is immaterial to the concept that both are fixed, known, and measurable adjustments for known changes to test-year conditions. He asserted that Mr. Dahlstrom's categorization of Mr. Naumick's analysis and proposed adjustment as a "projection" is incorrect and should be rejected.

Mr. VerDouw explained that the purpose of the adjustment was to account for the continued decline during the adjustment period, the twelve months of 2011. During the first nine months of 2011, the decline estimated by Mr. Naumick has manifested itself at a more dramatic rate. Monthly sales per customer for all customers have decreased by 1.5%, and for residential customers (the class for which the adjustment is made) the decline is 2.1%. On a total sales volume basis, 2011 year-to-date sales volumes are down 2.4% over the test year. Mr. VerDouw explained that 2011 has been hot and dry across all operations and so weather is not the cause of the decline.

In response to Mr. Dahlstrom's and Mr. Krohn's criticisms of his analysis for failure to consider other factors that may influence the declining residential usage trend, Mr. Naumick explained that his time series analysis recognizes that multiple factors are influencing the trend, and that these factors are occurring over time. He explained that rather than selectively including or excluding specific factors that may be impacting residential customer base usage, his analysis quantifies the composite effect that all relevant factors are having over time. He explained that in his linear regression analysis, time, as the dependent variable, functions as a proxy for price, fixture efficiency, income, employment, conservation ethic, and a host of other factors that impact the per customer usage of water over time. Mr. Naumick pointed out that none of the intervenors specifically addressed the drivers that are exerting strong downward pressure on residential usage per customer. Instead, the intervenors debated statistical methodology, took issue with small movements in the data within the context of an overwhelming downward trend, and expressed denial that the trend is continuing in the face of both the historical trend and the presence of continuing drivers toward conservation behavior. They raised arguments regarding growth and weather, which are irrelevant to the "base usage per customer" analysis Mr. Naumick presented. Mr. Naumick observed that the intervenors simply argue that the decline in residential customer usage will stop, or should be ignored, but fail to offer any information about any of the factors causing the decline, such as high efficiency fixtures and appliances or the regulatory standards on which these originate. Mr. Naumick testified that the intervenors' arguments not only contradict historical results that have been occurring for more than a decade and are anticipated to continue by most industry experts, but they would deny the residents of Indiana the opportunity to share in the benefits that a progressive regulatory approach to water and energy efficiency would present.

Mr. Naumick testified that he has a high confidence level that the replacement of older fixtures and appliances will continue to reduce residential usage per customer. He examined data provided in the U.S. Census Bureau's 2005- 2009 American Community Survey reflecting the age of the housing stock in the communities served by Indiana-American. He performed a quantitative analysis of the theoretical indoor usage in a fully conserving home. At full saturation of water efficient fixtures and appliances, indoor usage is estimated to be reduced to 95 gpcd compared to base usage by Indiana-American residential customers of 139 gpcd in 2011. This analysis projects that indoor usage by Indiana-American residential customers may continue to decline over time by an additional 32%, or 44 gpcd until full saturation with water efficient fixtures is reached. How long it will take for Indiana-American's customers to reach this theoretical threshold is dependent on numerous economic, demographic, and price factors that will impact the conversion rates over time. He analyzed the base usage of Indiana-American residential customers versus those in other states served by American Water, which showed that base usage by Pennsylvania-American customers is 8% lower (and still declining) and base usage by West Virginia-American customers is 18% lower (and still declining) when compared to usage exhibited by Indiana-American customers. Mr. Naumick asserted that this trend further illustrates that there is ample opportunity for the customers of Indiana-American to continue to reduce usage. In addition, Mr. Naumick testified that the active measures taken by the Company to promote wise water use as it implements its Statewide Wise Water Use Plan approved in Cause No. 43649 will be complementary to the trend already occurring, and will serve to accelerate reductions in usage per customer.

In response to Mr. Krohn's criticism that his analysis lacked thoroughness and sophistication, Mr. Naumick pointed to the overwhelming results of his analysis, which focused on the historical per customer usage trend over a group of time periods considering a broad range of customers. He provided data showing the winter consumption trend for periods ranging from the last 9 years to the most recent 2 years. In each period, base residential usage per customer shows a downward trend. In addition, Mr. Naumick referred to studies of residential usage trends for the American Water residential customers in 17 states, all of which showed declines in base residential usage.

In response to Mr. Dahlstrom's suggestion that any increase in the rate of declining usage is unfounded speculation, Mr. Naumick testified that the Energy Independence and Security Act of 2007 (which impacts the water efficiency of dishwashers and washing machines, effective in 2010 and 2011, respectively), the EPA's WaterSense program (which contains specifications for many plumbing fixtures and appliances that are even more efficient than those called for in the Energy Policy Act), and implementation of Petitioner's Statewide Wise Water Use Plan all may accelerate the usage decline further. Year-to-date sales data for 2011 presented by Mr. VerDouw in Petitioner's Exhibit GMV-9R reflects a more rapid decline in usage per residential customer than predicted by the analysis in Mr. Naumick's direct testimony.

In response to Mr. Krohn's criticisms of his analysis for not including the "t-test" and "f-test" and for failing to capture cyclical and counter-cyclical trends, Mr. Naumick opined that a more sophisticated statistical analysis does not necessarily lead to a better conclusion regarding customer usage trends. He defended his analysis as technically sound and effective at showing the magnitude of the trend that is occurring.

With respect to the R^2 result of his linear regression, Mr. Naumick defended the R^2 value of 0.63 as having a moderately strong explanatory value. According to Mr. Naumick, this indicates that, over the span of ten years, time has proven to be a good predictor of the trend in declining base usage. He noted that although using a historical period shorter than ten years would have increased the statistical R^2, this would give more weight to individual data points, including any anomalous data point. He defended his choice of a ten-year historical period and the winter months as representing the best balance of sample size, completeness, quality of historical data and relevance of historical period to contemporary demographics.

Mr. Naumick stated that Mr. Dahlstrom's five-year regression results underscore the need to examine the entire ten-year period. He stated that he conducted numerous analytical iterations before finalizing the ten-year analysis presented in his direct testimony. Using his professional experience and judgment, Mr. Naumick chose the historical period of study that provided the most logical and defensible result, regardless of whether that outcome would be favorable or not.

He explained that the 5-year trend results shown by Mr. Dahlstrom yield an average decline of -244 gallons per customer per year (gpcy) or -0.42%, whereas if a 4 year history were chosen, the result would be -931 gpcy, or -1.62%. Accordingly, Mr. Dahlstrom's 5-year analysis, which has fewer data points than Mr. Naumick's analysis, is more indicative of a bump in the data than a change in the trend. In addition, Mr. Naumick pointed out that all three regressions plotted by Mr. Dahlstrom on OUCC Exhibit JCD, Attachment 6 plainly show a strong downward trend. Mr. Naumick suggested Mr. Dahlstrom's own analysis contradicts his recommendation and supports Petitioner's position for a declining usage adjustment.

Mr. Naumick then responded to arguments related to the customer and sales data used in his analysis. He reiterated that his analysis indicates that an ongoing long-term trend is underway. He explained that field data is never perfect, and customer behaviors do not proceed in a perfectly linear fashion from year to year. Nevertheless, Mr. Naumick testified that individual customer data is of sufficient reliability and quality to render the intervenors' concerns inconsequential in the context of the long-term, broad-based evidence of declining usage that he presented. Mr. Naumick stated the four-month period studied each year is sufficiently long to minimize the impact of any potential variation in the meter reading cycle. Similarly, he stated the ten-year period analyzed minimizes the impact of a single year's data on the modeling results.

Mr. Naumick testified that Mr. Dahlstrom's and Mr. Guerrettaz's arguments that the declining usage adjustment analysis did not address consumption by other customer classes are irrelevant. He then responded to the objection of Messrs. Krohn and Guerrettaz to his analysis on the basis that weather can impact usage in a given year. He explained that his analysis takes a "weather neutral" approach through the study of usage in the winter months of January through April when customer usage is not influenced by outdoor weather. He stated that the intervenors' objection either signifies a misunderstanding of the underlying trend, or an attempt to simply cloud the issue. With respect to the objection by Messrs. Dahlstrom and Krohn that his analysis did not take into consideration customer growth, Mr. Naumick responded that his analysis is based on annual usage per customer and customer growth per se does not and will not impact usage per customer or those usage behaviors that impact usage per customer and hence Messrs. Dahlstrom's and Krohn's arguments are baseless.

Finally, Mr. Naumick responded to Mr. Dahlstrom's reference to two articles in support of the position that declining use has leveled off over the last five years. Mr. Naumick pointed out that the article in the September/October 2011 issue of Water Efficiency magazine from which Mr. Dahlstrom quoted actually supports, in numerous places, Indiana-American's position that new technologies will enable more efficient use of water for everyday customer uses, thereby continuing to lower residential usage per customer. Mr. Naumick observed that this article is one of many examples of the increasing momentum for declining water use and energy conservation. He reiterated Indiana-American's desire to partner with the Commission to seize the opportunity to enhance the economic, environmental, and energy reduction benefits that reduced water usage can bring. Mr. Naumick dismissed the Value Line article cited by Mr. Dahlstrom as irrelevant and not substantiated.

Petitioner also offered the rebuttal testimony of Mr. Kerry A. Heid to support the policy basis for the proposed declining usage adjustment. Specifically, Mr. Heid discussed the need to eliminate regulatory or financial bias against conservation, energy efficiency, and demand side management programs (collectively "conservation programs") and how Indiana-American's proposed declining usage adjustment supports that policy.

Mr. Heid explained that the water utility's costs are primarily fixed while its revenues are based to a large extent on sales. He testified that approximately 96% of Indiana-American's costs are fixed while only approximately 4% of Indiana-American's costs vary based on customer usage/utility production. Mr. Heid stated that under Indiana-American's present rate structure approximately 37% of Indiana-American's revenues are fixed (including fire protection and miscellaneous revenues), and approximately 63% of Indiana-American's revenues are variable. Mr. Heid explained that traditional utility ratemaking creates a paradigm where a utility's revenues, and therefore its ability to recover its costs, are directly dependent on customers' water usage. Unfortunately, he stated, because this rate design couples customer consumption with cost recovery, it is financially disadvantageous for a water utility to encourage its customers to use less water. Mr. Heid testified that innovative regulation and ratemaking is required to allow the water utility to advocate the benefits of conservation without sacrificing its own ability to recover its operating and capital costs.

Mr. Heid described Petitioner's current conservation program, its "Statewide Wise Water Use Plan" approved on August 26, 2009 in Cause No. 43649. This Plan was the first conservation plan approved by the Commission. Indiana-American requested approval to defer and eventually recover program costs related to the development and implementation of its Wise Water Use Plan. Indiana-American is not recovering lost revenues or an incentive for its conservation program. Mr. Heid explained that an incentive for a conservation program such as Petitioner's is needed because utilities have a natural disinclination to encourage a reduction in sales and utilities' profits are a function of their supply-side investments and their ability to earn a return on those rate base assets. Therefore, according to Mr. Heid, utilities need to be made whole for those lost opportunity returns that result from the use of demand-side rather than supply-side resources.

Mr. Heid stated one option for regulators to help remove the financial disincentive related to lost sales is to decouple profits from sales. He noted the Commission has used this approach successfully in a number of gas companies. Another approach described by Mr. Heid is a Lost Revenue Adjustment Mechanism ("LRAM"). Under this approach utility revenue losses associated with approved conservation measures are estimated or measured and the utility is allowed to recover the revenues from customers. Mr. Heid noted that the LRAM is most effective with electric utilities whose energy efficiency programs are more suitable for precise estimation or measurement. He explained Indiana has a Demand Side Management rule that provides electric utilities the opportunity to request lost revenues. The final alternative Mr. Heid mentioned is the demand-repression adjustment, which recognizes the effects of declining usage. Indiana-American's declining usage adjustment is such an adjustment. Mr. Heid noted that there are a number of other approaches and many variations of such approaches, such as straight fixed variable rate design, future test years, and regulatory incentives.

Mr. Heid testified that Indiana-American's proposed declining use per customer adjustment is a very modest mechanism to help remove some of the disincentives. He stated that the Company is not asking for full decoupling at this time, nor has it proposed anything approaching a straight fixed variable rate design. It has rather asked that one year's decline in residential sales, corresponding to the adjustment period, be reflected in the calculation of pro forma revenues.

Mr. Heid then cited the National Energy Policy Act of 1992, which urged state utility regulatory commissions to establish such regulation:

> The rates charged by any State regulated gas utility shall be such that the utility's prudent investment in, and expenditures for, energy conservation and load shifting programs and for other demand-side management measures which are consistent with the findings and purpose of the Energy Policy Act of 1992 are at least as profitable (taking into account the income lost due to reduced sales resulting from such programs) as prudent investments in, and expenditures for, the acquisition or construction of supplies and facilities.
>
> 15 U.S.C. §3203(b)(4).

He went on to quote NARUC's Resolution on Gas and Electric Energy Efficiency, adopted in July 14, 2004, which referred to the Joint Statement of the American Gas Association, the National Resources Defense Council, and the American Council for an Energy-Efficient Economy stating:

> WHEREAS, the National Resources Defense Council (NRDC), the American Gas Association (AGA) and the ACEEE have recently adopted a Joint Statement noting that traditional rate structures often act as disincentives for natural gas utilities to aggressively encourage their customers to use less gas. Therefore, the NRDC, AGA, and the ACEEE have urged public utility commissions to align the interests of consumers, utility shareholders, and society as a whole by encouraging conservation. Among the mechanisms supported by these groups are the use of automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales ....

NARUC's Resolution encouraged State Commissions to address regulatory incentives associated with sponsoring efficiency programs and to consider the regulatory recommendations set forth in the Joint Statement.

Mr. Heid testified that Petitioner's proposal is also supported by an August 2, 2006 NARUC Resolution which supports the EPA's National Action Plan on Energy Efficiency including "[modifying] policies to align utility incentives with the delivery of cost-effective energy efficiency and modify[ing] ratemaking practices to promote energy efficiency investments ...."

Finally, Mr. Heid noted that the State of Indiana has also encouraged removing financial disincentives for promoting energy efficiency in its 2006 report entitled "Economic Growth from Hoosier Homegrown Energy-Indiana's Strategic Energy Plan," under the heading "What We Need to Do Now." Mr. Heid testified that The Hoosier Homegrown Energy strategic plan includes the following action item on page 14: "Support alternative pricing regulatory mechanisms that encourage utilities to promote efficiency and conservation by their customers without incurring negative financial results." He pointed out that a second action item under the same heading states: "Support the National Action Plan for Energy Efficiency through gas and electric utilities, regulators and industry partners to create a sustainable, aggressive U.S. commitment to energy efficiency." Mr. Heid noted that one of the National Action Plan for Energy Efficiency recommendations states: "Modify policies to align utility incentives with the delivery of cost-effective energy efficiency and modify ratemaking practices to promote energy efficiency investments."

Mr. Heid further described the requirements placed on the Commission under the Energy Independence and Security Act of 2007 ("EISA") as recognized by the Commission in *Commission's Investigation, Pursuant to IC § 8-1-2-58, into the Effectiveness of Demand Side Management ("DSM") Programs*:

> The Commission further recognizes that additional issues are to be examined under the provisions of the recently enacted Energy Independence and Security Act of 2007. This Act, which amended the Public Utility Regulatory Policies Act of 1978 ("PURPA") (as amended by Section 1252 of the EPAct05), added two new PURPA standards. These standards, reflected under PURPA section 111(d)(16) and (17), address: (16) Integrated Resource Planning and (17) Rate Design Modifications to Promote Energy Efficiency Investments and state as follows:
>
> (16) INTEGRATED RESOURCE PLANNING.--Each electric utility shall--
>
> (A) integrate energy efficiency resources into utility, State, and regional plans; and
> (B) adopt policies establishing cost-effective energy efficiency as a priority resource.
>
> (17) RATE DESIGN MODIFICATIONS TO PROMOTE ENERGY EFFICIENCY INVESTMENTS.--
>
> (A) IN GENERAL.--The rates allowed to be charged by any electric utility shall--
> (i) align utility incentives with the delivery of cost-effective energy efficiency; and
> (ii) promote energy efficiency investments.
> (B) POLICY OPTIONS.--In complying with subparagraph (A), each State regulatory authority and each nonregulated utility shall consider--
> (i) removing the throughput incentive and other regulatory and management disincentives to energy efficiency;
> (ii) providing utility incentives for the successful management of energy efficiency programs;
> (iii) including the impact on adoption of energy efficiency as 1 of the goals of retail rate design, recognizing that energy efficiency must be balanced with other objectives;

(iv) adopting rate designs that encourage energy efficiency for each customer class;

(v) allowing timely recovery of energy efficiency-related costs; and

(vi) offering home energy audits, offering demand response programs, publicizing the financial and environmental benefits associated with making home energy efficiency improvements, and educating homeowners about all existing Federal and State incentives, including the availability of low-cost loans, that make energy efficiency improvements more affordable.

Cause No. 42693, 2008 Ind. PUC LEXIS 190, at *80-82 (IURC Apr. 23, 2008).

Mr. Heid concluded that there is widespread support among utilities, regulators, legislators, and environmental advocates for removing financial or regulatory bias that discourages the promotion of energy efficiency. He advocated that the same should be true for water utilities. He asserted it is important for the Commission to provide timely cost recovery for declining use per customer to support the objective of increasing water conservation in Indiana.

(f) **Commission Discussion and Findings.** Petitioner asks us to authorize an operating revenue adjustment of $861,090 to reflect a decline in per customer residential usage. The decline in usage asserted by Petitioner is based on an analysis performed by Mr. Naumick, looking at residential use in January through April of 2001 through 2010. Mr. Naumick's analysis shows that for those periods, the typical residential customer's usage has declined by an average of 769 gallons per year. Indiana-American argues that this downward trend is likely to continue going forward. The evidence in this case demonstrates a general downward trend in residential customer usage. However, Indiana-American has traditionally come to the Commission with a new base rate case every two years and anticipates continuing to do so in the future.

While Petitioner's evidence may suggest a historical downward trend in residential customer usage, we do not agree that such a trend is sufficiently predictive of future usage to meet the fixed, known, and measurable standard. In our discussion of revenues from post-test-year customer growth above, we reached a similar conclusion. We agreed with Petitioner that average usage per customer could not be used to predict a volumetric revenue adjustment for future usage. We find that same to be true for future decreased usage.

In addition, Petitioner's request relies solely on the argument that its total revenues will decline based on a decline in per customer usage. Petitioner's analysis does not take into account other sources of additional revenues that might offset the decline, for example, growth in the number of residential customers, increased usage due to weather, and the possibility of increased usage by other customer classes. Further, because Petitioner has traditionally filed base rate cases every two years and anticipates continuing to do the same, any change in actual usage from rate case to rate case is captured on a regular basis and reflected in Petitioner's base rates.

Therefore, we conclude that Petitioner's declining usage adjustment does not meet the fixed, known, and measurable standard, and should not be included as a pro forma operating revenue adjustment. The sum of all the preceding revenue test-year adjustments totals $14,724,664, which results in a pro forma present rate operating revenue of $196,426,042.

B. Operating Expenses. The Company proposed in its case-in-chief a total pro forma Operating Expense of $147,232,818. The OUCC proposed a total Operating Expense of $145,124,782. The OUCC accepted Petitioner's proposed expense levels for purchased water expense, pension and post-retirement benefits other than pensions ("OPEB") expense, Insurance Other Than Group Expense, maintenance expense, rate case expense, depreciation expense, amortization expense, and Petitioner's proposed adjustment in calculating the IDEM Safe Drinking Fee. On rebuttal, Petitioner accepted the OUCC's pro forma adjustment for Security Expense and its methodology for pro forma IURC Fee expense. Petitioner further noted that its rate case expense estimate was likely understated due to the need to call an additional rebuttal witness and the breadth of discovery in this case. We now proceed to address the remaining contested issues, as well as issues raised by other parties.

(1) Labor Expense. Petitioner proposed a pro forma adjustment to labor expense in excess of test-year labor expenses, resulting in total pro forma labor expense of $18,151,438. The first component of the adjustment was for normalization of raises that took place during the test-year or adjustment period, which no party opposed. The remainder of the adjustment falls into three basic categories – O&M labor positions, incentive pay, and overtime, all of which the OUCC opposed. These adjustments also impact other adjustments for 401(k) expense, the defined contribution plan ("DCP"), group insurance, and payroll related taxes.

(a) O&M Labor Positions.

(i) Petitioner's Position. Petitioner's Witness Mr. VerDouw calculated a pro forma labor expense based on a level of 370 full-time associates and ten temporary, summer-help associates. Mr. VerDouw stated that of the 370 full-time associates included in the total, nine of these associates were Service Company associates for a part or all of the actual test year. Four have since transferred to Indiana-American as full-time, Indiana-American employees. And five were shifted to the Indiana-American payroll for adjustment purposes. Mr. VerDouw explained that those five associates are classified as Service Company employees to allow them to charge time for non-Indiana-American work to other American Water affiliates; however, the time charged to those affiliates is miniscule. As such, Mr. VerDouw testified, they are essentially full-time, Indiana-American employees and are reflected as such in this case. He stated that an offsetting adjustment was made to Support Services Expense for these employees. If an associate was hired during the test year, his or her hours were adjusted to reflect a full year of employment. Likewise, if an associate left during the test year, Mr. VerDouw stated that those hours were eliminated. Finally, Mr. VerDouw testified that any current vacancies were adjusted to reflect the normal level of regular and overtime hours for each specific classification.

(ii) OUCC's Position. Mr. Patrick disagreed with Petitioner's proposed pro forma labor expense. Mr. Patrick testified that in order to calculate pro forma labor expense, he reduced Petitioner's pro forma full-time employee count by twelve and Petitioner's temporary employee count by one. Mr. Patrick explained that the 370 full-time employees consisted of 345 filled positions and 25 vacant positions. As of June 30, 2011, he calculated that three of the 345 positions were unfilled, leaving a balance of 342. He further stated that as of June 30, 2011, nine of the 25 vacant full-time positions were filled internally or never filled, leaving a balance of 16 employees. In addition, Mr. Patrick testified that as of June 30, 2011, one of the temporary positions was not filled. As a result, Mr. Patrick removed the O&M expense for the three additional vacant positions as of June 30, 2011, the nine internally filled or never filled full-time positions, and the one unfilled temporary position from Petitioner's pro forma expense adjustment. His proposed pro forma O&M labor expense was based on 358 full-time and 9 temporary employees. His adjustment carried through to his proposed level of overtime expense, employee benefits, and payroll tax.

Mr. Patrick also expressed concern with the monthly count of full-time, Indiana-American employees from January 2008 through June 2011. He asserted that Petitioner's number of actual employees never exceeded 356 during the period from January 2008 through June 30, 2011. He argued that Petitioner's proposed full-time employee count of 370 employees is inconsistent with Indiana-American's full-time employee history. The OUCC proposed a total pro forma O&M labor expense of $15,576,920.

(iii) Petitioner's Rebuttal. On rebuttal, Mr. VerDouw accepted Mr. Patrick's reduction in head count with respect to the one temporary employee, but did not agree with Mr. Patrick's proposed elimination of the 12 full-time positions. Mr. VerDouw explained that of the three positions on Attachment CEP-9 that Mr. Patrick lists as "never filled," two are currently filled and it is the Company's intent to fill the third position as quickly as possible. Of the nine additional positions Mr. Patrick claimed were vacant as of June 30, 2011, Mr. VerDouw pointed out that Attachment CEP-9 lists three of the positions as "filled internally" thus indicating the positions have been filled and should not be excluded from Petitioner's pro forma headcount. Of the remaining six positions, Mr. VerDouw stated four have been filled and the Company intends to fill the other two positions as quickly as possible. Mr. VerDouw further noted that none of the positions Mr. Patrick seeks to exclude are new positions and all have been on the Company's organization chart for some time. Mr. VerDouw recommended that Petitioner's proposed pro forma O&M labor expense be reduced only by $7,209, reflecting the elimination of one temporary employee. Therefore, he proposed a pro forma O&M Labor Expense of $16,122,003, which is based on 370 full-time and nine temporary employees.

Mr. VerDouw also disagreed with Mr. Patrick's assessment that the Company's actual employee levels do not reach authorized staffing levels. He explained that Mr. Patrick makes an invalid comparison between pro forma headcount and Indiana-American historical headcount, because pro forma headcount levels include at least ten positions which have been Service Company employees during all or a portion of the time frame examined by Mr. Patrick. He stated that the Company has made adjustments to its pro forma labor expense to include certain Service Company employees in Indiana-American payroll expense for rate case purposes. While these positions are included in rate cases on a pro forma basis, they are not included in the employee headcount numbers that Mr. Patrick refers to in his testimony.

(iv) Commission Discussion and Findings. We find that

Petitioner's labor expense should be based on 358 full-time employees, resulting in an O&M labor expense of $15,576,920. Indiana-American had vacant full-time positions during the test year and during the pro forma period. In addition, during the Evidentiary Hearing in December, 2011, Mr. VerDouw indicated Petitioner currently had fifteen unfilled positions.

Further, as discussed below, the Commission finds that Petitioner has not adequately supported its proposal to include Business Development expense as a component of its revenue requirements. Therefore, the Commission finds Petitioner's O&M Labor Expense should be reduced by $129,370 to eliminate the Senior Manager Business Development position. This results in a pro forma O&M Labor Expense of $15,447,550.

(b) Incentive Pay Program.

(i) Petitioner's Position. Petitioner's total labor expense on a pro forma basis includes its annual incentive plan ("AIP") to reflect the actual AIP payout relative to 2010 performance goals for those employees that received an AIP payout in March 2011. For positions that were AIP eligible but were not in place in 2010, AIP was calculated based on each eligible employee's target percentage multiplied by the pro forma wages. Petitioner's proposed AIP pro forma expense is $926,872. Mr. VerDouw testified that this is the same AIP program that has been approved and recovered in the past several cases.

(ii) OUCC's Position. Mr. Patrick proposed two adjustments to Petitioner's AIP expense. First, Mr. Patrick used his proposed staffing levels of 358 full-time employees to reduce Petitioner's proposed pro forma incentive pay expense by $34,948. Second, Mr. Patrick stated that AIP rewards performance designed to enhance shareholder position, and therefore, he recommended that a significant portion of AIP should be borne by the shareholders and not the ratepayers. Mr. Patrick stated that financial success represents 70% of the AIP, while operational success represents 30% of AIP. He asserted that the focus of AIP is primarily on American Water achieving its financial goals measured by diluted earnings per share and GAAP operating cash flow. He opined that this meant the majority of AIP focuses on providing benefit directly and indirectly to the shareholders. As such, Mr. Patrick stated that shareholders should be responsible for 70% of the AIP costs and ratepayers should be responsible for 30% of the AIP costs. As a result, he recommended a further reduction to AIP expense in the amount of $624,347 resulting in pro forma AIP expense of $267,577.

Mr. Patrick also recommended the Commission disallow additional compensation in the amount of $96,945 described as Long-Term Incentive Pay ("LTIP") for Petitioner's Director of Engineering, Vice President of Operations, Director of Finance, and President. He stated American Water's shareholders should pay this additional award to those employees out of corporate profits. Mr. Patrick argued that this award is driven by American Water's stock value and therefore shareholders should bear the burden of the award for the Company meeting this goal.

(iii) Petitioner's Rebuttal. Mr. VerDouw explained that the AIP is simply the portion of compensation that is "at risk" and is not paid unless the employee has actually earned it. He described Indiana-American's compensation system which targets base pay at the 50th percentile of compensation in the market for a given position. He explained that the incentive program is designed to give employees an opportunity to receive total compensation at the 65th percentile of the market based on the additional performance elements included in the AIP performance evaluation. Mr. VerDouw testified that the AIP benefits ratepayers by helping the Company attract and retain competent personnel, reduce expenses, maintain the financial health of the Company, improve service to customers, and increase operational efficiencies. He described the three components to the Company's incentive plan: financial, operational, and individual. He stated the financial element of the incentive plan provides incentives to Company personnel related to meeting the overall financial goals of the Company, which benefits both shareholders and ratepayers. The operational and individual goals, Mr. VerDouw stated, benefit ratepayers by providing employees incentives to work to ensure that service is reliable and efficient and that customer satisfaction is high.

Mr. VerDouw noted that both Petitioner and the OUCC have recommended recovery through rates of Petitioner's AIP. According to Mr. VerDouw, the difference of opinion relates to the amount of benefits that Petitioner assumes should be allocated to shareholders on a pro forma basis. As noted above, in its Case-In-Chief, Petitioner assumed actual 2011 payout levels for those employees that received an AIP payout in March of 2011. For eligible positions that were filled after January 1, 2011, and did not receive an AIP payout in March of 2011, AIP was assumed at 100% of the position's eligibility percentage.

Mr. VerDouw disagreed with Mr. Patrick's position that a 30% payout level should apply. He testified that Mr. Patrick's position goes against prior Commission approved levels for Indiana-American and other case precedent regarding AIP payouts. He cited the Commission's Orders in *Southern Ind. Gas & Elec. Co.*, Cause No. 43839 (IURC Apr. 27, 2011) and *Northern Ind. Pub. Serv. Co.*, Cause No. 43526 (IURC Aug. 25, 2010) to support his statement that Mr. Patrick's position is inconsistent with other Commission cases involving incentive pay. He noted that the *NIPSCO* order rejected an argument very similar to Mr. Patrick's which attempted to allocate to shareholders the percentage of AIP which is driven by financial performance metrics. Mr. VerDouw testified that both of the orders cited are consistent with the Company's position in this case on AIP and that the Company's position is consistent with the determination made in the 2010 Rate Order.

Mr. VerDouw explained that in past cases, the OUCC has agreed to a level of payout for AIP equal to a three-year-average percentage payout for Indiana-American. If the OUCC had followed that same methodology in this case, Mr. VerDouw calculated that the average AIP payout percentage would have been 100.33% of target levels. However, Mr. VerDouw recommended capping the AIP payout at 100% of target eligible employee AIP, with shareholders paying any amount above the 100% target level. Mr. VerDouw testified this percentage should be applied to the Company's proposed pro forma level of staffing and not the reduced staffing level proposed by Mr. Patrick. Mr. VerDouw's rebuttal position adjustment for pro forma incentive plan expense results in a reduction to the proposed adjustment in the amount of $189,535. With this adjustment, the Company's recommended pro forma test-year level of incentive plan expense is $737,337.

With respect to Mr. Patrick's recommendation to eliminate $96,945 included in the Company's labor expense for LTIP expense, Mr. VerDouw responded that the purpose of the LTIP is to give high level management positions additional incentives to remain with the

Company so that the Company and ratepayers can benefit from their experience and expertise. Accordingly, he recommended that the Company's pro forma LTIP expense of $96,945 not be eliminated.

(iv) Commission Discussion and Findings. The Commission recognizes the value of incentive compensation plans as part of an overall compensation package to attract and retain qualified personnel. The criteria for the recovery of incentive compensation plan costs are well established. We allow recovery in rates when: (1) the incentive compensation plan is not a pure profit-sharing plan, but rather incorporates operational as well as financial performance goals; (2) the incentive compensation plan does not result in excessive pay levels beyond what is reasonably necessary to attract a talented workforce; and (3) shareholders are allocated part of the cost of the incentive compensation program. *N. Ind. Pub. Serv. Co.*, Cause No. 43526, 2010 Ind. PUC LEXIS 294, at *195-96 (IURC Aug. 25, 2010).

In Petitioner's last three litigated rate cases, we have found Petitioner's AIP to be recoverable under this standard. Similarly, there is no dispute in this case that the AIP is recoverable: the only dispute is how much should be allocated to customers. Petitioner requests an AIP payout level at 100% of target level, based on a three-year-average payout of 100.33% of target. In *S. Ind. Gas & Elec. Co.*, we authorized recovery of 100% of the incentive plan target level. Cause No. 43839, 2011 PUC LEXIS 115, at *148-151 (IURC Apr. 27, 2011). However, in that case, the evidence demonstrated that the petitioner's average payout had exceeded target by as much as 190% over the past ten years, and that shareholders absorbed the cost of incentive compensation that exceeded the target level.

Here, Petitioner's evidence indicates that the three-year average payout was 100.33% of target level. Yet, Petitioner requests recovery of the full target level: in essence, leaving shareholders to pay only the extra 0.33%. In addition, a review of Petitioner's past several rate cases demonstrates that Petitioner's incentive payout has not typically exceeded the target level. Authorizing Petitioner to recover 100% of the AIP target level, would not allocate a sufficient amount of the incentive costs to shareholders. Therefore, we conclude that Petitioner shall recover 85% of the three-year average payout based on 358 employees with a further reduction to eliminate the incentive pay associated with the Senior Manager Business Development position. This results in a pro forma AIP expense of $587,416.

The OUCC also recommended that we disallow recovery of expenses for Petitioner's LTIP. Mr. VerDouw testified that Petitioner strives to provide employees with a base compensation at the 50th percentile of the market and the opportunity to earn up to the 65th percentile through AIP. Petitioner's top executives then have an opportunity to earn additional compensation through the LTIP. LTIP is based on the total shareholder return and internal performance goals. Although the LTIP is not a pure profit-sharing plan, it is strongly tied to financial performance in that the Board of Directors determines the level of additional compensation. In addition, the Commission notes that given the current economic climate and the other increases being requested by Petitioner in this case, it is reasonable for Petitioner to mitigate rate increases and control costs where possible. Therefore, we find that Petitioner's LTIP expense should be borne by its shareholders rather than its ratepayers, and we disallow the pro forma LTIP expense.

(c) Overtime Pay.

(i) Petitioner's Position. Petitioner based its proposed pro forma overtime expense on a two-year average of overtime hours rather than a three-year average. Mr. VerDouw explained that Petitioner was able to capture overtime savings in the last two years, therefore, a two-year average was used.

(ii) OUCC's Position. The OUCC proposed a pro forma overtime expense of $986,688 based on the OUCC's proposed staffing levels.

(iii) Petitioner's Rebuttal. Mr. VerDouw testified that he disagreed with the OUCC's elimination of twelve positions from Indiana-American's pro forma labor headcount. Therefore, he recommended overtime expense of $998,408.

(iv) Commission Discussion and Findings. Based on our findings above regarding the pro forma employee level, we accept the OUCC's pro forma overtime expense of $986,688.

(d) Miscellaneous Labor Expenses. Petitioner's 401(k) expense, DCP Expense, Overtime Expense, group insurance, and payroll taxes are dependent on the number of full-time employees. The OUCC and Petitioner proposed alternative employee headcounts and, thus, alternative expense amounts. Based on our finding above, we conclude pro forma 401(k), DCP Expense, group insurance, and payroll taxes should be calculated based on a headcount of 358 with a further reduction to eliminate the Business Development Manager position as discussed below. Of these components, 401(k) and DCP are a component of Miscellaneous Expense; Group Insurance is a category of expense by itself; and Payroll Taxes are a Tax Expense.

(e) Total Labor Expense. Based on our findings above, we find Petitioner's total pro forma Labor Expense is $17,021,654, which is an increase of $1,187,706 from the test year.

(2) Support Services Expense.

(a) Petitioner's Position. Petitioner proposed several adjustments to Support Services Expense including: (1) elimination of one-time costs; (2) elimination of disputable expenses; (3) elimination of lobbying and penalty expenses; (4) removal of certain labor and related expenses to reflect certain Service Company employees in Indiana-American Labor Expense; (5) an increase in Service Company payroll to reflect a 2011 merit increase of 3%; and (6) an adjustment to decrease pension and OPEB expense for Service Company employees. Petitioner's total pro forma Support Services Expense is $19,090,575.

(b) OUCC's Position. Ms. Stull accepted all of Petitioner's proposed pro forma adjustments to Support Services Expenses and proposed additional pro forma adjustments including the elimination of certain costs that provide no benefit to ratepayers and are not necessary for the provision of water utility service. Ms. Stull's pro forma adjustment includes: (1) elimination of one-half of Service Company Business Development expenses; (2) elimination of all External Communication expenses; and (3) elimination of non-recurring or non-allowed expenses. The OUCC's total pro forma Support Services Expense is $17,846,148.

(i) **Business Development Expenses.** Ms. Stull proposed eliminating one-half of the Business Development expenses included in Support Services Expense, totaling $275,546. She testified that business development activities primarily benefit shareholders and, only to a lesser extent, ratepayers. Shareholders benefit by increased operating income which, all other things being equal, increases the value of the shareholders' investment in American Water. She also testified that because most of American Water's cost allocations are made on the basis of customer count, a larger customer count also means increased costs will be assigned from the Service Company. Further, a company can only add so many additional business units, and customers, before fixed costs must be increased to operate these additional business units and serve these additional customers. Ms. Stull testified that the matching principal is a basic accounting tenet that requires matching of revenues (benefits) with the costs generating those revenues (benefits). Ms. Stull argues the matching principal should be applied such that ratepayers share Business Development costs on a 50/50 basis with shareholders.

(ii) **External Communications Expenses.** Ms. Stull proposed to eliminate all External Communications expenses from Support Services Expense, including expenses related to Governmental Affairs ($43,665), External Affairs ($626,933), Marketing ($126,895), External Communications ($78,641), and Social Responsibility ($53,062), for a total reduction of $929,196. She cited Ind. Code § 8-1-2-6(c) in support of her adjustment, stating that the External Communications expenses she excluded are institutional or image building, charitable donations, community relations, marketing, and lobbying expenses that could not be included in rates if incurred by Indiana-American and, thus, should not be allowed in rates as a charge from the Service Company. Ms. Stull testified this adjustment of $929,196 removes expenses that provide no material benefit to ratepayers, and are not necessary for the provision of water utility service.

(iii) **Non-Recurring or Non-Allowed Expenses.** Ms. Stull proposed to remove from Support Services Expense an additional $39,685 of costs that she contends are either non-recurring or not allowed for ratemaking purposes and include charitable donations, employee awards, flowers, and costs belonging to other jurisdictions. Her proposed adjustment also includes $10,365 of Price Waterhouse invoices related to the BT Project.

(c) Petitioner's Rebuttal.

(i) **Business Development Expenses.** Mr. VerDouw testified on rebuttal that Ms. Stull has no support for her claim that Business Development primarily benefits shareholders. He noted that Ms. Stull and others at the OUCC have attended meetings in which Mr. DeBoy has stated that Indiana-American would not pursue any acquisition unless it is good for Indiana-American and its customers.

Mr. VerDouw also explained that Ms. Stull accepted the adjustment made to Support Services Expense for Service Company employees moved to Indiana-American payroll for rate case purposes. One of the employees moved to Indiana-American payroll was an employee working in the Business Development area. Mr. Patrick accepted the inclusion of that position as part of his testimony on pro forma labor expense. Accordingly, Ms. Stull's position is inconsistent with Mr. Patrick's acceptance of the adjustment to pro forma labor expense and also results in a double counting of the removal of that position from Support Services Expense.

Mr. VerDouw also pointed out that the allocation formula used to account for Business Development expenses already allocates 50% of those expenses to American Water's non-regulated businesses and therefore 50% of those allocated expenses are already borne by the shareholders. Finally, Mr. VerDouw stated that Business Development activities continue to provide benefits long after a particular contract is negotiated or a deal closed. He presented a calculation of the net benefit to Indiana-American ratepayers of annualized revenues of Business Development activities completed or in progress from 2005 through 2011 as compared to Business Development expense included in Petitioner's rate case, amounting to $1,854,030.

(ii) External Communications Expenses. Mr. VerDouw responded to Ms. Stull's proposed elimination of External Communications expenses by pointing out that under the Commission's rules, Indiana-American is required to provide certain information that is located on the American Water website and is required to keep its rate schedules on its website. In addition, Mr. VerDouw pointed out that the OUCC and other Intervenors in this case have used information from Indiana-American's website to conduct their preparation and to cross-examine Petitioner's witnesses. Accordingly, Mr. VerDouw testified the labor and expenses incurred to maintain the website should not be disallowed.

In addition, just as Ms. Stull had agreed to the adjustment to Support Services Expense related to moving the Service Company employee in the Business Development area to Indiana-American payroll for rate case purposes, so too did she accept a similar adjustment for an employee working in the External Affairs area. Mr. VerDouw explained that the labor and related expense for that employee had already been removed from Support Services – External Affairs expense to Labor Expense and Mr. Patrick had accepted the inclusion of that position as part of his testimony on pro forma labor expense. Once again, Ms. Stull's proposed adjustment represents a "double dipping" of adjustments taken for that position.

Mr. VerDouw stated that, for the most part, the expenses incurred in the External Communications categories are labor and related costs, not the charitable donations, community relations, marketing, and lobbying expenses that are not allowed for ratemaking purposes as Ms. Stull suggests. He stated that although Ms. Stull had all of the information she needed to make specific deductions to any part of External Communications expense that did fit into one of these categories, she instead chose to eliminate all External Communications expense.

Finally, Mr. VerDouw defended the External Communications expense as benefitting ratepayers and permitting Petitioner's compliance with requirements to maintain certain information on its website, including tariff information. He stated that to expect Petitioner to provide these services without recovery of the expense incurred would be unreasonable.

(iii) Non-Recurring or Non-Allowed Expenses. Mr. VerDouw agreed that a total of $14,752 should be deducted from Support Services Expense. He disagreed with the deduction of other expenses from Support Service Expense totaling $24,933. Mr. VerDouw agreed with Ms. Stull's removal of Price Waterhouse invoices related to the BT project, since such expenses were non-recurring. He also accepted Ms. Stull's adjustment in the amount of $4,387 for expenses paid for other jurisdictions. However, he disagreed with the remaining deductions made by Ms. Stull. First, Mr. VerDouw testified that none of the items in the list provided by Ms. Stull in MAS Attachment 28 were related to charitable deductions or flowers. He stated the majority of the remaining items Ms. Stull removed from Support Services Expense were for Service Company recognition awards for employees celebrating milestone anniversaries with the Service Company, plus expenses related to employee meetings, work-related promotions, and other employee functions. Mr. VerDouw defended the inclusion of such expenses as serving a valuable role in maintaining and enhancing employee morale, which helps to insure customers experience a high level of service.

(d) <u>Commission Discussion and Findings</u>.

(i) <u>Business Development Expenses</u>. Mr. VerDouw defended Petitioner's proposed Business Development expense by presenting an analysis purporting to show a net benefit of $1,854,030 to ratepayers since 2005 as a result of Business Development activities. We find Mr. VerDouw's analysis to be flawed. First, the analysis includes wholesale revenues received from the New Whiteland acquisition, a significant portion of which would be included in test-year revenues, and thus effectively lost, once the acquisition is complete. In addition, Mr. VerDouw's analysis only includes annualized revenues for each deal type. The analysis does not consider the additional annual operating and capital costs incurred by the Company. The Commission finds no evidence that the Business Development activities provide a benefit to ratepayers – in fact, the Commission is concerned that ratepayers may be subsidizing business development with limited offsetting benefits. Therefore, we conclude that Petitioner's Business Development expense of $467,474 should be disallowed. Because we are disallowing Petitioner's Business Development expense, we also find that $129,370 of Petitioner's labor expense associated with the Senior Manager Business Development position should be eliminated.

(ii) <u>External Communications Expenses.</u> The Commission reviewed the workpapers that Ms. Stull provided to support her proposed external communications expense disallowances. The Commission accepted the proposed disallowances for any item that could be clearly identified as travel, food, entertainment, gifts, donations, grants, advertising for image building, or political contributions. The result is an adjustment of $221,077 as a decrease in Petitioner's pro forma expenses.

(iii) <u>Non-Recurring or Non-Allowed Expenses.</u> Similarly, the Commission reviewed the workpapers that Ms. Stull provided to support her proposed non-recurring or non-allowed expense disallowances. The Commission accepted the proposed disallowances for any item that would be clearly identified as related to other affiliated companies, entertainment, gifts, or sponsorships. In addition, we accepted Ms. Stull's proposed disallowance for the Price Waterhouse invoice. The result is an adjustment of $27,781 as a decrease in Petitioner's pro forma expenses.

Based on our findings above, we conclude that Petitioner's total pro forma Support Service Expense is $18,374,243, which is a decrease of $1,927,059 from the test year.

(3) Purchased Power Expense.

(a) Petitioner's Position. Petitioner's Witness Lewis E. Keathley sponsored five adjustments to fuel and power costs during the test year. The first adjustment, \$304,106, annualized test-year fuel and power increases. Mr. Keathley stated that the Company annualized 2010 expenses by recalculating each fuel and power 2010 invoice using the tariff and riders in place for the December 2010 bills. The recalculated bill amounts were then compared to the actual bills and the difference between these amounts constituted Petitioner's proposed adjustment.

Mr. Keathley then discussed the second adjustment to fuel and power expenses, which was made to update the fuel and power costs based on the latest known energy cost rates in effect for 2011. He explained that, similar to the first adjustment, changes to the tariffs for Petitioner's energy accounts were applied to the 2010 bills to determine what the bill would be in 2011. The adjustments for each account were added together for a total adjustment for 2011 cost changes for fuel and power expense of \$38,542.

Mr. Keathley's third adjustment was to update the fuel and power cost for changes that will occur as a result of the new Warsaw WTP. He stated that the net reduction in fuel and power costs is projected to be \$7,476.

Mr. Keathley's fourth adjustment to fuel and power expense was to reflect the rate increase for Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc. ("Vectren Electric") authorized by this Commission in its Order dated April 27, 2011. Petitioner's proposed adjustment in its case-in-chief for Vectren Electric costs was \$8,737, based on an estimated 6% increase. This was updated in Mr. VerDouw's supplemental testimony to reflect the actual increase to applicable Vectren Electric rates of 8%, producing an additional adjustment of \$2,912 for a total adjustment for Vectren Electric costs of \$11,649. Mr. Keathley explained in his direct testimony that although NIPSCO currently had a pending rate increase, due to the uncertainty that existed at that time as to when new rates would be implemented, the Petitioner did not make an adjustment for NIPSCO costs.

Finally, Mr. Keathley proposed an adjustment to reflect the pro forma system delivery calculated by Mr. VerDouw. Mr. Keathley stated that Mr. VerDouw's adjustment reduces the amount of volume assumed for this rate case. The adjustment was calculated by taking the difference between the pro forma system delivery and the test-year system delivery and multiplying that amount by the pro forma fuel and power cost per thousand gallons, resulting in an adjustment to decrease fuel and power by \$56,449.

In his supplemental direct testimony, Mr. VerDouw also proposed an additional adjustment to increase purchased power expense by \$240,000 due to electric usage at Borman Park, which was not being metered during the test year. Apparently, during the course of installing new equipment, it was discovered that a portion of electricity used at Borman Park was not flowing through the meter. A new meter was then installed to capture the usage. Mr. VerDouw's proposed adjustment was based on the April 2011 bill received by Petitioner for this meter, which reflected charges for two months.

Petitioner's total pro forma purchased power expense is $6,841,614.

(b) OUCC's Position. Ms. Stull accepted Mr. Keathley's proposed adjustment for normalization of purchased power tariffs and riders in effect for 2010 and 2011 and for the Vectren Electric rate increase that took effect in May 2011. She then proposed an adjustment for the Warsaw WTP to reduce purchased power expense in the amount of $10,643 based on a revised calculation of the cost savings associated with the plant provided by Petitioner in discovery.

Ms. Stull also proposed a system delivery adjustment for purchased power expense based on her proposed adjustment for customer growth discussed in the section of this Order addressing operating revenue. Her proposed adjustment increases purchased power costs of $18,441 related to increased water sales due to customer growth during and subsequent to the test year. Ms. Stull testified that her methodology to calculate this adjustment is similar to Petitioner's methodology.

Ms. Stull also proposed an adjustment for the Borman Park meter of $206,896 based on additional bills received by Petitioner for this meter for the months of May and June 2011. She testified that her adjustment reflects the average amount of power usage for the months of April, May, and June on an annualized basis.

Ms. Stull proposed an additional adjustment to decrease purchased power costs by $56,189 due to a major leak discovered and repaired during the test year in the Southern Indiana Operations (the "Southern Indiana Leak"). Ms. Stull testified a leak was discovered in the Southern Indiana District on September 23, 2010. Petitioner represented the leak was causing an estimated loss of over 4 million gallons per day ("GPD"). In response to OUCC Data Request Q 10-3, Petitioner estimated the leak could have started as early as May 2010. Ms. Stull testified that assuming the leak continued over a period of 100 days (May 15 – September 23), a total of 400,000,000 gallons of water would have been lost.

Ms. Stull acknowledged that leaks are generally considered a normal, recurring expense for a water utility that should be considered a normal cost of business. However, a leak of this magnitude that goes undetected for such a long period of time is unusual and therefore not a normal recurring operating expense. She confirmed on cross-examination that she does not assert that the leak should have been prevented or detected sooner; rather that it was non-recurring.

Ms. Stull testified that by excluding the first two weeks in May from her calculation of the water lost through this leak, she has acknowledged that part of the cost of the leak was a normal operating expense. Further, she testified the OUCC did not propose any adjustment for the Richmond leak identified and discussed at the evidentiary hearing held in August 2011. Ms. Stull testified that going forward; all other things being equal, Indiana-American will not need to pump as much water as it did during the test year to generate the same level of sales. Since there is less water pumped, less electricity is used.

The OUCC's total pro forma purchased power expense is $6,824,044.

(c) Petitioner's Rebuttal. Mr. Keathley testified in rebuttal that he agreed with Ms. Stull's proposed adjustment to reduce purchased power expense for the Warsaw WTP in the amount of $10,643. Mr. VerDouw responded to Ms. Stull's purchased power adjustment relative to customer growth. As explained above, Mr. VerDouw disagreed with the volumetric additions Ms. Stull made relative to her customer growth adjustment and therefore does not accept Ms. Stull's resulting purchased power system delivery adjustment. As a result, Mr. VerDouw testified that purchased power expense should be reduced by Petitioner's proposed system delivery adjustment in the amount of $56,449.

With respect to Ms. Stull's proposed adjustment for the by-passed Borman Park meter, Mr. Keathley agreed that the adjustment should be based on as much information as possible. Instead of restricting the calculation to 3 months worth of bills, he updated the adjustment to reflect April, May, June, July, and August 2011 bills for a total adjustment of $219,413.

Mr. VerDouw responded to Ms. Stull's adjustment to purchased power expense for the Southern Indiana Leak. He referred to the unusual circumstances of the main break as described in greater detail by Bruce A. Hauk's rebuttal testimony. Mr. VerDouw testified that he does not believe singling out an isolated issue for a specific adjustment is prudent or necessary. He noted that Mr. Rees, who addressed the leak in his prefiled testimony, did not provide a recommendation to penalize the Company for this leak. Accordingly, Mr. VerDouw opposed Ms. Stull's pro forma adjustment to reduce purchased power expense by $56,189.

The effect of Petitioner's rebuttal position is to decrease total pro forma purchased power expense to $6,817,860.

(d) <u>Commission Discussion and Findings</u>. The Parties agree on some adjustments related to Petitioner's Purchased Power Costs. All parties accepted Petitioner's adjustment for normalization of purchased power tariffs and riders in effect for 2010 and 2011 and for the Vectren Electric rate increase that took effect in May 2011, which we find accept. The Parties also agreed to the revised adjustment to reduce purchased power expense relative to the Warsaw WTP by $10,643, which we also accept.

Thus, the remaining disputes are the adjustments for system delivery, the Borman Park meter, and the additional adjustment proposed by the OUCC for the Southern Indiana Leak. As discussed above, consistent with our past decisions, we reject Ms. Stull's volumetric additions relative to post-test-year customer growth. As a result, we also reject her corresponding adjustments to the purchased power adjustments for system delivery.

With respect to the adjustment for the Borman Park meter, we find that Petitioner and the OUCC generally agree to the use of the most recent information available for calculating the appropriate adjustment. Mr. Keathley's rebuttal testimony provides the most up-to-date billed amounts for the Borman Park meter. Accordingly, we find that the proposed adjustment based on this, more recent information is appropriate and accept the adjustment of $219,413, proposed in Mr. Keathley's rebuttal testimony.

We agree with Petitioner that, in general, an adjustment for a specific leak is not warranted. Leaks are a normal cost of business for a water utility. However, this particular leak was of an unusual magnitude and circumstance. Mr. VerDouw explained that the leak occurred in a location that made it hard to detect. The water from the leak flowed directly into a nearby creek, and, thus, did not flood the area. In addition, the leak occurred at the beginning of summer seasonal usage, which made a sudden increase in flow seem unremarkable. This combination of circumstances allowed the leak to go undetected for several months. Petitioner's evidence states that the leak caused an estimated loss of over 4 million GPD. Ms. Stull estimated that between May 15 and September 23, 2010, the leak resulted in a total loss of 400,000,000 gallons of water.

Based on this evidence, we conclude that the leak was sufficiently exceptional to constitute a non-recurring event. Therefore, we accept Ms. Stull's proposed adjustment. However, on rebuttal, Petitioner identified a mistake in Ms. Stull's calculation and indicated the adjustment should actually be $63,029. We conclude that the proposed adjustment of $63,029 is reasonable. The result is a total adjustment of $443,589, which increases Purchased Power test-year expense to $6,754,830.

(4) **Chemical Expense.**

(a) **Petitioner's Position.** Petitioner's Witness Keathley testified that three adjustments are necessary for chemical expenses, totaling $20,253. He explained that the first adjustment was necessary to annualize the 2011 chemical prices. He explained that the 2011 chemical price was multiplied by the quantity of chemical units used in 2010 to obtain the 2011 pro forma amount. The 2010 chemical amount was then subtracted from the 2011 pro forma amount, which results in a $161,991 reduction in chemical expense.

Mr. Keathley's second adjustment to chemical expense accounts for Mr. VerDouw's revenue adjustments based on water sales. The result is a $21,656 reduction in chemical expense, calculated by taking the difference between the pro forma units and the test-year units and multiplying that amount by the 2011 chemical price.

Mr. Keathley's final adjustment to chemical expense was for chemical treatment changes that are being implemented in 2011 and are based on an analysis by Indiana-American operations department. These changes are for new drinking water regulations, algae control, and the Warsaw WTP. Mr. Keathley explained that Kokomo, Richmond, and Muncie Operations will require operational changes in 2011 in order to comply with the new drinking water regulations to control disinfection byproducts - Stage 2 Disinfectants and Disinfection Byproducts Rule ("Stage 2 DBP Rule"). He testified that Petitioner's Kokomo and Richmond Operations will change their surface water treatment to include chemical oxidation with permanganate and the application of ammonia to form chloramines at the entry point to the distribution systems. He stated the additional chemical treatment costs based on 2011 prices will amount to approximately $50,000 for Kokomo and $58,000 for Richmond. With respect to the Muncie Operation, Mr. Keathley testified it will reduce DBPs seasonally by decreasing the water age in the distribution system, which will require seasonal flushing plus chemical treatment of the flushed water to remove the disinfectant residual at an estimated cost of $39,000. The total adjustment proposed by Mr. Keathley as a result of these new drinking water regulations is $147,000. To provide algae control for the Muncie and Richmond operations in 2011, Mr. Keathley stated the additional chemical treatment costs are estimated to be $3,000 for Muncie and $3,500 for Richmond. Mr. Keathley also proposed an adjustment for additional water treatment costs of

$50,400 per year that will be incurred in 2011 at the Warsaw WTP due to feeding sodium hypochlorite, fluoride, sodium permanganate, and polymer.

Petitioner's total pro forma chemical expense is $2,245,177.

(b) OUCC's Position. Ms. Stull accepted Petitioner's adjustment to normalize 2011 chemical prices, but proposed adjustments that provide for a net overall decrease of $176,207 to test-year chemical expenses. Ms. Stull's first adjustment to chemical expense was an increase of $5,536 to reflect the additional cost due to test-year and post-test-year customer growth based on her revenue adjustment for customer growth.

Ms. Stull did not agree with Petitioner's proposed adjustments for chemical treatment changes related to new drinking water regulations, algae control, and the Warsaw WTP, citing lack of supporting documentation or calculations for the amounts for each adjustment. She noted that Petitioner had responded to discovery requests for supporting documentation for the proposed chemical treatment adjustments by stating that the additional chemical cost estimates were the product of its professional and experienced engineering staff. She testified that Petitioner had failed to provide supporting documentation on which she could make a determination as to the reasonableness of the proposed adjustment. Ms. Stull also took issue with the proposed increase to chemical costs for the Warsaw WTP based on the Petitioner's proposed decrease in purchased power costs as a result of the efficiencies gained by the new Warsaw WTP. She stated it would be reasonable to expect the same decrease with respect to chemical costs as for purchased power costs. Ms. Stull concluded that Petitioner had not met its burden of proof with respect to its proposed adjustments and therefore the chemical expense adjustments for chemical treatment changes should be disallowed.

Ms. Stull also recommended a reduction to chemical expense for the Southern Indiana Leak in the amount of $19,752.

(c) Petitioner's Rebuttal. Mr. VerDouw opposed Ms. Stull's proposed adjustment to chemical expense for system delivery based on his opposition to the Ms. Stull's volumetric adjustments for customer growth. He testified that the Company's proposed system delivery chemical expense reduction of $21,656 should stand. Mr. Keathley disagreed with Ms. Stull's methodology in calculating the adjustment. Mr. Keathley stated that Ms. Stull uses total chemical costs to calculate her cost per thousand gallons, but a more accurate methodology is to calculate the cost per chemical, based on the pro forma system delivery and the quantity of each chemical used per thousand gallons.

Petitioner's Witness Hoffman addressed Ms. Stull's proposed adjustment for chemical treatment changes related to the Stage 2 DBP Rule. Mr. Hoffman first corrected Ms. Stull's description of the Warsaw WTP, clarifying that although Ms. Stull's testimony stated that the Warsaw WTP is replacing existing treatment plants, one of which is a surface water plant, the Company has not operated any surface water treatment plants in Warsaw since acquiring the utility in 2000 and all of the existing treatment plants are ground water treatment plants. Mr. Hoffman testified that Petitioner accepts Ms. Stull's proposed 2011 pro forma chemical expense for the Warsaw WTP.

Mr. Hoffman then provided updated estimates of chemical costs for the new drinking water regulation projects, with a proposed adjustment amount of $70,995. Mr. Hoffman explained that the difference between Petitioner's original proposed adjustment and the updated estimates is due to the fact that the previous estimate was developed early in the project design phase and since then the Company has been operating the new chemical feed systems and flushing outlets for a few months and is able to provide a more accurate determination of feed rates and flush volumes. He proposed that the DBP-related chemical and power expenses be based on the updated estimates. Mr. Keathley took issue with Ms. Stull's rejection of the chemical expense adjustment for algae control. He testified that Ms. Stull had removed the adjustment without comment or testimony, and it was therefore arbitrarily excluded without cause or reason. Accordingly, Mr. Keathley opined that the Company's chemical expense adjustment for algae control of $6,500 should stand.

Mr. VerDouw provided rebuttal testimony responding to Ms. Stull's third adjustment to chemical expense to account for water lost in the Southern Indiana Leak. He reiterated that singling out the Southern Indiana Leak for a specific adjustment is neither prudent nor necessary and that Mr. Rees did not provide a recommendation to penalize the Company for the leak. Accordingly, he disagreed with Ms. Stull's pro forma adjustment to reduce chemical expense for the Southern Indiana Leak.

The Company's proposed pro forma chemical expense after rebuttal was $2,118,772.

(d) <u>Commission Discussion and Findings</u>. We have previously addressed and rejected the OUCC's proposal to make volumetric adjustments to Petitioner's revenue and expenses. Therefore, we accept Petitioner's position with respect to the customer growth adjustment to chemical expenses.

Ms. Stull also proposed disallowing certain chemical treatment adjustments because they were not supported by documentation. On rebuttal, Petitioner supplied documentation for most of the expenses. However, our review of Petitioner's evidence did not uncover documentation to support the $6,500 expense for algae control at the Muncie and Richmond Operations. Therefore, we accept the adjustment proposed by Petitioner in its rebuttal less the $6,500 algae control expense, resulting in an increase to Petitioner's chemical expense of $70,955.

Finally, as we discussed above, we find that the Southern Indiana Leak constitutes a non-recurring event, and we agree with Ms. Stull that it is appropriate to make an adjustment to Petitioner's chemical expenses to account for it. Therefore, we adopt the OUCC's decrease of $19,752 to chemical expenses. Based on the evidence, we approve an adjustment of $132,444, which decreases Chemical test-year expense to $2,092,480.

(5) <u>Waste Disposal Expense</u>.

(a) <u>Petitioner's Position</u>. Mr. Keathley proposed three adjustments that, in combination, reduce waste disposal expense: a true-up adjustment; an adjustment for the Northwest Ogden Dunes sludge removal; and an adjustment for revised future tonnage of sludge removal. The total of these proposed adjustments reduces waste disposal expense by $961,981. Total pro forma waste disposal expense is $2,291,817. Mr. Keathley explained that the waste disposal true-up adjustment amounts to a reduction of waste disposal expense of $33,252 for the districts of Kokomo, Noblesville, and Northwest Ogden Dunes to update the accruals to ensure that the accrued amount equals the estimated amounts based on the most recent bills and the revised estimates for sludge removal and waste disposal. The adjustment for Northwest Ogden Dunes sludge removal reflects an additional amount of $1,403,785 that was expensed in 2010 due to a greater amount of sludge that was required to be removed than originally estimated. Mr. Keathley explained that the Ogden Dunes sludge lagoon was to be closed per an agreement with the Indiana Department of Environmental Management for future use as a storm water collection basin. Mr. Keathley proposed to amortize the $1,403,785 over five years with an annual amortization amount of $280,757. As a result, the proposed adjustment eliminates all but one year's worth of the five year amortization, or $1,123,028.

The final waste disposal adjustment proposed by Mr. Keathley was for revised estimates of the tonnage of sludge that will need to be removed from the sludge lagoons at Marlin 1, Blue River 1, and Ogden Dunes. He stated the estimates are based on measuring the current depth of the sludge in the lagoons and projecting additional accumulations until the next cleaning. Comparing this revision to the 2010 costs results in an adjustment for the Marlin 1 Lagoon of $3,888 over ten years, or $389 per year and an adjustment for the Blue River 1 lagoon of $14,251 over 20 years, or $713 per year. Initially, Mr. Keathley also proposed an adjustment for the Northwest Ogden Dunes lagoon in the amount of $194,299 over the 2010 cost. However, in response to discovery requests from the OUCC, Mr. Keathley acknowledged that this amount was in error and withdrew the request for the $194,299 adjustment for the Northwest Ogden Dunes lagoon. Mr. Keathley's proposed total adjustment for all the revised tonnage, after removing the Northwest Ogden Dunes lagoon amount, is $1,102.

(b) <u>OUCC's Position</u>. Ms. Stull accepted Petitioner's accrual true-up adjustments of -$33,252 and revised tonnage adjustments for the Johnson County and Shelbyville Districts in the amount of $1,102. She also proposed additional accrual adjustments for the Kokomo, Noblesville, and Northwest Indiana districts and proposed changes to the Petitioner's Ogden Dunes sludge removal adjustment.

Ms. Stull calculated an additional decrease of $10,781 to the waste disposal accrual for the Kokomo District to reflect Petitioner's current estimate of annual waste disposal expense based on the difference between Petitioner's annual accrual amount of $50,016 as reported in its workpapers and adjusted test-year expense of $60,797. Similarly, she calculated an additional decrease of $61,087 to the waste disposal accrual for the Noblesville District to reflect Petitioner's current estimate of annual waste disposal expense based on the difference between Petitioner's annual accrual as reported in its workpapers and adjusted test-year expense of $71,851.

Ms. Stull also made a similar adjustment for the Northwest Indiana District (excluding Ogden Dunes lagoon cleaning costs) using the monthly annual waste disposal accrual amount as reported in Petitioner's workpapers and multiplying by twelve to yield annual waste disposal accrual of $450,816. She calculated test-year expense for the same accruals in the amount of $535,024 based on her review of test-year transactions for the Northwest Indiana District. Decreasing that amount for Petitioner's proposed true-up adjustment of $26,508, Ms. Stull calculated an adjusted test-year expense of $508,516, which was $57,700 more than her estimated annual waste disposal accrual. Accordingly, she proposed a decrease of $57,700 to waste disposal accrual expense for the Northwest Indiana District.

With respect to the Northwest Ogden Dunes lagoon cleaning costs, Ms. Stull accepted Petitioner's proposed amortization period for the costs, but disagreed with the costs included in the amortization calculation and proposed a decrease of $1,213,028 to Petitioner's pro forma waste disposal expense as opposed to Petitioner's proposed decrease of $1,123,028. She noted that in response to discovery requests from the OUCC, Petitioner acknowledged that the estimate of costs to clean the lagoon were revised in June 2011 based on meetings with its consultant and contractor, reducing those costs from $1,200,000 to $750,000. Accordingly, Ms. Stull reduced cleaning costs by $450,000 and proposed an adjustment based on annual amortization of $190,757. Ms. Stull acknowledged that Petitioner has since indicated the estimated costs will be higher than the $750,000 but has not determined what that higher amount would be.

Ms. Stull's proposed adjustments provide for a net overall decrease to test-year waste disposal expense in the amount of $1,374,746. Her pro forma waste disposal expense was $1,879,051.

(c) <u>Petitioner's Rebuttal</u>. Mr. Keathley responded to Ms. Stull's pro forma waste disposal expense level. He accepted her additional accrual adjustments for Kokomo (a reduction of $10,781) and Noblesville (a reduction of $61,087) and her adjustment to the Northest Ogden Dunes lagoon cleaning costs. However, he opposed Ms. Stull's proposed additional adjustment to the waste disposal accrual for the Northwest Indiana District. He explained that Petitioner's test-year waste disposal expense for Northwest Indiana includes not only accruals for waste disposal expense, as do Kokomo and Noblesville, but also includes direct charged expenses relative to waste disposal for items such as sample testing and cleaning of basin. Mr. Keathley testified that these direct charged waste disposal expenses are normal and recurring and are reflective of a typical test-year expense for waste disposal expense for the Northwest District. He stated that Ms. Stull had included only accrued amounts in her pro forma test-year expense for Northwest District waste disposal expense and removed direct charge items in the amount of $57,700. He explained that while this was the proper approach for Kokomo and Noblesville, he believes the direct charge items for the Northwest District are proper expenses and should not be adjusted out of pro forma waste disposal expense for the Northwest District.

Mr. Keathley noted that because the Company's engineering team is still in the process of revising the cost estimate for the Northwest Ogden Dunes lagoon cleaning costs, Petitioner is accepting Ms. Stull's adjustment to reduce total lagoon cleaning costs to $953,785, to be amortized over five years for an annual expense of $190,757.

On rebuttal, the Company's total adjustment is a decrease of $1,317,046, producing total pro forma waste disposal expense of $1,936,751.

(d) <u>Commission Discussion and Findings</u>. Having reviewed the evidence, we find that Petitioner has sufficiently addressed Ms. Stull's remaining issues. Accordingly, we accept Petitioner's revised total adjustment of $1,317,046, which decreases Waste Disposal test-year expense to $1,936,751.

(6) **Miscellaneous Expense.** Petitioner proposed eleven separate adjustments to Miscellaneous Expense to produce total pro forma Miscellaneous Expense of $6,696,875, an increase of $162,984 over the test year. The adjustments include: (a) an increase to 401(k) expense in the amount of $70,726; (b) an increase to DCP expense of $50,604; (c) a decrease of $25,751 to eliminate labor costs; (d) an increase to legal costs in the amount of $79,638; (e) an increase to security expense in the amount of $29,682; (f) a decrease to vehicle insurance in the amount of $7,703; (g) the elimination of penalty expenses in the amount of $3,927; (h) a decrease to leased vehicle expense in the amount of $259,687; (i) an increase in fuel costs by $225,626 due to an increase in gasoline prices; (j) a decrease to expenses related to the "Call Before You Dig" program in the amount of $2,644; and (k) an increase in the amount of $6,421 to reflect increases in National Association of Water Companies ("NAWC") and American Water Works Association ("AWWA") dues. The OUCC accepted Petitioner's adjustments for vehicle insurance, the elimination of penalty expenses, and the "Call Before You Dig" program. On rebuttal, Petitioner accepted the OUCC's rejection of the adjustment to eliminate certain expenses labeled as "labor expenses." The OUCC noted that the labor expense adjustment is unnecessary as the expense is properly recoverable. Petitioner also accepted Ms. Stull's calculation of additional security expense to be included as a pro forma adjustment and agreed with her adjusted amount of $23,313. In addition, Petitioner accepted Ms. Stull's adjustment of $2,883 for AWWA and NAWC dues. Total pro forma Miscellaneous Expense reflected in Indiana-American's rebuttal position is $6,575,342. We have already addressed the adjustment to 401(k) and DCP Expense in connection with our discussion of labor positions, and therefore find that the OUCC's adjustment to increase these amounts by $57,754 and $30,033 respectively should be approved. In addition, we have reduced Petitioner's 401(k) expense by $1,554 and DCP Expense by $6,792 to account for the removal of expenses associated with the Senior Manager Business Development position. The other disputed Miscellaneous Expense adjustments are addressed in detail below.

(a) **Legal Expense.**

(i) **Petitioner's Position.** Mr. VerDouw proposed to adjust legal expense to the budgeted 2011 level. He testified that legal expense varies year by year and depends on the number of cases and activities requiring legal expertise. The Company determined that the 2011 budgeted level of legal expense would reflect the most reasonable expense level. Using this assumption, the pro forma adjustment for legal expense increases miscellaneous expense by $79,638.

(ii) **OUCC's Position.** Ms. Stull testified that Petitioner based its pro forma legal expense on the amount included in its 2011 budget. She testified that a budgeted number, without any further supporting documentation, is not a reasonable basis on which to base an operating expense adjustment for ratemaking purposes. In prior rate cases, Petitioner proposed an adjustment to legal expense based on an average of legal expense over a three year period. In this case, Petitioner presented a three year average for legal expenses for the years 2008, 2009, and 2010 but based its proposed adjustment on the higher amount included in its 2011 budget.

Ms. Stull testified the OUCC attempted to validate the three-year average presented in Petitioner's workpapers. She said the OUCC requested copies of all test-year legal invoices over

$1,000, as well as all legal invoices over $1,000 for the years 2008 and 2009. She stated that Petitioner provided invoices for some vendors that supported the associated legal expense. However, for the remaining legal expense, the support merely consisted of a document with the name of the law firm and the amount due. Ms. Stull testified these documents contained no information regarding the matter for which the legal fees were incurred.

Ms. Stull testified that at a minimum, the supporting documentation should include the subject matter, as well as the date, the name of the attorney providing the service, the hourly rate for each attorney, and the hours worked by each attorney for each matter included in the invoice. Ms. Stull testified that without such information, a reviewing agency is unable to determine whether the legal fees are properly recoverable and includable in pro forma legal expense. Therefore, Ms. Stull proposed a decrease of $139,327 to eliminate all unsupported test-year legal fees.

(iii) Petitioner's Rebuttal. Mr. VerDouw opposed Ms. Stull's position. He noted that Petitioner produced redacted legal invoices in similar fashion to what it had done in prior cases and that the OUCC did not request any further information concerning the invoices it disputed. He also noted that her suggested outcome would result in annual legal expense on a pro forma basis of $15,000, which he testified is an unreasonable level for a company the size of Indiana-American. He testified that the Commission should accept the Company's original adjustment, which increases the test-year level of legal expense based on the 2011 budget. Barring that, he testified the Commission should accept no adjustment and utilize the test-year level. Since the OUCC is proposing to disallow much of the test-year level of expense, he testified the OUCC bears a greater burden of explaining why it believes these expenses should be disallowed.

(iv) Commission Discussion and Findings. Adjustments to test-year expenses must be fixed, known, and measurable. We agree with the OUCC that it is not appropriate to base adjustments on a budgeted amount without any supporting documentation. Petitioner bears the burden of producing documentation that sufficiently details the expenses and requesting confidential treatment of information when appropriate. However, we disagree with the OUCC's proposal to remove almost all test-year legal expense. Petitioner's test-year level of legal expense is $154,362. Because Petitioner has not met its burden of proof with respect to any adjustment to the test year, we conclude Petitioner's total legal expense is $154,362.

(b) Leased Vehicle Expense.

(i) Petitioner's Position. Mr. VerDouw explained that the Company is converting its fleet from leased vehicles to owned vehicles. As leases expire, the Company is purchasing new vehicles. He reviewed the Company's list of vehicles with leases that expire in 2010 and made adjustments to remove the lease expense. He proposed an adjustment to reduce leased vehicle expense in the amount of $259,687.

(ii) OUCC's Position. Ms. Stull accepted Petitioner's adjustment and added an additional adjustment of $87,264 to eliminate rental expense for vehicle leases that will expire during the adjustment period. Ms. Stull testified the basic difference between her proposed adjustment and Petitioner's adjustment is the definition of pro forma expense for rate-making purposes. She said Petitioner's adjustment is based on the number of months billed in 2011, while her adjustment is based on the recurring annual expense Petitioner will incur subsequent to the test year. Ms. Stull indicated there were numerous vehicles whose leases expired during 2011. She said based on Petitioner's change in practice of purchasing vehicles rather than leasing them, Petitioner should not be renewing these vehicle leases. Therefore, her adjustment eliminates all vehicle leases that expire within 2011 yielding a recurring annual expense of $1,294,628 or a decrease of $346,951 to test-year leased vehicle expense.

(iii) <u>Petitioner's Rebuttal</u>. Mr. VerDouw opposed the additional adjustment for leases expiring in 2011. He noted the vehicles with leases expiring in 2011 will need to be replaced with a purchased vehicle, which Ms. Stull did not include in her total rate base. He noted that it would be improper to remove the rental expense without also matching it with the increase to rate base.

(iv) <u>Commission Discussion and Findings.</u> Ms. Stull proposed that we disallow expense associated with vehicles whose leases will expire in 2011 and will need to be replaced, but she did not propose an adjustment to account for the replacement of the vehicles. Therefore, we approve Petitioner's proposed adjustment to leased vehicle expense of $259,687 as a decrease in test-year expense.

(c) <u>Fuel Expense</u>.

(i) <u>Petitioner's Position</u>. Mr. VerDouw proposed an adjustment to gasoline and diesel costs. The gasoline and diesel costs for the Company's fleet for the actual test year reflected an average cost of $2.77 per gallon. On April 29, 2011, a survey provided by Gasbuddy.com showed the gasoline prices in the State of Indiana were as high as $4.35 a gallon in Gary and averaged $4.17 per gallon across the state. Diesel prices were even higher. He testified that Gasbuddy.com is a website that offers a real time gas price forum so that consumers can access the most current local gas prices available. He proposed an adjustment, which he styled as conservative to reflect the cost of gasoline and diesel fuel at $4 per gallon. This resulted in an increase to fuel prices of $225,626.

(ii) <u>OUCC's Position</u>. While expressing some reservation about his assumptions, Ms. Stull ultimately accepted Mr. VerDouw's methodology, but she proposed a different price per gallon. She visited Gasbuddy.com at a different date and proposed a current gas price of $3.258 per gallon. Her proposed adjustment was an increase of $89,516.

(iii) <u>Petitioner's Rebuttal</u>. On rebuttal, Mr. VerDouw pointed out that his survey of Gasbuddy.com came at perhaps the highest gas price of the year and that Ms. Stull's survey was made at perhaps the lowest price of the year. He noted that the average price of unleaded gasoline in the State of Indiana has been above $3.50 almost continually from the period of March 1 through September 20, 2011. The average price on October 13, 2011 was $3.468 per gallon. He proposed on rebuttal that the average price be set at $3.50 per gallon which would produce a pro forma adjustment of $128,038.

(iv) **Commission Discussion and Findings.** The price of gasoline and diesel fuel has been extremely volatile over the course of the last few years. Therefore, the use of an average price per gallon as a proxy for a reasonable level of expense is appropriate. Based on the various charts and graphs presented by Mr. VerDouw and Ms. Stull, we find that $3.50 per gallon is a reasonable average price. Accordingly, we accept Petitioner's proposed adjustment as modified on rebuttal. The result is an adjustment of $128,038 as an increase in test-year expense.

(d) **Non-Recurring/Non-Allowed Expenses.**

(i) **OUCC's Position.** Ms. Stull proposed an adjustment to eliminate non-allowed and non-recurring expenses that provide no material benefit to ratepayers and are not necessary for the provision of water utility service. She said these expenses should not be borne by ratepayers and include, among other things, image building expenses such as sports sponsorships, memberships in civic organizations, and other community relations expenses, as well as charitable donations, golf outings, employee awards, and non-allowed advertising expenses. She testified the Commission has disallowed these types of expenses in prior Indiana-American rate cases including Cause Nos. 42029, 42520, 43187, and 43680.

She said her adjustment does not eliminate any Chamber of Commerce dues because the Commission has allowed these expenses to be included in operating expenses. However, she said if she could identify an expense labeled as "Chamber of Commerce" as an expense for a sports sponsorship, advertising, or other non-allowed type of activity, then she did exclude it. She said she does not believe the Commission intended to allow these types of expenses under the guise of paying them to a Chamber of Commerce organization. Ms. Stull proposed a decrease of $163,387 for these non-allowed and non-recurring expenses.

(ii) **Petitioner's Rebuttal.** Mr. VerDouw noted that one of Ms. Stull's proposed adjustments for $3,900 was to eliminate a penalty that the Company had already removed. He also opposed her elimination of employee awards and recognition for celebrating milestone anniversaries which accounted for $26,501. He noted that many of these expenses were incurred to make sure that employees are involved in their communities by supporting their membership in local Rotary Clubs, Kiwanis Clubs, and various local economic development groups. Doing so benefits customers. He also noted that Ms. Stull is proposing to eliminate membership dues and various other miscellaneous costs that he described as the cost of doing business and included everything from educational items to manning a booth at the State Fair. He did accept $39,789 of her reductions.

(iii) **Commission Discussion and Findings.** Petitioner accepted $39,789 of Ms. Stull's adjustment, but contested the remaining $123,599. Petitioner contended that Ms. Stull removed $3,900 for a penalty, which Petitioner had already removed, and we agree this amount should be reduced from Ms. Stull's adjustment. Based on our review of the remaining adjustments, we find they are not reasonably necessary for the provision of water utility service to ratepayers. Therefore, we accept Ms. Stull's adjustment of $163,387 minus the $3,900 penalty, for a total adjustment of $159,487 as a decrease in test-year expense.

(e) **Total Miscellaneous Expense Adjustment.** Based on the discussion above, we conclude Petitioner's total pro forma Miscellaneous Expense is $6,334,088, which is a decrease of $199,773 from the test-year.

(7) **Rent Expense.**

(a) **Petitioner's Position.** Petitioner proposed a pro forma decrease to rent expense in the amount of $44,477 to reflect a negotiated decrease in the Greenwood Corporate Office Lease that takes effect in 2011.

(b) **OUCC's Position.** Ms. Stull accepted Petitioner's proposed adjustment for the Greenwood office lease and proposed an additional adjustment to remove the costs of leasing the Bibler plant property in the Warsaw District in the amount of $16,469. Ms. Stull testified that as part of Petitioner's new Warsaw WTP, the existing water treatment plants and well fields will be retired. In response to OUCC Data Request Q-19-4 Petitioner indicated the Bibler plant property was not owned by Indiana-American and was being leased. During the test year, Petitioner incurred $16,469 of lease payments for the Bibler plant property. Ms. Stull's proposed adjustment eliminates these test-year lease payments.

(c) **Petitioner's Rebuttal.** Mr. Hoffman opposed Ms. Stull's additional adjustment related to the Bibler wellfield lease. He explained that although Petitioner will not be using the Bibler wellfield with the new Warsaw WTP, Petitioner has certain remaining obligations under the lease agreement for the property, including an obligation to pay a termination fee in the amount of the annual lease cost. Because the Company has needed to maintain use of the wellfield until the Company is comfortable with the operation of the new treatment plant, and because the lease requires removal of all facilities within 60 days of notice of lease termination, Mr. Hoffman explained that the Company cannot yet provide notice of lease termination to the Lessor. He testified that the Company plans to provide notice to the Lessor in November 2011, once it is satisfied with operation of the new treatment facility, and will be able to remove the existing facilities at the Bibler wellfield. Mr. Hoffman stated that because the Company has incurred the cost of the lease in the 2010 test year, and has incurred the cost of the lease in 2011, and will incur the cost of the lease termination fee in the amount of the annual lease amount which will essentially equate to a lease cost for 2012, two years after the test year, the Company believes it to be fair and appropriate for the Company to recover these costs.

(d) **Commission Discussion and Findings.** The parties agree with the adjustment of $44,477 for the Greenwood corporate office lease, and we accept this adjustment. With respect to the Bibler wellfield, we agree with Ms. Stull that once the Warsaw WTP is functioning, Petitioner will no longer need the Bibler wellfield. Therefore, the annual lease expense should be eliminated. However, as Mr. Hoffman testified, Petitioner will be responsible for a lease termination payment. It is appropriate that Petitioner be able to recover this cost through rates. However, the cost is non-recurring and is therefore not appropriately recovered as a pro forma expense adjustment. Therefore, Petitioner shall account for the termination fee as a regulatory asset amortized over two years – the expected period Petitioner's rates from this case will be in effect. Accepting Ms. Stull's calculation that annual lease cost is $16,469 and Mr. Hoffman's testimony that the termination fee equals the annual lease cost, the result is a pro forma adjustment of $8,235. Therefore, we conclude Petitioner's total rent expense adjustment is $52,712 as a decrease in test-year expense.

(8) <u>Group Insurance</u>. The OUCC accepted Petitioner's proposed adjustment for Other Post-Employee Benefits of $719,844 as a decrease in test-year expense. The only dispute is with respect to Group Insurance is $98,700 and it relates to total headcount in pro forma labor. We previously accepted the OUCC's count of 358 full-time employees; therefore we also accept the OUCC's adjustment of $696,467 as an increase in test-year expense. However, we previously removed the Senior Manager Business Development position from rates. Therefore, we have reduced test-year expense by $6,321, which results in a pro forma expense adjustment of $690,146. We conclude the total Group Insurance adjustment is a test-year decrease of $29,698, resulting in a pro forma insurance expense of $3,639,343.

(9) <u>Customer Accounting Expense</u>.

(a) <u>Petitioner's Position</u>. Petitioner proposed two adjustments to customer accounting expense: (1) an increase to uncollectible expense of $406,224 based on a three year average uncollectible expense rate of 1.1772%; and (2) an increase of $15,666 to postage expense based on rate increases implemented in April 2011.

(b) <u>OUCC's Position</u>. Ms. Stull accepted Petitioner's methodology for calculating both uncollectible expense and postage expense, but proposed different adjustment amounts. She also proposed an adjustment to capture additional postage expense due to customer growth experienced during the test-year and post-test-year periods. Ms. Stull proposed an uncollectible expense adjustment of $405,903. This differs from Petitioner's proposed adjustment in that it is applied to the OUCC's pro forma operating revenues, which differ from Petitioner's proposed levels as described elsewhere in this Order. In addition, Ms. Stull testified that Petitioner's pro forma uncollectible expense was incorrectly calculated using total operating revenues rather than just water and sewer revenues.

Ms. Stull noted that when Petitioner calculated its pro forma postage expense to account for the increase in postage rates that took effect in April 2011, it applied the new rates only to mail processed after the new rates went into effect. As a result of the correction of this error, Ms. Stull proposed an increase to postage and mailing expense of $22,666. Ms. Stull also proposed an adjustment to reflect increased postage costs related to additional billings due to customer growth during and subsequent to the test year, yielding increased postage expense of $11,363.

(c) <u>Petitioner's Rebuttal</u>. Mr. VerDouw accepted Ms. Stull's methodology in calculating the uncollectible expense adjustment wherein only water and sewer revenue are included. However, he pointed out that Ms. Stull included her proposed revenue adjustment for late payment fees though such an adjustment would be included in "other" revenue. As a result, Mr. VerDouw's proposed uncollectible expense adjustment is $368,327.

Mr. VerDouw agreed with Ms. Stull's correction to postage expense of $22,666. Mr. VerDouw also agreed with Ms. Stull that an adjustment should be made to postage expense for additional billings related to customer growth. However, he calculated an adjustment of $10,387 for a total postage expense adjustment of $33,053.

(d) <u>Commission Discussion and Findings</u>. The parties agree on the methodology for calculating the appropriate amount of uncollectible expense, but disagree on the result. The Commission calculated the uncollectible expense adjustment, using Petitioner's proposed 1.772% 3-year average uncollectible rate on water/sewer revenues of $192,995,582. The result is an adjustment of $378,464 as an increase in test-year expense.

Petitioner and the OUCC agreed to a postage expense adjustment of $22,666, and we accept the adjustment. With respect to increased postage for customer growth, the OUCC made its calculation based on customer growth of 33,422. On rebuttal, Petitioner made its calculation based on customer growth of 30,550. We accept Petitioner's rebuttal adjustment calculation of $10,387. These amounts comprise a total customer accounting adjustment of $411,517, which increases Customer Accounting test-year expense to $4,954,641.

(10) <u>General Office Expense</u>.

(a) <u>Petitioner's Position</u>. Mr. VerDouw proposed two pro forma adjustments to the test year for General Office Expense. The first adjustment was made to eliminate labor expenses that were reflected in General Office Expense. The second adjustment was made to eliminate items that may be considered disputable with regard to recovery in a rate case. Rather than argue the recovery of these items, Mr. VerDouw explained that the Company made the determination to eliminate the items up front. The amount of the pro forma adjustment made for these two items decreased test-year General Office Expense by $4,835.

(b) <u>OUCC's Position</u>. Ms. Stull proposed a net overall decrease to test-year General Office Expense in the amount of $17,904. Her pro forma General Office Expense was $1,326,890. She did not accept Petitioner's proposed elimination of general office "labor" expense in the amount of $838. She testified that, during the on-site accounting audit, Mr. VerDouw explained that these expenses were actually reimbursement of employee out of pocket expenses that are reimbursed to the employee via their paycheck. Ms. Stull stated that she believes these should be considered legitimate operating expenses and should be included in Petitioner's revenue requirement.

Ms. Stull accepted Petitioner's proposed adjustments to eliminate non-allowed expenses but also proposed elimination of additional expenses in the amount of $13,907, which she identified as not allowed for ratemaking purposes. She described the additional items as providing no material benefit to ratepayers and not necessary for the provision of water utility service. According to Ms. Stull, the items included Rotary Club dues, Kiwanis Club dues, various economic development groups, flowers, and non-work related meals.

(c) <u>Petitioner's Rebuttal</u>. Mr. VerDouw stated that he accepted Ms. Stull's rejection of an adjustment to reduce General Office Expense by $838 for employee-type expenses that have been reimbursed to the employee via their paycheck.

However, he disagreed with her additional adjustment to reduce General Office Expense by $13,907 for the items identified in her prefiled testimony. He explained that local district managers and their employees are encouraged to be active members of the communities they serve and that memberships in Rotary Clubs, Kiwanis Clubs, various local economic development groups, and other civic organizations do benefit the customers by giving the

Company an avenue to build partnerships with businesses, communities, and consumers. He stated these activities allow the Company to participate in organizations that guide building and construction standards as well as provide a forum to discuss plans, coordinate building activities and promote programs like water conservation to consumers, fellow utility members, and business and government leaders. Mr. VerDouw testified that such participation benefits the Company's customers and serves to open up communication lines to customers. He then explained that $2,398 of Ms. Stull's adjustment was for three events that she classifies as non-work related meals when, in fact, they were meals for leadership meetings and training events held for Indiana-American managers and employees. Of Ms. Stull's proposed reduction to General Office Expense, Mr. VerDouw identified $1,434 as payments to floral shops for flowers sent to employees who were hospitalized and/or to the families of Indiana-American employees when a loved one passed away. Although he believes these payments are a necessary cost of doing business, Mr. VerDouw stated he was willing to concede on this portion of Ms. Stull's adjustment. Accordingly, Mr. VerDouw stated the appropriate adjustment for additional disputable expenses is to reflect a reduction of $1,434 to General Office Expense.

Petitioner's total pro forma General Office Expense on rebuttal was $1,339,364.

(d) <u>Commission Discussion and Findings</u>. The Parties have agreed that no adjustment should be made to eliminate $838 of miscellaneous test-year general-office expense for reimbursements for various employee expenses. We conclude these costs are proper expenses to recover through rates.

The Commission also agrees with Ms. Stull's proposed adjustment to eliminate an additional $13,907 of non-allowed General Office Expenses. In Cause No. 43680, we denied recovery of dues and membership fees in various community organizations, and we remain unconvinced that membership in such associations and organizations is necessary for the provision of utility service to ratepayers. With respect to employee meals at leadership meetings and training sessions, we find it is not reasonable to ask ratepayers to fund these meals in light of the current state of the economy. During the field hearings in this case, we heard from many members of the public who told us how much they have already sacrificed to pay their bills. As Petitioner asks us to approve significant increases in one of those bills, we find it is appropriate for the Company to make sacrifices as well, especially when those sacrifices do not compromise its ability to provide quality utility service. Therefore, we conclude that Petitioner's General Office Expense adjustment is $17,904 as a decrease in test-year expense.

(11) <u>Taxes</u>.

(a) <u>Federal Income Tax</u>.

(i) <u>Petitioner's Position</u>. Petitioner calculated its pro forma federal income tax expense utilizing the Muncie Remand Method. This is a long-standing practice of Petitioner, which reflects the impact of its inclusion in a consolidated federal income tax return. The Muncie Remand Method allocates a portion of American Water's interest deduction to Petitioner for purposes of computing tax expense, thereby providing a tax benefit to customers. The interest allocated under this procedure was $3,929,964 and this reduced tax expense by $1,375,487.

(ii) **OUCC's Position.** Mr. Smith explained that Indiana-American is a participant in the American Water consolidated federal income tax return, and thus does not pay federal income taxes directly to the government. He added that when Indiana-American shows a positive current federal income tax obligation, it remits the money to American Water, which in turn may or may not remit an income tax payment to the federal government depending on the results of its consolidated federal income tax return. Based on the information available in the rate case, Mr. Smith said Indiana-American has not had an obligation to pay federal income taxes in recent years. Mr. Smith noted that any federal tax liability on the American Water consolidated return would be paid by American Water. Mr. Smith noted that Indiana-American's responses to OUCC 52-051(e) and (f) indicated that Indiana-American did not pay any 2009 federal income tax and did not expect to pay any 2010 federal income tax. However, in this rate request, Petitioner has reflected positive federal taxable income and positive current federal income tax expense. Mr. Smith noted that subsequent discovery responses provided by Petitioner indicate that American Water did not pay 2009 or 2010 federal income taxes and that it does not expect to pay 2011 federal income tax. Mr. Smith noted also that American Water reported in its 2010 Securities and Exchange Commission ("SEC") form 10-K that it had a federal NOLC in excess $1.185 billion as of December 31, 2010, which grew from approximately $1.124 billion as of December 31, 2009.

Mr. Smith noted the amounts that Indiana-American recorded on its books related to the American Water federal NOLC as of December 31, 2009 and 2010, respectively, are listed in the Company's confidential response to OUCC 52-039. Mr. Smith also noted that in another response Petitioner stated that based on current tax law, Indiana-American currently anticipates that American Water will pay alternative minimum tax in 2011. Mr. Smith stated that Indiana-American does not know if American Water will pay federal income taxes in any year, 2012 through 2015, but anticipates the parent company will pay only alternative minimum tax in each of those years. Mr. Smith noted that American Water did not pay federal alternative minimum tax in 2010. He added that Indiana-American stated no analysis has been done to project alternative minimum tax liability for 2011-2015." Thus, there is no reliable basis for concluding that American Water is likely to pay federal alternative minimum tax in any year in that period.

Mr. Smith noted that Indiana-American's income tax calculations for ratemaking purposes reflect that it would have positive state and federal taxable income. Thus, he noted Petitioner has included a positive amount for current state and federal income tax expense in its rate increase request. Mr. Smith noted that Petitioner has reflected a reduction to current federal income tax expense of $1,375,487 related to a tax deduction for interest on parent company debt. Mr. Smith added that Petitioner determined the amount of its equity capital that was supported by American Water debt, and computed an interest deduction for the parent company debt of $3,929,964, which Indiana-American multiplied by the 35% federal income tax rate to obtain the reduction to current income tax expense for parent company debt interest of $1,375,487.

Mr. Smith advised that in a data request response, Petitioner explained that American Water does not allocate interest expense (or any other parent company expenses) to the operating companies for either book or tax purposes. For ratemaking purposes, Indiana-American advised in a discovery response that Petitioner uses the "Muncie Remand Method" to reflect the impact of participating in the consolidated federal income tax return. Mr. Smith noted language from the Commission's Order in Cause No. 37176 states as follows:

> The Petitioner is a subsidiary of American Water Works Company, Inc. (AWW). As such it joins with AWW and other affiliated companies in filing a consolidated federal income tax return. Both the Petitioner and the Staff reduced the Petitioner's federal income tax expense allowable for ratemaking purposes by allocating a portion of AWW's interest expense to the Petitioner, thereby reducing taxable income. The same type of adjustment has been made in rate proceedings of other AWW subsidiaries. The method which was used was set forth by the Commission in its Supplemental Order on Remand dated September 16, 1981 in Cause No. 34571 involving Muncie Water Works Company. The Commission hereby takes administrative notice of the Supplemental Order on Remand in Cause No. 34571 and the methodology employed therein. The Commission finds and determine [sic] that such methodology accurately reflects the tax benefits resulting from the Petitioner's participation in the filing of a consolidated tax return, and should be used in this proceeding.

Indiana-American Water Co., 1983 Ind. PUC LEXIS 86, at *12-13 (Pub. Serv. Comm'n of Ind. Nov. 23, 1983).

Mr. Smith advised that the parent company interest deduction does not fully reflect the tax benefits resulting from Indiana-American's current participation in the consolidated income tax return. Rather, he noted it only reflects a sharing of the tax savings relating to the parent company interest deduction. To fully reflect the tax benefits from participation in a consolidated federal income tax return for ratemaking purposes, Mr. Smith stated it is necessary to make a consolidated federal income tax savings adjustment.

Mr. Smith explained that consolidated income tax savings adjustments are made in jurisdictions where Indiana-American's affiliates are regulated including Pennsylvania, New Jersey, and West Virginia. Of those, he was most familiar with the consolidated tax savings adjustments made in Pennsylvania and West Virginia, having participated in recent rate cases involving the American Water utility-operating subsidiaries in those states. Previously, a consolidated tax savings adjustment had also been made for the American Water utility-operating subsidiary in Kentucky; however, that adjustment was discontinued in the most recent Kentucky-American Water Company rate case.

Mr. Smith also discussed the impacts from filing a consolidated federal income tax return. Mr. Smith explained that the Consolidated Tax Savings Adjustment reflects the consolidated tax savings that result from Indiana-American's participation in a consolidated federal income tax return. Based on the four-year period, 2007 through 2010, Indiana-American had total positive federal taxable income of $24,545,225, which was 6.0% of the total positive federal taxable incomes on the American Water consolidated federal income tax returns of $409,318,033. During that period, the losses from non-regulated affiliate tax loss companies amounted to $447,038,088. Mr. Smith noted Indiana-American's share of those, based on its 6.0% of total positive taxable income amounted to $26,822,285, and the federal income tax benefit at the 35% statutory rate totaled $9,387,800. He added that the average benefit over the four-year period to Indiana-American is $2,346,950. Therefore, Indiana-American's share of the consolidated income tax savings are $2.347 million. Mr. Smith explained that because a portion of the benefit of participating in a consolidated federal income tax return has already been reflected by Indiana-American in its calculation of the parent company debt interest deduction, only the additional consolidated income tax savings above that amount are being reflected as an adjustment in the OUCC's calculation of current federal income tax expense. The net amount of consolidated tax savings adjustment is $908,681.

Mr. Smith explained that Indiana-American computed federal income tax expense for the test period by applying a 35% federal income tax rate to the Company's determination of the test period's taxable income. He noted this is referred to as the "stand-alone" method, which assumes that the Company files a separate federal income tax return. Mr. Smith reiterated the fact that Petitioner reflected a deduction for parent company debt interest in computing its proposed current federal income tax expense for rate making purposes. He described that as the single exception to Indiana-American's use of a "stand-alone" or "separate return" method for computing its requested income tax expense for ratemaking purposes.

Mr. Smith noted Indiana-American does not actually file a separate federal income tax return. Rather, Indiana-American is part of the consolidated federal income tax return that is filed by American Water to minimize its federal income tax liability. Mr. Smith explained a consolidated income tax return generates tax savings because some members of the consolidated group generate tax losses, and these tax losses are used to offset a portion of the taxable income generated by the other affiliates, such as Indiana-American, to reduce income taxes payable for the entire consolidated entity. Mr. Smith noted that without a consolidated filing, it could take several years under the carry-forward and carry-back provisions of the Internal Revenue Code ("IRC") for recurring loss companies to fully realize tax savings. Without combining those recurring loss companies into a consolidated tax return with other companies that generate positive taxable income, such savings might not be realized. Mr. Smith testified that by filing a consolidated return, the consolidated entity, American Water, as a whole is able to realize, in the current tax year, the tax benefits generated by the loss companies.

Mr. Smith asserted that Indiana-American's ratepayers should share in the tax savings realized from the consolidated federal income tax filings. To that end, Mr. Smith stated that Indiana-American's ratepayers should only reimburse the Company for actual income taxes paid. He noted that if the tax savings from the consolidated income tax filings do not flow through to the Indiana-American ratepayers on an appropriate, proportionate basis, the ratepayers will pay rates that are higher than necessary to compensate Indiana-American for its actual costs. He therefore recommended that an appropriate consolidated income tax benefit be calculated for Indiana-American and reflected as a reduction to its current federal income tax expense in this case.

To calculate the consolidated income tax benefit adjustment for Indiana-American, Mr. Smith used the "effective tax rate" method, which is the exact same method that has been applied in the five Pennsylvania-American Water Company rate cases (four wastewater and one water) that Mr. Smith has participated in as an expert witness in the past two years. The only exception is that the calculation for Petitioner can include actual 2010 federal income tax results for American Water, which have become available as the result of American Water filing its consolidated federal income tax return for tax year 2010 by September 15, 2011. First, he considered the combined annual taxable income of all of the consolidated group members (including both regulated and non-regulated group members) with positive taxable income. He examined the four years 2007 through 2010, obtaining information from Indiana-American's confidential response to OUCC data request 52-065, which listed the taxable income and tax losses each year for Indiana-American and each regulated and non-regulated affiliate that participates in the American Water consolidated federal income tax return. He then calculated for each year the ratio of Indiana-American's positive taxable income in that year to the total of all positive taxable income by consolidated group members. Next, he determined the combined annual taxable losses of all non-regulated group members for each year. Regulated group members with tax losses were not used in the analysis because such tax losses were not considered to be recurring events, and it is generally considered inappropriate to share the tax losses of a regulated utility with another regulated utility in a different jurisdiction. He then applied the Indiana-American ratio to the combined annual tax loss amounts from the non-regulated affiliates to arrive at the annual tax losses that should be allocated to Indiana-American in order to calculate Indiana-American's share of tax benefits produced by the consolidated income tax return filing. Finally, Mr. Smith applied the federal income tax rate of 35% to the average consolidated tax loss benefits allocated to Indiana-American. This calculation indicates a normalized consolidated tax savings benefit for Indiana-American of $2,346,950 on a four-year average basis.

Mr. Smith explained that the calculation of the consolidated tax savings adjustment he derived for Petitioner is generally consistent with the derivation of the consolidated income tax savings adjustments in recent rate cases involving Indiana-American's affiliates in West Virginia and Pennsylvania, where consolidated tax savings adjustments have been made. For the Indiana-American calculation, the American Water consolidated federal income tax return for 2010 was filed by September 15, 2011; so, 2010 information is currently available, and he used it in the calculation shown on his Attachment LA-2, Schedule 2.

In the event that his proposed consolidated tax savings adjustment is not accepted, Mr. Smith proposed that an adjustment should be made to impute a domestic production deduction ("Section 199 Deduction"). He testified that, to the extent Indiana-American has positive federal taxable income on a separate return basis and otherwise qualifies, the Company would be eligible to claim a deduction under Section 199 of the IRC for domestic production activities. Because Indiana-American has its own water supply and treats the water, such activities qualify and would render Indiana-American eligible for the deduction if it has positive taxable income and meets the other requirements. He testified that, if his proposed consolidated tax savings adjustment is rejected and Indiana-American's current federal income tax expense is calculated primarily on a separate return basis, then the Section 199 Deduction should also be calculated on a separate return basis. Mr. Smith calculated a stand-alone Section 199 Deduction to be $1,432,402 at Petitioner's proposed rates and $1,079,763 at the OUCC's proposed rates.

Mr. Smith's final proposed adjustment for federal income taxes was to reduce current federal income tax expense by $12,841 for the research and development credit based on Petitioner's discovery responses.

(iii) Petitioner's Rebuttal. Mr. Warren accepted Mr. Smith's research and development credit, but he opposed the consolidated tax savings adjustment and the Section 199 Deduction. He testified that, by adhering to the Muncie Remand Method, Petitioner properly reflected the benefits of its participation in a consolidated federal income tax return under Indiana regulatory practice. He explained that the Muncie Remand Method was this Commission's specific attempt to address the proper ratemaking treatment for Petitioner's participation in a consolidated federal income tax return. In the Muncie Remand Order, the Commission determined that the tax savings from participation in a consolidated return were limited to the tax deduction taken by the parent company for its interest expense and rejected a method very much like that proposed by Mr. Smith. Mr. Warren testified that Mr. Smith's proposed adjustment is based on the tax results of the operations of non-regulated affiliates having nothing to do with the provision of regulated service to Indiana customers. Mr. Warren testified there were three major reasons for his disagreement with Mr. Smith's proposal. First, this Commission specifically considered and definitively rejected such a proposal in the Muncie Remand Method case. Second, his calculation is demonstrably one-sided. Mr. Smith imports tax losses from affiliates for the benefit of Indiana-American when Indiana-American has taxable income and the affiliates have tax losses. However, Mr. Smith does not export Indiana-American's tax losses to affiliates when Indiana-American has tax losses and those members have taxable income. Third, he believes it is neither economically justifiable nor equitable to reflect in ratemaking the tax consequences of expenses that are not, themselves, reflected in ratemaking. Mr. Warren testified that he knows of only four jurisdictions where consolidated tax savings adjustments are made. The only one that uses a method like that proposed by Mr. Smith is Pennsylvania - and that method was mandated by the Pennsylvania courts.

Mr. Warren further provided an example of why, philosophically, he opposes consolidated tax savings adjustments generally. If Indiana-American were to make a charitable contribution to a food bank, which is non-recoverable in rates, no party would contend that the benefit of the tax deduction for the charitable contribution should be allocated to ratepayers. However, under Mr. Smith's proposed consolidated tax savings adjustment, if an affiliate of Indiana-American made precisely the same charitable contribution, ratepayers could be allocated all or a portion of the benefit of that tax deduction. In his opinion, there is no justification for this inconsistency. Further, when a consolidated tax savings adjustment is imposed, the results of non-jurisdictional operations will have a direct effect on the setting of jurisdictional rates. A consolidated tax savings adjustment will reduce rates only if non-regulated affiliates produce tax losses. Conversely, if the Company's non-regulated affiliates begin to produce taxable income, the Company's revenue requirement will increase even if regulated operations do not change. Thus, decisions having tax implications that a non-regulated company makes in the normal course of business have the potential to impact customer rates.

As for the Section 199 Deduction, Mr. Warren testified that this is a very complex mechanism Congress enacted to provide a tax subsidy for certain domestic production activities. American Water presently does not qualify for a Section 199 Deduction – not because it does not engage in the requisite activities, but because the deduction is limited to consolidated taxable income. Largely due to bonus depreciation and the Repairs Method Change, American Water has no consolidated taxable income. Since the Section 199 Deduction is computed only on a consolidated basis, he testified that there is no deduction to allocate. Mr. Smith proposes to impute a tax deduction that does not exist in the tax law. Mr. Warren further explained that, even accepting, for the sake of argument, Mr. Smith's assertion that a commission could reasonably impute a Section 199 Deduction where it computes tax expense on a "stand-alone" basis, in Indiana, that is not the way tax expense is computed. The Muncie Remand Method is not a stand-alone approach to taxes but rather an attempt to account for the savings from participation in a consolidated income tax return. He further had two disagreements with Mr. Smith's calculation of the Section 199 Deduction adjustment. First, Mr. Smith failed to take account of Indiana-American's stand-alone NOLC which must be absorbed before Indiana-American would qualify for a Section 199 Deduction on a stand-alone basis. Second, Mr. Smith would need to make assumptions that no party has made about deductions that will be taken on the tax return in years during which rates will be in effect in order to determine that Indiana-American would even qualify for the Section 199 Deduction on a stand-alone basis.

(iv) Commission Findings. As noted, Petitioner has accepted Mr. Smith's research and development credit adjustment, and we accept that portion of Mr. Smith's proposed adjustments. With respect to the proposed consolidated tax savings adjustment, we have previously determined that tax savings from participation in a consolidated return are limited to the tax deduction taken by the parent company on its interest expense. We use the following procedure to compute the parent company interest allocation: 1) compute the parent company's long-term debt to equity ratio; 2) multiply the Indiana utility's equity amount by the results of step 1; 3) calculate the parent company's average cost of long-term debt; and 4) multiply the results in steps 2 and 3. The result represents the interest expense on that portion of the parent company's debt that supports investment in the Indiana utility. The tax benefits of this amount should be allocated to the Indiana utility to determine its federal income tax expense for rate-making purposes. *Muncie Remand Order*, 1981 Ind. PUC LEXIS 246, at *37-38.

We have relied on this method for computing the benefits from participation in a consolidated federal income tax return for over thirty years. The precedent results from a remand from the Court of Appeals directing us to undertake such an effort. We continue to be concerned about the allocation to Indiana ratepayers of either the tax burden or the tax savings of out-of-state affiliated companies. The effect of the OUCC's proposed consolidated tax savings adjustment would be to change Petitioner's revenue requirement due solely to the activities of affiliate companies. Therefore, we reject the OUCC's proposed consolidated tax savings adjustment and adhere to the Muncie Remand Method.

We further reject the Section 199 Deduction adjustment because that adjustment assumes a stand-alone income tax expense calculation. Insofar as we continue to employ the Muncie Remand Method, we do not utilize a stand-alone calculation. As a result, it is inappropriate to impute the Section 199 Deduction on a stand-alone basis.

(b) General Taxes.

(i) Petitioner's Position. The Company proposed five adjustments totaling a $1,130,374 increase to test-year general tax expense. The first was to payroll tax expense based on the pro forma level of wages. The second was to the Safe Drinking Water Act fee based on test-year accounts and rates. The third and fourth adjustments were for the IURC fee and utility receipts tax based on pro forma level of revenues. The final adjustment was to property taxes. Mr. VerDouw explained that property taxes were adjusted based on a calculation that starts with property taxes paid in 2010, determines the ratio of property taxes to total utility plant in-service on December 31, 2009, and applies that same ratio to utility plant in service on June 30, 2011, including the major project. The pro forma adjustment to property tax expense increased general taxes by $768,267.

(ii) <u>OUCC's Position</u>. Mr. Patrick explained the OUCC's opposition to the property tax expense adjustment. Mr. Patrick noted that Petitioner's estimate of real and personal property taxes is based on estimated total utility plant on June 30, 2011. Mr. Patrick explained that property tax returns are filed on or before May 10 of each year based on the utility plant in service at the end of the prior calendar year or on February 28 of the current year. Mr. Patrick added that these returns are filed in each township within the county where the property resides. Mr. Patrick explained that utility plant in service added during 2011 will not be reported to the various county assessor offices until May 2012. He further explained that assessments for utility plant in service added during 2011 will not be assessed until late 2012 or 2013. Mr. Patrick noted that payment will not be made on property added in 2011 until 2013. Mr. Patrick added that tax assessments will be based on individual county budget requirements. Pursuant to the Commission's Prehearing Conference Order in this Cause, the adjustment period consists of the 12 months following December 31, 2010. As a result, Mr. Patrick rejected any adjustment from property taxes based on plant that would not be assessed before the end of the adjustment period or December 31, 2011. Accordingly, he computed a pro forma property tax expense adjustment of $219,297 over the test year.

(iii) <u>Petitioner's Rebuttal</u>. Mr. VerDouw testified that Mr. Patrick's methodology has been rejected several times in prior Commission orders because it violates the matching principal. He testified that the level of property tax expense is to be matched to the approved rate base that produces the corresponding revenues. Mr. VerDouw testified that this corresponding "matching principle" has been used in every case that he has worked on for Indiana-American, and that until now it has never been disputed by the OUCC. Mr. VerDouw testified that Mr. Patrick's proposed methodology does not follow this precedent.

(iv) <u>Commission Discussion and Findings</u>. The parties agreed to an IDEM Safe Drinking Water Fee adjustment of $11,157 as a decrease in test-year expense, and we accept the adjustment. The parties differing calculations of payroll tax stem directly from their disagreement on the level of labor expense. Based on our finding above that Petitioner's labor expense is $17,021,654, we approve an increase of $31,026 for a total pro forma payroll tax expense of $1,257,784. Similarly, the parties disagreement over Environmental Tax, IURC Fee, Utility Receipts Tax, and State Income Tax were attributable solely to the different pro forma levels of revenue and net operating income. We approve those amounts as adjusted in light of the other findings in this Order.

With respect to property taxes, Petitioner cites prior Commission orders to support its argument that Mr. Patrick's approach, which removed property tax expense for property not assessed in the adjustment period, violates the matching principle and is inconsistent with our past decisions. In *Midwest Natural Gas Corp.*, we addressed a similar situation. Cause No. 39097, 1991 Ind. PUC LEXIS 352 (IURC Nov. 1, 1991). The utility sought to include an expense adjustment for recently constructed plant. *Id.*, at *25-27. The Property had been assessed in March 1991, which was during the pro forma period following the test year. *Id.* Therefore, we found that the adjustment was fixed, known, and measurable, and we included the adjustment in the utility's property tax expense. *Id.*

We addressed a similar situation in *Ind. Cities Water Corp.*, Cause No. 39166, 1992 Ind. PUC LEXIS 215 (IURC Jul. 8, 1992). The utility sought to include an adjustment for plant added between December 31, 1990, and May 31, 1991. *Id.*, at *28-33. The test year in that case ended June 30, 1990, with a 1-year adjustment period. The new plant was assessed for tax purposes on March 1, 1991. *Id.*, at *28. The utility's witness admitted that the tax rate would not be set until 1992, and the taxes would not be due until 1993. *Id.* However, he explained that the utility's accrual accounting system records property taxes as a liability in the year of assessment, i.e. during the adjustment period. The utility estimated the property tax expense based on the most current tax rate. *Id.* The OUCC argued that the expense was not fixed, known, and measurable because the tax rate was not known within the test-year adjustment period. *Id.*, at *31. The Commission included the utility's proposed expense for new plant, finding that estimating the property tax using the most-current tax rate and an assessment made during the adjustment period resulted in a sufficiently fixed, known, and measurable expense. *Id.*, at *33.

In both *Midwest Natural Gas* and *Ind. Cities Water*, the Commission relied on an assessed value that occurred during the adjustment period. That is not the case here. Petitioner asks us to include property tax expense for property that will not be assessed until 2012, and will not be payable until 2013. In *Lincoln Utils., Inc.*, the Commission denied an adjustment to include property tax expense on new plant, finding that the property would not be assessed until after the adjustment period ended. Cause No. 38169, 1990 Ind. PUC LEXIS 44, at *14 (IURC Feb. 14, 1990). The Commission concluded the expense was not fixed, known, and measurable. *Id.* Similarly here, we conclude that Petitioner's proposed adjustment for property tax expense on new property that was not assessed during the adjustment period is not fixed, known, and measurable, and we accept the OUCC's deduction of $219,297 from total property tax expense.

Based on our findings above, we conclude that Petitioner's total pro forma General Taxes Expense is $15,257,962, which is an increase of $489,644 from the test year.

10. <u>Net Operating Income at Present Rates.</u> Based on the evidence and the determinations made above, we find Petitioner's adjusted operating results under its present rates are as follows:

Operating Revenues		$ 196,426,042
Operating & Maintenance Expenses	73,904,211	
Depreciation and Amortization Expens	35,367,373	
Taxes Other than Income	15,257,962	
State Income Tax	5,229,715	
Federal Income Tax	16,283,049	
Total Operating Expenses		146,042,310
Net Operating Income		$ 50,383,732

In summary, we find that with appropriate adjustment for ratemaking purposes, Petitioner's annual net operating income under its present rates for water/sewer service would be $50,383,732. We have previously found that the fair value of Indiana-American's utility property is $1,051,885,770, and a fair return on that property is $51,509,986. Petitioner's current return of $50,383,732 is insufficient to represent a fair return on the fair value rate base. We therefore find that Petitioner's present rates are unreasonable and confiscatory.

11. Authorized Rate Increase. On the basis of the evidence presented in these proceedings, we find that Petitioner should be authorized to increase its rates and charges to produce additional operating revenue of $1,948,284, a 1.00% increase in water/sewer revenues, resulting in total annual operating revenue of $198,374,326. This revenue is reasonably estimated to afford Petitioner the opportunity to earn a net operating income of $51,509,986, as follows:

Operating Revenues	$198,374,326
Less: O&M Expenses	73,927,146
Depreciation/Amortization	35,367,373
Other Taxes	15,287,154
State Income Tax	5,393,176
Federal Income Tax	16,889,491
Total Expenses	**146,864,340**
Net Operating Income ("NOI")	$ 51,509,986
Less: NOI at Present Rates	50,383,732
Increase Required	$ 1,126,254
Times: Revenue Conversion Factor	1.72988
Authorized Increase in Revenue	**$ 1,948,284**
Revenue Percent Increase	**1.00%**

12. Cost of Service Study and Rate Design.

(a) **Petitioner's Position.** Mr. DeBoy sponsored Petitioner's proposed rate design for this case. He testified that the Company is proposing to move closer to full STP in this case. He provided a history of the gradual move the Company has been making to full STP over the course of 14 years. In the last rate case, the Company proposed and was granted authority to consolidate to full STP except for volumetric rates for retail general water service, for which there are currently two groups. Area Two includes the former United Operations and Wabash. Area One includes everything else. In this case, Petitioner proposes to move West Lafayette and Warsaw to Area One and to move Area Two closer to Area One rates.

He also testified concerning Petitioner's proposal for public fire protection. The Company proposed to roll the public fire protection surcharge costs into the customer charges. What was formerly included in the direct-billed public fire protection surcharge rates would, under Petitioner's proposal, be included in the customer charges for purposes of billing all customers on a single-tariff basis. In addition, Mr. DeBoy explained that the Company is proposing to eliminate public hydrant charges by directly recovering public fire protection costs from all customers by meter size. This would include those remaining municipalities that have not adopted an ordinance pursuant to Ind. Code § 8-1-2-103. He noted that customers in unincorporated areas within 1,000 feet of a hydrant are already paying the surcharge by meter size without any ordinance being adopted. He testified that letters had been sent to all mayors in the municipalities that have not previously adopted the Ind. Code § 8-1-2-103 ordinance, explaining that any municipality that wished to be withdrawn from this request and continue paying hydrant charges would have its wishes honored if they simply inform the OUCC or

Indiana-American prior to the close of the record in this case. He indicated that Petitioner would supplement its rebuttal testimony with any requests received prior to the close of the record.

Mr. Heid testified concerning Petitioner's Cost of Service Study and Rate Design. He also provided a history of the Company's movement towards STP, beginning with the 1997 Rate Order. The Company then continued a phased approach towards STP in its next several rate cases, Cause No. 41320, 42029 and 42520. Pursuant to the 2007 Rate Order, Petitioner increased its rates on an across-the-board basis. Then in the 2010 Rate Order, Petitioner was authorized to make a significant move towards STP. In this proceeding Petitioner proposes to move two of its Area Two districts into Area One, reduce the differential between Area One and Area Two commodity charge, and roll the public fire protection rates into the customer charges on a meter equivalency basis.

Mr. Heid conducted and presented a Cost of Service Study ("COSS"). He atated that the basic premise in establishing fair and equitable rates is that rates reflect the cost of providing service to each customer class and that a COSS is the tool used to make this determination. The purpose of the COSS is to allocate the total cost of service to each customer class. Mr. Heid used the AWWA Base-Extra Capacity method to allocate costs to customer classes. He testified that this method has been widely used and accepted in Indiana and elsewhere. Under the Base-Extra Capacity method, Petitioner's revenue requirements are allocated to the following cost functions according to the design and operation of the water system: base, extra capacity, customer, and direct public fire protection costs. These functionalized costs are then allocated to each customer class according to its usage and demand characteristics and other factors. Base costs are those costs that vary directly with the total quantity of water used as well as those costs associated with serving customers under average load conditions. Extra capacity costs are costs incurred due to demands in excess of average load conditions. Customer costs tend to vary in proportion to the number of customers. Direct public fire protection costs include the cost for maintaining and flushing public fire hydrants and the costs associated with those hydrants.

He testified that the total base costs are allocated to customer classes based on each customer class's average-day demand compared to the total average-day demand of all customer classes. Costs associated with facilities designed to meet peak demands are assigned to the maximum-day cost function. The total maximum-day costs are allocated to customer classes based on each customer class's maximum-day demand compared to the total maximum-day demand for all customer classes. Costs associated with facilities to meet peak hour demands are assigned to the maximum-hour cost function, which are allocated to customer classes based on each customer class's maximum-hour demand compared to total maximum-hour demand. Customer costs are directly assigned to their respective cost functions, either billing related or meters related.

He testified that there is also a need to differentiate the use of facilities between small volume and large volume users. In this expansion of cost categories, costs assigned to the basic cost functions (base and extra capacity) are further classified as common to all customers or common to small customers. As an example, sale-for-resale customers and very large volume industrial customers tend to be served from transmission mains and do not use the distribution mains. Smaller customers, on the other hand, are served by both the transmission mains and the distribution mains.

Mr. Heid testified that the water system is comprised of various facilities, each designed and operated to fulfill a given function. The system must be capable of providing not only the average annual amount of water used, but also supplying water at maximum daily and hourly rates of demand. Since all customers do not exert maximum demands at the same time, capacities of the various system facilities are established to meet the maximum coincident demand of all classes of customers. The maximum-day and maximum-hour coincident demand ratios were determined from an analysis of historical recorded average-day, maximum-day, and maximum-hour rates of water deliveries to the system. Mr. Heid relied on Petitioner's comprehensive planning reports for purposes of conducting this analysis. His analysis indicated that the maximum-day coincident demand is 1.54 of the average-day demand and the ratio of system maximum-hour coincident demand to average-day demand was determined to be 2.25. In Petitioner's Exhibit KAH-2: Schedule 1, presents the derivation of the maximum-day and maximum-hour functional cost allocation factors; Schedule 3, shows the allocation of the rate base to the various cost functions; Schedule 4, presents the allocation of depreciation and amortization expense; Schedule 5, shows the allocation of operation and maintenance expense; Schedule 6, presents the allocation of taxes; and Schedule 7, presents the allocation of miscellaneous revenues and credits.

Mr. Heid testified that the next step in the process is to allocate each of the functional costs to customer classes based on the respective cost responsibilities of each customer class. This is accomplished by determining each customer class's relative volume, extra capacity requirements, bills, and equivalent meters. These are commonly referred to as units of service. Petitioner's Exhibit KAH-2, Schedule 9 shows the customer classes along with their respective units of service. This schedule also shows the maximum-day and maximum-hour capacity factors for each customer class respectively. He testified that for purposes of this proceeding he used the capacity factor percentages that have been used for several cases now. He testified that each customer class's relative maximum-day and maximum-hour rates of use serve as the basis for allocating maximum-day and maximum-hour capacity-related costs to customer classes. The rationale for this is that customers with a high peak rate of use as compared with an average rate of use require larger capacity pumps, mains, and certain other system facilities than a customer who has the same total volume of use but takes water at a uniform rate. Maximum rates of use are expressed in terms of a capacity factor. Thus, if a customer class maximum-day rate of use is 2.0 times its average rate it is said to have a maximum-day capacity factor of 200%.

Mr. Heid testified that in Cause No. 43680, the Commission found that the Company should conduct and present a new capacity factor analysis in this case. He did so utilizing the methodology set forth in the AWWA Water Rates Manual, Fifth Edition (the "AWWA Rates Manual") and it was contained in his workpapers. He recommended that the COSS not be based on these capacity factor percentages because the results were surprising to him and were not reasonable. He testified that the residential and commercial capacity factors derived by his study were extraordinarily low and were not reasonable. He instead designed rates based on the previous capacity factor percentages that have been used for many cases. He testified he did so rather than implement the significant shifts among rate classes that would be called for from the new capacity factor analysis and needing to reverse those shifts should later studies prove these results to be an anomaly. He explained the difficulty with respect to performing a capacity factor analysis based solely on the AWWA Water Rates Manual methodology. The capacity factor analysis seeks information pertaining to customer class peak day and peak hour information.

However, the sole source of data to review capacity factors are monthly and bi-monthly meter reading and billing records. This requires Mr. Heid to estimate customer class peak and peak day and peak hour capacity factors using the methodology outlined in the AWWA Rates Manual. On completing the estimation, certain tests of reasonableness are performed to determine whether the allocation factors are within a reasonable range. The AWWA Rates Manual recommends that a system diversity ratio be computed and the ratio should be in the range of 1.10 to 1.40. He calculated the diversity ratio from the new analysis to be 1.13 for both the maximum-day and maximum-hour. Given the extreme proximity of this diversity ratio to the bottom end of the range of reasonableness, he found the results to be troubling, confirming his concern about the unreasonableness of the capacity factors developed utilizing the AWWA Water Rates Manual. As such he used the capacity factors that had been in use for many cases now but recommended to the Petitioner that a much more in-depth capacity factor study be developed for use in its next rate case. He recommended that the Company continue to study and review capacity factors over a longer period utilizing a more sophisticated and accurate methodology than set forth in the AWWA Water Rates Manual. For example, Mr. Heid recommended that the Petitioner consider utilizing load research by installing load research meters on a statistically valid sample of customers, an approach that is unprecedented for a water utility in Indiana.

Mr. Heid testified that the next step in the COSS is to calculate the unit cost of service for each cost function. Petitioner's Exhibit KAH-2, Schedule 12, shows this computation. Unit costs provide a means of distributing costs to the customer classes based on their respective service requirements. Unit costs of service are instrumental in rate design. Petitioner's Exhibit KAH-2, Schedule 13, shows the application of the unit costs of service to the units of service for each customer class to determine the total cost of service for each class. Petitioner's KAH-2, Schedule 14, compares the customer class revenues under current rates to the customer class costs of service computed in this fashion. The overall average increase to the customer classes, based on Petitioner case-in-chief filing, is 10.72%, so any customer class requiring less than a 10.72% increase to reach cost of service is providing a subsidy. Those requiring more than a 10.72% increase are receiving a subsidy. He noted that Indiana-American is proposing to moderate certain of the significant rate impacts.

Having completed the COSS, Mr. Heid then discussed the proposed rate design. He explained that the Company hoped to move completely to STP in Cause No. 43680. However the rate impacts in Mooresville, Warsaw, West Lafayette, Winchester, and Wabash would have been unacceptably large. This is a result of those operations having very low tail-block rates, which began at a low monthly usage level. This led to the creation of Area One and Area Two tariff rates. In this proceeding, Warsaw and West Lafayette would be transferred to Area One tariff rates leaving only three districts in Area Two tariff rates. In Petitioner's next rate case, its objective would be to move completely to STP or, as in this case, reduce the differential between the area rates. In addition, the Company is also proposing, consistent with the 2010 Rate Order, that future changes in DSIC be implemented on a STP basis.

Petitioner's Exhibit KAH-3, Schedule 1, presents the calculation of the proposed monthly and bi-monthly customer charges, prior to the addition of public fire protection surcharges. He noted that all customers would be subject to the same schedule of customer charges. Mr. Heid then described how the commodity charges were calculated for each class. In developing Area

One and Area Two commodity charges, he considered the stand-alone impacts for the Area Two districts. To the extent practicable, he attempted to keep bill impacts below the level of the stand-alone percentage increases. Since Area Two rates for Mooresville, Winchester, and Wabash were the critical rates causing the need for bifurcation of the commodity charges, his initial focus was on establishing Area Two commodity charges. He then designed the Area One commodity charges. Mr. Heid proposed the continuation of a declining block rate structure for retail general water service, which is designed so that each of the four retail customer classes recovers its respective costs of service. Industrial and large industrial reach the larger volume blocks so that rates are appropriately designed for those classes.

The sales-for-resale customer class has its own classification, which utilizes a single block rate structure. Mr. Heid proposed revisions to Petitioner's existing tariff for sale-for-resale standby service. Petitioner's Exhibit KAH-3, Schedule 4 contains the derivation of this rate.

Mr. Heid then described the calculation of proposed fire protection charges. Petitioner's Exhibit KAH-3, Schedule 3, provides calculation of rates for fire service both public and private. Public fire protection surcharge rates were derived based on meter size. He also testified that Indiana-American is proposing to moderate the impacts on public fire protection increases.

With respect to sewer service, Petitioner proposed to design the sewer rates at the same level as previously approved in the 2010 Rate Order. This would recover approximately $112,000 less than the sewer revenue requirement, which would be recovered through water rates. Mr. Heid testified that if this proposal was not acceptable, sewer customers would pay a monthly residential rate of $80.94 rather than the current $61.29 per month. The average residential water customer would experience an increase of slightly more than 3¢ per month to accommodate this proposal.

(b) <u>OUCC's Position</u>. Mr. Dahlstrom testified that the OUCC strives, where possible, to base its COSS and Rate Design on the methodologies identified in the AWWA Rates Manual. In addition, the OUCC aims to develop cost-based rates. Mr. Dahlstrom's COSS followed the Base-Extra Capacity method, as spelled out in the AWWA Manual. Mr. Dahlstrom testified regarding the OUCC's three primary goals in developing a COSS and rates. The first goal is to propose rates that are fair, equitable, and cost-based, and that eliminate subsidies where possible. The second goal is achieving consistency in cost functionalization, allocation, and rate design. Third, new rates should not produce rate shock for customers when implemented.

Mr. Dahlstrom testified that he had concerns with the functional allocation of costs in Mr. Heid's COSS. He testified that one of his major concerns with Mr. Heid's allocation of costs to the various functions is the mismatch in updating some, but not all, of the allocation factors, with test-year data. Mr. Dahlstrom said there are two main functional allocation percentage factors used in both Mr. Heid's and the OUCC's cost of service studies. Those are the Maximum-Day/Average-Day (Max Day) factor and the Maximum-Hour/Average-Day (Max Hour) factor. Mr. Dahlstrom testified that in Mr. Heid's model, Mr. Heid updated the Max Day factor, but not the Max Hour factor. When asked to provide support for the two factors used in Mr. Heid's study, Petitioner responded by providing support for the Max Day factor only.

Indiana-American said they did not have support for the Max Hour factor, but they were simply using the factor used in the two previous Causes.

Mr. Dahlstrom stated the AWWA Rates Manual, on page 299, discusses the fact that Max Hour factors build on the determination of the Max Day factors. He said the strong relationship between the two factors indicates it would not be appropriate to consider the two factors in isolation, as Petitioner has done. Mr. Dahlstrom testified that the AWWA Rates Manual indicates, in the Base-Extra Capacity method of Functional allocation, that the analyst can choose to subdivide these costs between Max Day and Max Hour functions. Mr. Dahlstrom said Mr. Heid selected this option when developing Petitioner's COSS. Mr. Dahlstrom testified that subdividing these costs indicates using two related factors, not factors based on two different sets of input data. Mr. Dahlstrom testified Petitioner has used one factor based on historical data far outside the test year. Further, Petitioner provided no documentation on the derivation of its historical Max Hour factor.

Mr. Dahlstrom testified that he used functional percentage factors based on test-year information, for both allocators. He said this yields the most reasonable and fairest rates, because it most closely matches current conditions. Inconsistently updating only one of the functional allocation percentage factors, not both, yields unfair and unreasonable results. Mr. Dahlstrom said Mr. Heid used test-year sales, customer counts, expenses, and numerous other test-year data. Mr. Dahlstrom said it was inconsistent that Mr. Heid would not update both functional percentage allocation factors using test-year data, when Mr. Heid used test-year data in calculating almost every other factor in Petitioner's COSS and rate design in this Cause.

Mr. Dahlstrom was also critical of Mr. Heid's allocation of costs to functions. Mr. Heid had allocated costs associated with mains that are 2-inches and smaller directly to the customer function. Mr. Dahlstrom testified that only those costs that would be avoided if a customer leaves the system, such as meters, services, meter reading, and customer service/accounting should be used in the derivation of the monthly customer charge. He cited as support Citizens Gas & Coke Util., Cause No. 42767, p. 76 (IURC Oct. 19, 2006). He testified that in Petitioner's last case, Petitioner did not include any allocation of mains to the customer function, but that in prior cases, Petitioner had included an allocation of mains 4 inches and smaller to the customer function.

Mr. Dahlstrom then addressed allocation to customer classes. He testified the major driver in allocating costs to customer classes is the capacity factor. He testified that the capacity factors used in Mr. Heid's study had been developed some time in the past and that there is no current support for them. He testified that the use of old capacity factors is inappropriate pursuant to the AWWA Rates Manual and suggested the capacity factors need to reflect the most recent five years of data. Mr. Dahlstrom used the newly updated capacity factors created by, but not used by, Mr. Heid. Mr. Dahlstrom testified that using these factors represents the most recent data available on customer demands and it is his preference to use test-year data, where possible, in his COSS.

Mr. Dahlstrom said that in addition, using test-year based data is consistent with the majority of other data used in his COSS. He said his data includes, but is not limited to, test-year sales, test-year customer counts, test-year assets, test-year expense, test-year billing determinants, and test-year functional-percentage allocators. Mr. Dahlstrom testified these test-year Capacity Factors, while different from the old Capacity Factors Petitioner has used, meet the same Calculation of Diversity Factor reasonableness test discussed on pages 22 and 23 of Mr. Heid's testimony and which are explained further on page 300 of the AWWA Rates Manual.

Mr. Dahlstrom also criticized Mr. Heid's equivalent meter factors analysis, which was based on the costs of various size meters. Mr. Dahlstrom noted that in testimony at the hearing, Mr. Heid discussed that his analysis was not based on actual meter costs. Mr. Dahlstrom also noted that Mr. Heid discussed that the reference to cost in his written testimony was for explanatory purposes. Mr. Dahlstrom testified Petitioner was unable to provide an explanation on how the equivalent meter factors in this Cause were calculated.

Mr. Dahlstrom said equivalent meter factors are used to allocate customer function costs to the various customer groups and are ultimately used in the calculation of the monthly customer charges for each meter size. Therefore, using known and current data is the best way to allocate these costs. Mr. Dahlstrom testified that since this information is unavailable, the OUCC proposes to keep the monthly customer charges at their current levels. Mr. Dahlstrom recommended that in Petitioner's next rate case a new equivalent meter study be conducted.

With respect to rate design, Mr. Dahlstrom proposed to reduce subsidies to move towards cost-based rates. He testified Petitioner's proposed rate design creates an artificial subsidy for each of its customer classes with the residential customers subsidizing industrial and sale-for-resale customers, by as much as 12%. He said, as a result, Petitioner's rate design assigns an inappropriate share of its proposed rate increase to the residential customers. Mr. Dahlstrom testified the OUCC's COSS more appropriately allocates, in accordance with the AWWA Rates Manual, the revenue requirements, including any increases, among all customer classes, based on the cost to provide service to the individual customer classes, and thus minimizing any inter-class subsidies.

Mr. Dahlstrom testified there are special challenges to overcome in this Cause regarding rate design. Mr. Dahlstrom said currently, Indiana-American has two sets of residential commodity rates. One residential rate is for Indiana-American's Area-1 customers. The other residential rate is for its Area-2 customers, whose rates are currently lower than those in Area-1. He noted Petitioner has proposed, as it has in previous Causes, to continue its plan to move all residential customers toward STP.

Mr. Dahlstrom testified regarding his concerns with the way Petitioner has proposed the continued move to STP in this Cause. He said his main concern is the inconsistency in which Petitioner is proposing to move various Area 2 customers to STP. He said Petitioner has proposed moving two of the five current Area 2 districts to STP rates, while the remaining three Area 2 customers continue to pay lower commodity rates. Mr. Dahlstrom testified that under Petitioner's proposal, West Lafayette and Warsaw customers will see their commodity rates increase from between 75% to 88% when moved to STP. Mr. Dahlstrom said commodity rates for the remaining Area 2 customers will see commodity rate increases of 33% for the first block and 41% for the second block. Mr. Dahlstrom testified that he is concerned with the rate shock that West Lafayette and Warsaw customers would see under Petitioner's proposal. He said Petitioner's proposed commodity rate increase is on top of an almost 25% increase in the proposed monthly customer charge, which equates to an annual increase of over $58 dollars per residential customer.

Mr. Dahlstrom noted the OUCC has filed for an overall reduction in the revenue requirement and the resulting rates in this Cause. He said that with this reduction in revenue requirement and based on the OUCC's COSS allocations, he was proposing rates that complete the move to STP for all residential customers. The Commission's final determination, as to the total revenue requirement allowed and COSS allocations approved, will influence the amount of movement to STP possible and any potential rate shock in this Cause. Mr. Dahlstrom said, in addition, he is proposing rates that will produce substantially lower subsidies than the subsidies proposed by Petitioner.

Mr. Dahlstrom said if the Commission approves anything other than the OUCC's proposed revenue requirement and COSS, then a subdocket may be the best way to approach rate design in this Cause. He said the wide difference in the revenue requirement being proposed by the two parties, the wide divergence in COSS methodologies between the Petitioner and the OUCC, and the fact Petitioner's COSS does not tie to its filed revenue requirement, complicates the development of any rates. On cross-examination, Mr. Dahlstrom agreed that pending resolution of the subdocket, rates would be modified on an across-the-board basis.

Mr. Dahlstrom also had concerns regarding Petitioner's proposed monthly customer charge. He stated Petitioner has inappropriately allocated mains and related costs to the customer function. This misallocation has overstated the customer function costs and the resulting monthly customer charge. Mr. Dahlstrom said his allocations justify a much lower monthly customer charge – even lower than Petitioner's current monthly commodity charges. However, he proposed to maintain the current level of monthly customer charges for all customers in this Cause.

Mr. Dahlstrom testified in opposition to Petitioner's public fire protection proposal. He opposed moving the eight remaining municipalities that have not adopted an ordinance pursuant to Ind. Code § 8-1-2-103 to a surcharge by meter size. Ms. Stull also opposed the inclusion of the fire protection rates within the base charge because doing so would cause Petitioner's customers to be subject to additional sales tax.

Mr. Dahlstrom objected to Petitioner's proposal with respect to sewer rates. He testified that he could not identify the level at which sewer rates are currently being subsidized and suggested that further study is needed. He did ultimately recommend that until the subsidies can be determined current sewer rates be maintained. He proposed a COSS be conducted for sewer service. Mr. Dahlstrom testified this study should determine the amount sewer rates are being subsidized by water customers and Petitioner should use this information in making a proposal to move sewer rates to cost-based rates sometime in the future.

(c) <u>West Lafayette's Position</u>. Mr. Krohn provided the position of West Lafayette on rate design. He testified that Petitioner acquired the West Lafayette system in 2000. After the 2002 Rate Order, a typical residential customer would have paid $15.52 per month. After the 2004 Rate Order, that customer paid $17.57. After the 2007 Rate Order the rates went to $19.52. And after the 2010 Rate Order, the typical residential customer in West

Lafayette increased to $27.10, which was roughly a 39% increase over the prior rates. He testified that the cumulative increase in rates for West Lafayette residents from the fourth quarter of 2002 to the second quarter of 2010 amounted to approximately 75%.

In this case, the proposed increase for West Lafayette would increase the average bill by an additional 62%, taking the cumulative increase to more than 182%. Mr. Krohn believes that the Commission should consider the history of rate increases when evaluating the economic impact of Petitioner's proposal. He cited to Cause No. 43645 were the Commission held that to impose a rate increase in excess of 50% on both the industrial and resale customers on top of a recent 10.8% increase would be excessive and should be mitigated.

He compared West Lafayette's rate increases to various consumer price indices over this period. He suggested that the attempt to reduce the subsidy between Area One and Area Two rates in a manner that accelerates the elimination of a subsidy to West Lafayette customers over what is in essence a two-year period is drastic and results in rate shock. He proposed that West Lafayette be left in Area Two rates and moved to full STP rates along with the other Area Two districts in future cases and that the proposed rate increases for Area Two districts should be modified so that no district experiences an increase that is greater than 50% or greater than two times the system-wide average increase. In the event this proposal was unsuitable, he proposed that the West Lafayette district be moved into an intermediate rate area and moved to full STP in future cases and that this same restriction of no increase greater than 50% or greater than two times the system-wide average increase be applied to West Lafayette.

(d) Crown Point's Position. Mr. Guerrettaz described the Crown Point system and plant. He described the contract between Crown Point and Petitioner whereby Petitioner is to provide up to 6 million GPD at a maximum flow rate not to exceed 4,170 gallons per minute ("GPM"), with provisions for increasing maximum flow up to 8 million GPD. He described the system's two pressure zones including Crown Point's five water storage facilities that total six million gallons of water storage. He described the system's two pumping stations with five high capacity pumps. He testified that the system is designed so that it can minimize burdens on Petitioner's system but that design capability was not considered in Petitioner's COSS. He testified Crown Point's six million gallons of storage meet additional demands on Crown Point's system from main peak times and fire events without impacting Petitioner's system.

Mr. Guerrattaz criticized Petitioner's proposed capacity factors as outdated and proposed that the capacity factors prepared by Mr. Heid be modified. He proposed changing the sale-for-resale maximum-day capacity factor to 120% and the maximum-hour capacity factor to 160% to be in line with industrial large customers. He testified that Crown Point's demands and flows are more similar to the large industrial class. He cited the water supply agreement with Indiana-American which limits maximum flow to Crown Point and Crown Point's substantial water storage facilities as a means of limiting demands on Petitioner. He provided the range of reasonable max day and max hour capacity factors as shown in the AWWA Rates Manual, which shows his proposed factors are within the range of both Industrial and wholesale customers

Mr. Guerrettaz explained that the 3 million gallon storage facility near Crown Point's intake pipe from Petitioner's system was designed and financed in 1997 when the water supply contract was first negotiated between Crown Point and Petitioner's predecessor Northwest Water. He explained that there was considerable discussion between the parties intended to moderate Crown Point's demands on Northwest's system resulting in the addition of the 3 million gallon storage facility. He emphasized the Petitioner's COSS does not reflect the limitation on flows, the substantial storage facilities and the manner of system operations, all intended to limit water demands on Petitioner's system.

He quoted from the AWWA Rates Manual to support his proposed maximum-day maximum-hour factors for Crown Point and sale-for-resale customers, which gives the example of a wholesale utility purchasing water to recharge a water storage facility. Allowing the storage tank elevation to rise or fall with demand of end-use customers, the wholesale customer's demand profile may more resemble that of a large industrial customer and can actually result in reducing the maximum-hour demand placed on the water supplier.

Mr. Guerrettaz testified that an option that would be fairer to Crown Point and achieve his proposed revenue allocations is a two-tier, declining-block rate similar to what Petitioner proposed for other large volume customers. He cited sections of the AWWA Rates Manual to support his request for a declining-block rate structure.

Mr. Guerrettaz expressed concern regarding the allocation of transmission and distribution mains in Mr. Heid's study. He testified no comprehensive study of main size exists creating a lack of evidence to support 12-inch mains allocated to sale-for-resale customers. He also expressed concern regarding the allocation of mains that are unidentified by size to sale-for-resale customers.

Crown Point also submitted cross-answering testimony. Mr. Guerrettaz testified the OUCC recommendation that Petitioner's rates be reduced presents an opportunity to properly align rates while mitigating rate and STP impacts on the various classes and divisions. Mr. Guerrettaz generally agreed with many of the concerns of Mr. Dahlstrom and also requested a subdocket be created for rate design. He objected to Mr. Dahlstrom's proposed use of the test-year capacity factors, testifying he doubts that either Mr. Dahlstrom's or Mr. Heid's capacity factors are correct. He opposed Mr. Dahlstrom's treatment of sale-for-resale customers in his COSS and rate design.

Mr. Guerrattaz testified that Mr. Dahlstrom has proposed a monthly service charge, volumetric charge, and demand charge for sale-for-resale customers and he opposed such charges. He testified Mr. Dahlstrom's treatment of sale-for-resale customers does not recognize that some, like Crown Point, have utility plant, storage, and operating practices that minimize peak demands, while other sale-for-resale customers do not. To properly recognize the diminished demands that Crown Point and potentially other sale-for-resale customers may place on Petitioner's system, it would be appropriate to have a second set of rates for customers that have plant and operating practices necessary to minimize demand or shift demand to off peak periods.

He testified Crown Point currently sets its intake valve to meet average flows, not peak flows because it relies on its robust storage to meet peaks. This allows Crown Point to avoid the sharp peak consumption spikes that are commonly attributed to residential customers during peak summer hours and on hot days. Crown Point's diverse commercial and industrial customer load of 9,739 residential, 786 commercial, and 49 industrial customers further reduces peak demands. Crown Point's ability to control its water intake and reliance on storage can make its demand more like an industrial customer rather than residential. He pointed out however, that the Company's proposed sale-for-resale rates, that Mr. Dahlstrom apparently accepts, treat Crown Point worse than if they were just a single, huge residential or industrial customer by denying it a lower cost declining block rate, like the lower cost third block of the General Service Rate applicable to all other customers.

Mr. Guerrettaz provided a discovery response from Petitioner, in which Petitioner indicated it is erroneous to assume that sale-for-resale rates could be separated into two sets of STP rates, one for those that can control or shift peak use and one for those that cannot. Instead, to recognize cost drivers in those customers would not result in two STP sets of rates but rather in separate rates for each individual sale-for-resale customer. He testified it is incongruent for Petitioner to argue the cost of service to each sale-for-resale customer is so different as to require a separate rate while at the same time Petitioner opposes even a second sale-for-resale rate that would allow some sale-for-resale customers that can shift demand to be closer to their lower cost of service. He testified Petitioner's position incorrectly indicates that we are better off staying with a single sale-for-resale rate that does not recognize or promote peak avoidance or reduction rather than fashioning a simple second rate e.g. with lower capacity factors and a declining block that more closely matches cost of service and encourages management of peak hour demands. He pointed out the incongruity that Petitioner charges customers for the Wise Water Program to survey select municipalities about water conservation and to spread well-known messages, promoting residential water conservation and asks for accelerated rate recognition of declining residential customer use from conservation; yet, Petitioner will not even consider a simple second STP sale-for-resale rate that would give large volume municipal customers rate recognition for their ability to minimize or shift peak consumption levels. He indicated that implementation of such a rate might encourage and make financially feasible other sale-for-resale customers to add plant, programs, and operations needed to participate in peak reduction.

Mr. Guerrettaz testified that the AWWA Rates Manual is not like a book of set chemistry formulas intended to always reach the exact same results. The manual offers the cost of service study artisan situational specific flexibility within reasonable parameters and helps define those parameters. Mr. Guerrettaz quoted several excerpts from the AWWA Rates Manual that support the application of declining block rates to sale-for-resale customers. Some of these excerpts also acknowledge that the diversity of customers served by sale-for-resale customers translates into a more uniform demand on the supplying utility and that system costs decline with economies of scale e.g. spreading fixed costs over more sales units. He remained convinced that Crown Point's huge water volumes and its ability through valve and storage use to minimize demand justifies a declining block rate.

Mr. Guerrettaz testified that the burden of Petitioner's frequent base rate/DSIC increases and its rate design may force municipal sale-for-resale customers to seek alternative supply options leaving Petitioner's unrecovered costs to be recovered from other customer classes. He opined these large municipal loads are of the type Petitioner should be working to retain rather than force away or "squeeze" out of business by increasing rates and harsh rate design.

Mark D. Downing, a professional engineer with Commonwealth Engineers, also submitted cross-answering testimony to respond to the testimony of Mr. Dahlstrom. He confirmed and adopted Mr. Guerrettaz's description of the Crown Point water plant and system. He emphasized Crown Point's remotely controlled solenoid water intake valve currently is set to match average daily flows, not peak flows, because Crown Point has six million gallons of storage facilities to handle its customer's peaks throughout the day. He testified that the solenoid valve is very sophisticated, well designed, and in conjunction with storage, allows far less impact on wholesale peaks than would less sophisticated systems. He testified that under appropriate terms and rates Crown Point or similarly situated sale-for-resale customers could completely close their intake valve at peak hour, rely on stored water and replenish storage post-peak. Yet despite this ability to shift consumption Crown Point is lumped with all other sale-for-resale customers in a one size fits all rate, which seems unfair to him. He suggested two rates, one for those that can minimize peak loads and one for those who cannot. He opined that to do otherwise is to overcharge those utilities that have gone to the expense and efforts to minimize peak contribution, and reward those that drive peak. Offering a lower rate for those that minimize peak demand would also create an economic incentive for other sale-for-resale customers to improve their respective plants and operations to further minimize peak demands. Such peak minimization benefits the Company and all its customers by delaying and/or decreasing demand related additions and expenses.

(e) **Schererville's Position.** Sue Sargent Haase, with London Witte Group testified in opposition to Petitioner's proposal regarding public fire protection. She testified that the Town of Schererville did not request nor has it contracted with Petitioner to provide fire protection services to customers located within the Schererville corporate boundaries or for assistance in collecting revenues to cover Schererville's own fire protection costs. Ms. Hasse noted that Schererville, like other wholesale customers, maintains and flushes its own hydrants and provides the capital for fire protection within its community. Ms. Haase testified that for Petitioner to collect a fire protection surcharge from wholesale customers, it must first present evidence that the wholesale customer has specifically sought such service. Therefore, Schererville objects to paying rates to recover fire protection costs. She also testified that the proposal to move the costs of public fire protection to the base charge would subject Indiana-American's customers to additional sales tax.

(f) **Industrial Group's Position.** The Industrial Group presented cross-answering testimony by Mr. Gorman in response to the class cost allocation proposal by the OUCC. Mr. Gorman disagreed with the proposal presented by Mr. Dahlstrom to use the revised capacity factors developed by Mr. Heid. Mr. Gorman expressed his concern that Mr. Dahlstrom did not accurately apply the AWWA Rates Manual methodology with regard to the data to be used in developing the Company's capacity factors. Mr. Gorman testified that the capacity factors should be measured using many years of data to estimate load characteristics. Mr. Gorman opined that Mr. Heid's conclusion that the capacity factors he developed for this proceeding were not reliable was reasonable. Mr. Gorman agreed with Mr. Heid's proposal to use existing capacity factors and to initiate an investigation to properly estimate capacity factors.

Mr. Gorman opined that the capacity factors used by Mr. Dahlstrom cannot be used to produce an accurate cost of service study and testified that the Commission should disregard Mr. Dahlstrom's revised cost of service study as flawed and unreliable. Mr. Gorman stated that because the OUCC's cost of service proposal was flawed, it could not be used to move the Company's rates closer to STP. Mr. Gorman also testified that even with the OUCC's proposed reduction in the Company's revenue requirement, the OUCC's proposed cost of service study results in a 15.9% increase for the industrial class, compared to a 13.1% decrease for the residential class and a system-average decrease of 4.11%. Mr. Gorman opined that the double digit-increase for the industrial class should give the Commission pause before adopting the OUCC's proposal, and testified that it was further indication that the revised capacity factors required additional study.

Mr. Gorman stated that the increase to the industrial class under the OUCC's proposal would result in rate shock for that class. He also testified that if the Commission were to adopt the OUCC's proposal to utilize the revised capacity factors, industrial rates should not be increased by more than 120% of the system-average increase. Mr. Gorman also recommended that if the OUCC's proposal were to be adopted, the Commission should limit all class increases to no more than 120% of the system-average increase in order to avoid rate shock. Mr. Gorman opined that this modest variation from the system-average increase is appropriate given the uncertain reliability of the class cost of service studies and the need to be cautious in ensuring that customers' rates are not moved further away from true cost of service.

(g) <u>Petitioner's Rebuttal</u>. Mr. DeBoy responded to the testimony regarding public fire protection. He testified that based on the risk of additional sales tax that would result for its customers, Petitioner is withdrawing the request to include public fire protection as a part of the base charge on the bill and will continue to show public fire protection as a separate charge. He testified that, to the extent the Commission determines that it has the discretion to move the remaining eight municipalities to a surcharge by meter size, he believes the evidence in this case supports the proposal. No municipalities responded to his letter offering them the opportunity to withdraw from the request. The only intervenor who would be subject to the request, West Lafayette, also did not oppose his request.

As to sewer rates, Mr. Heid testified that his exhibits had already identified the level of subsidies. He further testified that a sewer COSS would be of no benefit for determining the amount of the sewer subsidy and would instead simply serve to further increase the cost of sewer service.

With respect to equivalent meters, Mr. Heid testified that Mr. Dahlstrom proposed to ignore equivalent meter factors and rather retain the present level of customer charges. He noted that the equivalent meter factors had been developed many years previously and no workpapers could be located to support them. He did not believe that this would warrant simply disregarding equivalent meter factors, which had been used by this Commission for many years. Mr. Heid also testified that Mr. Dahlstrom did not explain how the COSS could be completed without the use of equivalent meter factors which are required to allocate customer-related costs. His recommendation instead was that a new equivalent meter factor study be conducted and used in the next proceeding.

As to capacity factors, Mr. Heid disagreed that the AWWA Rates Manual required that capacity factor studies be conducted every five years. The language on which Mr. Dahlstrom relied in the AWWA Rates Manual rather indicated that five years of system coincident peak data must be reviewed but did not dictate any particular time frame for conducting capacity factor studies. Nevertheless, he considered the issue moot because Petitioner is in the process of conducting a more robust and new capacity factor study. He described the new capacity factor study as much more involved than is customarily done in connection with a capacity factor study and beyond the scope of a capacity factor study contemplated when this issue was discussed in Cause No. 43680. As explained on cross-examination, it will involve statistical sampling, the installation of new metering equipment, and analysis of the results. He described the scope as being unprecedented in Indiana.

Mr. Heid responded to Mr. Dahlstrom's objection to a portion of water mains being functionalized as a customer cost. He took issue with Mr. Dahlstrom's characterization that customer costs should be only those costs that would be avoided if the customer leaves. He noted that the *Citizens Gas* Order on which Mr. Dahlstrom relies never resulted in the actual implementation of rates. In that case, there was a dispute among the parties concerning the cost of service determination, and a subsequent settlement agreement substantially changed the result. Moreover, the settlement agreement (to which the OUCC was a party) states that "... in future proceedings, no presumption will be given to any prior cost of service or rate design methodology." Mr. Heid noted that there is no other support for Mr. Dahlstrom's position. He further explained why the Company had previously functionalized 4-inch and smaller mains to the customer cost and subsequently switched to 2-inch. The 4-inch functionalization had been in place for many years until, in the last case, Mr. Heid learned that some 4-inch mains served fire hydrants. Based on this, Mr. Heid did not allocate any small mains to the customer function in Cause No. 43680 because he had not yet had an adequate opportunity to investigate. In this case, he had conducted his investigation and determined that it would be improper to allocate 4-inch mains to the customer functions but that 2-inch mains should be so allocated. He noted that the number of feet of water mains is a function of the number of customers and that the OUCC agreed the dollar investment in water mains increased with the length of the mains. He further testified that the functionalization of a portion of mains as a customer cost is extremely prevalent in Indiana.

Mr. Heid objected to Mr. Dahlstrom's characterization of maximum-day/maximum-hour factors. He testified that there was considerable support for the derivation. Mr. Heid first determined the maximum-day/average-day coincident demand ratio by analyzing 11 years of data, which resulted in a ratio of 1.54. Mr. Heid then observed that the ratio was basically unchanged from the previous case leading him to conclude that the maximum-hour/average-day coincident demand peak ratio should remain unchanged such that the maximum-hour/maximum-day coincident demand ratio would remain in the design range of 1.4 to 1.5 as recommended by Indiana-American's Director of Engineering and hydraulic modeler. He objected to using test-year factors by Mr. Dahlstrom because the most recent year is not used for design purposes. Rather, Indiana-American's comprehensive planning reports used a 95% confidence interval for a multi-year period. He also noted that, despite Mr. Dahlstrom's objections, Mr. Dahlstrom had actually used Mr. Heid's maximum-day/average-day functional cost allocation ratio in his COSS. With respect to maximum-hour/average-day, Mr. Dahlstrom had simply prorated the functional cost allocation by the same percentage as he had proposed to modify the maximum-day/average-day function. Mr. Heid disagreed with this methodology. He stated that it is imperative to analyze both maximum-day and maximum-hour information independently and for that analysis to be an informed analysis or judgment based on the design basis of the utility system.

Mr. Heid also responded to Mr. Dahlstrom's criticisms of residential subsidies. He noted that the residential subsidy is only 1.36% above cost of service, which Mr. Heid testified is not excessive by any definition. He noted the Commission routinely approved subsidies of this magnitude or larger, more often than not with the residential customers being the beneficiaries of subsidies by other customer classes. He found it ironic that the OUCC never supports cost-based rates when residential customers are receiving a subsidy but is now supporting cost-based rates when residential customer are providing a subsidy even at the minuscule level of 1.36%.

Mr. Heid objected to the need for a subdocket to review cost of service and rate design. He testified that it is routinely the case that a cost of service study will need to be rerun after the Commission's final order using the actual revenue requirements as found by the Commission. This will then be submitted as a part of a compliance filing. This is a routine procedure that exists in almost all cases. There is no need to commence creating subdockets for every rate case that would bifurcate every rate case into a revenue requirement phase and a cost of service allocation and rate design phase. He further noted that there would not be sufficient time during a subdocket to complete the new capacity factor study because of the intent to conduct load research.

Mr. Heid also responded to the testimony of Mr. Guerrettaz. He took issue with Mr. Guerrettaz's statement that Crown Point has consistently believed the rates and charges developed by Indiana-American are simply too high. He noted that Crown Point has never previously submitted testimony objecting to STP or the use of the capacity factors. Mr. Heid pointed to Mr. Guerrettaz's testimony submitted in Cause No. 43680, where rates for sale-for-resale customers were established on an STP basis with no declining rate block and utilizing the capacity factor which Mr. Heid used in this case. Mr. Guerrettaz submitted no testimony objecting to these aspects of the Company's proposal.

Mr. Heid disagreed with Crown Point's testimony that its system design supported a more favorable capacity factor. He noted that Indiana-American has no control over the flow control valve described by Mr. Downey. He further noted that Mr. Guerrettaz's recommendation that a 120% capacity factor be used for sale-for-resale doesn't match Crown Point's actual flows or the agreement with Indiana-American. The agreement requires Indiana-American to provide up to 6 million GPD. Using the contractual maximum would support a much higher capacity factor than the 160% proposed by Mr. Heid. He analyzed Mr. Guerrettaz's summary of flows from 2010 and 2011 and testified that if this data for 2010 were used to establish Crown Point's capacity factor it would be 205%. Using 2011 data, the capacity factor would be 256% for the nine months of data provided by Crown Point. Mr. Heid also analyzed Mr. Guerrettaz's summary of flows from 2010 taking into consideration Mr. Downey's stated concerns about weekend meter reads and still concluded that Mr. Guerrettaz's proposed 120% capacity factor was significantly understated.

Mr. Heid also objected to Mr. Guerrettaz's criticism of allocating 12-inch mains to the sale-for-resale class. He reviewed Indiana-American's system maps and conferred with Petitioner's Director of Engineering and confirmed that flow to Crown Point and other sale-for-resale customers does in fact utilize mains as small as 12-inches. He also disagreed with Mr. Guerrettaz's exclusion of a portion of unidentified pipe. He testified a portion of the "unidentified pipe" was pipe whose size was not recorded in Indiana-American's property accounting records, while the remainder of the "unidentified pipe" was in fact other main-related appurtenances. He testified that all utilities have unidentified pipe, frequently because of its age. Moreover, all water utilities have main-related appurtenances. According to Mr. Heid, the only fair way to allocate these unidentified assets is proportionate to all identified mains.

Mr. Heid also responded to the request for a two-tiered rate design for sale-for-resale. He clarified that Mr. Guerrettaz is misconstruing the AWWA Rates Manual. The provisions on which Mr. Guerrettaz was relying are provisions concerning inverted block rate structures as opposed to declining block rate structures. An inverted block rate structure is one where the rate increases as consumption increases. If a utility attempted to use a single inverted block rate structure, this would unfairly and adversely impact large volume users such as sale-for-resale customers. This language does not mean, however, that a declining block rate structure should be utilized. According to Mr. Heid's cross-examination testimony, the declining block rate structure is established to design rates for particular customer classes. Since sale-for-resale customers have their own rate classification, a declining block structure is not needed.

Next, Mr. Heid responded to Ms. Haase's criticism that public fire protection rates should not be paid by Schererville. He clarified that the sale-for-resale class rates have not been designed to recover the direct public fire protection costs (the costs of hydrants). However, Mr. Heid noted that sale-for-resale customers require capacity on Indiana-American's system so that sale-for-resale customers can provide fire protection. These costs should be recovered from sale-for-resale customers, and Mr. Heid testified that his proposed rate design does so.

Mr. Heid responded to the testimony of Mr. Krohn. He noted that the Company had already attempted to mitigate the impact on the sale-for-resale customers with its proposed rate design. In determining which of the five Area Two districts could be moved to Area One, Mr. Heid first performed a rate design under STP. The proposed average increase to West Lafayette and Warsaw under proposed Area One rates is significantly lower than what would have occurred on a stand-alone basis and is approximately equal to full STP rates. He noted that on a stand-alone basis, Warsaw and West Lafayette would see increases far in excess of that proposed here because of new water treatment plants in both systems. That is not the case with the remaining three districts, Mooresville, Wabash, and Winchester. The proposed average increase to these operations under the proposed Area Two rates is significantly lower than full STP rates. The overall average rate increase would have almost doubled for all three districts had they been moved to full STP. Moreover, industrial customers in all three districts would have experienced significant increases with a full move to STP.

Mr. Heid testified that West Lafayette has already received mitigation as a result of STP. In Indiana-American's last rate case, West Lafayette ultimately received an overall increase of approximately 25%. On a stand-alone basis, because of the new water treatment plant which was constructed there, the increase would have been approximately 147%. In the current case, West Lafayette is receiving a larger increase of approximately 70%, but on a stand-alone basis it would have been approximately 83%. Moreover, if Indiana-American had moved fully to STP, West Lafayette would still receive an almost 68% increase.

(h) Commission Discussion and Findings.

(i) Capacity Factors. In Cause No. 43680, Petitioner and the OUCC agreed that Petitioner's capacity factor study was outdated, and we directed Petitioner to conduct and provide a new capacity factor analysis in this case. 2010 Rate Order, 2010 Ind. PUC LEXIS 155, at *305. When the Commission orders that an analysis be conducted, such as a capacity factor study, we fully expect that the information will not only be developed but will also be utilized in the next rate case. Petitioner conducted a new capacity factor analysis utilizing the methodology set forth in the AWWA Rates Manual. However, Mr. Heid testified that he did not rely on the study because the results were questionable and he deemed the study unreliable. Instead, Petitioner proposed to use the capacity factors that have been the basis of Petitioner's rates for many years.

Petitioner leaves us little choice but to rely on a capacity factor study that we considered outdated over two years ago. The OUCC presented us with an alternative capacity factor study, however, that study relies only on test-year data rather than five years of data recommended by the AWWA Rates Manual. As such, we reject the OUCC's proposed capacity factors. Mr. Heid indicated that Petitioner is currently in the process of conducting a new, more robust, capacity factor study. Before its next rate case, Petitioner shall conduct and complete a new capacity factor analysis, and shall utilize the results of the analysis in its proposed COSS. In addition, because we find that Petitioner has not complied with the 2010 Rate Order mandate to conduct and provide a new capacity factor analysis in its next rate case, Petitioner's recovery of costs associated with the COSS in this case is disallowed.

With respect to sale-for-resale, we reject Crown Point's proposal to use the same capacity factor as large industrial customers. We heard considerable evidence about Crown Point's ability to operate its systems so as to mitigate its impact on Petitioner's system. The reality is that Crown Point's flow control was not coordinated with Petitioner in terms of design or operation and is beyond Petitioner's control. We also recognize that the installation of flow control does not negate the years of planning and investment that Petitioner has made in the system to accommodate the peak demands that are experienced today. Crown Point's actual flow data does not support Crown Point's proposed capacity factors, and Crown Point has a contract which obligates Indiana-American to provide much more water than Crown Point is using. If Crown Point wishes to explore potential savings that might be produced as a result of controlling its demands on Petitioner's system, this would necessitate an amendment to the agreement between Crown Point and Indiana-American. It appears that both parties are open to have such discussions, and we encourage them to do so. Until an alternative agreement is reached, however, we will continue to utilize a capacity factor for sale-for-resale on a single tariff basis, and the existing capacity factor of 160% for sale-for-resale will be retained.

(ii) Allocation of Small Mains to Customer Costs. We have often approved the classification of a portion of distribution facilities as customer-related. These are costs that vary with the number of customers. We accept Petitioner's explanation of why this allocation was not made in the last case and why Petitioner has changed the allocation from 4-inches to 2-inches in this case. As such, we approve the allocation of mains 2-inches and smaller to the customer cost function.

(iii) **Allocation of 12-Inch Mains and "Unidentified Mains."** Based on Mr. Heid's detailed review of the system in Northwest Indiana that delivers water to Crown Point, as well as his review of the entire system and discussions with Petitioner's Director of Engineering, it is apparent that Petitioner does utilize mains as small as 12-inches to serve sale-for-resale customers. Accordingly, we reject Mr. Guerrettaz's request to exclude 12-inch mains from the allocation of transmission mains costs. Mr. Heid indicated that the fairest way to allocate unidentified mains and main-related appurtenances is proportionate to all identified mains. Accordingly, we approve Mr. Heid's allocation.

(iv) **Maximum-Hour/Maximum-Day Factors Coincident Demand.** Mr. Heid adequately explained how he derived the maximum-day/average-day and maximum-hour/average-day coincident demand factors. Accordingly, we approve Mr. Heid's proposed factors.

(v) **Equivalent Meter Factors.** Mr. Dahlstrom rejected equivalent meter factors that this Commission has approved and utilized for many cases now. Instead, he simply maintained the existing customer charge, without any basis or support. Mr. Dahlstrom offers no alternative equivalent meter factors, nor does he explain how the COSS service study can be completed without the use of equivalent meter factors to allocate customer-related costs. We find the better course is to continue utilizing the equivalent meter factors that we have utilized previously. However, we order Petitioner to present new and meaningful equivalent meter factors in its next base rate case.

(vi) **STP, Mitigation, and Subdocket Request.** In terms of percentage, the increases for West Lafayette and Warsaw are large. The increases for both of these communities result partially from significant capital improvements, which were preapproved by this Commission. For example, West Lafayette's increase results partially from a project placed in service in the last case, the cost of which was spread over the course of two rate cases. Both West Lafayette and Warsaw have benefited extensively from STP. But for STP, both of these communities would have seen rate increases on a stand-alone basis far in excess of what they will see with Petitioner's phased approach to STP. In addition, the fact that we have authorized a 1% increase in Petitioner's revenues, rather than the 10.48% increase Petitioner originally requested, should further mitigate the rate increases for West Lafayette and Warsaw.

We also find that the level of subsidy paid by residential customers under Petitioner's proposed rate design is extremely small. Typically when we are addressing subsidy issues, the magnitude is many multiples of the 1.36% that results from Petitioner's proposed rate design. While we strive for the goal of cost-based rates, we recognize that the difference results from the use of a single declining block rate structure that attempts to match revenue recovery to cost of service for four retail customer classes. We do not find the level of residential subsidy to be unreasonable.

Finally, we address the request for a subdocket. Petitioner submitted an electronic copy of its COSS pursuant to our MSFRs. Any party executing the non-disclosure agreement had access to that electronic version, and Mr. Dahlstrom agreed on cross-examination that he had an electronic copy of the COSS. The movement to STP in this case is far less dramatic than it was in Cause No. 43680, and the size of the requested increase is substantially below that level. We fail to see why a subdocket creating a bifurcated case is necessary. Accordingly, we reject the request for a subdocket and order Petitioner to conduct and file as a part of its compliance filing a rerun of its COSS based on the inputs provided by this Order.

(vii) Public Fire Protection. There are three issues raised with respect to public fire protection. The first is whether surcharges by meter size can be incorporated within the base charge. Based on Ms. Haase's and Ms. Stull's testimony, Petitioner has withdrawn that portion of its request, and so we find that Petitioner should continue to show public fire protection surcharges by meter sizes as a separate item on the bill.

The second issue with respect to public fire protection is Petitioner's proposal to move the remaining eight municipalities to a surcharge by meter size. Ind. Code § 8-1-2-103 states that fire protection costs shall be included in the basic rates of all customers of the utility within the municipality if the governing body of a municipality adopts an ordinance so providing. In the 2010 Rate Order, we found that Ind. Code § 8-1-2-103 requires the governing body of a municipality to adopt an ordinance that provides that such charges shall be included in the basic rates of customers serviced by the utility within the municipality. 2010 Ind. PUC LEXIS 155, at *319-20. We denied Petitioner's proposal in that case because it did not submit adopted ordinances from the eight municipalities. *Id.*, at *320. The Commission is concerned that residents of the eight municipalities could already be paying for fire protection through taxes and would pay twice for the same service if billed directly by Petitioner. Requiring the municipalities to adopt an ordinance under Ind. Code § 8-1-2-103 provides at least some notice of this possibility to municipal residents. In this case, Petitioner has submitted proof that it notified the municipalities of its intent to bill customers directly for fire protection and indicated that no municipality objected. Tacit approval by the municipalities does not equal an adopted ordinance. Therefore, we deny Petitioner's proposal.

The final issue is whether sale-for-resale customers should pay public fire protection costs. Mr. Heid explained that his proposed rate design does not include recovery of direct public fire protection costs from sale-for-resale customers. It does, however, include recovery of costs to maintain the capacity that is necessary so that sufficient quantities of water can be delivered for sale-for-resale customers to fight fires. That is an appropriate cost to recover. As such we approve the method of recovery of cost from sale-to-resale customers.

(viii) Sewer Rates. If Petitioner's sewer customers paid rates based on the costs of serving them, the rates would be in excess of $80 per month. For a very small subsidy of 3¢ per month per customer, these rates can be held at their current level of $61.29. We agree with Mr. Dahlstrom that permanent subsidies, regardless of their size, are not the solution to rate shock for sewer customers. Therefore, we find that Petitioner's proposed subsidy shall be reduced by 50%. We also deny the OUCC's proposal that Petitioner conduct a COSS specifically for sewer service.

13. Depreciation Rates.

(1) Petitioner's Position. Petitioner proposed no general change in its depreciation rates; however it did propose a new depreciation accrual rate for its assets being installed pursuant to its BT Project. Mr. VerDouw provided a general description of this information systems project. This project is the subject of a preapproval petition pending in Cause No. 44059. We will not repeat the description of that comprehensive project here, as the need for and appropriate ratemaking treatment of BT will be dealt with fully in that pending Cause.

The relief that Petitioner seeks in this Cause with respect to BT is the approval of a new depreciation accrual rate which would apply to the BT assets. Mr. VerDouw testified that the appropriate depreciation rate for BT is 10 years, the anticipated service life of the BT assets. He testified that Indiana-American does not have an approved depreciation rate that would encompass assets such as BT that will be useful for such a period.

(2) <u>OUCC's Position</u>. Mr. Patrick opposed the proposed depreciation rate for the BT assets. He testified that in the OUCC's view Petitioner had not adequately justified the proposed 10-year rate. He further recommended that a comprehensive depreciation study be conducted by Petitioner and filed in a separate docket at least six months prior to the filing of its next rate case. He confirmed on cross-examination that the routine practice would be for the resulting rates to become effective in that rate case. Thereafter, the OUCC recommended that Indiana-American establish a five-year cycle for reviewing depreciation rates. He testified that this was necessary given the growth in Petitioner's utility plant and service since Petitioner's last study was conducted in 2006.

(3) <u>Crown Point's Position</u>. Mr. Guerrettaz expressed concerns over the magnitude of the BT project and its timing. He urged that all issues concerning BT be dealt with in the specific BT preapproval docket.

(4) <u>Petitioner's Rebuttal</u>. In rebuttal, Mr. VerDouw responded to Mr. Patrick's disagreement with the proposed depreciation accrual rate for BT and his separate request for a five-year depreciation cycle. He noted that all Petitioner is attempting to do in this case is to match the depreciation expense for a very significant asset to its estimated useful life. He noted that if the request is not approved, the only depreciation rate that is currently available and approved would depreciate the assets over a five-year period. No party contended that the life of the BT assets would be as short as five years and Mr. VerDouw testified this is what justifies the need for a separate depreciation accrual rate. As to the proposed future timing for depreciation rates, Mr. VerDouw testified that Petitioner's current depreciation rates went into effect in October, 2007. They have only been in effect for four years. Historically depreciation studies are conducted approximately every 10 years. Mr. VerDouw noted that Mr. Patrick cites no authority suggesting a more abbreviated timetable is necessary. Depreciation studies are expensive to conduct, and conducting them more frequently would serve to increase future rate case expense.

(5) <u>Commission Discussion and Findings</u>. Petitioner does not have an appropriate, currently effective rate that applies to this asset. No party disputes that 10 years is an appropriate lifespan for the BT project. Accordingly, we approve a 10-year depreciation accrual rate for the BT project. This finding is limited to the appropriate depreciation rate for the BT project, and should not be taken as an indication of our opinion regarding the prudence of the project, which is the subject of a separate proceeding in Cause No. 44059.

14. Bonus Depreciation Deduction.

(a) **OUCC's Position.** Mr. Smith raised a prudence issue with regard to 2011 bonus tax depreciation. This issue does not relate to an adjustment in the current case but could influence future Indiana-American rate cases. On December 17, 2010, the President of the United States signed legislation known as the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010. This Act provides for 100% bonus depreciation for qualifying capital investments acquired and placed in-service after September 8, 2010, and before December 31, 2011. For 2011, American Water, including Indiana-American, opted out of the 100% bonus tax depreciation deduction. Mr. Smith testified that for a regulated public utility that normalizes its federal income tax expense, the 2011 bonus depreciation would reduce current federal income tax expense, increase deferred federal income tax expense by a similar amount and thereby increase ADIT, which would be reflected in the capital structure at zero cost. While the bonus depreciation election for 2011 will not be made until American Water files its consolidated federal income tax return in September, 2012, American Water has already made a preliminary determination that it will not elect bonus depreciation for 2011. Mr. Smith noted that American Water's explanation for opting out of 2011 bonus tax depreciation on a total group basis is that American Water may not be able to fully utilize the NOLC that would result from making the election in 2011. As to Indiana-American and the election, Mr. Smith noted that Petitioner asserted that much of its investment made in 2011 was financed with tax exempt debt and that portion would not qualify for bonus depreciation. Mr. Smith testified that Indiana-American stated in response to discovery that it is not required that all affiliates of American Water opt out of bonus depreciation on a consolidated basis but that they could make the election on an affiliate by affiliate basis. Mr. Smith's concern is that inadequate analysis has been completed on the impacts of claiming or not claiming bonus depreciation by Indiana-American. This could cause Indiana-American's ADIT balance to be lower in future cases than it otherwise might be, with the consequence that Indiana-American's future charges to ratepayers will be higher than prudent or necessary.

Mr. Smith reviewed the analysis of Petitioner's decision to not take the 100% bonus tax depreciation provided in response to OUCC discovery and the Company's explanation for why not taking 2011 bonus depreciation was prudent. Mr. Smith believes that both of those analyses suggest imprudence. By not taking advantage of the tax deduction for 2011 bonus tax depreciation, other things being equal, Petitioner will have lower ADIT and less non-investor-supplied cost free capital in its capital structure for the regulated utility in future cases.

The first analysis was conducted only at the American Water level. That analysis shows that American Water currently has a large NOLC. In making American Water's decision not to use 2011 bonus tax depreciation, the only analysis that was done in support of that decision was at the American Water, consolidated level. No analysis was done for Indiana-American or of the impact on Indiana ratepayers.

A separate analysis was conducted by Indiana-American in response to additional discovery, but that analysis ignores the time value of money. Mr. Smith explained that it is appropriate to consider the time value of money when one evaluates a projected series of cash flows. To ignore the time value of money in such an analysis is itself imprudent.

When the time value of money is considered, the Indiana-American analysis shows that ratepayers are disadvantaged by the Company's failure to take 2011 bonus tax depreciation. Mr. Smith explained that the ratepayer disadvantage results from lower Deferred Taxes. Less non-investor supplied capital in all years until the 2011 plant additions, which would have generated the 100% bonus tax depreciation applicable in tax year 2011, would have become fully depreciated for book purposes. Applying present value analysis to Indiana-American's own analysis, clearly indicates that using any discount rate other than zero, Indiana customers are adversely affected because Petitioner elected not to take 2011 bonus tax depreciation.

Mr. Smith's ultimate recommendation is that the American Water's decision not to utilize 2011 bonus tax depreciation be fully analyzed with a view to whether Indiana-American's ratepayers are harmed from American Water's decision with respect to bonus tax depreciation.

(b) Petitioner's Rebuttal. Mr. Warren responded to Mr. Smith's testimony. Regarding tax exempt financing, Mr. Warren testified that the issuance of tax exempt debt to finance substantial improvements in 2011 disqualified those assets from bonus depreciation. He noted that Petitioner closed on the tax exempt debt on September 16, 2010. The 100% bonus depreciation in 2011 did not become law until December, 2010. As a result, it would have been impossible to evaluate the merits of issuing tax exempt debt versus electing bonus depreciation at the time the tax exempt debt was issued. He noted that taxpayers are not required to claim the special bonus depreciation. He explained that bonus depreciation is not always in the best interest of the taxpayer. He recited a number of possible reasons why a taxpayer would elect not to claim bonus depreciation including that it would cause an existing federal NOLC to expire. American Water has concluded that it would be in the best interest of the consolidated group for no members to claim bonus depreciation with respect to any fixed assets placed in-service in 2011. Mr. Warren testified that both witnesses agree that total tax expense would be precisely the same whether or not American Water claims bonus depreciation. This is because of normalization. Further, he disputed Mr. Smith's present value analysis of the decision to claim or not claim bonus depreciation.

(c) Commission Discussion and Findings. This dispute is of limited significance given Petitioner's issuance of tax exempt debt at a time before the 100% bonus depreciation was available. Given that the issue has no impact on this case, we decline to make any determination on this issue.

15. Nonrevenue Water, Leaks, and Customer Complaints.

(a) OUCC's Position. Mr. Rees testified concerning customer complaints, leaks, and nonrevenue water. Regarding customer complaints, Mr. Rees concluded that the Company would be well served to develop a simple standard guideline for the personnel who receive and process information from the customers. He illustrated the various terms that different districts use to describe customer-reported problems, and he suggested that better consistency with this process could lead to better comparisons of the districts. In addition, he reviewed data concerning customer complaints and noted the total annual results for three of the districts (Kokomo, Southern Indiana, and Northwest) were much higher than the others: Kokomo had a total of 132 annual complaints; Southern Indiana had 304; and Northwest had 273. Mr. Rees compared these results to a benchmarking survey conducted by the AWWA.

This benchmark has values for Technical Quality Complaints per 1000 customers. Using this benchmark, Petitioner's company-wide complaint level was approximately at the median; Southern Indiana, Kokomo, and West Lafayette were above the median; and the other operations, including the Northwest district, were much lower and below the median. Mr. Rees recommended that the Petitioner review the complaints in the Southern Indiana, Kokomo, and West Lafayette operations to determine the reason for the high amount of complaints and also to develop a plan to reduce the level of Technical Quality complaints.

Mr. Rees then evaluated Indiana-American's efforts at discovering leaks. He noted that Indiana-American has taken significant steps in setting up a program that will lead to improved performance in this area but he determined that there may be a correlation between the level of customer complaints, main break data, and nonrevenue water. He suggested that the Southern Indiana leak may be the source of some of the complaints there. He recommended that the Company's larger transmission mains be surveyed regarding whether enough metering currently exists that would detect leaks sooner and what operating procedures are in place for periodic inspections. He concluded that Indiana-American has taken strides in developing a plan to improve its water leak detection; however, water leaks in the system are still occurring and probably always will.

Mr. Rees discussed the line protection services offered by American Water Resources, Inc. ("AWR"); Mr. Rees made some recommendations relative to Indiana-American's relationship to AWR and the line protection services. Mr. Rees recommended that Indiana-American require AWR to remove identification of the utility's name from all AWR customer contact and associated education/promotion materials. Mr. Rees went on to recommend that AWR report annually to its customers about its quality of service and explain what AWR customers should do if they encounter problems. Mr. Rees also recommended that Indiana-American request that AWR provide at least 120 days written notice to customers regarding any rate changes.

(b) Petitioner's Rebuttal. Mr. Hauk testified in rebuttal regarding Mr. Rees' analysis of nonrevenue water, leaks, and customer complaints. He first noted that Indiana-American takes customer complaints very seriously anywhere in its system. He noted improvements to the results from 2010 to 2011 year-to-date. Specifically, Southern Indiana has improved by 70%, Kokomo has improved by 45%, West Lafayette has improved by 22%, Northwest has improved by 17%, and overall performance has improved by 33% comparing 2011 performances to 2010. The results indicate substantial improvements in all of the districts that Mr. Rees suggested needed an improvement. For year-to-date 2011, Indiana-American, in total, was well below the median level of complaints, and all but West Lafayette of the four operations identified by Mr. Rees were below the median. Concentrating on Customer Service Complaints, another metric in the AWWA benchmark, there is even more favorable performance in the same districts that Mr. Rees highlighted. All four districts are exceeding the performance of other utilities that participated in the survey and would fall in the Top Quartile. The overall performance of Indiana-American for this indicator exceeds the Top Quartile of performance by 59%.

Mr. Hauk then responded to the nonrevenue water issues raised by Mr. Rees. He disagreed that nonrevenue water is a proper metric for evaluating a water system. Instead, the current industry approach to better manage water loss and system performance is the application of the infrastructure leakage index ("ILI") performance indicator. This performance indicator is an output of the International Water Association/AWWA Best Practice Water Audit Methodology developed over the period of 1997 to 2000. The ILI performance indicator gives a reliable assessment of water loss standing from operational, financial, and water resource management perspectives. A water audit is conducted for purposes of computing an ILI index, and the first water audit was completed for each of Indiana-American systems in October 2009 based on 2009 third-quarter-ending data. This data is then updated each successor quarter thereafter.

Mr. Hauk testified that the ILI is a performance indicator designed for reliable benchmarking of leakage that allows direct comparison among water utilities. Mr. Hauk presented the calculated ILI performance indicator for each of the operations. He noted that the ILI method is a significantly more robust and rigorous approach to evaluating the real losses from a distribution system than nonrevenue water. It includes as part of its analysis the cost and benefit of pursuing efforts at eliminating lost water. For example, he noted that the total production cost for all nonrevenue water per year in the Northwest Operation is $600,000. Included within this nonrevenue water is water that is used to fight fires, water that is used internally at the treatment plants, water that is stolen, and water that escapes the system through the normal and accepted tolerances of mains and meters. While lost water should be pursued where it is cost-effective to do so, the cost of measures to eliminate lost water must be measured against the reduction in costs from producing that water. When the cost of producing non-relevant water is $600,000, and a significant portion of that is unavoidable, one can more readily evaluate the costs and benefits of further measures. In other words, Petitioner could replace every meter, every main, every valve, and every hydrant in its Northwest Operation, and the cost savings from reduced nonrevenue water would be considerably less than $600,000 per year. This is why it is important to consider the costs and benefits, and is part of the reason why the ILI is the industry standard today rather than simply looking at nonrevenue water as a percentage.

Mr. Hauk disagreed with Mr. Rees' attempt to correlate nonrevenue water, main breaks and customer complaints. He noted that use of nonrevenue water fails to discern any cost benefit impacts that may financially impact customers. The ILI indicator allows utility personnel to make strategic and economic decisions from a fiscal perspective. Mr. Hauk noted that fifteen districts have seen improvements in their ILI values from the original assessment to the most recent four-quarter rolling average. Twenty have ILI values of less than five, and sixteen have ILI values of approximately three or less. He then described Indiana-American's efforts to improve its performance in those operations with the higher ILI figures.

(c) <u>Commission Discussion and Findings</u>. Petitioner presented evidence that the issues raised by Mr. Rees have been addressed. We are satisfied that Petitioner is prudently addressing leaks and other causes of nonrevenue water through its use of the ILI index. We will expect Petitioner to continue to make strides in this regard.

16. <u>Confidentiality</u>. Petitioner filed five motions for protective order, all of which were supported by affidavits showing documents to be submitted to the Commission were trade secret information within the scope of Ind. Code §§ 5-14-3-4(a)(4), 5-14-3-9, and 24-2-3-2. The

Presiding Officers issued Docket Entries on June 9, 2011, October 18, 2011, November 2, 2011, November 22, 2011, and December 21, 2011, respectively, finding such information to be confidential on a preliminary basis, after which such information was submitted under seal. We find all such information is confidential pursuant to Ind. Code §§ 5-14-3-4 and 24-2-3-2, and is exempt from public access and disclosure by the Commission.

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

1. Petitioner is authorized to adjust and increase its rates and charges for water and sewer utility service to produce an increase in total operating revenues of approximately 1.0%. Petitioner's rates and charges shall be designed to produce total annual operating revenues of $198,374,326, which are expected to produce annual net operating income of $51,509,986.

2. Petitioner shall file new schedules of rates and charges with the Water/Wastewater Division of the Commission on the basis set forth in Finding No. 12. Petitioner shall simultaneously file its cost of service study and revenue proof based on the findings set forth in this Order. Petitioner's new schedules of rates and charges shall be effective on filing after approval by the Water/Wastewater Division and shall apply to water and sewer usage from and after the date of approval.

3. Petitioner's proposed depreciation accrual rate of 10% for the BT assets is approved.

4. The information filed by Petitioner in this Cause pursuant to its Motions for Protective Order is deemed confidential pursuant to Ind. Code §§ 5-14-3-4 and 24-2-3-2, is exempt from public access and disclosure by Indiana law, and shall be held confidential and protected from public access and disclosure by the Commission.

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

ATTERHOLT, BENNETT, MAYS AND ZIEGNER CONCUR; LANDIS ABSENT:

APPROVED: JUN 06 2012

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

Brenda A. Howe

Brenda A. Howe
Secretary to the Commission

BEFORE THE TENNESSEE REGULATORY AUTHORITY

NASHVILLE, TENNESSEE
April 27, 2012

IN RE:	)	
	)	
PETITION OF TENNESSEE AMERICAN WATER	)	**DOCKET NO.**
COMPANY FOR A GENERAL RATE INCREASE	)	**10-00189**
	)	

FINAL ORDER

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This matter came before Chairman Mary W. Freeman, Director Eddie Roberson and Director Sara Kyle of the Tennessee Regulatory Authority (the "Authority" or "TRA"), the voting panel assigned to this docket, at Authority Conferences held on April 4, 2011 and April 18, 2011, to consider the *Petition of Tennessee American Water Company for a General Rate Increase* ("*Petition*") initially filed on September 17, 2010.[1] In addition, at the August 22, 2011 Authority Conference, the panel considered the appropriate method by which TAWC may recover $275,000 in regulatory expenses, incurred during its previous rate case in Docket No. 08-00039, following reversal of the TRA's decision in that docket by the Court of Appeals on June 7, 2011.[2] Upon consideration of the entire record, including all exhibits and the testimony of the witnesses, the panel concluded that the Company had a revenue deficiency of $5,551,013, which should be recovered through increases in rates charged in all customer classes.[3] These conclusions, as well as the TRA's determinations concerning revenues, expenses, taxes and fees, Net Operating Income, Rate Base, Revenue Conversion Factor, and Rate of Return, are fully discussed below.

I. TRAVEL OF THE CASE

Tennessee American Water Company ("TAWC" or the "Company") filed its *Petition* seeking TRA approval of its proposed increased rates, alleging that "[t]he Company's existing rates and charges will not provide, and cannot be made to provide, sufficient revenues to cover all the costs incurred in providing adequate quality water service including its cost of capital."[4] The Company sought to put into effect "customer rates that will produce an overall rate of return

[1] The *Petition*, proposed tariffs and all pre-filed witness testimony of the Company were withdrawn and re-filed in this docket on September 23, 2010.
[2] The Court of Appeals issued its mandate in the appeal of *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678 (Tenn. Ct. App. Jan. 28, 2011) on June 7, 2011.
[3] A majority of the panel determined that the revenue deficiency was in the amount of $5,551,013 and Director Roberson voted against the majority on the following issues: Salaries and Wages, Utility Plant in Service, Rate of Return-Return on Equity, and Revenue Deficiency.
[4] *Petition*, p. 2 (September 23, 2010).

of 8.38% on a rate base of $125,472,973."[5] According to TAWC, its *Petition* would produce additional gross revenues of approximately $9,984,463 for the attrition period ended December 31, 2011, amounting to a 26.77% increase.[6] Following considerable discovery by the parties, and prior to the hearing, the Company amended the *Petition* to reflect a proposed revenue deficiency of $11,580,683, which would equate to a 31% increase.[7] Nevertheless, during the hearing on March 2, 2011, the Company stated that despite the updated numbers that were developed during the discovery process, "[t]he Company is not requesting more than the $9.9 million that it originally filed for."[8] In support of the *Petition*, TAWC filed extensive exhibits along with the pre-filed testimony of John S. Watson, Michael A. Miller, Sheila A. Miller, James Vander Weide, Patrick Baryenbruch, Paul R. Herbert and Dr. Edward L. Spitznagel, Jr.

TAWC is a public utility as defined in Tenn. Code Ann. § 65-4-101 and is engaged in providing residential, commercial, industrial, and municipal water service, including public and private fire protection service, to the City of Chattanooga and surrounding areas, serving approximately 75,000 customers as of March 31, 2010. The rates of TAWC customers located in Georgia are not regulated by the Public Service Commission of the State of Georgia, but instead are set by the TRA.[9] The Company is a wholly-owned subsidiary of American Water Works Company, Inc. ("AWWC"), which is headquartered in Voorhees, New Jersey. AWWC is the largest water holding company in the United States, providing water and wastewater services to sixteen million people in thirty-five states and two Canadian provinces.[10]

On September 21, 2010, the Consumer Advocate and Protection Division of the Office of the Attorney General (the "Consumer Advocate" or "CAPD") filed a petition to intervene. At a regularly scheduled Authority Conference held on September 27, 2010, the panel voted

[5] *Id.* at 11.
[6] *Id.* at 8.
[7] TAWC's Supplemental Revised Exhibit No. 1, Schedule 1 (February 22, 2011).
[8] Transcript of Proceedings, Vol. III B, p. 123 (March 2, 2011).
[9] *Petition*, p. 1.
[10] *Id.* at 2.

unanimously to convene a contested case proceeding, suspend the effective date of the tariffs, and appoint Chairman Freeman as Hearing Officer for the purpose of preparing this matter for hearing, including handling preliminary matters and establishing a procedural schedule to completion.[11] The Chattanooga Regional Manufacturers Association (the "CRMA") and the City of Chattanooga (the "City") filed petitions to intervene on October 4, 2010 and October 6, 2010, respectively. On October 12, 2010, the Hearing Officer issued an Order granting the interventions of the Consumer Advocate, the City, and the CRMA, and setting a status conference on October 18, 2010 to address any pending intervention petitions, identify issues, set a procedural schedule, and issue a Protective Order.[12]

On October 14, 2010, a petition to intervene was filed by the Utility Workers Union of America, AFL-CIO and UWUA Local 121 ("UWUA" or the "Union"), and on October 18, 2010, Walden's Ridge Utility District ("Walden's Ridge") and the City of Signal Mountain ("Signal Mountain"), a municipality, also filed a joint petition to intervene in this docket. Pursuant to special contracts with TAWC, Walden's Ridge and Signal Mountain purchase all of their water for distribution to their customers from TAWC.

A status conference was convened on October 18, 2010, at which time the parties submitted an agreed proposed protective order to the Hearing Officer. The Hearing Officer granted the UWUA's petition to intervene, but the joint petition of Walden's Ridge and Signal Mountain was filed too late to be considered during the status conference. Thereafter, motions were filed by the UWUA, the City, and the Consumer Advocate for permission to issue discovery requests exceeding the number set by TRA rule. In an Initial Order issued on November 12, 2010, the Hearing Officer established a preliminary procedural schedule, granted the joint petition of Walden's Ridge and Signal Mountain, and limited the Consumer Advocate

[11] Transcript of Proceedings, pp. 42-43 (September 27, 2010).
[12] *See Order Granting Petitions to Intervene and Requiring the Parties to Submit a Proposed Procedural Schedule and Protective Order* (October 12, 2010).

to eighty initial requests, and the UWUA and the City to forty requests each, the limit set by TRA Rule 1220-1-2-.11(5)(a).[13] On November 15, 2010, the Hearing Officer entered the proposed protective order, which was subsequently amended pursuant to TAWC's unopposed motion.

The CAPD, the City, the CRMA, and the UWUA (collectively, the "Intervenors") filed pre-filed direct testimony on January 5, 2011. The CAPD submitted the testimony of William H. Novak, John Hughes, Dr. Christopher C. Klein, and Terry Buckner. The City filed the testimony of Kimberly H. Dismukes. The CRMA filed the testimony of Michael Gorman, and the UWUA filed the testimony of James Lewis. The CAPD filed a correction to the pre-filed testimony of Dr. Klein on January 24, 2011 and amended testimony from Mr. Buckner on January 31, 2011. On February 8, 2011, the Company filed the pre-filed rebuttal testimony of Dr. Spitznagel, Bernard L. Uffelman, Ms. Miller, Mr. Vander Weide, James I. Warren, Mr. Baryenbruch, Mr. Watson, Mr. Herbert and Mr. Miller. Following additional discovery, the Company filed Revised Exhibits on February 14, 2011. In addition, the Company filed supplemental revised exhibits on February 16, 2011, the revised rebuttal testimony of Mr. Miller on February 17, 2011, and final supplemental revised exhibits on February 22, 2011. The City filed amended testimony of Ms. Dismukes, along with revised schedules KHD-15 and KHD-17, on February 10, 2011. The Consumer Advocate filed the rebuttal testimony of Mr. Buckner on February 24, 2011 and several revisions to the testimony of Mr. Hughes on March 1, 2011.

Various filings were made in this docket in accordance with the procedural schedule, and discovery responses were supplemented and updated by TAWC and the intervening parties throughout the course of the docket. TAWC also responded to data requests from the TRA staff. In addition, on February 14, 2011 and February 16, 2011, TAWC filed revised supplemental

[13] Tenn. Comp. R. & Regs. 1220-1-2-.11(5)(a); *Order Granting Petitions to Intervene, Reflecting Action Taken at Status Conference and Establishing a Procedural Schedule*, p. 9 (November 12, 2010).

accounting exhibits and work papers to replace those that were submitted with earlier pre-filed testimony.

I. Disputed Pre-Hearing Matters

During the pre-hearing process, the Hearing Officer resolved a variety of disputed matters that emerged between the parties, the most significant of which included the following:

City's Motions to Compel Discovery

On November 18, 2010, the City filed a motion to compel, requesting that the Hearing Officer compel TAWC to respond to certain discovery requests. In this motion, the City asserted that TAWC refused to produce a log identifying the documents and information that TAWC had withheld from discovery based on a claim of privilege or protection, and the City asked that the Hearing Officer compel TAWC to comply with Tenn. R. Civ. P. 26.02(5).[14] The City filed a subsequent motion to compel on December 6, 2010.[15] The second motion, however, involved other discovery objections asserted by the City and did not relate to production of a privilege log.

On December 23, 2010, the Hearing Officer issued an Order finding that Tenn. R. Civ. P. 26.02(5) did not contain a provision that made the production of a "privilege log" mandatory.[16] Therefore, the Hearing Officer did not require the parties to prepare "privilege logs," concluding instead that a party that claims a privilege or protection from discovery should provide specific information about the items it has withheld and set forth its reasons for doing so.[17] Accordingly, the Hearing Officer ordered the parties to identify any information and/or documents withheld from discovery on grounds of privilege or protection, state the privilege or protection claimed,

[14] *The City of Chattanooga's Motion to Compel Tennessee American Water Company to Respond to Discovery Requests*, pp. 3-4, § B (November 18, 2010).
[15] *The City of Chattanooga's Second Motion to Compel Tennessee American Water Company to Respond to Discovery Requests* (December 6, 2010).
[16] *Order on First Round Discovery Disputes*, pp. 18-19 (December 23, 2010).
[17] *Id.*

and describe the withheld materials with sufficient specificity so as to enable the Authority to evaluate "the applicability of the claimed privilege or protection."[18]

Thereafter, on December 30, 2010, TAWC filed its response, entitled *TAWC Privilege Log Document*. TAWC's privilege log charted ninety-six written communications and materials that TAWC determined to be responsive to discovery requests on which it asserted the applicability of a privilege or protection.[19] All of the communications and materials identified in TAWC's privilege log related in some respect to the management audit that had been ordered by the TRA in Docket No. 08-00039. TAWC acknowledged that it had withheld these communications and materials, which were classified as internal e-mail messages, chains of internal e-mail exchanges, documents, and attachments, on grounds of attorney-client privilege or work product, or both.[20]

On January 7, 2011, the City filed with the Authority a third motion to compel, in which the City asserted that TAWC's privilege log failed to comply with the Hearing Officer's December 23, 2010 Order because the log did not describe the materials withheld in a manner that enabled the parties or the TRA to determine the factual basis of TAWC's claims of attorney-client privilege and/or work product protection.[21] On January 14, 2011, the Company filed its response to the City's third motion to compel. In its response, TAWC contended that it had properly asserted its claims of attorney-client privilege and work product as to each item listed in its privilege log and that it had, in fact, gone beyond the requirements of the Hearing Officer's ruling on discovery by producing a privilege log that identified the sender of the communication

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[18] *Id.* at 19.
[19] *TAWC Privilege Log Document* (December 30, 2010).
[20] *Id.*
[21] *The City of Chattanooga's Third Motion to Compel Tennessee American Water Company to Respond to Discovery Requests,* pp. 4-5 (January 7, 2011).

and its recipients, provided the date and general subject matter, and set forth the privilege or protection asserted as its basis for withholding each item.[22]

TAWC asserted that all of the materials not produced consisted of documents or written descriptions of communications that had been exchanged internally between TAWC employees, or between TAWC employees and TAWC's parent company, AWWC, its affiliated service company American Water Works Service Company ("AWWSC"), state affiliate companies, or legal counsel.[23] Further, TAWC asserted that the internal email communications and documents, which all related to some aspect of the management audit, were intended to be confidential and were created in the course of ongoing litigation or in reasonable anticipation of litigation.[24] TAWC further asserted that it had provided the parties with all of the discoverable, non-privileged communications that had been exchanged between TAWC and the auditor, Schumaker & Co.[25]

TAWC stated that the sole purpose of the audit was to confirm or reject the reasonableness of the management fees sought by TAWC in contested litigation, and that any business-related purpose was incidental and ancillary.[26] According to TAWC, each item listed on its privilege log represented internal communication "about the TRA management audit, an audit that has little, if any, commercial or business purpose for the Company outside these contested rate cases."[27] For this reason, TAWC asserted that, under the work product doctrine, all of TAWC's internal correspondence relating to the Schumaker management audit would be protected from discovery.[28] Other documents withheld on grounds of attorney-client privilege,

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[22] *Tennessee American Water Company's Response to the City of Chattanooga's Third Motion to Compel*, pp. 3-4 (January 14, 2011).
[23] *Id.* at 7.
[24] *Id.* at 6.
[25] *Id.* at 4.
[26] *Id.* at 6.
[27] *Id.* at 8.
[28] *Id.* at 6.

according to TAWC, were confidential communications with in-house legal counsel concerning the audit and would also be exempt from disclosure.[29]

In a motion for leave to reply filed on January 18, 2011, the City contended that by merely providing conclusory statements, TAWC had not met its burden, as the party opposing discovery, to demonstrate a factual basis for its nonproduction of the email communications and documents at issue.[30] Further, the City asserted that merely sending copies of documents to in-house counsel does not conclusively establish attorney-client privilege or protection from discovery.[31] Rather, the party opposing discovery must demonstrate that the elements of the privilege or protection are present as to each item withheld.[32] On January 24, 2011, TAWC filed an affidavit by Mr. Miller to provide evidentiary support for its privilege log and to bolster its assertions of the attorney-client privilege and work product protection.[33] During the Status Conference held on January 24, 2011, the parties presented extensive oral argument before the Hearing Officer on the City's third motion to compel.

On February 25, 2011, the Hearing Officer issued an Order setting forth an extensive discussion of the attorney-client privilege, the work product doctrine and the use of privilege logs in asserting those protections in response to discovery requests.[34] The Hearing Officer provided substantive analysis of TAWC's privilege log and concluded that TAWC did not sufficiently describe the nature of the information that it had withheld to enable the Authority to make a determination as to the applicability of the privileges or protections asserted by TAWC.[35]

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[29] *Id.* at 7-8.
[30] *City of Chattanooga's Motion for Leave to Reply in Support of Its Third Motion to Compel,* pp. 2-3 (January 18, 2011).
[31] *Id.* at 3-4.
[32] *Id.*
[33] Michael Miller, Affidavit (January 24, 2011).
[34] *Order Reflecting Hearing Officer's Ruling with Respect to City of Chattanooga's Third Motion to Compel* (February 25, 2011).
[35] *Id.* at 16-27.

Further, the Hearing Officer found that TAWC's descriptions of the materials withheld consisted of a general categorization of communications that were a part of the audit process and did not provide a factual basis from which the Hearing Officer could readily determine the applicability of privilege.[36] Because TAWC had the burden of demonstrating that the communication or document was covered by privilege or otherwise protected, the application of privilege had to be clearly shown.[37] Further, the Hearing Officer concluded that such application of privilege had to be construed narrowly.[38]

Therefore, the Hearing Officer determined that for items as to which the attorney-client privilege was raised, TAWC was required to establish with objective facts or competent evidence that the communication was made in order to seek or give legal advice, and not for a business or other purpose, and was intended to be kept confidential, and the privilege had not been waived. Without such specificity, the Hearing Officer could not conclude, based on the subject matter descriptions that the items for which TAWC asserted attorney-client privilege or work product protection was, in fact, protected.[39] Nevertheless, recognizing the importance of maintaining a valid privilege or protection, the Hearing Officer ordered an *in camera* review of the communications and documentation listed in TAWC's privilege log to determine whether the attorney-client privilege or work product protection should attach to the materials.[40] The decision of the Hearing Officer was announced at a pre-hearing conference held on February 25, 2011. Counsel for TAWC agreed to meet with and provide the materials to the TRA's General Counsel for that purpose on February 27, 2011.

On February 27, 2011 and March 2, 2011, TRA General Counsel, accompanied by TRA Deputy General Counsel, conducted an *in camera* review of the materials referenced in TAWC's

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[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.* at 27.
[40] *Id.*

privilege log. TRA counsel examined in detail all of the communications and documents noted or otherwise referred to in the privilege log. Mr. Miller, who serves as TAWC's Treasurer/ Comptroller was present with TRA counsel on March 2, 2011 and responded to questions and provided clarification as requested. Upon completion of the *in camera* review, TRA counsel concluded that the communications and documents identified in the privilege log had either been produced to the parties in discovery already or qualified for protection from discovery. The TRA's General Counsel subsequently conveyed those conclusions to counsel for TAWC and the City.

Deposition and Testimony of Patricia Schumaker

On January 12, 2011, TAWC filed a motion stating that as Schumaker & Company had prepared the comprehensive independent management audit ordered by the TRA, it requested that the TRA call Patricia H. Schumaker to present testimony in this case.[41] Specifically, TAWC wanted Ms. Schumaker to address the procedures, methodology and facts that support the conclusions contained in the audit because the intervening parties had indicated that they intended to call those same components of the audit into question.[42]

In addition, on January 18, 2011, the City filed its own motion requesting the setting of a deposition of Ms. Schumaker.[43] Both motions were addressed by the Hearing Officer during a status conference held on January 24, 2011. Subsequently, by letter dated January 28, 2011, the parties agreed on a procedure for taking Ms. Schumaker's deposition.[44] After ascertaining the availability of Ms. Schumaker and the parties, on February 11, 2011, the Hearing Officer issued an Order setting Ms. Schumaker's deposition for February 18, 2011,[45] in the Hearing Room of the TRA with General Counsel presiding over the deposition. The deposition of Ms. Schumaker

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[41] *Motion to Call Schumaker & Company to Present Testimony Regarding Its Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority,* p. 1 (January 12, 2011).
[42] *Id.* at 3.
[43] *City of Chattanooga's Motion That Witness Be Ordered to Appear for Deposition,* p.1 (January 18, 2011).
[44] *Letter from Henry Walker to Chairman Mary W. Freeman* (January 28, 2011).
[45] *Order Setting the Deposition of Patricia H. Schumaker,* p. 2 (February 11, 2011).

was taken on February 18, 2011, with the City, the Consumer Advocate and TAWC participating in the questioning.

Following her deposition, the parties agreed that Ms. Schumaker would appear and provide testimony during the Hearing in Chattanooga on Tuesday, March 1, 2011. During the Pre-Hearing Conference held on February 25, 2011, the parties requested clarification as to the manner in which Ms. Schumaker would offer her testimony during the Hearing. Based on the parties' agreement, it was determined that counsel for TAWC would initially question Ms. Schumaker as an independent witness, followed by questioning by counsel for the intervening parties consistent with the order established during the Pre-Hearing Conference.[46]

UWUA's Motion to Substitute Affiant and TAWC's Motion In Limine

On February 7, 2011, the UWUA filed a motion requesting permission to substitute the sworn statement of Martin R. Blevins for that of Jerry Haddock, which had been attached to Mr. Lewis's pre-filed testimony.[47] Stating that Mr. Haddock's current job made it difficult for him to be available, the UWUA requested permission to present Mr. Blevins for examination during the hearing and include his testimony in the record.[48] According to the UWUA, Mr. Blevins was familiar with TAWC's valve maintenance program and could attest to the accuracy of Mr. Haddock's descriptions.[49] UWUA stated that it had only recently become aware of Mr. Blevins's availability and, thus, had acted in as timely a manner as possible in obtaining his sworn statement.[50]

In a response filed on February 14, 2011, TAWC contended that the UWUA's motion to substitute should be denied as improper and without any basis under the Tennessee Rules of

[46] *See Order Establishing Procedure for Testimony of Patricia H. Schumaker,* p. 3 (February 28, 2011).
[47] *Motion to Substitute Affiant,* p. 1 (February 7, 2011).
[48] *Id.*
[49] *Id.*
[50] *Id.* at 2.

Civil Procedure, the Tennessee Rules of Evidence, or the TRA's Rules.[51] TAWC asserted that, as the Intervenors' pre-filed testimony was due by January 5, 2011, Mr. Blevins's statement was untimely under the November 12, 2010 procedural schedule.[52] TAWC also noted that, in fact, the UWUA had previously stated that it did not intend to call Mr. Haddock.[53] Nevertheless, less than three weeks before the Hearing, the UWUA had offered Mr. Blevins to provide testimony through the adoption of Mr. Haddock's statement.[54] TAWC further asserted that there was no legal basis for allowing a witness to "adopt" the affidavit of another individual; such adoption would constitute hearsay on three levels.[55] TAWC further noted that Mr. Haddock's written statement was not an affidavit as it was unsworn.[56]

The Hearing Officer denied the UWUA's motion to substitute, finding that Mr. Haddock's statement was not confirmed by oath or affirmation but was merely submitted as a signed statement attached to Mr. Lewis's pre-filed testimony.[57] The Hearing Officer also found that because Mr. Haddock had not been designated as a witness and the UWUA had not pre-filed any testimony from him, Mr. Blevins could not adopt Mr. Haddock's statement and then testify in person.[58] The Hearing Officer further determined that the UWUA's request was both prejudicial and improper.[59]

In conjunction with its response to the UWUA's motion, TAWC filed a motion in limine

[51] *Tennessee American Water Company's Response in Opposition to the Utility Workers Union of America, AFL-CIO and UWUA Local 121's Motion to Substitute Affiant*, p. 1 (February 14, 2011).
[52] *Id.* The only pre-filed testimony filed by the UWUA was that of Mr. Lewis, which included a statement signed by Mr. Haddock in support of certain portions of Mr. Lewis's testimony. Mr. Haddock did not submit pre-filed testimony, and the UWUA never indicated that Mr. Haddock was intended to be a witness or provide testimony. *Id.* at 2.
[53] *Id.*
[54] *Id.*
[55] *Id.* at 2-3. First, Mr. Lewis was reciting his conversation with Mr. Haddock; second, Mr. Blevins was attesting to Mr. Haddock's statement; and, third, Mr. Haddock's unsworn statement was an out-of-court statement inadmissible as hearsay. *Id.*
[56] *Id.*
[57] *Order Denying the UWUA's Motion to Substitute Affiant and Granting TAWC's Motion in Limine to Strike the Statement of Jerry Haddock, Strike Certain Testimony of James Lewis, and to Exclude the Testimony of Martin Blevins*, pp. 3-4 (February 25, 2011).
[58] *Id.*
[59] *Id.*

on February 14, 2011 asking the Authority to strike both Mr. Haddock's unsworn statement and portions of Mr. Lewis's testimony.[60] TAWC also moved to exclude Mr. Blevins's testimony.[61] Stating that Mr. Lewis's testimony about its valve operations and maintenance was based solely on Mr. Haddock's unsworn statement, TAWC asked that Mr. Haddock's statement be stricken.[62] TAWC asserted that attaching it to Mr. Lewis's pre-filed testimony did not convert Mr. Haddock's statement into pre-filed testimony.[63] TAWC contended that Mr. Lewis did not have personal knowledge of valve operations and maintenance and merely relied on a conversation with Mr. Haddock.[64] TAWC also argued that Mr. Blevins's testimony should be excluded as hearsay and untimely.[65]

On February 25, 2011, the Hearing Officer issued an Order striking, as inadmissible hearsay, the portions of Mr. Lewis's pre-filed testimony that recounted his discussion with Mr. Haddock concerning valve operations and maintenance; the Hearing Officer further ruled that Mr. Lewis would not be permitted to adopt Mr. Haddock's statement or testify at the hearing.[66] Relying on Tenn. R. Evid. Rule 602, the Hearing Officer found that Mr. Lewis could not testify about TAWC's valve maintenance and operation for lack of personal knowledge.[67] The Hearing Officer struck Mr. Haddock's statement and ruled that Mr. Blevins would not be permitted to adopt Mr. Haddock's statement or testify, since the UWUA had not identified or pre-filed testimony from him.[68]

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[60] *Tennessee American Water Company's Motion In Limine to Strike the Statement of Jerry Haddock, Strike Certain Testimony of James Lewis, and to Exclude the Testimony of Marvin Blevins*, p. 1 (February 14, 2011).
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Order Denying the UWUA's Motion to Substitute Affiant and Granting TAWC's Motion in Limine to Strike the Statement of Jerry Haddock, Strike Certain Testimony of James Lewis, and to Exclude the Testimony of Martin Blevins*, pp. 6-7 (February 25, 2011).
[67] *Id.* at 6.
[68] *Id.* at 7.

On February 28, 2011, the UWUA filed a request to appeal the Initial Order.[69] Also that day, the parties presented oral argument on the Union's reconsideration request before the full panel prior to the hearing.[70] The Union explained that Mr. Haddock's statement was an exhibit to Mr. Lewis's testimony, and Mr. Haddock would not be available to attend the hearing.[71] Therefore, the Union asserted, it was necessary to replace Mr. Haddock with Mr. Blevins, who was also a former TAWC employee and had been Mr. Haddock's direct supervisor in valve maintenance.[72] The Union stated that Mr. Blevins would attest to Mr. Haddock's statement and was available to participate in the hearing.[73] The Union acknowledged that Mr. Haddock's statement was not notarized but stated that it included the representation, "I swear and affirm this statement is true to the best of my knowledge," and Mr. Blevins's statement adopting Mr. Haddock's statement was notarized.[74]

In addition, the Union contended that variances in the form of an affidavit are allowed when necessary to prevent injustice and urged the panel to consider the circumstances under which Mr. Haddock's statement was prepared.[75] Because of his new job as a truck driver, Mr. Haddock was not able to get a notary public to witness his statement.[76] The UWUA asserted that Mr. Haddock was merely a retired former TAWC employee and, under the circumstances, his statement should be accepted.[77] In addition, UWUA stated that Mr. Blevins was able to attest to Mr. Haddock's statements on the important issue of valve maintenance at TAWC.[78] The UWUA further stated that Mr. Blevins had been directly involved in the Company's valve maintenance

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[69] *Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's First Motion in Limine* (February 28, 2011).
[70] Transcript of Proceedings, Vol. I A, pp. 49-69 (February 28, 2011).
[71] *Id.* at 50.
[72] *Id.*
[73] *Id.*
[74] *Id.* at 49-50.
[75] *Id.* at 51.
[76] *Id.*
[77] *Id.* at 51-52.
[78] *Id.* at 52.

activities, could speak from personal knowledge, and had been Mr. Haddock's direct supervisor.[79] The UWUA also stated that the substance of the testimony had been made available to the Company in a timely manner.[80]

TAWC responded that it would be highly improper to allow Mr. Blevins to "adopt" the statement of Mr. Haddock because it constituted multiple levels of hearsay.[81] Further, TAWC asserted that Mr. Haddock's unsworn statement did not meet the requirements of Tennessee law and would not be allowed into evidence in court.[82] TAWC reiterated that Mr. Blevins's testimony was untimely filed.[83] TAWC also noted that Mr. Lewis was not an expert on valves and his current job duties were to handle arbitrations, negotiate contracts, and handle grievance procedures.[84] The inclusion of a signed statement of a former TAWC employee was clearly the Union's attempt to use an exception that applies only to expert testimony, but Mr. Lewis was not testifying as an expert.[85] Finally, the Company argued that it was highly prejudicial to bring Mr. Blevins into the proceeding only two and half weeks before the hearing, as it had not had an opportunity to conduct discovery in response to his testimony.[86]

The panel questioned the parties at length about Mr. Haddock's possible unavailability, the basis of Mr. Blevins's personal knowledge, the importance of the issues, and the potential prejudice to TAWC.[87] The panel voted to uphold, but modify, the Hearing Officer's Order.[88] The panel directed the UWUA to produce Mr. Haddock to testify and be cross-examined on the valve issues.[89] In the event Mr. Haddock was not available, the question of whether Mr. Blevins

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[79] *Id.* at 52-53.
[80] *Id.* at 54-55.
[81] *Id.* at 55.
[82] *Id.*
[83] *Id.* at 56.
[84] *Id.* at 57.
[85] *Id.*
[86] *Id.*
[87] *Id.* at 59-68.
[88] *Id.*
[89] *Id.*

would be permitted to testify was left open due to the importance of the valve maintenance issue and its possible impact on the setting of rates.[90]

TAWC's Motion to Strike Consumer Advocate's Rebuttal Testimony

On February 24, 2011, the Consumer Advocate filed rebuttal testimony from Mr. Buckner in response to certain testimony presented during Ms. Schumaker's deposition on February 18, 2011, and also to address the revised tax position of TAWC and an audit report prepared concerning New Jersey American Water Company.[91] In a motion in limine filed on February 25, 2011, TAWC moved to strike Mr. Buckner's rebuttal testimony including the attached audit of New Jersey American Water Company.[92]

The parties presented oral argument on this motion in limine during a Pre-Hearing Conference held on February 25, 2011. TAWC asserted that, contrary to the permissible scope of rebuttal testimony set forth following the deposition of Ms. Schumaker, the rebuttal testimony of Mr. Buckner, filed by the Consumer Advocate, was an improper attempt to put forth testimony concerning unrelated tax issues.[93] TAWC further asked that the audit report of New Jersey American Water Company be stricken as unreliable hearsay because it had not yet been considered, much less approved, by the New Jersey Board of Public Utilities and was not similar to the type of audit ordered by the TRA.[94] In response, the Consumer Advocate asserted that the New Jersey American Water Company audit was not being offered for the truth of the matters asserted therein, but instead was provided as an example for comparison with the audit of TAWC performed by Ms. Schumaker.[95] According to the Consumer Advocate, Mr. Buckner's testimony concerning the tax issues was filed due to the Company's change in position on those

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[90] *Id.*
[91] Terry Buckner, Pre-filed Rebuttal Testimony (February 24, 2011).
[92] *Tennessee American Water Company's Motion in Limine to Strike the Rebuttal Testimony of Terry Buckner and Attachment* (February 25, 2011).
[93] *See Order Granting, in Part, and Denying, in Part, Tennessee American Water Company's Motion in Limine to Strike Testimony of Terry Buckner and Attachment*, p. 1 (February 25, 2011).
[94] *Id.*
[95] *Id.*

issues as set forth in the pre-filed rebuttal testimony of Michael A. Miller filed on February 17, 2011.[96]

Based on the Company's second motion in limine and the arguments presented by the parties, the Hearing Officer determined that the New Jersey American Water Company audit and the rebuttal testimony of Mr. Buckner with respect to that audit should not be considered as evidence in this proceeding or be filed as part of the record.[97] Nevertheless, the Hearing Officer ruled that because the audit was not being offered for the truth of the matters asserted therein, the audit of New Jersey American Water Company could be used during cross-examination of witnesses but not filed as evidence.[98] The Hearing Officer also ruled that the rebuttal testimony of Mr. Buckner with respect to the tax issues should not have been filed with testimony to rebut the deposition testimony of Ms. Schumaker, but would be permitted as testimony offered to rebut TAWC's change in position.[99]

THE CITY'S MOTION TO EXCLUDE TAWC'S REGULATORY EXPENSES ARISING FROM DOCKET NO. 08-00039

On January 28, 2011, the Tennessee Court of Appeals issued its decision in *Tennessee American Water Co. v. Tennessee Regulatory Authority*, Case No. M2009-00553-COA-R12-CV, in which it affirmed in part, and reversed in part, the TRA's Final Order in TAWC's rate case filed in TRA Docket No. 08-00039. In its Opinion, the Court reversed the TRA's decision to limit TAWC to a recovery of one half, or $275,000, of its projected rate case expenses requested in Docket No. 08-00039, and ruled that TAWC should instead recover "the full amount of its proposed rate case expenses."[100] Thereafter, on February 8, 2010, TAWC amended its request for recovery of rate case expenses in this rate case proceeding (Docket No. 10-00189) to include

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[96] *Id.* at 2.
[97] *Id.* at 2-3.
[98] *Id.* at 3.
[99] *Id.* at 3.
[100] *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *30 (Tenn. Ct. App. Jan. 28, 2011).

the rate case expenses previously denied in Docket No. 08-00039.[101] In a motion in limine filed on February 24, 2011, the City asserted that the rate case expenses associated with the Company's previous rate case in Docket No. 08-00039 were not properly before the Authority because the Authority's subject matter jurisdiction would not be reinstated until transmission of the mandate by the Court of Appeals, which had not yet been received as of February 8, 2010.[102]

Due to timing, TAWC did not have an opportunity to file a written response, but the Company presented oral argument before the Hearing Officer during the Pre-Hearing Conference held on February 25, 2011. In responding to the City's motion in limine, TAWC stated that the Authority should take judicial notice of the Court of Appeals' January 28, 2011 Opinion so as to include and expedite the Company's recovery of the unrecovered portion of its regulatory expenses incurred in Docket No. 08-00039.[103] TAWC argued that including in this rate case the regulatory expenses related to Docket No. 08-00039 was more efficient for the Company and the Authority, and that it would not be improper for the Authority to consider TAWC's accumulated deferred regulatory expenses with its current projected expenses, as a whole.[104] According to TAWC, the Authority's consideration in this docket of the Company's regulatory expenses, including those not recovered previously as part of Docket No. 08-00039, would not violate the jurisdictional parameters of the TRA.[105]

During the Pre-Hearing Conference held on February 25, 2011, the Hearing Officer informed the parties that the City's motion in limine was well-founded and, therefore, was granted. On February 25, 2011, the Hearing Officer issued an Order granting the City's motion

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[101] Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 75-79 (February 8, 2011).
[102] *City of Chattanooga's First Motion in Limine* (February 24, 2011).
[103] *Order Granting City of Chattanooga's First Motion in Limine*, p. 3 (February 25, 2011).
[104] *Id.*
[105] *Id.*

in limine, which reflected that ruling.[106] Later, TAWC raised the issue of rate case expense in Docket No. 08-00039 before the panel during the Hearing.

Thereafter, on March 16, 2011, the City filed with the Tennessee Supreme Court a request for permission to appeal the decision of the Court of Appeals. In light of this development, the panel remained firm in its decision and did not consider the $275,000 recovery in its initial deliberations. On May 25, 2011, the City's request for permission to appeal was denied by the Supreme Court, and the Court of Appeals issued its mandate to the Authority on June 7, 2011. On August 3, 2011, the Hearing Officer in this docket issued a notice of filing and deliberations, stating that the Authority would consider the method by which to allow TAWC to recover the unrecovered $275,000 rate case expense during the Authority Conference on August 22, 2011.[107] On August 22, 2011, a majority of the panel voted to allow recovery of the regulatory expense through a separate line item charge on customers' bills that will discontinue once the full amount was recovered.[108] A majority of the panel further directed that the amount should be recovered over a six-month period and be collected from all customer classes, resulting in a uniform surcharge of approximately $0.62 monthly.[109] The Company was directed to file tariffs implementing the surcharge, including all supporting calculations, within ten days and to work with TRA Staff on the line item language that would be acceptable to include in customers' bills.[110]

II. <u>THE HEARING AND POST-HEARING FILINGS</u>

On January 31, 2011, the Authority issued a Notice of Hearing reflecting the panel's

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[106] *Id.*
[107] *Notice of Filing and Deliberations*, p. 1 (August 3, 2011).
[108] Transcript of Authority Conference, pp. 79, 82 (August 22, 2011). Director Kyle, who voted against the prevailing motion, made a motion instead to allow TAWC to recover the $275,000 through an increase in fixed monthly service charges and usage rates, as proposed by the Company, and to direct the Company to reduce the rates to current levels when the Company had collected the $275,000 and to file all documentation for the new rates up to $275,000 and work with David Foster and Pat Murphy of the TRA Staff. *Id.* at 79-81. This motion failed for lack of a second.
[109] *Id.* at 79.
[110] *Id.*

decision to hold the hearing in Chattanooga, Tennessee, during the week of February 28, 2011 through March 4, 2011.[111] On February 14, 2011, TAWC published the required notice of the Hearing in the *Chattanooga Times Free Press* and filed proof of publication with the Authority on February 23, 2011. The Hearing was held in Chattanooga, Tennessee, beginning February 28, 2011 through March 4, 2011, and reconvened in Nashville on March 7 and March 8, 2011. Participating in the Hearing were the following parties and their respective counsel:

Tennessee American Water Company – R. Dale Grimes, Esq., E. Steele Clayton, IV, Esq., David Killion, Esq., and Chad Jarboe, Esq., Bass, Berry & Sims, PLC, 150 Third Avenue South, Suite 2800, Nashville, TN 37201.

Consumer Advocate and Protection Division – Ryan L. McGehee, Esq., Mary L. White, Esq., and Scott Jackson, Esq., Office of the Attorney General, 425 5th Ave. N., John Sevier Building, P.O. Box 20207, Nashville, TN 37202.

City of Chattanooga, Tennessee – Frederick L. Hitchcock, Esq. and Willa B. Kalaidjian, Esq., Chambliss, Bahner & Stophel, P.C., 1000 Tallan Building, Two Union Square, Chattanooga, TN 37402; and **Michael A. McMahan, Esq.**, Office of the City Attorney, 100 East 11th Street, Suite 200, Chattanooga, TN 37402.

Chattanooga Regional Manufacturers Association – Henry M. Walker, Esq., Bradley, Arant, Boult, Cummings, PLC, 1600 Division Street, Suite 700, P.O. Box 340025, Nashville, TN 37203; and **David C. Higney, Esq.**, Grant, Konvalinka & Harrison, P.C., 9th Floor, Republic Centre, 633 Chestnut Street, Chattanooga, TN 37450-0900.

Utility Workers Union of America, AFL-CIO and UWUA Local 121 – Scott H. Strauss, Esq. and Katherine M. Mapes, Esq., Spiegel & McDiarmid LLP, 1333 New Hampshire Ave., NW, Washington, D.C. 20036.

During the Hearing, the Company presented the following witnesses: John Watson, Michael A. Miller, Sheila A. Miller, James Vander Weide, Patrick Baryenbruch, Paul R. Herbert, and Dr. Edward Spitznagel. Witnesses for the Consumer Advocate included Terry Buckner, John Hughes, Dr. Christopher C. Klein, and Hal Novak. Kimberly Dismukes testified on behalf of the City. The Union presented James Lewis and Marvin Blevins as witnesses. The CRMA

[111] Upon consideration of the CRMA's request to hold the Hearing in this matter in Chattanooga, Tennessee (Letter, October 20, 2010), which was supported by all intervening parties and the Hamilton County Commission (Resolution No. 1110-13, October 4, 2010) and duly noting the concerns of the Petitioner (Letters, October 22, 2010 and November 12, 2010) *see also*, Transcript of Proceedings (January 24, 2011), during the regularly scheduled Authority Conference on January 24, 2011, the panel voted unanimously to convene the Hearing on the Merits in Chattanooga, Tennessee. *Id.* at 34-43.

presented the testimony of Michael Gorman based on its proposed agreement with the Company. Public Hearings were held at various times during the Hearing to give TAWC customers and members of the public an opportunity to address the panel. Though several hours were set aside specifically for public comment, a limited number of comments were provided.

Additionally, there were three appeals to the full panel of initial orders issued by the Hearing Officer, two filed by TAWC and one by the UWUA. TAWC appealed to the panel the Hearing Officer's granting of the City's February 24, 2011 motion in limine.[112] The panel unanimously affirmed the Hearing Officer's decision and ruled that, upon receipt of the mandate from the Court of Appeals, the TRA would act swiftly and take the necessary action.[113]

Further, TAWC appealed to the panel the Hearing Officer's February 25, 2011 ruling on the City's third motion to compel.[114] This matter was resolved off the record between the first and second days of the Hearing, and the panel did not take it up again during the Hearing.

Finally, the Union appealed the Hearing Officer's February 25, 2011 initial order on its motion to substitute affiant.[115] After hearing arguments of counsel on this issue, the panel voted to uphold the Hearing Officer's ruling, with the understanding that Mr. Blevins could be heard on matters about which he had personal knowledge, and Mr. Haddock would be heard if he became available.[116]

At the conclusion of the Hearing, Director Roberson expressed concern that the Authority should have a complete record on rate case expenses and moved that the Company be required to provide detailed evidence of rate case expenses in a separate hearing that would be held on March 28, 2011. The motion was approved unanimously by the panel. On March 16, 2011, the

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[112] *Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's First Motion in Limine* (February 28, 2011).
[113] Transcript of Proceedings, Vol. I A, pp. 47-49 (February 28, 2011).
[114] *Tennessee American Water Company's Petition for Appeal of the Hearing Officer's Initial Order Granting the City of Chattanooga's Third Motion to Compel* (February 28, 2011).
[115] *Petition for Appeal of the Hearing Officer's Initial Order* (February 28, 2011).
[116] Transcript of Proceedings, Vol. I A, pp. 67-69 (February 28, 2011).

parties filed a joint motion in which the parties expressed their agreement to limit the amount of rate case expenses in this docket to the $645,000, the amount originally filed in the Company's *Petition.*[117] The agreement was reached in order to expedite the completion of the case within the statutory time required under Tenn. Code Ann. § 65-5-103. As part of the parties' agreement, TAWC further agreed to forego implementing its requested rates under bond until April 5, 2011 as provided in Tenn. Code Ann. § 65-5-103(b)(1).

On March 21, 2011, the parties filed post-hearing briefs. On March 22, 2011, the Hearing Officer issued an Order concluding that it was not necessary to proceed to hearing on the issue of rate case expense in light of the filing of the March 16, 2011 joint motion, which acted as a stipulation between the parties with respect to the necessity, reasonableness, and prudency of rate case expenses incurred by TAWC in this docket, and therefore, no additional evidence was necessary on the issue of rate case expense.[118] In addition, the Hearing Officer re-suspended the Company's tariffs through April 4, 2011.[119]

On March 28, 2011, the CRMA and TAWC filed a joint summary detailing the settlement they had announced during the hearing in Chattanooga on February 28, 2011.[120] In the settlement, the CRMA and TAWC agreed that all three classes of customers would receive an equal percentage of any rate increase.[121] TAWC explained that while the larger industrial customers would receive lower rate increases than smaller industrial customers, the result would be larger plant expansion and more economic growth in the Chattanooga area.[122] However, the settlement agreement between CRMA and TAWC affected only the rates within the industrial

[117] *Joint Motion for Approval of Rate Case Expenses* (March 16, 2011).
[118] *Initial Order of the Hearing Officer Relating to Proof on Rate Case Expenses and the Joint Motion Filed by the Parties*, pp. 5-6 (March 21, 2011).
[119] *Id.* at 6.
[120] *Summary of Settlement between CRMA and TAWC* (March 28, 2011).
[121] *Id.* at 1.
[122] *Id.* at 1-2.

class.[123]

On April 4, 2011, this docket was convened for consideration of the settlement agreement filed by CRMA and TAWC. The panel directed TAWC to file two sets of tariffs; one set was to reflect an across-the-board increase on all customer classes and individual rates, and the other was to spread the revenue increase proportionately across all customer classes, including industrial customers.[124]

On April 7, 2011 the UWUA filed its objection to the tariffs filed by TAWC asserting that neither tariff incorporated reporting conditions with respect to staffing and valve maintenance issues, which had been placed on the Company by the Authority at the April 4, 2011 Authority Conference.[125] On April 14, 2011, TAWC responded in opposition to the Union's objection.[126]

During the regularly scheduled Authority Conference held on April 18, 2011, the panel voted to deny the Union's objections concerning TAWC's failure to incorporate staffing and valve maintenance reporting requirements into its tariffs, on the condition of TAWC's agreement to submit semi-annual reports concerning its staffing levels and valve operation and maintenance programs to the Utilities Division Chief on April 5th and October 5th of each year.[127] In addition, the panel reconsidered the settlement agreement that had been previously filed by CRMA and TAWC.[128] Thereafter, a majority of the panel voted to approve the settlement agreement of the CRMA and TAWC, and tariffs filed on April 6, 2011 reflecting an across-the-board increase.[129]

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[123] *Notice of Filing Amended Tariffs*, p. 2 (April 6, 2011).
[124] Transcript of Proceedings, p. 65 (April 4, 2011).
[125] *Objection to "Notice of Filing Amended Tariffs"* (April 7, 2011).
[126] *Tennessee American Water Company's Response in Opposition to UWUA's Objection to Notice of Filing Amended Tariffs* (April 14, 2011).
[127] Transcript of Proceedings, p. 10 (April 18, 2011).
[128] *Id.* at 11-12.
[129] Director Sara Kyle voted against the settlement agreement and moved to adopt the tariff to reflect an across-the-board increase to all customer classes and individual rates. Her motion failed for lack of a second. *Id.*

III. Criteria for Establishing Just and Reasonable Rates

In carrying out its ratemaking function, the Authority is obligated to balance the interests of the utilities subject to its jurisdiction with the interests of Tennessee consumers; it is obligated to fix just and reasonable rates.[130] The Authority must also approve rates that provide regulated utilities the opportunity to earn a just and reasonable return on their investments.[131]

The TRA is not bound to follow rate-making methodology that it has employed in the past.[132] Further, the Uniform Administrative Procedures Act authorizes the TRA to take notice of "generally recognized technical and scientific facts within the agency's specialized knowledge," and in the evaluation of evidence the agency is specifically authorized to utilize its "experience, technical competence, and specialized knowledge."[133] The TRA is not to be "hamstrung by the naked record" and can consider all relevant circumstances shown by the record, all recognized technical and scientific facts pertinent to the issue under consideration and may superimpose upon the entire transaction its own expertise, technical competence and specialized knowledge.[134]

The Authority considers a petition for a rate increase filed pursuant to Tenn. Code Ann. § 65-5-103 (2004) in light of the following criteria:

1. The investment or rate base upon which the utility should be permitted to earn a fair rate of return;
2. The proper level of revenues for the utility;
3. The proper level of expenses for the utility; and
4. The rate of return the utility should earn.

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[130] Tenn. Code Ann. § 65-5-101 (Supp. 2011).
[131] *See Bluefield Water Works and Improvement Company v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923).
[132] *Tennessee American Water Co. v. Tenn. Regulatory Auth.*, 2011 WL 334678, at *25 (Tenn. Ct. App. Jan. 28, 2011); *CF Indus. v. Tennessee Pub. Serv. Comm'n*, 599 S.W.2d 536, 542-45 (Tenn. 1980).
[133] Tenn. Code Ann. §4-5-314 (2011).
[134] *Tennessee American*, 2011 WL 334678, at *26.

It is settled law that the TRA has discretion with regard to setting rates and may exercise this discretion in selecting among the test periods proposed or the use of different test periods altogether.[135] The TRA is not limited to adopting a single test period in order to make known and measurable adjustments to produce just and reasonable rates.[136]

The TRA has the discretion to use a historical test period, a forecast period, a combination of these where necessary, or any other accepted method of rate-making necessary to arrive at a fair rate of return.[137] The Tennessee Supreme Court has noted in this regard:

> [T]here is no statutory nor decisional law that specifies any particular approach that must be followed by the Commission. Fundamentally, the establishment of just and reasonable rates is a value judgment to be made by the Commission in the exercise of its sound regulatory judgment and discretion.[138]

There is no single, precise measure of the fair rate of return a utility is allowed an opportunity to earn. Therefore, the TRA must exercise its judgment in making an appropriate determination. The Authority, however, is not without guidance in exercising its judgment:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[139]

In addition, the United States Supreme Court has determined that regulated firms are

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[135] *Tennessee American*, 2011 WL 334678, at * 20, *citing Powell Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 660 S.W.2d 44, 46 (Tenn. 1983); *Am. Ass'n of Retired Persons v. Tennessee Pub. Serv. Comm'n*, 896 S.W.2d 127, 133 (Tenn. Ct. App. 1994).
[136] *Tennessee American,* 2011 WL 334678 at *3.
[137] *Id.* at *20.
[138] *Powell Tel. Co. v. Tenn. Pub. Serv. Comm'n*, 660 S.W.2d 44, 46 (Tenn. 1983*); citing CF Industries v. Tennessee Pub. Serv. Comm'n.*, 599 S.W.2d 536 (Tenn. 1980).
[139] *Bluefield Water Works & Improvement Company v. Public Service Commission*, 262 U.S. 679, 692-93 (1923); *see also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989).

entitled to a return that is "just and reasonable."[140] The rate a firm is permitted to charge should enable it "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed."[141]

The general standards to be considered in establishing the fair rate of return for a public utility are financial integrity, capital attraction and setting a return on equity that is commensurate with returns investors could achieve by investing in other enterprises of corresponding risk.[142] The utility's fair rate of return is the minimum return investors expect, or require, in order to make an investment in the utility.[143] The proper level of return on the Company's capital, including equity capital, must be commensurate with returns on investment in other enterprises having corresponding risk.[144]

Applying these criteria, and upon consideration of the entire record, including all exhibits and the testimony of the witnesses, the panel makes the following findings and conclusions.

IV. TEST PERIOD AND ATTRITION PERIOD

Establishing a "test period," or "test year," allows the Authority to measure a utility's financial operations and investments over a specific twelve-month period. The test period is used to develop an "attrition year," which is the forecast period used to set rates. The test period takes into consideration revenues, expenses, and investments.

The Company used a normalized historical test period of the twelve months ended March 31, 2010 to forecast attrition period results.[145] The Company made normalizing adjustments to the test period to forecast the results for the attrition period of the twelve months ended December 31, 2011.[146] The CAPD, however, used the twelve months ended September

[140] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).
[141] *Id.*
[142] *Id.* at 603.
[143] *Id.*
[144] *Id.*
[145] Sheila A. Miller, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).
[146] *Id.*

30, 2010 as its test period for residential, commercial and all other revenue categories, with adjustments for known and reasonably anticipated changes through the attrition year ended December 31, 2011.[147]

The panel finds that both the normalized test period for the twelve months ended March 31, 2010, as proposed by TAWC, and the September 30, 2010 normalized test period, as proposed by Consumer Advocate, are acceptable test periods that best fit each of the individual items being forecasted.[148] Both the Company and the Consumer Advocate are in agreement as to the attrition period, and a majority of the panel votes to adopt the twelve months ended December 31, 2011 as the attrition period.[149]

V. CONTESTED ISSUES

The positions of the parties and the determinations of the voting panel are set out below for each of the following contested issues related to the determination of a fair rate of return: Section V(A) – Revenues; Section V(B) – Expenses; Section V(C) – Taxes and Fees; Section V(D) - Net Operating Income; Section V(E) – Rate Base; Section V(F) – Revenue Conversion Factor; Section V(G) – Rate of Return; Section V(H) – Revenue Deficiency; and Section V(I) – Rate Design.

V(A). REVENUE

In order to accurately calculate overall revenues, TAWC's revenues must be calculated for each class of service. This is a two-step process. First, the number of customers must be determined and thereafter, a growth factor is applied to the number of bills for the test period (typically based on historical trend) to arrive at a forecasted number of bills for the attrition period. The forecasted bills are then multiplied by the current rate for each location and class. The next step in the process is to calculate water usage revenue for the attrition period.

[147] John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).
[148] Transcript of Proceedings, p. 63 (April 4, 2011).
[149] *Id.* at 63-65.

Generally, usage is forecasted for the attrition period in much the same way as the number of bills. The water usage is then multiplied by the tariffed usage rates to calculate usage revenue. The flat rate revenue amounts and water usage revenue amounts are added together along with any other revenues, such as forfeited discounts, to arrive at the total amount of revenue forecasted for the attrition period for a particular class of service. The goal in forecasting the number of billing determinants is to develop a forecast that reflects what can be reasonably expected to occur in the future, or the attrition period.

TAWC receives revenue from six customer classes: (1) residential; (2) commercial; (3) industrial; (4) other public authority; (5) other water utility; and (6) public and private fire service. TAWC serves the cities of Chattanooga, Lookout Mountain, Lakeview, Suck Creek, and Lone Oak, Tennessee and sells water to Fort Oglethorpe, Catoosa Utility District, Signal Mountain and Walden's Ridge, Tennessee. Other TAWC operating revenues include service fees, late payment penalties, rent sewer revenues, connection fees and miscellaneous fees.

TAWC projected revenues by starting with billing determinants for the test year ended March 31, 2010. Thereafter, five normalizing adjustments were made: "(1) normalized test year adjustments which include annualizing the rate increase for the following: Walden's Ridge effective June 1, 2009, Signal Mountain effective July 1, 2009, Fort Oglethorpe effective November 1, 2009 and a rate decrease for the commercial classification effective September 1, 2009; (2) weather normalization adjustment for the residential and commercial customer classes; (3) eliminating the net change in accrued revenues; (4) adjusting for a duplicate miscellaneous invoice sent March 2010 to one commercial customer; and (5) including revenue for the estimated number of new customers to be added during the attrition year."[150] TAWC estimated the number of new customers based on twenty-three years of historical data. Based on this data, the Company projected an annual growth rate for residential customers of twenty-six additional

[150] Sheila A. Miller, Pre-Filed Direct Testimony, p. 6 (September 23, 2010).

customers monthly.[151] For commercial customers, the Company projected an additional five customers per month. The Company's forecasted total by class was $37,296,457.[152]

The Company's expert, Dr. Edward L. Spitznagel, Jr., provided testimony on weather normalization usage per customer per day for both the residential and commercial customer classes in the attrition year.[153] Dr. Spitznagel stated that temperature and precipitation cause changes in water consumption and more water would be used in hotter and drier periods.[154] Dr. Spitznagel also pointed to the gradual introduction of water saving appliances that reduce water consumption as affecting usage.[155] He rejected temperature as a variable to use in his predictive models and instead, relied on the Palmer Modified Drought Index ("PMDI").[156]

The Company used a bill analysis that reflects the actual billing determinants for the historical test year and is adjusted to normalize any new customers, loss of customers, or changes in usage (for large users) that occurred in the historical test-year, including customer growth through the attrition year, and an adjustment in residential and commercial usage using weather normalized usage per customer per day.[157]

In rebuttal, on the question of weather normalized daily customer usage during the attrition year, Dr. Spitznagel criticized the CRMA's expert for using the previous five-year averages since it would result in an over-statement of future water consumption by failing to take into account declining water consumption trends.[158] Dr. Spitznagel also called into question the CRMA's expert's methodology and usage estimates.[159] Dr. Spitznagel performed various computations to demonstrate that CRMA witness Mr. Gorman's proposal was an inaccurate

[151] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-REVENUES, p. 47 (September 24, 2010).
[152] *Petition*, Exhibit No. 4, Schedule 1 (September 23, 2010).
[153] Dr. Edward L. Spitznagel, Jr., Pre-Filed Direct Testimony, p. 5 (September 23, 2010).
[154] *Id.* at 2
[155] *Id.* at 3.
[156] *Id.* at 4.
[157] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 5-6 (September 23, 2010).
[158] Dr. Edward L. Spitznagel, Jr., Pre-Filed Rebuttal Testimony, pp. 1-2 (February 8, 2011).
[159] *Id.* at 1-2.

predictor of future water consumption because it used data from the period 2005 through 2009 and claimed that residential and commercial consumption are declining.[160]

Dr. Spitznagel criticized Mr. Novak for simply averaging the R-squares, which could be misleading and would not produce the appropriate measure of variation explained by his model.[161] Disputing Dr. Klein's contention that he was unfamiliar with and had ignored considerable literature on estimating water demand, Dr. Spitznagel stated that he has reviewed more than one hundred papers on water demand and found that few pertain precisely to weather normalization.[162] Dr. Spitznagel contended that the papers cited by Dr. Klein are not useful for normalizing average monthly water usage.[163]

CAPD expert Mr. Novak stated that he assisted in developing the current Weather Normalization Adjustment ("WNA") rules for gas utilities in Tennessee and had presented testimony on the development of the first ever-approved WNA for a public utility in the state of Virginia.[164] Mr. Novak also stated that he developed the TRA Staff's WNA model and has testified on WNA issues in numerous rate cases.[165] Mr. Novak testified that neither the TRA nor its predecessor, the Tennessee Public Service Commission ("TPSC"), has ever directly addressed or approved a WNA for TAWC and the Company's statements and conclusions on this issue are incorrect.[166] Mr. Novak stated that he adapted the Staff's WNA model for gas utilities to fully examine the impact of weather on the Company's rate case in TPSC Docket No. 89-15388 and used it to consider the impact of heating and cooling degree-days and rainfall on the residential and commercial sales volumes using linear regressions.[167] Mr. Novak concluded the correlation

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[160] *Id.* at 2-4.
[161] *Id.* at 5-6.
[162] *Id.* at 7.
[163] *Id.*
[164] William H. Novak, Pre-Filed Direct Testimony, p. 7 (January 5, 2011).
[165] *Id.*
[166] *Id.* at 8.
[167] *Id.* at 9.

factors he used were too poor to suggest a direct causal relationship between weather and water use; therefore, he disregarded the results.[168]

Mr. Novak stated that in TPSC Docket Nos. 91-05224, 93-02943, and 96-00969, all of which involved TAWC, the Company accepted the WNA model that he had proposed in the 1989 rate case.[169] Mr. Novak stated that to the best of his recollection, allowance for the impact of weather was excluded because there was no demonstrated direct causal relationship between weather and water sales.[170] The issues in those three cases were settled between the parties without any allowance for weather normalization.[171] He noted that in testimony before the Kentucky Public Service Commission the Company stated that it has been allowed to use a WNA in Tennessee since 1989.[172] While it is possible that TAWC has included a WNA in each of its petitions for rate increases since 1991, all of those rate cases except the last two were resolved through "black box" settlements with no specific resolution of any weather normalization issue.[173] Mr. Novak stated that the 2006 and 2008 rate cases, however, were fully litigated, with the Company's proposed WNA adjustments never being explicitly adopted by the TRA.[174]

Dr. Klein did not agree with Dr. Spitznagel's weather normalization study.[175] Dr. Klein contended that there is considerable literature on estimating water demand that Dr. Spitznagel was either unfamiliar with or had ignored.[176] Dr. Klein pointed out that Dr. Spitznagel included only weather as measured by the PMDI, but none of the studies cited in Dr. Spitznagel's

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[168] *Id.*
[169] *Id.* at 10.
[170] *Id.* at 11.
[171] *Id.* at 10.
[172] *Id.*
[173] *Id.* at 10-11.
[174] *Id.*
[175] Dr. Chris Klein, Pre-filed Direct Testimony, p. 19 (January 5, 2011).
[176] *Id.*

testimony made use of the index.[177] Thus, Dr. Spitznagel's results could be biased due to the failure to include all relevant variables.[178] Dr. Klein stated that Dr. Spitznagel used very little data, looking at only ten data points for each month, and that measures of good fit and statistical significance are generally unreliable for such small samples.[179]

The CAPD used the actual billing determinates reported for the twelve months ended September 30, 2010 as a basis to project forecasted attrition period revenues.[180] The CAPD's forecasted revenues listed by class totaled $38,399,479.[181] The CAPD disagreed with two areas of the Company forecasted operating revenue.[182] First, the CAPD argued that the WNA proposed by the Company should be disregarded in calculating operating revenue.[183] The total WNA adjustment calculated by TAWC for the year ended December 31, 2011 was $318,523.[184]

In forecasting residential revenues, the CAPD compiled monthly billing determinants for that class.[185] These billing determinants were then combined with data from previous TAWC rate cases filed in 2004 (Docket No. 04-00288), 2006 (Docket No. 06-00290), and 2008 (Docket No. 08-00039) because, in the CAPD's view, the data provided in those cases furnished an excellent history of billing determinants for use in trend analysis.[186] The CAPD's calculation of residential operating revenue, which excluded the Company's WNA revenue reduction, exceeded the Company's calculation by $867,880.[187]

In projecting commercial revenue, the CAPD established billing determinants by trending the number of meters and water usage history from the twelve month period beginning August

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[177] *Id.* at 20.
[178] *Id.*
[179] *Id.*
[180] John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).
[181] *Id.* at 3.
[182] *Id.* at 3-4.
[183] *Id.*
[184] *Id.*
[185] *Id.* at 6-7.
[186] *Id.*
[187] *Id.* at 8.

2003 through the twelve months ended September 2010 for Chattanooga, Lookout Mountain, Lakeview, and Suck Creek.[188] For Lone Oak, the CAPD used billing determinants from the twelve-month period beginning August 2006 through September 2010.[189] The CAPD's calculation for commercial operating revenue, which excluded the Company's proposed WNA, exceeded the Company's calculation by $147,361.[190]

In projecting industrial revenues, the CAPD established billing determinants by trending the number of meters and water usage history from January 2004 through the twelve months ended September 30, 2010.[191] The CAPD's calculation of industrial operating revenue exceeded that of the Company by $118,733.[192] The CAPD forecasted industrial revenues of $3,520,697 for the attrition period at current rates.[193]

In forecasting Other Public Authority Revenues, the CAPD applied the current rates to its test year billing determinates to arrive at its forecasted attrition period amount.[194] The CAPD contended that the volumetric billing determinants for other public authority revenues in the Chattanooga area have declined from a total of 1,216,889 cubic feet at the beginning of 2004 to a total of 1,025,432 cubic feet in 2009.[195] By using trend analysis on the historical billing determinants, the CAPD detected a decline in volumes and a resulting decline in other public authority revenues.[196] The CAPD forecasted Other Public Authority Revenues of $2,549,888 for the attrition period at current rates.[197]

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[188] *Id.*
[189] *Id.*
[190] *Id.* at 8-9.
[191] *Id.* at 4
[192] *Id.* at 10.
[193] *Id.* at 9.
[194] *Id.* at 10-11.
[195] *Id.*
[196] *Id.*
[197] *Id.*

The CAPD predicted a decline in Other Water Utility Revenue[198] to $1,293,805 during the attrition year ended December 31, 2011,[199] while TAWC estimated that this revenue would remain constant during the attrition period at the test period amount of $1,308,493, which was calculated for the twelve months ended March 31, 2010.[200] The CAPD used the more recent test year data for the year ended September 30, 2010.[201]

The CAPD noted a sharp decline in volumetric usage by Catoosa County during the test year ended September 30, 2010.[202] Based upon this decline, the CAPD forecasted Other Water Utility Revenue would decline by at least $14,688 during the attrition year, noting that the Catoosa Utility District Authority stopped purchasing water from TAWC in 2008.[203]

TAWC calculated Private Fire Service Operating Revenues of $1,735,066 for the attrition period while the CAPD projected $1,719,717.[204] Consistent with the methodology used for other classes of service, the CAPD used historical billing determinants.[205] The CAPD used the trend analysis technique for each pipe size to determine whether any attrition year estimates should be changed.[206] As a result, the CAPD determined that, although the total billing determinants are the same as those in TAWC's forecast, different pipe sizes produced different forecasted revenues.[207] Therefore, the CAPD's trend analysis of Private Fire Service Operating Revenues was $14,688 lower than the amount calculated by TAWC.[208] However, no testimony was offered on Public Fire Service Revenues or Other Operating Revenues. For these categories, the Company projected $1,517,135, and the CAPD projected $1,522,545, for the attrition period of

[198] The class "Other Water Utility Operating Revenues" included the utility districts of Fort Oglethorpe, Catoosa, Signal Mountain, and Walden's Ridge.
[199] John Hughes, Pre-Filed Direct Testimony, pp. 6,8 (January 5, 2011).
[200] *Id.* at 11-12.
[201] *Id.*
[202] *Id.*
[203] *Id.*
[204] *Id.* at 12-13.
[205] *Id.*
[206] *Id.*
[207] *Id.*
[208] *Id.* at 12-13.

the twelve months ended December 31, 2011.[209] The CAPD amount is greater by an immaterial amount of $5,410.

Mr. Gorman, testifying for the CRMA, attested that Dr. Spitznagel's estimates of 135.93 gallons per customer per day for residential usage and 989.64 gallons per customer per day for commercial usage were simply too low.[210] In fact, the Company's own actual data indicated that Dr. Spitznagel had underestimated daily volume.[211] The CRMA contended that a normal residential consumption estimate of 144.2 gallons per customer per day more reasonably projected actual usage for a residential customer based on historical usage patterns yet still reflected continued water conservation gains.[212] To project the residential usage for Lookout Mountain and Lakeview, the CRMA calculated the percentage change between Mr. Gorman's residential usage estimate and Dr. Spitznagel's for the Chattanooga district and applied that percentage change to volumes that Dr. Spitznagel estimated for Lookout Mountain and Lakeview.[213] Mr. Gorman stated that TAWC's projection of 989.64 gallons per customer per day was not reasonable when compared to the Company's historical data.[214] CRMA recommended that attrition period commercial usage be based on the five-year average of 1,033.6 gallons per day per commercial customer because it was more reasonable and consistent with actual sales volume of commercial customers over the last ten years than the daily volume estimate of 989.64 gallons used by Dr. Spitznagel.[215] Additionally, over the last sixteen years, with the exception of 2009, the actual commercial usage substantially exceeded the estimate proposed by Dr. Spitznagel.[216] Additionally, CRMA pointed out that TAWC's expert used the

[209] John Hughes, Pre-Filed Direct Testimony, Workpaper R-Revenue Comparative Summary (January 5, 2011).
[210] Michael Gorman, Pre-Filed Direct Testimony, pp. 7-8 (January 5, 2011).
[211] *Id.*
[212] *Id.* at 9.
[213] *Id.*
[214] *Id.*
[215] *Id.*
[216] *Id.* at 9-10.

same database and analyzed data for the months of May to September 2009, which was the wettest year since 1895.[217]

TAWC claimed that it did not meet the TRA's revenue forecast adopted in the last rate case, Docket No. 08-00039, and that its revenues have actually decreased by $3.293 million.[218] TAWC claimed that this reduction in revenue accounts for 33.3% of the overall requested rate increase.[219] Nevertheless, in Docket No. 08-00039, the Company had forecasted revenues of $37,142,460 for the attrition period ended August 31, 2009.[220] The CAPD forecasted revenues of $39,492,768. The TRA adopted a revenue forecast of $38,934,309. A comparison of the actual results from TAWC's 3.06 report for the year ended August 31, 2009 (the attrition period used in Docket No. 08-00039) with the revenue figures forecasted by the parties and the TRA showed that the forecast prepared by the TRA was the most accurate. After performing several trend calculations on this historical data and an analysis of the past five years of residential and commercial customer accounts, the Authority accepts as reasonable four of TAWC's normalizing adjustments but excluded weather normalization, as further discussed below.

The Authority rejects the CAPD's projection of meters for the attrition period. During cross-examination, it was unclear which specific information the CAPD relied upon to make its projections, although there was some discussion of data from the 3.06 Monthly Reports. Further, during cross-examination by the Company, the CAPD's witness admitted to having made numerous errors[221] and inappropriate assumptions, and that recognition of these errors had prompted the CAPD to file amended testimony on February 25, 2011, March 1, 2011 and March 8, 2011. The CAPD's projections were found to contain numerous errors and could not be relied

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[217] *Id.* at 10.
[218] Michael A. Miller, Pre-Filed Direct Testimony, p. 6 (September 23, 2010).
[219] *Id.*
[220] *In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Final Order*, p. 9 (January 13, 2009).
[221] Transcript of Proceedings, Vol. IV B, pp. 133-134 (March 3, 2011).

upon with any degree of certainty. Therefore, the Authroity declines to adopt the CAPD's revenue forecast.

The Company's forecast for residential and commercial usage relied on Dr. Spitznagel's WNA model. In the previous rate case for TAWC, Docket No. 08-00039, the Authority made it clear that it had not previously adopted the Company's WNA mechanism.[222] The panel again rejects Dr. Spitznagel's WNA model as it was applied to the residential and commercial classes because the monthly regressions employed in the model have too few observations to be statistically reliable.

The CRMA's witness, Mr. Gorman, testified that the Company underestimated the level of revenues that it would earn at its current rates by overestimating the effect of a reduction in sales due to conservation.[223] He further stated that sales projections would be $1,217,115 more for the attrition period at current rates than forecasted by the Company.[224] However, the CMRA presented little evidence in the form of supporting schedules or workpapers to demonstrate or justify this assertion. For this reason, the Authority has been unable to verify Mr. Gorman's assertions and does not accept the forecast of revenues presented by CRMA.

The TRA determines that the most reasonable historical data upon which to base usage forecasts is contained in the Company's Rebuttal Exhibit MAM-10, Page 5. The moderate decline in usage per customer from 2005 through 2009 was demonstrated by data the Company provided; however, the TRA further notes that this decline has started to level off. This conclusion is based on what the TRA deems to be the most reliable data in the record for determining the future average residential and commercial usage per customer. The TRA's analysis is based on its calculations applying several methodologies used to examine probable future usage per customer, as well as an examination of the historical volumetric usage provided

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[222] *Final Order*, Docket No. 08-00039, p. 11 (January 13, 2009).
[223] Michael Gorman, Pre-Filed Direct Testimony, p. 7 (January 5, 2011).
[224] *Id.*

by TAWC in its Rebuttal Exhibit MAM-10. This data clearly demonstrates only a moderate decline in customer usage in recent years. While, as TAWC points out, the data may show usage declining substantially over the entire period 1986 through 2010, usage for residential customers has declined by only one-half gallon per day for the more recent period 2004 through September 2009.

The Company's test period usage was determined from the twelve months ended March 31, 2010 based on a review and analysis of five-year customer counts. The residential and commercial usage, as normalized and adjusted for the attrition period, represented reasonable usage for the test period. Again, the TRA declines to adopt weather normalized adjustments to revenue in forecasting usage.

TAWC and the CAPD both projected a small increase in the Industrial, Other Public Authority, Other Water Utilities, Public/Private Fire Service and Other Operating Revenues classifications from the test period to the attrition period. Little or no testimony was provided by either party on these revenues; however, the projected increases were immaterial. Further, the CAPD's revenue projections have been found to be unreliable in this rate case, having been revised by the CAPD's witness three times during the course of the docket. Therefore, the TRA adopts the projection of TAWC for these revenue classes.

Based on the foregoing, the TRA adopts an estimate of $37,614,978 for total operating revenues for the attrition period consisting of the following: (1) residential revenue of $15,555,318; (2) commercial revenue of $11,540,748; (3) industrial revenue of $3,401,964; (4) other public authority revenue of $2,556,253; (5) other water utility revenue of $1,308,493; (6) private fire service revenue of $1,735,066; (7) public fire service revenue of $0; and (8) other operating revenue of $1,517,135.

V(A)1. American Water Resources ("AWR") Water and Sewer Protection Programs

During the course of the proceedings, the City raised certain issues concerning the Company's relationship, subsidization, and transfer of utility assets and benefits without compensation to its non-regulated affiliate company American Water Resources ("AWR").[225] AWR provides homeowner protection plans to TAWC customers and other AWWC utility customers.[226] These specialized protection programs include water line protection,[227] sewer line protection,[228] and in-home plumbing emergency protection services, which cover certain repairs to the water and/or sewer lines running from a home to the street and for plumbing repairs that occur within the home (lateral water and wastewater lines/facilities owned by the customer, not TAWC), and are designed to insulate homeowners from the unexpectedly high costs that can be associated with water or sewer line failures and in-home plumbing repairs.[229]

Under the *Agreement for Support Services between American Water Resources, Inc. and Tennessee American Water Company ("Service Agreement")* executed on May 1, 2004, TAWC bills to and collects from its mutual customers AWR protection plan charges, distributes AWR promotional marketing materials and customer surveys, and notifies AWR of claims and/or initiates repair services,[230] as follows:

> Billing and Collection. AWR shall provide [TAWC] with a list of enrolled customers in its Programs who have chosen to have charges from AWR included on their bill from [TAWC], and shall keep such list up to date. [TAWC] shall

[225] Like TAWC, AWR is a wholly-owned subsidiary of AWWC.
[226] Kimberly H. Dismukes, Pre-filed Direct Testimony, pp. 10-11 (January 5, 2011); *see also* Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-8, p. 26 of 143 (February 17, 2011).
[227] The Water Line Protection Program offered to TAWC customers, subject to its terms and conditions, provides a service to repair customer-owned water lines that leak or break due to normal wear and tear. TAWC's Responses to The TRA's Fourth Set of Data Requests, Question 152, TN-TRA-04-Q152-ATTACHMENT, p. 23 of 24 (*Service Agreement*, Appendix A) (February 18, 2011).
[228] The Sewer Line Protection Program offered to TAWC customers, subject to its terms and conditions, provides a service to clear or repair blocked customer-owned sewer lines that become clogged or blocked due to normal wear and usage. *Id.*
[229] Kimberly H. Dismukes, Pre-filed Direct Testimony, pp. 10-11 (January 5, 2011); *see also* Michael A. Miller, Pre-filed Direct Testimony, Exhibit MAM-8, p. 26 of 143 (February 17, 2011).
[230] TAWC's Responses to The TRA's Fourth Set of Data Requests, Question 152, TN-TRA-04-Q152-ATTACHMENT, pp. 11-13 & 24 of 24 (February 18, 2011) *(Service Agreement* § 6, pp. 8-10 & Exhibit 1).

> include such charges on the customer's bill and collect such charges from the customer until such time as the customer or AWR notifies [TAWC] that the customer is no longer receiving services from AWR or has elected a different payment option. [TAWC] shall forward collected payments from enrolled customers to AWR within fifteen days following the end of each calendar month for amounts collected during such month. . . . AWR shall be responsible for all collection efforts for non-payment by [TAWC] customers for AWR Programs.[231]

In performing its duty to provide billing and collections services, TAWC includes AWR protection plan charges on its regular bill to the customer, collects payments for such charges, along with its own charges for service, and forwards the payments to AWR.[232] Payments are applied first to utility services, and any remainder is thereafter credited to amounts owed to AWR.[233] Utility service will not be interrupted, stopped, or refused, as a result of non-payment of amounts owed to AWR, and AWR is responsible for all collection efforts necessary due to non-payment by TAWC customers for AWR programs.[234]

In addition, AWR is responsible for the administrative activities of the programs,[235] but TAWC agreed to manage and direct the distribution of materials related to the protection plan programs for its customers:

> Distribution of Promotional Materials. Upon request of AWR, [TAWC] shall manage and direct the distribution of informational and promotional materials regarding the Program to its customers. Such materials shall be developed by AWR and provided to [TAWC] in sufficient quantities and in a timely manner so as not to impede any planned distribution efforts by [TAWC]. The materials shall be distributed as a part of [TAWC]'s normal billing process, unless arrangements are made, at least sixty (60) days in advance, for a special mailing. The materials provided by AWR must be satisfactory in form and content to [TAWC], and nothing in this Agreement shall require [TAWC] to distribute any materials that are not satisfactory to [TAWC]. [TAWC] shall make all reasonable efforts to promptly notify AWR when additional quantities of promotional materials are

[231] *Id.* at 12-13 of 24 (*Service Agreement,* § 6.1.3, pp. 9-10 & Exhibit 1).
[232] *Id.*
[233] *Id.*
[234] *Id.*
[235] Under § 10.4 of the *Service Agreement,* administration of the AWR protection plan programs include activities such as enrollment, billings, accounting, marketing, financial analysis and reporting. *See,* TAWC's Responses to The TRA's Fourth Set of Data Requests, TN-TRA-04-Q152-ATTACHMENT, p. 17 of 24 (February 18, 2011) (*Service Agreement* § 10.4, p. 14).

> needed. [TAWC] shall have the sole discretion to determine the customers who will receive the informational and promotional materials for the Program.[236]

All promotional and informational materials will be developed, produced, printed and supplied to TAWC, by AWR.[237] Further, AWR provides TAWC with the opportunity to review and approve of all materials in advance of distribution to customers.[238] All materials must be satisfactory to TAWC in form and content and TAWC is not compelled to distribute any materials that it does not determine to be satisfactory. TAWC retains control over the form and content of the AWR materials it distributes, and has discretion to determine which customers will receive these materials. In addition, TAWC reviews and has input as to AWR customer surveys prior to distributing such surveys to its customers.[239]

Finally, under the *Service Agreement,* TAWC has also agreed to provide AWR notification of possible claims:

> Notification of Claim. Should a [TAWC] associate, as a part of his/her normal duties, determine that a [TAWC] customer has a covered occurrence with the Customer's water or sewer service line, the [TAWC] associate shall notify AWR by calling a toll-free telephone number to be supplied by AWR. AWR shall then engage a qualified contractor to provide the covered services to the customer. AWR shall timely provide that necessary information to cause [TAWC]'s customer records to reflect when coverage is available.[240]

Thus, TAWC employees who determine, as part of their duties, that a customer has a covered water or sewer line occurrence are required to notify AWR, who then engages a qualified contractor to provide service in accordance with the protection plan.[241]

In its fee provision, the *Service Agreement* distinguishes the fee paid for billing and collection services from other services:

> 4.1 Fee. The fee paid to Utility by AWR for Services rendered pursuant to this Agreement shall be equal to one hundred and fifteen (115%) percent of the Fully

[236] *Id.* at 11-12 of 24 (*Service Agreement,* § 6.1.1, pp. 8-9).
[237] *Id.* at 16 of 24 (*Service Agreement,* § 10.1, p. 13).
[238] *Id.*
[239] *Id.* at 24 of 24 (*Service Agreement,* § 6.1.4, p. 10, Exhibit 1(3)).
[240] *Id.* at 12 of 24 (*Service Agreement,* § 6.1.2, p. 9).
[241] *Id.*

> Distributed Costs incurred by Utility in providing the Services *except* for billing and collection services. The Fee for billing and collection services rendered by Utility as set forth in Paragraph 6.1.3 below shall be at a rate of $.405 per customer per billing period and apply in the aggregate to customers participating in one or more of AWR's Programs. The $.405 rate may be adjusted from time to time as determined by the agency having regulatory authority over Utility to be consistent with any other such billing and collection service rates charged by Utility, under tariff, to others.[242]

As noted, TAWC receives 40.5¢ per customer per billing period for the billing and collection services it renders on behalf of AWR. The *Service Agreement* allows for adjustment of this fee by the TRA in order maintain consistency with any other third-party billing and collection fee arrangements extended to others under the Company's tariff. Other, non-billing and collection, services performed by TAWC, as described in the *Service Agreement,* are to be paid at 115% of the Fully Distributed Costs.[243] The *Service Agreement* defines "Fully Distributed Costs" as follows:

> "Fully Distributed Costs" means costs determined in a manner that complies with the standards and procedures for the apportionment of special, joint, and common costs between the [TAWC] and any non-regulated entity in accordance with applicable regulations of the State commission or board having jurisdiction over the operations of [TAWC], except taxes as discussed in Section 5. A fully distributed costing methodology apportions the total costs of a group of services of products, including the authorized rate of return, among the individual services or products in that group.[244]

Thus, TAWC agreed, in summary, to provide billing and collection "at a rate of $.405 per customer per billing period" **and** to provide services other than billing and collection for "one hundred and fifteen (115%) percent of the Fully Distributed Costs incurred" by it.

Through the testimony of its expert witness, Ms. Kimberly H. Dismukes, the City asserted that AWR receives significant tangible and intangible benefits as a result of its affiliate relationship and association with TAWC and made specific recommendations:

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[242] *Id.* at 10 of 24 (*Service Agreement,* § 4.1, p. 7).
[243] For ratemaking purposes, the costs incurred and revenue received by TAWC as a result of providing service(s) are proper considerations for the TRA in setting just and reasonable rates.
[244] *Id.* at 8 of 24 (*Service Agreement,* § 1, p. 5).

> AWR receives significant benefits as a result of its relationship with TAWC. I recommend that the TRA increase test year revenue by $1,071,281 for representing the revenue earned by AWR from the Protection Programs provided to TAWC customers. I also recommend that the TRA order a thorough examination of this affiliate relationship. Two areas need to be examined. First, procedures should be developed to ensure that costs are properly allocated to AWR to ensure that ratepayers do not subsidize this nonregulated affiliate. Second, the TRA should attribute revenue (through a royalty fee or other mechanism) to TAWC to ensure that ratepayers receive compensation for intangible and tangible benefits bestowed to the nonregulated Protection Programs offered to TAWC customers.[245]

As described in the *Service Agreement,* TAWC is to receive fee compensation for its billing and collection services[246] and payment of 115% of fully distributed costs for other services. Nevertheless, the City asserted that TAWC provides certain services and intangible assets that benefit AWR, for which it is not compensated.[247] These additional services include the use of TAWC's name and president's signature, logo, reputation, goodwill, corporate image, personnel, and customer names and addresses.[248] Ms. Dismukes highlighted TAWC's efforts to promote AWR's services:

> As shown on pages 6, 10, and 13 of Schedule KHD-3, the letters sent to potential customers offering these protection programs were sent on TAWC's letterhead. Moreover, the letters were signed by the President of Tennessee American Water Company. In addition, the letters make strong statements about the potential financial consequences associated with a line break without the program.[249]

The City contended that the transfer of intangible assets and provision of services to AWR, without compensation, demonstrates that "[c]learly there is no arms-length relationship between TAWC and AWR's sale of these Protection Programs."[250] Ms. Dismukes stated:

> There are substantial benefits to AWR for its affiliation with TAWC. These benefits include the use of TAWC's name and president's signature, logo, reputation, goodwill, and corporate image; being associated with a large, financially strong, well-entrenched water company; use of TAWC's personnel;

[245] Kimberly H. Dismukes, Pre-Filed Direct Testimony, p. 3 (January 5, 2011).
[246] The City noted that TAWC charged AWR $52,617 in 2007, $43,200 in 2008, $39,365 in 2009, and $40,900 for the twelve months ended September 30, 2010, for its provision of third-party billing services to AWR. *Id.* at 10.
[247] *Id.* at 14-17.
[248] *Id.* at 15.
[249] *Id.* at 14.
[250] *Id.* at 15.

> and use of TAWC's customer names and addresses. All of these benefits were developed as a result of the regulated operations of TAWC. However, AWR obtains these significant benefits because of its association with the regulated utility operations at no cost.[251]

Because of its unique association and direct affiliate relationship, AWR obtains free of charge the benefits of assets generated or developed through TAWC's regulated utility operations.[252] Further, TAWC's intangible assets, which are of significant value in the promotion and sale of AWR homeowner protection plans to TAWC customers, are not compensated under the *Service Agreement.* To compensate ratepayers, Ms. Dismukes recommended that TAWC's new rates reflect this relationship with AWR:

> Because of this, I recommend that the TRA increase test year revenue to include the revenue earned by AWR for the provision of these services that is applicable to TAWC. To estimate this amount, I distributed the AWR Home Services revenue to TAWC based upon its proportion of customers to the total number of regulated customers. My recommendation indicates that test year revenue should be increased by $1,071,281, as depicted on Exhibit KHD-4.
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> * * *
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> The TRA should require payment by AWR to TAWC of a royalty fee on the revenue of AWR attributable to tangible and intangible benefits bestowed by TAWC.[253]

Ms. Dismukes recommended that the Authority increase TAWC's test year revenue to include revenue earned by AWR, based upon the proportion of TAWC customers to AWR's total customer base.[254] The City asserted that AWR has 11,129 water line protection contracts, 6,410 sewer line protection contracts and 2,490 home plumbing contracts in Tennessee,[255] and that these programs were marketed through materials printed using TAWC's name and logo, and signed by the President of TAWC.[256] Ms. Dismukes distributed AWR Home Services revenue

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[251] *Id.*
[252] *Id.*
[253] *Id.* at 16.
[254] *Id.* at 16.
[255] *Id.* at 11; *see also* TAWC's First Supplemental Responses To The First Discovery Request And First Responses to the Supplemental Discovery Request Of The CAPD, TN-CAPD-01-Q77 and Q78 (December 2, 2010).
[256] *Id.* at 14 (Schedule KHD-3).

($47,532,000)[257] to TAWC using the ratio (.0225381) of TAWC Customers (74,774) to the total number of AWWC regulated customers (3,317,672).[258] As a result of this calculation, the City asserted that TAWC's test year revenue should be increased by $1,071,281 to account for revenue earned by AWR from its lucrative marketing arrangement with TAWC.[259] During cross-examination, Ms. Dismukes conceded that it would be appropriate to impute the earnings of AWR's Tennessee-specific operations to the revenues of TAWC to compensate the ratepayers.[260]

The City also asserted that the Authority should require AWR to pay a royalty fee to TAWC on the AWR revenue attributable to its use of TAWC's tangible and intangible assets.[261] Ms. Dismukes pointed out that payment of a royalty fee was consistent with the position taken by TAWC witness, Bernard L. Uffelman, in a book on cost allocation, in which Mr. Uffelman discusses the regulatory practice of requiring a non-regulated affiliate to pay a royalty or referral fee to its regulated utility affiliate for use of the utility's brand name and logo.[262] Finally, Ms. Dismukes recommended that the Authority order a thorough investigation of AWR operations and develop procedures to ensure that TAWC ratepayers do not subsidize AWR, an unregulated affiliate.[263]

The CAPD concurred with the City's assertion that additional revenue should be attributed to TAWC for certain services it performs on behalf of its affiliate, AWR.[264] Specifically, the CAPD agreed that AWR receives considerable benefits as a result of its

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[257] As noted in footnote 20 in her pre-filed testimony, Ms. Dismukes obtained AWR Home Service revenue for 2008 from TAWC's response to Schumaker IR 02-39, Attachment 1. *See* Kimberly H. Dismukes, Pre-Filed Direct Testimony, Schedule KHD-4 (January 5, 2011).
[258] *Id.* at 16 (Schedule KHD-4).
[259] *Id.* at 3 (Schedules KHD-2, 3 and 4).
[260] Transcript of Proceedings, Vol. II C, p. 292 (March 1, 2011).
[261] *Id.* at 232, 241-43; *see also* Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp.16-17 (January 5, 2011).
[262] Transcript of Proceedings, Vol. II C, pp. 232, 241-43 (March 1, 2011); *see also* Transcript of Proceedings, Vol. IV B, pp. 81-83 and Hearing Exhibit 53, p. 19 (March 3, 2011).
[263] Kimberly H. Dismukes, Pre-Filed Direct Testimony, p. 16 (January 5, 2011).
[264] *Consumer Advocate and Protection Division's Post-Hearing Brief,* pp. 15-16 (March 21, 2011).

affiliation with TAWC and the use of intangible assets, including TAWC's logo, in the marketing and sale of its products to TAWC customers.[265] Therefore, the CAPD joined with the City in urging the Authority to review the affiliate relationship between TAWC and AWR and consider imputing a portion of AWR's revenues to TAWC.[266]

In response to the City's and CAPD's contentions, the Company, through its witnesses, Mr. Michael A. Miller and Mr. John Watson, asserted that its only participation in the water line/service line protection programs was to provide third-party billing and collection services for AWR at the tariff rate approved by the TRA for such services, which is also the same rate charged to the City of Chattanooga Sanitary Board.[267] Mr. Miller asserted that as TAWC already bills its customers for water service, aside from incremental printing costs, TAWC incurs little, if any, additional cost in providing billing services to AWR:

> The Agreement indicates that TAWC will also bill AWR for any costs not covered by the billing fee at 115% of cost (Article 3.3.2 of the Affiliated Agreement). The Agreement also indicates that TAWC will distribute, upon the request of AWR, informational and promotional materials regarding the AWR programs to its customers though inserts in its billing envelopes, which is the same service TAWC would provide to its contract sewer billing customers upon request.
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> * * *
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> Other than incremental cost to print additional information on the bill and collect the fees there is little, if any, additional costs incurred by TAWC.[268]

Mr. Miller acknowledged that the Company is not compensated for AWR's use of the signature of TAWC's President used on its marketing materials, and asserted that, under the *Service Agreement,* TAWC is entitled to compensation only when it incurs an additional cost,

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[265] *Id.*
[266] *Id.*
[267] Michael A. Miller, Revised Rebuttal Testimony Amendment, p. 95 (February 17, 2011); Transcript of Proceedings, Vol. VI A, p. 52 (March 7, 2011); *see also* TAWC's First Supplemental Responses to City of Chattanooga's First Discovery Request, TN-COC-01-Q39 and TAWC's First Supplemental Responses To The First Discovery Request And First Responses to the Supplemental Discovery Request Of The CAPD, TN-CAPD-01-Q77 and Q78 (December 2, 2010).
[268] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 96 (February 8, 2011).

and no such cost is incurred.[269] Mr. Watson contended that his endorsement and approval, as TAWC President, has little value or benefit to AWR in the marketing and sale of the protection plans to TAWC customers.[270] Rather, he asserted that the real benefits accrue to the customers in the important service they receive when, through the AWR marketing materials, they become educated of their responsibilities for certain water service/sewer lines and aware of the significant costs involved in maintaining and repairing those lines.[271]

TAWC asserted that it provides no services to AWR that are not covered by the contract billing fee and that such fees "more than adequately compensate" TAWC for the services it provides to AWR.[272] Nevertheless, Mr. Miller's contentions with Ms. Dismukes's recommendations were founded primarily on the claim that TAWC incurs no additional costs in providing services to AWR over or above what TAWC incurs for the regulated services TAWC is already providing to its customers:

> When any customer calls with a concern about a leak, TAWC employees respond initially. If the leak is identified on the customer's service line, they are so advised. . . . Because the Company's personnel always respond to a customer's service issue regarding a high bill or leak, TAWC does not incur any additional costs when it instructs the customer that the leak appears to be on the customer owned line and they need to call AWR if they have the service line protection with AWR.
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> TAWC has borne no cost for producing or sending that information to its customers.
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> The regulatory process is a cost-based process. While Ms. Dismukes perceives value for these attributes, there is no rate base value or expense recognition allowed by the TRA for them. Thus, TAWC recovers nothing from its regulated customers for these attributes or intangible assets. Therefore, there is no value for

[269] *Id.* at 99 (February 18, 2011).
[270] Transcript of Proceedings, Vol. III A, pp. 83-84 (March 2, 2011).
[271] Michael A. Miller, Revised Pre-Filed Rebuttal Testimony Amendment, pp. 97-98 (February 17, 2011); *see also* Transcript of Proceedings, Vol. III A, pp. 83-84 (March 2, 2011).
[272] Michael A. Miller, Revised Pre-Filed Rebuttal Testimony Amendment, p. 101 (February 17, 2011).

> those intangible assets recovered from the rate payers, and they should not, and are not entitled to a lower rate from assets to which they do not contribute.[273]

Moreover, TAWC asserted that as there is no overt rate base value or expense recognition in the ratemaking process for intangible assets or attributes, ratepayers have not contributed to the development of such utility assets and, thus, are not entitled to any benefits that the Company may enjoy as a result of intangible assets.[274] Mr. Miller concluded:

> Therefore, because the customers bear no risk for the costs of AWR in the rates of TAWC they are not entitled to any portion of the revenue generated by the contracts between AWR and the customers who elect to accept AWR services.[275]

The Company also disputed the necessity of an investigation concerning the affiliate relationship between TAWC and AWR.[276] Relying on the Schumaker Audit Report, the Company asserted that the management auditors had already examined the relationship between TAWC and AWR and determined that the billing methodology was reasonable.[277] On February 19, 2011, in response to Question 150 in the TRA's Fourth Set of Data Requests, the Company filed income statements related to the AWR Service Line Protection services overall and specifically to their operations in the state of Tennessee as of December 31, 2010.[278]

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[273] *Id.* at 98-99.
[274] *Id.*
[275] *Id.* at 101. Mr. Miller made similar statements in response to TRA data request Question 168:

> Q. For the same years, what was the net effect on TAWC's financial results from the agreement with AWR?
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> A. The revenue from AWR is recorded in account number 403001.AW21 (above the line) and is included in the going-level revenue of this case. Therefore, the revenue from AWR serves to lower the amount of revenue required from the Company's regular water service tariffs. The Company does not track the incremental cost of billing and collecting services for AWR (or for any other third party billing customer, i.e. City of Chattanooga). Because TAWC would have to read the meters, print the bills, mail the bills, and collect the bills even if the third party billing contracts did not exist, other than the small incremental costs of third party billing and collecting (which is automated), the cost is well below the 40.5¢ charged for the service.

See TAWC's Responses to the TRA's Fifth Set of Data Requests, Question 168, TN-TRA-05-Q168 (February 22, 2011).
[276] *Id.* at 102; *see also TAWC's Post-Hearing Brief in Support of Its Petition to Change and Increase Certain Rates and Charges,* p. 25 (March 21, 2011).
[277] *Id.*
[278] TAWC's Responses to the TRA's Fourth Set of Data Requests, Question 150, with attached schedules TN-TRA-04-Q150-ATTACHMENT (February 18, 2011).

In fixing just and reasonable rates, the Authority adheres to its precedent and longstanding regulatory policy of looking beyond its regulated utility to consider the impact of the unregulated operations of its affiliate and parent companies.[279] Review of the record demonstrates that, contrary to TAWC's position, by contracting to provide its name and goodwill to AWR, TAWC transferred valuable intangible assets to an affiliate.[280] The regulatory consequences of such a transfer have been broadly recognized: "Where a utility derives benefit from the use of a non-rate-based asset paid for by the ratepayers, [the regulatory commission] may allocate part of the cost borne by the ratepayers to the shareholders."[281] Therefore, "[i]nsofar as the ratepayers have borne the costs for creating value in [the utility's] name and reputation, the ratepayers are entitled to a prudent use of those assets."[282]

In addition, notably under the heading "Notification of Claim," TAWC provided the services of its employees to AWR apart from billing and collection. This type of practice carries with it similar opportunities for improper subsidy:

> Regulated utilities also subsidize their subsidiaries and affiliates when the expertise and experience of the utilities' employees are placed at the disposal of the subsidiaries for consultation and advice. Since ratepayers have paid for these human resources through training, salaries, bonuses and other incentive programs, the diversion of employee resources on subsidiary and affiliate matters imposes costs on the ratepayers.[283]

Accordingly, it has been held that

> it is in the public interest to require [an unregulated affiliate] to compensate [a regulated utility] for the many intangible benefits its receives, including, but not limited to the following: the use of the [utility's] name; the use of the [utility's]

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[279] *See, e.g., TPSC v. Nashville Gas Company,* 551 S.W.2d 315 (Tenn. 1977) (holding that Commission is not bound to observe corporate charters, form of corporate structure, or stock ownership in regulating a public utility and in fixing fair and reasonable rates for its operations).

[280] *See In re: Affiliated Activities, Promotional Practices and Codes of Conduct of Regulated Gas and Electric Companies*, Maryland Pub. Serv. Comm'n, Case No. 8820, *Order* (July 1, 2000); *US West Communications, Inc. v. Washington Utils. and Transp. Comm'n*, 949 P.2d 1337, 1351 (Wash. 1997) (citing cases).

[281] *Rochester Tel. Corp. v. Pub. Serv. Comm'n of New York*, 660 N.E.2d 1112, 1117 (N.Y. 1995), *cited in BellSouth Advertising and Publ'g Corp. v. Tennessee Regulatory Auth.*, 2001 WL 134603, *42 (Tenn. Ct. App. Feb. 16, 2001) (Cottrell, J., dissenting), *rev'd* 79 S.W.3d 506 (Tenn. 2002).

[282] *Rochester Tel.,* 660 N.E.2d at 1117.

[283] *Id.*

> logo; reliance on the [utility's] reputation; immediate access to financing; and the ability to capitalize, through contractual arrangements, on a trained, skilled workforce.[284]

In setting TAWC's rates, the TRA is empowered to assess the adequacy of compensation for these benefits and to take steps to ensure that TAWC's customers are not being made to subsidize a non-regulated company without proper compensation. As stated by the Supreme Court of Washington, "[t]he general rationale for [a regulatory] Commission's authority to review transactions between affiliated companies is fear of collusion in the absence of arm's-length dealings."[285] The Court further stated:

> It does not matter . . . whether the utility paid the affiliate too much money for too little service or property, or whether . . . the utility gave the affiliate something of far greater value than the affiliate paid for in return. The effect in either situation is to give to the shareholders of the affiliate something of value at the expense of the ratepayers of the utility.[286]

These statements are consistent with Tennessee law, which recognizes the TRA's ability to exert jurisdiction over non-regulated affiliates of regulated utilities when necessary for proper ratemaking. As the Tennessee Supreme Court stated over thirty years ago, "a regulatory body, such as the Public Service Commission, is not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility, and in fixing fair and reasonable rates for its operations."[287]

TAWC's implementation of the *Service Agreement* with AWR does not adequately compensate TAWC's customers for the disposition of intangible assets or for employee effort and expertise. First, TAWC's statement that it incurs no costs in providing its name and goodwill to AWR lacks credibility. Second, and more importantly, TAWC's implementation of the service contract deprives its customers of proper compensation. Although TAWC provides

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[284] *United Tel. Long Distance, Inc. v. Nichols*, 546 So.2d 717, 719 (Fla. 1989).
[285] *US West*, 949 P.2d at 1348.
[286] *Id.*
[287] *Tennessee Pub. Serv. Comm'n v. Nashville Gas Co.*, 551 S.W.2d 315, 319 (Tenn. 1977), *quoted in BellSouth Advertising and Publ'g Corp. v. Tennessee Regulatory Auth.*, 79 S.W.3d 506, 516 (Tenn. 2002) (recognizing the potential detriment to ratepayers in dealings with non-regulated affiliates).

billing and collection services for which it receives compensation from AWR, TAWC plainly provides other services as well. For example, TAWC has contracted to "manage and direct the distribution of informational and promotional materials regarding the [AWR] Program to [TAWC's] customers." The *Service Agreement* also provides that "[s]hould a Utility associate, as a part of his/her normal duties, determine that a Utility customer has a covered occurrence with the Customer's water or sewer service line, the Utility associate shall notify AWR by calling a toll-free telephone number to be supplied by AWR."

The fact that the *Service Agreement* separates AWR's compensation to TAWC into two components, a fee of $.405 per bill and a fee of 115% of fully distributed costs, acknowledges that TAWC is providing something of value to AWR other than billing and collection. The use of a fully distributed cost method of allocating costs between a regulated utility and its non-regulated affiliate has been deemed acceptable.[288] However, TAWC's position that it "incurs no additional costs" to provide these services is inconsistent with the provision that the fee paid by AWR for services other than billing and collection—services that are clearly part of the *Service Agreement*—will be based on TAWC's fully distributed costs of providing the service. Put simply, TAWC is not distributing the costs between itself and AWR as the *Service Agreement* requires.

More than one option exists for the appropriate regulatory treatment of a utility's disposition of a regulatory asset. One is the imputation of a royalty, an approach suggested by Ms. Dismukes and adopted in some instances.[289] Another may be the use of a contract calling for payment of fully distributed costs, properly applied.[290] TAWC's position, namely, that it incurs no additional costs and therefore has no costs to report, leaves the TRA without sufficient

[288] *See, e.g., In re: Affiliated Transactions*, 183 P.U.R.4th 277 (Md. P.S.C. February 23, 1998).
[289] *See, e.g., In re: St. Lawrence Gas Co., Inc.*, 183 P.U.R.4th 457, New York Pub. Serv. Comm'n, Case No. 97-G-0409, *Order* (January 22, 1998).
[290] This is the approach endorsed by the National Association of Regulatory Utility Commissioners ("NARUC") for allocating indirect costs: "The general method for charging indirect costs should be on a fully allocated cost basis." ROBERT L. HAHNE & GREGORY ALIFF, ACCOUNTING FOR PUBLIC UTILITIES, § 19.03[4][d] (2011).

information upon which to base a royalty. At the same time, this position denies TAWC's customers adequate compensation for the intangible assets.

Faced with the Company's broad dismissal of the AWR issue, the panel decided to impute to TAWC the net income generated from AWR's Tennessee water and sewer line protection programs.[291] This will insure that TAWC's regulated customers are adequately compensated for establishing the value of the asset TAWC transferred. While Ms. Dismukes's conception of this issue is basically sound, the TRA cannot accept her recommendation to impute $1,071,281, as this figure is based upon the total revenue of AWR from all water systems, not just those related to TAWC. Moreover, during cross-examination, Ms. Dismukes admitted that imputing the earnings of AWR's Tennessee-specific operations to the regulated side would be appropriate.[292] Accordingly, the panel concluded that the $306,611 net income generated from AWR's Tennessee water and sewer line protection programs shall be imputed to TAWC.

V(B) EXPENSES

V(B)1. SALARIES AND WAGES

The Company forecasted Salaries and Wages Expense of $5,680,299.[293] For current employees, wages for the twelve months ended March 31, 2010 were adjusted to account for the wage level to be paid during the attrition year.[294] The Company calculated the attrition year wage levels by prorating known wage rate increases that will occur during the attrition period.[295] For TAWC Union employees, whose current contract expires on October 31, 2011, the Company assumed a 3% increase effective November 1, 2011 consistent with the Union contract for the

[291] The use of imputation of income is broadly supported in regulatory decisions. *See US West*, 949 P.2d at 1351 and n. 9 (citing cases).
[292] Transcript of Proceedings, Vol. II C, p. 292 (March 1, 2011).
[293] *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).
[294] *Id.* at 7.
[295] *Id.*

last five years.[296] For non-Union employees and current salaried employees, the Company calculated the rate based on a 3% wage increase to take effect on January 1, 2011.[297]

The Company sought to expand its employee level from the 109 employees accepted for ratemaking purposes in Docket No. 08-00039 to 110 employees.[298] According to TAWC witness Mr. Watson, the employee level of 110 reflects the number needed and required to meet the expected service levels during the attrition year.[299] Mr. Watson stated that each position had particular responsibilities that played an integral role within the Company; however, due to natural workforce turnover and a recently unplanned termination of ten employees, there were vacant positions.[300] These factors brought TAWC's actual employee numbers down, but TAWC was working diligently to fill the remaining positions.[301] Mr. Watson testified that as of the week of the hearing in this rate case TAWC's employee count was 108.[302]

The Company used a capitalization rate[303] of 15.83% to determine the amount of Salaries and Wages charged to operations and maintenance ("O&M") expense, based on the actual twelve-month average of capitalized labor as of March 2010 (the end of the test period used by TAWC).[304] The Company included Annual Incentive Plan ("AIP") costs of $146,640 in Salaries and Wages Expense. The Company stated that its AIP was changed in 2009 to make the entire individual employee AIP award applicable to each eligible employee's individual goals, which are not tied to the financial performance of TAWC or AWW.[305] The Company also stated that its incentive compensation program is part of its overall compensation plan and was established

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[296] *Id.* at 8.
[297] *Id.*
[298] John S. Watson, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).
[299] John S. Watson, Pre-Filed Rebuttal Testimony, pp. 5-6 (February 8, 2011).
[300] *Id.* at 6.
[301] *Id.* at 6-7.
[302] Transcript of Proceedings, Vol. III A, p. 76 (March 2, 2011).
[303] The capitalization percentage represents the actual time charged to capital projects. The amount of capitalized salaries and wages removed from salaries and wages expense is accounted for (recovered) in rate base.
[304] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TRA-01-Q031-ATTACHMENT, p. 2 (September 24, 2010).
[305] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 80 (February 8, 2011).

to motivate better employee performance. The overall compensation plan is claimed to be market-driven to result in benefits to TAWC's customers. Mr. Miller stated that a "performance based culture does benefit the customer, the employee (who meets high performance goals) and the shareholder."[306]

The CAPD forecasted Salaries and Wages Expense of $4,915,111 for the attrition period.[307] The CAPD argued that TAWC historically has not achieved or maintained the employment levels it forecasted.[308] The CAPD, therefore, opted to use the actual employee level of 104.[309] The CAPD priced out Salaries and Wages Expense using actual wage rates per employee, actual overtime hours as of September 2010, prospective payroll increases as of January 1 of each year pursuant to the Company's policy for salary and non-Union employees, and a 3% annual pay increase on November 1 each year for Union employees, pursuant to their contract.[310] Secondly, the CAPD eliminated 70% ($102,646) of the AIP costs from Salaries and Wages Expense.[311] The CAPD stated that 70% of the incentive payroll claimed by TAWC is based on financial performance measures and opined that any increase in regulated earnings will benefit solely the employees and the shareholders at the expense of the ratepayer.[312] The CAPD stated that it does not object to a mechanism that provides a reward for TAWC's employees for increasing earnings from regulated operations; however, the cost should be charged to those who reap the benefits, namely, the shareholders, and not the ratepayers.[313] The CAPD further noted that this treatment of incentive payroll is in accordance with established TRA precedent and decisions in several other States (Louisiana, Kentucky, Idaho, Connecticut, Illinois and

[306] *Id.* at 81.
[307] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[308] *Id.* at 4.
[309] *Id.* at 17.
[310] *Id.* at 13.
[311] *Id.* at 18.
[312] *Id.* at 19.
[313] *Id.*

Oklahoma) which have recently disallowed or limited plans of this type.[314] Additionally, the CAPD used a capitalization percentage[315] of 20.57%, which the CAPD based on the actual average capitalization rate TAWC experienced for the twelve months ended December 31, 2008.

The Union supported TAWC's request for approval to recover the "fully loaded and labor-related expenses" associated with 110 full-time employees but conditioned its support on a requirement that the Company maintain its full-time employee workforce at the 110-person level at all times.[316] The Union based its position on the assertion that (1) the Company testified that it is unable to conduct short and long-term activities in an efficient and cost-effective manner; (2) information provided by the Company showed that the current workforce is composed of a lower number of employees than previously accepted by the Authority; (3) TAWC has not maintained a union-represented workforce that is consistent with the level authorized by the authority; and (4) TAWC acknowledged that its current workforce is insufficient for the cost-effective conduct of either short-term or long-term activities, including valve maintenance.[317]

The Union further testified that TAWC's failure to conduct a valve operation and maintenance program could be significant in times of emergency situations, since the valve maintenance program helps to ensure easy valve location and proper functioning. A failure of this kind could have ripple effects leading to additional customer service disruptions in a larger area, continued water leakage, and considerable damage.[318] Moreover, the Union focused extensively on presenting evidence concerning the condition of valves and valve maintenance by TAWC and related these issues to employee levels at TAWC.

[314] *Id.*
[315] This represents the percentage of employee time spent working on capital projects.
[316] James Lewis, Pre-Filed Direct Testimony, pp. 2-4 (January 5, 2011).
[317] *Id.* at 3.
[318] *Id.* at 15-16.

As this discussion makes evident, the valve and valve maintenance issues brought by the Union became a central focus in this rate case in determining the proper employee levels at TAWC. Initially, these issues were raised by the Union through the Pre-filed Testimony of James Lewis, which was filed on January 5, 2011. Mr. Lewis, who is National Senior Representative for UWUA, Region II, is responsible for handling grievances, arbitrations, and contract negotiations in Florida, Maryland, Pennsylvania, Tennessee, Virginia and West Virginia, including in relation to the unionized portion of the workforce at TAWC.[319]

Attached to Mr. Lewis's pre-filed testimony was a written statement by Mr. Haddock concerning employee levels, valves and valve maintenance at TAWC. As stated previously, this statement was signed by Mr. Haddock but not notarized, yet the Union referred to it as an "affidavit." Thereafter, the Union filed a *Motion to Substitute Affiant* on February 7, 2011 to have a former employee, Mr. Blevins, adopt Mr. Haddock's statements. Mr. Blevins was Field Operations Supervisor for TAWC from 1992 until November 2010. The Hearing Officer denied the Union's motion by Order issued on February 25, 2011, but the Union raised its objection again on February 28, 2011,[320] the first day of the Hearing in Chattanooga, through a *Petition for Appeal of the Hearing Officer's Initial Order*.

The panel voted to uphold the Hearing Officer's Order denying the Union's motion to substitute Mr. Blevins for Mr. Haddock, but the panel allowed the UWUA to call Mr. Haddock as a witness to attest to his own statement regarding TAWC valves. However, the panel also stated that if Mr. Haddock was going to be unavailable, testimony on valves should be heard from Mr. Blevins, having been informed that he would be available during the hearing.[321] Mr. Haddock was subsequently discovered to be unavailable because he was in Washington State and could not return to Chattanooga in time for the hearing. Since TAWC witness Mr. Watson

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[319] *Id.* at 1-2.
[320] Transcript of Proceedings, Vol. I A, p. 49 (February 28, 2011).
[321] Transcript of Proceedings, Vol. II A, p. 6 (March 1, 2011).

had provided pre-filed rebuttal testimony on the valve issue, the panel determined that TAWC would not be unduly prejudiced[322] by the calling of Mr. Blevins, whom TAWC would have an opportunity to cross-examine. The panel upheld the Hearing Officer's ruling striking the portion of Mr. Lewis's statement that referred to Mr. Haddock's statement and excluding the signed statement of Mr. Haddock attached to Mr. Lewis's testimony (UWUA Exhibit 11).[323]

During the public comment period, Mr. Blevins offered comments specifically about a water main break that had occurred in Chattanooga the previous week and the problems TAWC has experienced with its valves.[324] Mr. Blevins discussed TAWC's valve inspection program, staffing, and his knowledge concerning its valve problems.[325] Additionally, as a result of the panel's determination that the valves and valve inspection program was important in this proceeding and testimony concerning this issue needed to be in the record, Mr. Blevins was permitted to testify on the record based on his own personal knowledge of TAWC's valve program. TAWC was also permitted to cross-examine Mr. Blevins.[326]

Also testifying for the Union, Mr. Lewis contended that TAWC's workforce level is not sufficient to continue to ensure safe, reliable, and high quality water services to customers[327] and that even if the TRA approves the employee level TAWC was requesting, TAWC may not fully staff its operations in the future.[328] Mr. Lewis suggested requiring TAWC to submit quarterly reports to the TRA showing both its authorized and its actual employment levels. Further, if TAWC should fail to maintain a workforce level consistent with the authorized number of employees, TAWC should be penalized.[329] This would serve to ensure that TAWC actually

[322] *Id.* at 7.
[323] Transcript of Proceedings, Vol. IV D, pp. 246-247 (March 3, 2011).
[324] *Id.* at 281.
[325] Transcript of Proceedings, Vol. I C, pp. 329-330 (February 28, 2011).
[326] *Id.* at 331-332.
[327] James Lewis, Pre-Filed Direct Testimony, p. 6 (January 5, 2011).
[328] *Id.* at 4.
[329] *Id.*

employs the number of employees that it has requested and, indeed, that it needs.[330]

Testifying for TAWC, Mr. Watson explained that workforce turnover had played a significant role in determining employee levels, and TAWC has been unable to avoid having unfilled positions.[331] Also, turnover at TAWC has been due to retirement, resignations, severance, terminations for cause, deaths, or other events beyond the Company's control, such as medical leave, military duty or personal relocations.[332] Mr. Watson stated that TAWC anticipated having employee levels of 110 full-time equivalents ("FTEs") for 2010-2011 on or about February 28, 2011.[333] TAWC had hired five additional employees, and three additional candidates had accepted offers of employment and were to be hired the week of February 21, 2011.[334]

In his rebuttal testimony, Mr. Watson stated that TAWC has had an ongoing valve inspection program in Tennessee for the past twelve years.[335] In addition, TAWC had invested in a new vehicle that was designed and equipped to provide a comprehensive approach to valve exercising and inspection, and employees have been trained on its use and operation,[336] TAWC keeps an extensive paper records system that contains distribution system valve information, valve maps, valve numbers, construction records, and valve inspection records, similar to a fire hydrant database.[337]

TAWC indicated that it would be willing to provide the number of employees on a quarterly report to the Authority.[338] The Consumer Advocate supported this idea.[339] Mr. Watson also stated that TAWC performs preventive valve maintenance, having set specific goals for

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[330] *Id.*
[331] John S. Watson, Pre-Filed Rebuttal Testimony, p. 8 (February 8, 2011).
[332] *Id.*
[333] *Id.*
[334] *Id.*
[335] John S. Watson, Pre-Filed Rebuttal Testimony, p. 26 (February 8, 2011).
[336] *Id.*
[337] Transcript of Proceedings, Vol. IV D, pp. 301-302 (March 3, 2011).
[338] Transcript of Proceedings, Vol. III A, pp. 34-35 (March 2, 2011).
[339] *Consumer Advocate and Protection Division's Post-Hearing Brief*, p. 22 (March 21, 2011).

2009 and 2010,[340] and had met its valve inspection/operation goals in 2010 except for smaller valves. According to Mr. Watson, TAWC was close to meeting its goal fully but was prevented by an employee's retirement.[341] Mr. Watson testified that additional employees had been hired, and once employee levels were at 110 FTEs, TAWC would be able to meet its valve maintenance goals by the end of 2011.[342]

The Company argued that it had been able to maintain its valves effectively, but it could not continue to perform proper valve operation and maintenance in the longer term without the additional staff requested in its *Petition*.[343] Until this point, TAWC had been able to sustain its valve maintenance program because of the weak economy and a decrease in housing starts in its service area and by shifting employees in other areas to valve maintenance functions.

During cross-examination, Mr. Watson agreed that TAWC's valve exercising, maintenance and inspection program is part of its obligation to operate its system in accordance with good utility practice and an appropriate program for a water utility.[344] Mr. Watson stated that he was not aware of any federal or state mandates for valves or valve maintenance.[345]

Mr. Blevins testified that some valves in TAWC's system had been in disrepair for a number of years.[346] He also stated that TAWC did not have enough employees handling valve maintenance, and often he had trouble finding valves that were sufficiently operational to allow TAWC to carry out a repair.[347] He stated that on occasion he had to conduct repairs without reducing water pressure because he was unable to turn off an inoperable valve.[348] He also testified that TAWC was aware that valves were inoperable and that valve issues had been

[340] John S. Watson, Pre-Filed Rebuttal Testimony, pp. 26-27 (February 8, 2011).
[341] *Id.* at 27.
[342] *Id.* at 28.
[343] *Id.* at 27.
[344] Transcript of Proceedings, Vol. IV D, p. 319 (March 3, 2011).
[345] *Id.* at 319.
[346] *Id.* at 290-291.
[347] *Id.* at 291.
[348] *Id.* at 295.

discussed during TAWC departmental meetings and group discussions.[349]

In its post-hearing brief, TAWC claimed that the Intervenors were attempting to shift the focus to a variety of irrelevant topics during this rate case, such as TAWC's policies and procedures for inspecting and maintaining the valves.[350] TAWC asserted that Mr. Watson's testimony had disproved the Intervenors' allegations of deficiencies in the valve maintenance program.[351]

The Union replied in its post-hearing brief that the Company's alleged staffing and maintenance deficiencies compromise the quality of service it provides to its customers.[352] The Union stated that its main concern was the potential inclusion in rates of expenses associated with all eighty-two hourly employees being included in the Company's 110 FTE level.[353]

The Consumer Advocate recommended that TAWC be allowed only 104 employees, based on the average number of employees during the test period ended September 2010, because TAWC had a track record of not maintaining authorized employee levels.[354] The Consumer Advocate later modified its position to state that the maximum number of employees should be 107, and the TRA should require a monthly report of employees by name and position.[355]

Tenn. Code Ann. § 65-4-103 provides, in pertinent part, that the TRA has an obligation in setting rates "to take into account the safety, adequacy and efficiency or lack thereof of the service or services furnished by the public utility." Tenn. Code Ann. § 65-4-115 further provides that no public utility shall "provide or maintain any service that is unsafe, improper, inadequate or withhold or refuse any service which can reasonably be demanded and furnished when

[349] *Id.* at 296.
[350] *Tennessee American Water Company's Post-Hearing Brief in Support of Its Petition to Change and Increase Certain Rates and Charges*, p. 118 (March 21, 2011).
[351] *Id.* at 171.
[352] *Id.*
[353] *Id.*
[354] *Consumer Advocate and Protection Division's Post-Hearing Brief*, p. 21 (March 21, 2011).
[355] *Id.*

ordered by the Authority." TRA Rule 1220-4-3-.42(2) requires that a utility "shall make all reasonable efforts to prevent interruptions of service and when such interruptions occur shall endeavor to re-establish service with the shortest possible delay consistent with the safety to its customers and the general public." Both the noted uncertainties surrounding employee levels and the related issue of adequate valve maintenance implicate these regulatory requirements, and the TRA must necessarily consider these issues in setting TAWC's rates for water service.

Based on the record and foregoing considerations, a majority of the panel sets $5,279,477 for Salaries and Wages Expense during the attrition period.[356] As further discussed below, the Salaries and Wages Expense amount that is calculated by the majority utilizes a price out that consists of 110 employees, reflects a deduction of 20% of the current salary of the newly created Government Affairs Specialist position, a 50% reduction ($67,619) to AIP incentive payroll, the elimination in full of allocations to the Long Term Incentive Plan ("LTIP") ($11,403), and a 20.57% capitalization rate.

The Authority agrees that the calculation of Salaries and Wages Expense appropriately begins with 110 employees, but deducts the portion of the current salary of the Government Affairs Specialist that correlates to time spent performing the job function of political lobbying or legislative/governmental actions advocacy.[357] The Company's witness, Mr. Watson, TAWC President, testified that the Government Affairs Specialist position was a newly created position, which replaced a previously contracted service position, filled by the Company on August 30,

[356] Director Roberson did not vote with the majority and files a separate opinion explaining his position. Additionally, Director Roberson voted to exclude from the calculation the position of Finance Manager because that employee's functions duplicate a portion of the function for finance services that are provided to TAWC by AWWSC. This would reduce TAWC's revenue requirement by $120,333. Transcript of Proceedings, p. 71 (April 4, 2011).

[357] Agreeing with the CAPD's position, Director Roberson moved to amend the pre-filed motion filed by Chairman Freeman to reflect a maximum allocation of 107 employees. Director Roberson derived this employee allocation based on the actual number of current TAWC employees (108) testified by Mr. Watson, President of TAWC, excluding the Government Affairs Specialist position and full salary paid to Mr. Kino Becton, TAWC's newly hired Government Affairs Specialist, who is a registered lobbyist in the State of Tennessee. The results of Director Roberson's amendment, had it succeeded, would have been to reduce the Salary & Wages Expense by an additional $163,944. *See,* Transcript of Proceedings, pp. 68-69 (April 4, 2011).

2010.[358] The duties of the Government Affairs Specialist include working closely with municipal officials, customers, and constituents on local issues, building relationships with state officials concerning activities, plans, and projects of interest to the Company, improving the Company's management of local and state issues, and monitoring changes in municipal, county, state and federal laws and regulations.[359] Mr. Watson estimated that 20% of the Government Affairs Specialist's time would be spent lobbying on behalf of TAWC and its customers.[360]

It is a well-established and long-standing policy of the TRA to disallow expenses related to lobbying when setting utility rates.[361] Consistent with its own policy and precedent, and that of most other state regulatory commissions throughout this country, the majority finds that expenses related to lobbying are expended for the benefit of the Company first and foremost, and are not necessary for the provision of safe and adequate service. Therefore, the majority concludes that insofar as 20% of the Governmental Affairs Specialist's time will be spent lobbying, it is reasonable for ratemaking purposes to deduct a proportional percentage of the current salary allocated to that position (20%).[362]

In addition, the Company testified that in 2009 and 2010, it scaled back some of its planned capital investment projects due to financial constraints following its last rate case order.[363] In light of the reduced completion of capital investment projects, the calculations for plant additions appear unusually low in the test periods used by both the Company and the CAPD and the Company's capitalization rate does not accurately reflect typical activity in this

[358] John S. Watson, Pre-Filed Direct Testimony, p. 23 (September 23, 2010).
[359] *Id.* at 23-24.
[360] TAWC's First Supplemental Responses To The First Discovery Request And First Responses To The Supplemental Discovery Request Of The CAD Questions 53-126, TN-CAPD-SUPPLEMENTAL-Q086 (December 2, 2010).
[361] Reaffirming its policy and practice of disallowing lobbying expenses in ratemaking, the Tennessee Public Service Commission, which was the predecessor agency of the TRA, stated, "We still believe that the first obligation of the company's lobbyist is to act in a manner that is beneficial to the company, which may or may not be beneficial to the company's customers. We will continue our position that this is an improper expense for rate-making purposes." *In re S. Cent. Bell Tel. Co.*, 22 P.U.R.4th 281, 297 (Dec. 30, 1977); *see also*, 48 P.U.R.4th 493, 496 (Sept. 20, 1982).
[362] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013, Workpaper Labor 12 months ended 2010 (September 24, 2010).
[363] John S. Watson, Pre-Filed Direct Testimony, pp. 13-14 (September 23, 2010).

category. Therefore, the panel elects to use the CAPD's capitalization percentage of 20.57%. This percentage is the actual capitalization rate for the twelve months ended December 31, 2008, a period that better reflects normal plant additions.

The Company confirmed that its reported AIP amount of $146,640 includes an LTIP of $11,403 of Equity Compensation, leaving a balance of $135,237 as the intended AIP amount. The TRA disagreed with the Company's position that the total of AIP and LTIP costs ($146,640) should be included in Salaries & Wages Expense. However, the CAPD's proposal to remove 70% of these costs based on financial targets is also unsatisfactory because this is the overall amount of AIP available for payment in a given year, and once determined, employee performance is no longer tied to the overall financial goals of AWW.[364]

The TRA determined that one half of AIP ($67,619) should be included in Salaries and Wages, since both TAWC and its customers benefit from AIP through higher financial returns for the Company. Regarding the LTIP plan, this program provides executive or director compensation based on the financial performance of AWWC's stock price. No just and reasonable basis exists for charging ratepayers this type of compensation, which rewards TAWC solely on the basis of financial performance. For ratemaking purposes, therefore, LTIP should be eliminated.

Further, the panel required TAWC to submit semi-annual reports of its staffing levels to the TRA's Utility Division Chief. Specifically, each such report should include (1) the actual number of full-time equivalent employees for the previous period, by month; (2) an explanation of any differences between authorized and actual FTEs; and (3) the date(s) TAWC expects to fill any vacant positions. The panel also required the Company to submit a semi-annual report to the Utility Division Chief regarding its Valve Operation and Maintenance Program. Each semi-annual report should also include (1) the number of employees assigned to the valve program, by

[364] Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 80-81 (February 8, 2011).

month; (2) the target number of larger and smaller valves scheduled during the preceding period for inspection/operation and maintenance, by month; (3) the number of valves actually inspected/operated and maintained during the report period, by month; (4) the number of valves found to be in need of repair or replacement, by month; (5) the date for repair or replacement of such valves; and (6) if TAWC decided not to repair or replace those valves, the number of valves that were not repaired or replaced and the reason for not doing so.

V(B)2. PURCHASED WATER

The Company forecasted Purchased Water Expense of $50,962. This amount represents the Company's 2011 purchased water budget.[365] The CAPD originally forecasted $47,708 for the attrition period.[366] This amount is based upon the Company's Income Statements for the twelve months ended September 30, 2010[367] and increased by the CAPD's growth/inflation factor of 1.51%,[368] which was later corrected to 1.40% growth factor.[369] The effect of this adjustment was to decrease Purchased Water Expense from $47,708 to $47,657.[370] On March 1, 2011, the CAPD filed amended testimony changing the residential customer growth factor from 0.89% to 1.05% (utilized to project revenues)[371] and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.[372] The effect of this adjustment was to increase Purchased Water Expense from $47,657 to $47,692.[373]

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365 TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q092D-Purchase Water Summary, p. 1 of 28 (December 1, 2010).
366 Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
367 Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PW (January 5, 2011).
368 Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).
369 Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-PW (January 31, 2011).
370 *Id.*
371 John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).
372 Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-PW (Hearing Exhibit 90) (March 8, 2011).
373 Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).

The Authority adopts $47,692 as the Purchased Water Expense projection for the attrition period. The panel reasons that the Company provided its budgeted amount but did not supply supporting documentation for its number, and the CAPD's projection is based upon known and measurable changes and accounts for inflation.

V(B)3. FUEL AND POWER

Fuel and Power Expense is the amount of fuel and power (electricity) necessary to pump TAWC's water to its customers. In order to calculate Fuel and Power Expense, the amount of water to be pumped, adjusted for an allowable water loss percentage, has to be determined. The Company projected total Fuel and Power Expense of $2,511,238 for the attrition period.[374] The calculation was based upon the expected volume of water pumped into the system during the attrition year, and the cost to pump and treat the water.[375] The Company estimated attrition year water sales of 9,878,253,000 gallons (13,171,004 CCF)[376] adjusted by a three year average of lost or unaccounted-for water of 22.70% to arrive at system delivery.[377] The Company used Chattanooga Electric Power Board ("EPB") tariff rates effective on October 1, 2009 adjusted for expected increases for the attrition year as indicated by the EPB. The Company stated that it had contacted an EPB representative during the summer of 2010 to determine rates going forward and was advised to expect 6% increases on both October 1, 2010 and October 1, 2011, along with Fuel Cost Adjustments that would continue monthly in 2010 and could level off or slightly decrease.[378] Later, the Company adjusted its projected attrition year Fuel and Power Expense

[374] Sheila A. Miller, Pre-Filed Direct Testimony, p. 10 (September 23, 2010).
[375] *Id.* at 9.
[376] 13,171,004 CCF * 7.5 = 9,878,253,000 gallons
[377] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013-Fuel and Power, p. 3 (September 24, 2010).
[378] John S. Watson, Pre-Filed Direct Testimony, pp. 26-27 (September 23, 2010).

from $2,511,238 to $2,575,657. The Company increased Fuel and Power Expense by $64,419, as a result of using the updated EPB November 2010 Fuel Cost Adjustment.[379]

The Consumer Advocate projected total attrition period Fuel and Power Expense of $2,410,868.[380] The CAPD calculated this cost based on water sales volumes of 13,582,557 CCF[381] for the attrition year. The CAPD incorporated the Fuel Cost Adjustment as of November 1, 2010 and capped the amount of lost or unaccounted-for water loss at 15%, as established by Authority Order in Docket No. 08-00039. The CAPD stated that the cap utilized for lost or unaccounted-for water was the primary difference between the Company and CAPD forecasts of Fuel and Power Expense.[382] On March 1, 2011, the CAPD filed amended expert witness testimony changing its calculation of water sales for the attrition period, utilized in projecting revenues, from 13,582,557 CCF to 13,508,335 CCF.[383] This adjustment decreased the CAPD's calculation of Fuel and Power Expense from $2,410,868 to $2,397,694.[384]

Water that is lost or unaccounted for in the system is water that is still pumped and treated, and TAWC still incurs an expense for the fuel and power needed to pump it. Recovery of the cost of the fuel and power incurred to pump lost or unaccounted-for water is allowed through the setting of a percentage that is then applied to determine Fuel and Power Expense.

The CRMA proposed 15% as an acceptable lost and unaccounted-for water ("UFW") percentage for use in the calculation of both Chemicals Expense and Fuel and Power Expense.[385] The CRMA chose 15% for the following reasons:

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379 TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 113, TN-TRA-02-Q113 (December 1, 2010).
380 Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).
381 Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-FP (January 5, 2011).
382 Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).
383 Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-FP (Hearing Exhibit 90) (March 8, 2011).
384 Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).
385 Michael Gorman, Pre-Filed Direct Testimony, p. 4 (January 5, 2011).

1. The American Water Works Association "Survey of State Agency Water Loss Reporting Practices" indicates that a reasonable lost water factor is 15% or less;
2. The water loss factor is consistent with the Authority's ruling in Docket No. 08-00039; and
3. The cost of replacing transmission lines is included in this filing, which the CRMA believes will bring the lost water factor down to a more reasonable level.[386]

In contrast, the Company recorded an unaccounted-for water percentage of 22.93% for the twelve-month period ended March 31, 2010.

The Company's water loss increased from the 20.43% level requested in its last rate case (the twelve months ended March 2008) to the 22.70% requested in this rate case. In its testimony, the Company stated it delayed part of its scheduled investment due to its poor earnings. However, the Company included additional plant investment in this rate case. With the additional investment in plant, it is reasonable to expect a decrease in water loss from current levels. The Authority determined that the baseline water loss percentage of 15% for TAWC, the same percentage established in the 2008 rate case,[387] remains viable, and TAWC should continue to strive to meet this goal. Also, the Authority agreed with the evidence put forth by the CRMA, and supported by the CAPD, that a 15% water loss was reasonable. Accordingly, the Authority determined the Fuel and Power Expense for the attrition period to be $2,277,057. This calculation was based on the Company's normalized usage during the test period of 13,132,968 CCF,[388] the rates in effect from the Chattanooga EPB plus the March 2011 Fuel Cost Adjustment, and a 15% water loss percentage.

The Authority uses the EPB's rates, as of October 2009, for the demand cost, energy cost, and the customer charge in the fuel and power calculation for the attrition year and did not include the Company's anticipated 6% increase in EPB rates that were forecasted, but unproven,

[386] *Id.* at 4-5.
[387] On appeal of this issue by TAWC, the Tennessee Court of Appeals affirmed the TRA's decision setting a 15% cap on UFW. *Tennessee Amer. Water Co. v. TRA*, 2011 WL 334678, * 27-28 (Jan. 28, 2011).
[388] *Petition*, Exhibit No. 4, Schedule 2 (September 23, 2010).

for implementation on October 1, 2010. Rather, EPB's actual rate on October 1, 2010 was verified, and the TRA included that $0.0063 current Fuel Cost Adjustment as of March 2011.

V(B)4. CHEMICALS

Chemical Expense is the cost of chemicals purchased by TAWC necessary to treat the water prior to consumption. The Company initially projected Chemical Expense for the attrition period of $1,069,369. The Company used the attrition year water sales of 13,171,004 CCF,[389] adjusted by a three-year average percentage of lost or unaccounted-for water of 22.70% to arrive at a system delivery amount. The Company used the estimated 2011 contract chemical prices to calculate its Chemical Expense.[390] Later, the Company decreased projected attrition year Chemical Expense by $97,447, as a result of obtaining lower actual 2011 contract prices for chlorine and sodium hydroxide (caustic soda) than originally anticipated.[391] The effect of the adjustment was to decrease Chemical Expense from $1,069,369 to $971,922.[392]

The CAPD forecasted Chemical Expense for the attrition period of $930,961.[393] The CAPD calculated this cost based on water sales volumes of 13,582,557 CCF[394] and known contract prices for 2011.[395] The CAPD capped the amount of lost and unaccounted-for water loss at 15% and stated that its treatment of this expense was consistent with the Authority's Order in Docket No. 08-00039.[396] In amended testimony filed on March 8, 2011, the CAPD changed the water sales calculation for the attrition period that it used in projecting revenues from 13,582,557 CCF to 13,508,335 CCF[397] and decreased its Chemical Expense forecast from

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[389] 13,171,004 CCF * 7.5 = 9,878,253,000 gallons.
[390] Sheila A. Miller, Pre-Filed Direct Testimony, p. 10 (September 23, 2010).
[391] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q117-Attachment 3, p. 3 (December 1, 2010).
[392] *Id.*
[393] Terry Buckner, Pre-Filed Direct Testimony, p. 21 (January 5, 2011).
[394] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CHEM 2 (January 5, 2011).
[395] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CHEM 1 (January 5, 2011).
[396] Terry Buckner, Pre-Filed Direct Testimony, p. 20 (January 5, 2011).
[397] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-CHEM2 (Hearing Exhibit 90) (March 8, 2011).

$930,961 to $925,894.[398] The CAPD priced out chemicals using known prices for 2011. The CRMA proposed that a 15% lost and unaccounted-for water percentage was reasonable to use in the calculation of both Chemicals Expense and Fuel and Power Expense for the reasons previously discussed.[399]

The panel determines the Chemicals Expense for the attrition period to be $881,439. Because known and measurable changes are appropriately considered, it was necessary to include the new contract chemical prices in the calculation of the Chemicals Expense. The panel agreed with the CRMA and the CAPD that the Authority should maintain its precedent and set a lost and unaccounted-for water percentage no higher than 15%. Using 13,132,968 CCF as the Company's usage,[400] adjusting for actual contract chemical prices, and applying a 15% capped lost water percentage, the panel finds that Chemicals Expense totals $881,439 for the attrition period.

V(B)5. Waste Disposal

The Company forecasted an attrition period Waste Disposal Expense of $197,386.[401] This amount is based upon the actual amount paid during the test period ended March 31, 2010. This amount ($183,965) was adjusted to reflect a 3% rate increase from the City of Chattanooga Sanitary Board effective January 1, 2010, a 2.75% increase effective October 1, 2010, and a 2.75% increase to be effective April 1, 2011, resulting in an adjustment of $13,421 for the attrition period.[402]

The CAPD projected an attrition period Waste Disposal Expense of $172,338.[403] The CAPD used actual book values of $169,774 as of September 30, 2010, which was reported in

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398 Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5, p. 5 of 9 (Hearing Exhibit 90) (March 8, 2011).
399 Michael Gorman, Pre-Filed Direct Testimony, pp. 4-7 (January 5, 2011); *see also*, 8 V(B)3, Fuel and Power.
400 *Petition*, TAWC Test Period Normalized Billing Determinants, Exhibit No. 4, Schedule 2 (September 23, 2010).
401 *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).
402 Sheila A. Miller, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).
403 Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).

TAWC's Income Statements, as the test period Waste Disposal Expense.[404] The CAPD increased the test period book value amount by one half of its calculated customer growth factor of .89% plus an inflation factor of .76%.[405] The CAPD later amended its growth factor to 1.4%,[406] and this decreased the CAPD's projected Waste Disposal Expense from $172,338 to $172,151.[407] Thereafter, the CAPD's amended testimony filed on March 1, 2011 changed the residential customer growth factor to be utilized in projecting revenues from 0.89% to 1.05%[408] and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.[409] The effect of this adjustment increased the CAPD's Waste Disposal Expense projection from $172,151 to $172,279.[410]

Considering the evidence in the record and adjusting for known and measurable changes in forecasting for the attrition period, the panel finds $194,993 appropriate for Waste Disposal Expense.

V(B)6. MANAGEMENT FEES

The category of management fees consists of the charges incurred by TAWC for services provided to it by AWWSC in accordance with their 1989 Service Company Agreement. AWWSC is an affiliated service company established by AWWC to aid, assist, and advise the business operations of AWWC subsidiaries, which includes TAWC, by providing accounting, administration, communications, corporate secretarial, engineering, finance, human resources,

404 Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-WASTE (January 5, 2011).
405 Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).
406 Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-WASTE (January 31, 2011).
407 *Id.*
408 John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).
409 Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-WASTE (Hearing Exhibit 90) (March 8, 2011).
410 *Id.*

information systems, operations, rates and revenue, risk management, and water quality services.[411] These services are billed to ratepayers at-cost to TAWC.[412]

Relevant Background

On May 15, 2007, as part of its deliberations in TAWC's 2006 rate case, the Authority allocated recovery of management fees in the amount of $3,979,825, which was an amount that was slightly lower than the $4,064,421 that TAWC had requested in its petition.[413] Further, the Authority ordered TAWC to obtain a management audit that conformed to the mandates of the Sarbanes-Oxley ("SOX") regulation.[414] The stated purposes of the audit were two-fold: to obtain an independent assessment as to 1) whether the significantly increasing costs incurred by TAWC for management fees reflected prudent decisions on the part of management, and 2) whether the allocation methodology used to charge the costs of the services to TAWC was reasonable.[415]

On March 14, 2008, along with a petition for a rate increase, TAWC filed with the Authority an audit report prepared by Booz Allen Hamilton ("BAH").[416] During the proceeding that followed, the City challenged the independence of the BAH auditor and report, and contended that the audit had not been conducted as the TRA had required, nor in compliance with SOX. After a thorough review and hearing, the Authority held that the BAH report had failed to adequately address the issue of whether the management fees at issue resulted from

[411] *See In re: Tennessee American Water Company's Request for Proposal for a Management Audit,* Docket No. 09-00086, *Notice of Filing of Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority,* Schumaker & Company, Affiliate Audit Report ("Schumaker Audit Report"), p. 13 (September 10, 2010).
[412] *Id.*
[413] *See In re: Petition of Tennessee American Water Company to Charge and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 06-00290, *Order,* p. 26 (June 10, 2008).
[414] *Id.; See also* 15 U.S.C 98 (2002) (Named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, the Sarbanes-Oxley Act of 2002 introduced major changes in the regulation of corporate governance and financial disclosure. Effective in 2006, all publicly-traded companies were required to implement and report internal accounting controls to the SEC for compliance.)
[415] *Id.* at 27.
[416] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Petition* (March 14, 2008).

prudent decisions made by TAWC management, and further, that the audit had not been conducted by an independent auditor in conformity with SOX and as ordered by the TRA in Docket No. 06-00290.[417] Therefore, the Authority determined that TAWC's request of $4,335,190 in management fees was unsupported in the record, and instead allocated $3,529,933 to attrition year expense.[418] Because the Authority concluded that the audit did not comply with the TRA's directive in the 2006 rate case, it further declined to include recovery of the costs of the BAH audit in the rate case. Further, the Authority ordered TAWC to develop and submit for Authority approval, a Request for Proposal ("RFP") for a comprehensive management audit by an independent certified public accountant and set certain minimum requirements and procedural deadlines concerning the RFP.[419]

Following entry of the Authority's Order in Docket No. 08-00039, TAWC filed an appeal with the Tennessee Court of Appeals alleging, among other issues, that the TRA's decisions concerning the management audit and fees were arbitrary and capricious, an abuse of discretion, and erroneous. On January 28, 2011, the Court issued an Opinion in which it found that the decisions of the TRA were not in error, arbitrary, or capricious, but, rather, an appropriate exercise of the agency's discretion and affirmed the TRA's decisions on all of the challenges TAWC had raised concerning the management audit and fees.[420] Finding that because TAWC had failed to meet its burden of proof to show that the charges it had requested were prudent, the Court affirmed the Authority's decision to allocate management fees in an amount that was lower than had been requested by TAWC as an appropriate exercise of the TRA's discretion.[421] Further, the Court affirmed the TRA's decisions concerning its choice of methodology used to

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[417] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Order,* pp.18-22 (January 13, 2009).
[418] *Id.* at 18, 21.
[419] *Id.* at 21-22.
[420] *See Tennessee American Water Co. v. Tenn. Regulatory Auth.,* 2011 WL 334678, at *18-21 (Tenn. Ct. App. Jan. 28, 2011).
[421] *Id.* at *18.

forecast the fees, determinations concerning the lack of independence of BAH, TAWC's chosen auditor, the TRA's subsequent disregard of the BAH report, and disallowance of the costs related to the BAH report.[422]

After announcing its decision in Docket No. 08-00039, the Authority opened Docket No. 09-00086 to accommodate all filings related to the RFP.[423] The TRA Staff continued to work with TAWC in further developing the necessary parameters of the RFP throughout the audit proceedings, until the culmination and filing of the final report. On September 10, 2010, TAWC filed in Docket No. 09-00086 the final management audit report that had been prepared by Schumaker & Company.[424] On September 23, 2010, following a request by TAWC, the Authority entered a protective order in the docket file.[425] On September 27, 2010, TAWC filed the confidential Workpapers and Exhibits that Ms. Schumaker prepared and provided to TAWC in conjunction with the Schumaker Audit Report.[426] Despite ongoing activity in the docket, a request for intervention was not filed in Docket No. 09-00086 until January 2011.[427] On January 24, 2011, Chairman Freeman, acting as Hearing Officer, took official administrative notice in Docket No. 10-00189 of all filings that had been made in Docket No. 09-00086.

[422] *Id.* at *19-21.
[423] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Order Moving Request for Proposal to New Docket* (July 16, 2009).
[424] *See In re: Tennessee American Water Company's Request for Proposal for a Management Audit,* Docket No. 09-00086, *Notice of Filing of Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority* (September 10, 2010). On December 9, 2010, TAWC filed a replacement disk of the Schumaker Audit Report, originally filed on September 10, 2010, asserting that the originally filed disk contained certain confidential information.
[425] *See In re: Tennessee American Water Company's Request for Proposal for a Management Audit,* Docket No. 09-00086, *Protective Order (As Modified,)* (September 23, 2010).
[426] *See In re: Tennessee American Water Company's Request for Proposal for a Management Audit,* Docket No. 09-00086, *Notice of Filing of Confidential and Proprietary Portions of Workpapers Related to Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority* (September 27, 2010).
[427] On January 6, 2011, following TAWC's filing of a *Motion to Approve and Adopt Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority,* the CAPD filed a petition to intervene in Docket No. 09-00086.

Positions of the Parties in Docket No. 10-00189

In the instant rate case, TAWC relied on the cost of service study, and the related testimony, of Mr. Patrick L. Baryenbruch, as well as, in part, upon the findings of the Schumaker Audit Report, to support its contentions that the $5,226,034 it projected in attrition period management fees were reasonable, necessary, and the result of prudent management decisions made by TAWC.[428] Through the study and testimony of Mr. Baryenbruch, the Company asserted that AWWSC's cost of $59.00 per customer was reasonable as compared to an average cost of $95.00 per customer for electric and combination electric/gas service companies.[429] In addition, TAWC had been charged the lower of cost or market for the administrative and professional services, which were vital, efficiently procured, and absent of any profit markup, resulting in substantial savings to the ratepayers and Company.[430] Further, the customer account services provided by the National Call Center are reasonable and fall below an average range of the study's electric comparison group.[431] Mr. Baryenbruch asserted that his study demonstrated that AWWSC's services are necessary, would be required even if TAWC were a stand-alone company, and that no redundancy or overlap exists in the services provided to TAWC.[432] Finally, Mr. Baryenbruch asserted that the Schumaker Audit Report affirmed his study's methodology as a reasonable approach to verifying that the service costs charged to TAWC do not harm ratepayers.[433]

TAWC also filed additional testimony prepared by Mr. Baryenbruch for the purpose of rebutting certain criticisms of Baryenbruch's study that were made by the City's witness, Ms.

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[428] Patrick Baryenbruch, Pre-filed Direct Testimony, attached Market Cost Comparison of Service Company Charges to Tennessee American Water Company 12-Months Ended March 31, 2010 (September 23, 2010).
[429] *Id.* at 4 of 8.
[430] *Id.* at 5-6 of 8.
[431] *Id.* at 6-7 of 8.
[432] *Id.* at 7 of 8.
[433] *Id.* at 7 of 8.

Kimberly H. Dismukes.[434] In response to Ms. Dismukes's criticisms concerning the use of electric and combination electric/gas companies, instead of water companies, as comparisons in analyzing the reasonableness of the service charges allocated to TAWC, Mr. Baryenbruch asserts that his methodology is reasonable because there is no publicly available cost information for water service companies.[435] In addition, very few water companies have a centralized service company arrangement, and those that do are not overseen by a single regulatory agency that requires a standard filing.[436] Further, Mr. Baryenbruch asserted that the differences in the operating and maintenance processes or functions between electric companies and water companies does not result in unreliable results because the study compares administrative and general expenses, rather than O&M expenses, which are similar across utility types.[437]

To calculate its projected management fees, the Company started with historical test-year expenses of $5.008 million, then eliminated a total of $46,230 in non-recurring and other properly excluded expenses to arrive at a normalized historical test-year amount of $4.962 million.[438] Next, the Company increased its normalized historical test-year amount using an annual inflation rate of 3% and adjusted the amount to account for the twenty-one (21) months remaining to the end of the attrition year.[439] The resulting calculation of $5.226 million in AWWSC charges for management fees was included in TAWC's rate case filing.[440]

TAWC's forecast of its 2011 attrition year management fees represented an increase of $1,659,901, or 46.55%, over and above its 2005 management fee expenses.[441] The Company asserted that compelling and justifiable reasons existed for the increases, which had occurred

[434] Patrick Baryenbruch, Rebuttal Testimony of Patrick Baryenbruch (February 8, 2011).
[435] *Id* at 4-5.
[436] *Id* at 5.
[437] *Id* at 5-16.
[438] Michael A. Miller, Pre-Filed Direct Testimony, p. 40 (September 23, 2010). Also note, as discussed previously in this *Final Order,* the Company used a historical test period ending March 31, 2010, and forecasted an attrition period of twelve months ending December 31, 2011.
[439] *Id.*
[440] *Id.*
[441] *Id.* at Exhibit MAM-10.

primarily due to a shift in functions from TAWC to AWWSC and increases in pension and group insurance costs related to financial market conditions, over which TAWC had little control.[442] In addition, an accounting change, in which the costs of capital assets now on the books of AWWSC were offset by the avoidance of those costs on the books of TAWC, contributed significantly to the increase.[443]

The Company filed testimony asserting that, from 2005 until the 2011 attrition year, ratepayers have saved $1.229 million because of the realignment and shifting of services from TAWC to AWWSC.[444] TAWC also asserted that customers benefitted from having (1) round-the-clock call center availability; (2) convenient automated Interactive Voice Response (IVR) contact with the call center; (3) on-line access to TAWC service personnel, which permits the scheduling of service orders at convenient times for the customers; and (4) improved efficiencies in the tracking of service orders and service employees.[445] Citing certain findings that were noted in section IV of the Schumaker Audit Report, the Company further maintained that the Schumaker Audit Report confirmed that the shifting of functions from TAWC to AWWSC had resulted in savings and service improvements to the benefit of TAWC's customers.[446]

Through its witness, Mr. Terry Buckner, the CAPD forecasted $3,653,946 in management fees for the attrition period.[447] In its calculations, the CAPD started with $3,529,933 as its base amount, which had been the management fees amount approved previously in Docket No. 08-00039, then increased this amount by the annual customer growth and GDP rate of 0.54% in 2009; 1.70% in 2010; and 1.60% for 2011.[448] The CAPD asserted that

[442] *Id.* at 46.
[443] *Id.*
[444] *Id.*
[445] *Id.*
[446] *Id.* at 47.
[447] Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 5 (Hearing Exhibit 90) (March 8, 2011).
[448] Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 28 (January 31, 2011).

its calculation was consistent with the methodology adopted by the TRA in Docket No. 08-00039.[449]

Further, the CAPD asserted that TAWC's calculation of management fees was not just and reasonable because it included costs unnecessary for the provision of water service, including: (1) an over-allocation of charges to TAWC primarily based on non-cost causative factors; (2) AIP compensation, which is primarily based on financial goals; (3) Stock Based Compensation Expense, also known as LTIP compensation; (4) Business Development expense, which is devoted to non-regulated operations; (5) External Affairs expense, which is devoted to marketing, advertising, lobbying, and political influence; (6) contained non-recurring accounting charges for changes in financial reporting to the IRS; (7) double counted and overestimated payroll increases; (8) failed to comport with current economic conditions; and (9) included non-normalized salaries.[450]

Through its witness, Ms. Dismukes, the City recommended that three adjustments be applied to management fees. Ms. Dismukes testified that the study conducted by Mr. Baryenbruch, TAWC's witness, contained numerous flaws and failed to demonstrate that AWWSC's charges are necessary, just or reasonable. Ms. Dismukes asserted that just as the operations of electric and gas utilities are very different from water companies, likewise the expenses of electric and gas utilities are dissimilar and, therefore, not comparable to the service company charges of water companies.[451] She contended that Mr. Baryenbruch failed to provide evidence to support his comparative analysis of the service company charges of electric and gas utilities to the charges of AWWSC as appropriate or reliable.[452] Ms. Dismukes recommended a comparison of the AWWSC's charges with that of other water and combination

[449] *Id.*
[450] *Id.* at 29-30.
[451] Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp. 4, 27-33 (January 5, 2011).
[452] *Id.* at 33-39.

water/wastewater utilities, and that the water company comparative analysis she had performed showed that the AWWSC charges were excessive.[453] As a result, Ms. Dismukes recommended that test year management fees be reduced by $4,089,360 in order to reflect a lower cost consistent with the costs incurred by comparable Class A water and combination water/wastewater companies.[454]

For these same reasons, Ms. Dismukes challenged Mr. Baryenbruch's comparison and findings concerning TAWC's customer service costs.[455] She asserted that the inherent differences that exist between water companies and electric and gas utilities would indicate that customer service costs should be less for water companies.[456] In keeping with her comparative approach and analysis using water companies, Ms. Dismukes recommended an additional reduction of $464,661 to expenses for excessive customer costs charged to the Company by AWWSC.[457] In addition, Ms. Dismukes asserted that the analysis employed in Schumaker Audit Report as to the reasonableness of the AWWSC charges in 2008, which compared the service charges of electric and electric/gas companies with AWWSC, an approach similar to that utilized by Mr. Baryenbruch, was similarly flawed and inappropriate and should be rejected by the TRA.[458] Ms. Dismukes further asserted that the analysis contained within the Baryenbruch study did not reliably support a finding that AWWSC's services were provided at the lower of cost or market, nor that the level of services provided by the service company would be required if TAWC were a stand-alone water company.[459]

Finally, Ms. Dismukes recommended the removal of a combined $94,658 for two categories of expenses, which she asserts the Company improperly included: business

[453] *Id.* at 27-33.
[454] *Id.* at 43.
[455] *Id.* at 43-45.
[456] *Id.* at 4, 43-44.
[457] *Id.* at 4, 44-45; and *see* Transcript of Proceedings, Vol. II C, Hearing Exhibit 35 (March 1, 2011) (Ms. Dismukes revised her recommendation that customer account expenses be reduced from $676,655 to $464,661).
[458] *Id.* at 45-46.
[459] *Id.* at 46-49.

development and corporate government affairs.[460] Business development expenses consist of expenses that the Company claims were incurred for the purpose of growing revenue and customer base.[461] Ms. Dismukes testified that, although TAWC failed to quantify the benefits that customers received from its business development efforts, she had examined the expenses incurred for business development activities at both the regional and national levels and found that the costs incurred by TAWC for business development have not resulted in significant enhancements in customer growth for the Company.[462] Further, Ms. Dismukes contended that TAWC had failed to demonstrate that the business development expenses charged to it by AWWSC are just and reasonable, cost effective, or necessary for the provision of safe and reliable service.[463] Further, Ms. Dismukes asserted that both the Florida and California state regulatory commissions have disallowed expenses related to business development and acquisitions.[464] Therefore, she recommended that $82,861 in business development expenses should be removed from the expenses allocated for the attrition year.[465]

Ms. Dismukes further recommended that expenses related to legislative functions and advocacy performed by service company personnel in the Corporate Government Affairs unit should not be passed on to ratepayers. She asserted that regulators often disallow these types of expenses, and noted that both the Florida and California state commissions do not allow utilities to recover expenses of this type from ratepayers.[466] Ms. Dismukes recommended that the $11,797 charged for legislative functions of corporate government affairs be removed from expenses allocated for the attrition year.[467]

Michael Gorman, witness for CRMA, asserted that no witness for the Company has

[460] *Id.* at 5, 49-55.
[461] *Id.* at 50.
[462] *Id.* at 51-52.
[463] *Id.* at 52.
[464] *Id.* at 53-54.
[465] *Id.* at 53.
[466] *Id.* at 54.
[467] *Id.* at 54.

provided sufficient evidence to the support the substantial increase requested in the rate petition and, therefore, the increase is not known and measurable and should be rejected.[468]

Findings and Conclusions

Previously, in Docket No. 08-00039, the TRA determined management fees using the amount forecasted by the Company for its 2005 management fees, as originally filed in Docket No. 04-00288, and applied a growth factor.[469] Based on this methodology, in this case the CAPD utilized the management fees amount that was most recently ordered by the Authority in Docket No. 08-00039 as its base, then applied its recommended growth factor.[470] The Authority disagrees with the CAPD's contention that the methodology used by the TRA to forecast management fees in Docket No. 08-00039 established precedent in this Docket. The method utilized by the Authority to forecast management fees in Docket No. 08-00039 was necessary as a result of the lack of sufficient evidence in the record to support TAWC's forecasted management fees, due in large part to the Company's failure to file a management audit that complied with the requirements ordered by the Authority. Nevertheless, the TRA is not bound to a previously employed methodology when determining the allocations appropriate in future cases. This is particularly true when better, more recent or accurate evidence is presented by the parties or otherwise made part of the record, which would allow the TRA to more accurately forecast future results.

In Docket No. 08-00039, the TRA ordered a comprehensive management audit be conducted by an independent certified public accountant for the primary purposes of investigating the management performance and decisions relating to internal processes and controls of AWWSC and to evaluate that the allocation methodology, factors, and resulting costs

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[468] Michael Gorman, Pre-filed Direct Testimony, p. 23 (January 5, 2011).
[469] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Order,* p. 21 (January 13, 2009).
[470] Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 28 (January 31, 2011).

for services charged to TAWC were efficient, accurate, and reasonable.[471] To that end, the Authority initiated the proceedings in Docket No. 09-00086, and wherein, upon completion, was filed the Schumaker Audit Report.[472] In the instant case, both the CAPD and City offered testimony concerning the Schumaker Audit Report, its processes and results. Yet, while the CAPD noted certain concerns about the reliability of the audit, it does not completely reject the methodology utilized or credentials of the auditor.[473] Rather, the CAPD's testimony focuses more on other, alternative methodologies that might have been utilized instead but does not critically analyze the methods and processes employed by Schumaker & Company in its preparation of the Schumaker Audit Report.[474]

In its recent opinion, the Court of Appeals held that the TRA's decision to use the 2005 management fees to forecast fees in Docket No. 08-00039 was a "reasonable, temporary, solution to the dilemma faced [by the TRA] until TAWC could submit a proper management audit."[475] Here, the Authority acknowledges that a new management audit has been performed by Schumaker & Company in compliance with the requirements of the RFP, and that the findings set forth in detail in the Schumaker Audit Report state that the management fees and cost allocations charged to TAWC are reasonable and prudent. Even the City's witness, Ms. Dismukes, agreed that the use of customers to allocate costs to TAWC was acceptable, even though in her opinion other, more superior approaches could have been utilized.[476]

Further, despite the panel's agreement that Mr. Baryenbruch's study cannot be relied

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[471] *See In re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges so as to Permit It to Earn a Fair and Adequate Rate of Return on Its Property Used and Useful in Furnishing Water Service to Its Customers,* Docket No. 08-00039, *Order,* pp. 21-22 (January 13, 2009).
[472] *See In re: Tennessee American Water Company's Request for Proposal for a Management Audit,* Docket No. 09-00086, *Notice of Filing of Confidential and Proprietary Portions of Workpapers Related to Schumaker & Company's Affiliate Audit Report of Tennessee American Water Company for the Tennessee Regulatory Authority* (September 27, 2010).
[473] Terry Buckner, Non-Confidential Direct Testimony Amendment, pp. 23-25 (January 31, 2011).
[474] *Id.*
[475] *See Tennessee American Water Co. v. Tenn. Regulatory Auth.,* 2011 WL 334678, at *20 (Tenn. Ct. App. Jan. 28, 2011).
[476] Kimberly H. Dismukes, Pre-Filed Direct Testimony, pp. 3, 18-20 (January 5, 2011).

upon to conclude that AWWSC provides services at less than the prevailing market rate, the Authority disagrees with the City's contention that $4,089,360 of expenses in service costs should be eliminated from management fees. While the Authority agrees that there were flaws in Mr. Baryenbruch's study, especially as to the billed rates and number of hours billed to professionals, it cannot agree with the City's assertion that Mr. Baryenbruch's study, however flawed, thereby leads to the conclusion that there is no evidentiary basis upon which to allow recovery of a majority of the management fees requested by TAWC.

Therefore, upon consideration of the record, the Authority allocates recovery of $4,741,068 in management fees for the attrition period. It determines this amount based on the Company's normalized amount of management fees of $5,048,200[477] for the twelve months ended September 30, 2010,[478] then eliminates $172,295 for External Affairs expense, $89,720 for Business Development, 50% ($89,734) of the AIP, and adjusts the residual amount by an annual inflation rate of .76% compounded for fifteen months (or .95%).

In its elimination of expenses related to corporate government affairs, the Authority determines that because lobbying expenses are not necessary to the provision of safe and reliable water service, such expenses are appropriately disallowed for rate making purposes. Further, because the Authority concludes that it is not reasonable to allow recovery of an expense that does not enhance customer growth, business development expenses in the amount of $89,720 are eliminated from our calculations. The Authority agrees with TAWC's assertion that both the Company and its customers benefit from AIP through higher financial returns for the Company. For this reason, the Authority therefore approves recovery of one-half of the AIP and correspondingly eliminates 50% ($89,734) of AIP. The elimination of 50% of AIP is consistent

[477] TAWC's December 8th Supplemental Responses To The First Discovery Request And Supplemental Discovery Request Of The CAPD, Question 102, TN-CAPD-SUPPLEMENTAL2-Q102-ATTACHMENT 2 (December 8, 2010).

[478] As noted previously in this *Final Order,* the twelve months ending September 30, 2010 is consistent with the test period recommended and utilized by the CAPD.

with the Authority's removal of 50% of AIP from employee benefits.

Following the aforementioned adjustments to management fees, the panel applies an inflation factor of .95%[479] in order to calculate management fees for the attrition period. The panel utilizes an annual GDP Chained Price Deflator growth rate of .76% as of September 2010, divides this rate by twelve months, then multiplies by fifteen months to arrive at the December 2011 growth rate. The result of these calculations is $4,741,068 for allocation to management fees in this case.

V(B)7. Group Insurance

The Company projected total Group Insurance Expense of $2,034,757.[480] This category included Group Insurance and Other Post Employment Benefits ("OPEB"). The Company forecasted Group Insurance expenses of $1,075,184.[481] This amount was calculated by applying March 31, 2010 insurance rates to 109[482] anticipated employees. The Company forecasted OPEB of $959,573 for the attrition period.[483] The Company's actuary, Towers/Watson, provided a letter which projects $1,140,000 for the total OPEBs.[484] The Company applied a 15.83% capitalization rate to the OPEBs to remove the capitalized portion of OPEBS from O&M Expense.

Subsequently, the Company adjusted its projection of Group Insurance Expense from $2,034,757 to $2,220,281 for the attrition period.[485] The Company updated the Group Insurance

[479] The mathematic calculation is demonstrated as follows: $5,048,200 - $172,295 - $89,720 - $87,734 = $4,696,451 (This number represents the balance of management fee calculation after the noted reductions, but before application of the growth factor).
[480] *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).
[481] *Petition*, Exhibit No. 1, Schedule 3, p. 3 of 6 (September 23, 2010).
[482] There are 110 forecasted employees as stated above in the discussion of Salaries and Wages. One employee, however, opted out of the Group Insurance plan.
[483] *Petition*, Exhibit No. 1, Schedule 3, p. 3 of 6 (September 23, 2010).
[484] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92d-Attachment, p. 9 of 28 (December 1, 2010).
[485] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q121-Attachment 2 (December 1, 2010).

portion to $1,260,708 to reflect October 1, 2010 insurance rates.[486] In rebuttal testimony, the Company further revised Group Insurance to $2,434,923 for the attrition period.[487] The Company then applied a capitalization factor of 15.83% to remove the capitalized portion from O&M Expenses.

The CAPD originally forecasted attrition period Group Insurance Expense of $2,166,396.[488] Subsequently, the CAPD adjusted its growth factor and changed the projection of Group Insurance Expense to $2,165,261,[489] including Group Insurance of $1,118,530 and OPEBs of $1,046,730.[490] Group Insurance of $1,118,530 was priced out based on October 1, 2010 insurance rates and 104 Employees.[491] The CAPD used the actual book value listed in TAWC's Income Statements for its test period of the twelve months ended September 30, 2010 as a starting point for OPEBs and then increased its estimate of OPEBS by its inflation factor plus one-half of the customer growth. [492] The CAPD filed amended testimony on March 1, 2011 in which it changed the residential customer growth factor utilized to project revenues from 0.89% to 1.05%,[493] and this caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%.[494] The effect of this adjustment was to increase the CAPD's figure for Group Insurance Expense from $2,165,261 to $2,166,035.[495]

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[486] *Id.*
[487] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 22, 2011).
[488] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[489] Terry Buckner, Non-Confidential Direct Testimony Amendment, Amended Exhibit 1, Schedule 5, p. 5 of 9 (January 31, 2011).
[490] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GI (January 31, 2011).
[491] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-GIA (January 5, 2011).
[492] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GI (January 31, 2011).
[493] John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-CUSTOMER GROWTH (March 1, 2011).
[494] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-GI (Hearing Exhibit 90) (March 8, 2011).
[495] *Id.*

The TRA adopts an attrition period forecast of $2,111,420 for Group Insurance Expense, after removing the capitalized amount using a 20.57% capitalization percentage, again consistent with the panel's treatment of Salaries and Wages Expenses. This forecast consisted of $1,189,740 related to Group Insurance costs and $921,680 related to OPEBs. This amount was calculated by using the 109 employees (out of the 110 anticipated employees) enrolling in the plan and the October 1, 2010 insurance rates to price out the Group Insurance and then applying the CAPD's capitalization percentage of 20.57% consistent with Salaries and Wages Expense. The OPEB amount for the attrition period was based on contribution under the funding policy amount of $38,678,936 for AWWSC from the latest actuarial report. This amount was allocated from the service company to TAWC at 3%. The capitalized amount of TAWC's portion was then revised, using the CAPD's 20.57% capitalization percentage, again consistent with the treatment of Salaries and Wages Expenses.

V(B)8. PENSION EXPENSE

The Company initially forecasted Pension Expense of $1,645,113 for the attrition period.[496] This amount was taken from a letter written by the Company's actuary, instead of the annual actuarial report that has been used in past cases, which stated that the minimum ERISA contribution for the service company would be $109.8 million for 2011.[497] Based on this, the amount to be allocated to TAWC would be 1.78% or $1,954,440.[498] The Company then applied its capitalization factor of 15.83% to eliminate the capitalized portion from O&M Expenses to reach its initial forecast.[499] Subsequently, the Company revised Pension Expense from $1,645,113 to $2,062,140. The revision was a result of a quarterly update from the actuary to the Company, which updated the forecast of minimum pension contributions for the service

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[496] *Petition*, Exhibit No.2, Schedule 3, p. 3 of 6 (September 23, 2010).
[497] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TN-TRA-01-Q013-Labor, p. 12 (September 24, 2010).
[498] *Id.*
[499] Sheila A. Miller, Pre-Filed Direct Testimony, p. 7 (September 23, 2010).

company to $137.6 million. The Company revised Pension Expense and allocated TAWC's portion (1.78% of the minimum ERISA contribution, or $2,449,880) then reduced that amount by the Company's capitalization percentage of 15.83%.[500]

The CAPD forecasted $1,552,412 attrition period Pension Expense.[501] The CAPD adopted $1,954,440, which was the 1.78% Tennessee portion of the original pension funding amount calculated by the Company and then applied its capitalization percentage of 20.57% to eliminate the capitalized portion from O&M Expenses.[502] The CAPD stated that the quarterly update from the actuary, which the Company relied upon, had a footnote stating that $37 million is "[s]ubject to change pending the results of the July 1, 2011 valuation, which will be known in late August."[503] The CAPD stated that it is reluctant to set rates on a pension contribution which is not known by the actuary and is subject to change.[504]

The Authority adopts an attrition period forecast of $839,965 for Pension Expense. The Authority has historically included in rates the minimum required contribution as recommended in the latest actuarial report, rather than a preliminary estimate in a letter from the actuary. The actuarial report submitted by the Company recommended a minimum contribution of $59,409,620 as of July 1, 2009.[505] The Authority adopted Pension Expense for TAWC based on an allocation factor of 1.78% applied to recommended minimum contributions set forth in the latest actuary report. The Company's portion of ERISA minimum pension contribution was multiplied by the CAPD's capitalization percentage of 20.57% to arrive at attrition period Pension Expense of $839,965.

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[500] TAWC's December 17th Supplemental Responses To The CAPD's Discovery Requests, TN-CAPD-01-PART III-Q48-Supplemental Confidential Attachment 3 (December 17, 2010).
[501] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PENSION (January 5, 2011).
[502] *Id.*
[503] Terry Buckner, Pre-Filed Direct Testimony, pp. 41-42 (January 5, 2011).
[504] *Id.* at 42.
[505] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, TRA-01-Q36-ATTACHMENT, pp. 55, 60 (Actuarial Report April 2010) (September 24, 2010).

V(B)9. Regulatory Expense

The Company projected $379,918 in Regulatory Expense for the attrition period. This amount represents the total of the amortization of various rate case expenses sought by the Company and included in this case. The Company stated in its testimony that it was seeking the following:

1. Estimated cost of this case ($645,000) amortized over 3 years;
2. Estimated cost of service study for this case ($42,500) amortized over 3 years; and
3. 12 months of amortization of 2006 rate case, 2008 rate case, 2008 cost of service, and the 2008 depreciation study totaling $150,751.[506]

In rebuttal testimony, the Company projected $847,368 in Regulatory Expense for the attrition period, which is $467,450 higher than stated in the *Petition*.[507] Part of the difference related to the Tennessee Court of Appeals' decision reversing the Authority's disallowance of $275,000 in rate case expense from Docket No. 08-00039.[508] The Company proposed to include that rate case expense, which the Company had absorbed since September 2008, in the attrition year. The Company also increased the expected cost of this case from the $645,000 estimated in the *Petition* to a total of $1,240,492.[509] The Company updated the current rate case expense by (1) including the actual costs incurred to date as of January 31, 2011, (2) adding the estimated additional legal costs for the witnesses' rebuttal testimony, which included two new witnesses whose testimony was not originally anticipated, and (3) adding the estimated costs associated with conducting a full evidentiary hearing in Chattanooga.[510] The Company stated that these costs were reasonable based on the volume of discovery requests propounded by the Intervenors, the number of issues raised and addressed by the Intervenors in the testimony they presented, the

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[506] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 12-13 (September 23, 2010).
[507] TAWC's Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 14, 2011).
[508] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 78 (February 8, 2011).
[509] *Id.*
[510] *Id.*

number of discovery disputes, the increased number of Intervenors, and the cost of moving the evidentiary hearing to Chattanooga.[511]

The CAPD projected Regulatory Expense for the attrition period of $195,284.[512] The CAPD stated in its testimony that its calculation of Regulatory Expense included the following:

1. Amortization for the cost of service studies performed in Docket No. 06-00290 at $8,004 per year and in Docket No. 08-00039 at $3,204 per year;
2. Amortization of the depreciation study in Docket No. 08-00039 amounting to $7,826 per year;
3. Amortization of rate case costs associated with Docket No. 08-00039 at $68,750; and
4. Estimated cost of this case ($322,500) amortized over three years at $107,500 for the attrition period.[513]

The CAPD did not include amounts for the cost of service study performed in the current docket. The CAPD eliminated this cost from its calculation of Regulatory Expenses asserting that (1) it is unacceptable to use "judgment factors" for a cost of service study because it would result in a cost of service study that cannot be independently verified or corroborated, and (2) the results of the cost of service study were not used by the Company in setting the proposed rates.[514] On March 8, 2011, the CAPD provided revised exhibits projecting Regulatory Expenses of $298,884, which included the following:

1. Amortization for the cost of service studies performed in Docket No. 06-00290 at $8,004 per year and in Docket No. 08-00039 at $3,204 per year;
2. Amortization of the depreciation study expense in Docket No. 08-00039, amounting to $7,826 per year;
3. Amortization of rate case costs associated with Docket No. 06-00290 ($44,433);
4. Amortization of rate case costs associated with Docket No. 08-00039 ($68,750); and
5. Amortization of the estimated cost of this case ($500,000) over three years at $166,667 for the attrition period.[515]

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[511] *Id.*
[512] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[513] *Id.* at 41-43 (January 5, 2011).
[514] William H. Novak, Pre-Filed Direct Testimony, p. 6 (January 5, 2011).
[515] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-REG (Hearing Exhibit 90) (March 8, 2011).

On March 8, 2011, prior to the close of the Hearing, the City motioned to exclude from the record certain exhibits consisting of revised schedules and rebuttal testimony filed or offered by TAWC that purported to increase TAWC's revenue requirement from the $9.9 million originally petitioned to approximately $11.5 million, of which a portion reflected an increase in rate case expense from $645,000 to $1.2 million, which TAWC asserted was properly considered by the Authority in setting rates.[516] Despite denial of the motion by Chairman Freeman, TAWC offered additional explanation of its position as to the appropriate use of the revenue information by the TRA.[517] The City objected, and reasserted its position that that such evidence should not be included or considered in the record.[518]

Following the arguments of the parties, Director Roberson stated that over the years he had seen a significant and dramatic increase in the amount requested for rate case expenses and voiced his concern that in this case, the testimony, exhibits, and responses to data requests failed to provide a sufficient evidentiary record upon which the TRA could base a decision on the issue of rate case expense requested by the Company.[519] Citing the Court of Appeals recent Opinion in which it reversed the TRA's decision to cut in half the rate case expenses allowed in Docket No. 08-00039, finding that such decision was arbitrary due to a lack of specific evidence in the record and Final Order, Director Roberson moved that the Company provide detailed evidence of its rate case expenses, including itemized bills from experts, attorneys, and Company witnesses, to demonstrate that the rate case expenses being claimed are necessary, reasonable, and prudent.[520] Director Roberson further moved to direct the Company to file this evidence through

[516] Transcript of Proceedings, Vol. VII B, pp. 114-115 and pp. 119-128 (March 8, 2011) (concerning City's "third item" for discussion).
[517] *Id.* at 119-121, 123-124.
[518] *Id.* at 121-123.
[519] *Id.* at 124-125, 127.
[520] *Id.* at 125-126 (citing *Tennessee American Water Co. v. TRA,* 2011 WL 334678 *27 (January 28, 2011) (holding that the record and Final Order did not explain which specific expenses the TRA deemed unnecessary, improvident, or improper, or that the Authority closely examined the costs associated with the rate case to determine the portion

affidavits or supplemental testimony, which was to be accompanied by bills, invoices, or other supporting documentation, and to grant the Intervenors an opportunity to respond through affidavits, live testimony, or supporting documentation, if necessary, so that the TRA would have a complete record on rate case expenses on the basis of which the Authority would closely examine the costs associated with this rate case.[521] Finally, Director Roberson moved that the Authority hear limited testimony with the appropriate cross-examination of witnesses in an expedited hearing to be held on March 28, 2011 exclusively on the issue of rate case expense.[522] The motion was approved unanimously by the panel.

On March 16, 2011, the parties filed a *Joint Motion for Approval of Rate Case Expenses* in which the parties agreed to limit the amount of rate case expenses approved in this docket to $645,000, as filed in the Company's original *Petition*. All of the parties in this docket asked that the Authority approve the agreed amount as the final rate case expenses to be recovered by TAWC without the necessity of further proof and in lieu of a separate proceeding on the issue. The parties' agreement reflected an effort to expedite the completion of the case and, thereby, avoid the possibility of TAWC implementing the full amount of its rate request under bond prior to April 5, 2011.[523] On March 22, 2011, the Hearing Officer entered an Initial Order[524] that found that the filing of the *Joint Motion* acted as a stipulation of the parties as to the issue of the rate case expense to be recovered in this case and concluded that no further proceedings, including the filing of testimony or convening of a hearing for the purpose of cross-examination

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to be recovered by rate payers, and further admonishing that such examination should have taken place and its results included in the record and Final Order).

[521] *Id.* at 126-127.

[522] *Id.*

[523] The Company would have been entitled to implement under bond the full amount of the requested rate increase under Tenn. Code Ann. § 65-5-103 (2004) in the event that the TRA did not render a final decision within six months of the Company's filing of its *Petition.*

[524] *Initial Order of Hearing Officer Relating to Proof on Rate Case Expenses and the Joint Motion Filed by the Parties*, pp. 5-6 (March 22, 2011).

of evidence, were necessary.[525] Furthermore, the decision to accept the amount proposed was within the purview of the voting panel assigned in this docket, and in light of this development, convening a separate proceeding on the issue of rate case expense at this time imposed an additional and unnecessary expense on the parties and, possibly, on the ratepayers of TAWC.[526]

During the hearing, the panel adopted an attrition period forecast of $277,880 for regulatory expenses. This included:

1. Amortization of attrition year unamortized balance of rate case costs associated with Docket No. 08-00039 of $146,139 for an annual cost of $48,713;
2. Cost of this case ($645,000) amortized over three years starting in April for an annual cost of $215,000; and
3. Estimated cost of service study for this case ($42,500) amortized over three years for an annual cost of $14,167.

In addition, this matter came before the panel during the regularly scheduled Authority Conference held on August 22, 2011, for consideration of the method by which recovery of $275,000 in regulatory fees due the Company following reversal of the TRA's decision in Docket No. 08-00039 by the Court of Appeals.[527] A majority of the panel voted to allow recovery of the $275,000 regulatory expense through a separate line item charge on customer bills, which will discontinue once the full amount has been recovered.[528] The Company was directed to file tariffs to include the surcharge, including all supporting calculations, within ten days and to work with the TRA Staff on the acceptable line item language for inclusion in customers' bills.[529]

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[525] *Id.*
[526] *Id.*
[527] The Court of Appeals issued its mandate in that appeal on June 7, 2011.
[528] Director Kyle moved to allow TAWC to recover the $275,000 through a temporary increase in fixed monthly service charges and usage rates, as proposed by the Company, which would reduce to current levels when the Company had collected the $275,000 in full, and directed that the Company file all documentation for the new rates and work with David Foster, Chief, and Pat Murphy, Deputy Chief, of the TRA's Utilities Division. This motion failed for lack of a second.
[529] Transcript of Proceedings, p. 79 (August 22, 2011).

V(B)10. INSURANCE OTHER THAN GROUP

The Company proposed $485,904 for the attrition period in Insurance Other than Group Expense.[530] The attrition period expense is calculated using the Company's 2010 actual insurance premiums of $477,086.92, less the Auto Liability Insurance of $28,300.36, for a total premium amount of $448,786.56 in 2010. The Company then adjusted the premiums for inflationary increases, which were provided by AWWC's insurance broker based upon the current commercial insurance market conditions.[531]

The CAPD forecasted $322,262 for the attrition period in Insurance Other than Group Expense.[532] The CAPD started its calculation using the September 30, 2010 income statement balances from Insurance General Liability, Insurance Workman's Compensation, and Insurance Other,[533] then applied a growth factor of 1.51%.[534] Later, the CAPD revised its growth factor to 1.40% and adjusted Insurance Other than Group Expense to $321,913.[535] The CAPD filed amended testimony on March 1, 2011, which changed the residential customer growth factor utilized in projecting revenues from 0.89% to 1.05%.[536] This amendment caused the CAPD's growth/inflation factor to change from 1.40% to 1.48%,[537] and increased Insurance Other than Group Expense from $321,913 to $322,151.[538]

The Authority adopts the CAPD's attrition period forecast of $322,151 for Insurance Other than Group because it reflected a verified downward trend of actual insurance premiums

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[530] TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3, p. 13 of 37 (February 16, 2011).
[531] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 125 (December 1, 2010).
[532] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[533] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-OI (January 5, 2011).
[534] Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).
[535] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-OI (January 31, 2011).
[536] John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).
[537] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-OI (Hearing Exhibit 90) (March 8, 2011).
[538] *Id.*

over the last three years. It is also based upon a later test year amount and has been adjusted upwards for inflation. For these reasons, the Authority adopts $322,151 for the attrition period in Insurance Other than Group Expense.

V(B)11. CUSTOMER ACCOUNTING

The Company projected $857,278 for Customer Accounting Expense. Customer Accounting Expense for the historical test year was $836,303. The Company applied an inflation factor of 3.58% to these expenses (excluding uncollectibles and normalizing adjustments for postage service totaling $3,348) to arrive at an increase of $17,627.[539] The Company stated that the projected postage increase of $3,348 is primarily the result of an increase in postage costs beginning May 2009.

The CAPD forecasted $841,387 for the attrition period in Customer Accounting Expense.[540] The CAPD adopted the general ledger balance for the twelve months ended September 30, 2010, made normalized adjustments for postage in the amount of $3,809,[541] and increased the result by one half of the customer growth of 0.89% plus the annual GDP Chained Price Deflator growth rate of 0.76%.[542] The CAPD later corrected its growth factor to 1.4%.[543] The effect of this adjustment was a decrease in Customer Accounting Expense from $841,387 to $840,475.[544] In amended testimony, the CAPD adjusted the residential customer growth factor that it utilized in projecting revenues from 0.89% to 1.05%, which caused the CAPD's

[539] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92d-ATTACHMENT, p. 13 of 28 (December 1, 2010).
[540] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[541] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-CA (January 5, 2011).
[542] Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).
[543] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-CA (January 31, 2011).
[544] *Id.*

growth/inflation factor to change from 1.40% to 1.48%.[545] This adjustment increased Customer Accounting Expense from $840,475 to $841,097.[546]

Thereafter, the panel adopted a Customer Accounting Expense projection in the amount of $841,097 for the attrition year. This projection is based upon a later test period, including normalizing adjustments, and better reflects the proper amount for the attrition period.

V(B)12. Uncollectible Expense

The Company projected Uncollectible Expense of $198,122 for the attrition period at current rates. In its calculation, the Company started with its historical test period amount of $202,677 and subtracted $8,343 from this figure to arrive at a normalized test period expense of $194,334. Then, the Company added $3,788 of attrition year adjustments to arrive at a projected expense of $198,122.[547]

The CAPD forecasted $250,290 for Uncollectible Expense for the attrition period.[548] This amount represented the actual uncollectible write-off balance for the twelve months ended September 30, 2010.[549]

The panel adopts an Uncollectible Expense amount at current rates of $198,122. This amount is based upon the amount booked by the Company for the twelve months ended March 31, 2010, plus a normalizing adjustment and attrition year adjustment at current rates. Any incremental increase in Uncollectible Expense will be accounted for by the application of the Revenue Conversion Factor.

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[545] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-CA (Hearing Exhibit 90) (March 8, 2011).
[546] *Id.*
[547] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 92, TN-TRA-02-Q092d-ATTACHMENT, p. 14 of 28 (December 1, 2010).
[548] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[549] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-UNC (January 5, 2011).

V(B)13. RENT EXPENSE

Rent Expense consisted of rental costs for such items as mobile radios, postage equipment, copiers, and land. The Company projected an attrition period Rent Expense of $8,706.[550] Rent Expense for the historical test year ended March 31, 2010, was $9,799. The Company incorporated three adjustments within this category of expense. The first adjustment eliminated the Oce Imagistics copier lease cost. The second adjustment eliminated the rental at the Chattanoogan Hotel, because this is a non-recurring expense.[551] The third and fourth adjustments normalized the ice machine rental and the Canon™ copier rental to include a full twelve month period, which resulted in a negative adjustment of $1,093.[552]

The CAPD projected a Rent Expense of $8,436 for the attrition period.[553] The CAPD started with the general ledger balance for the twelve months ended September 30, 2010 for the Real Property Rent Expense and Equipment Rent Expense. Then the CAPD applied normalizing adjustments to Equipment Rent Expense, causing a reduction in the amount of $408.[554]

The panel adopts $8,436 for Rent Expense as it is based on a later test period and includes normalizing adjustments.

V(B)14. GENERAL OFFICE EXPENSE

The Company projected General Office Expense of $217,933[555] for the attrition period.[556] The Company started with the test year amount of $210,461[557] and made three adjustments. The first adjustment annualized the sewer bill in the amount of a $166 increase because the test

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[550] Sheila, A. Miller, Pre-Filed Direct Testimony, p. 14 (September 23, 2010).
[551] *Id.*
[552] *Id.*
[553] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[554] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-RENT p. 41 (January 5, 2011).
[555] This expense category includes costs associated with the general expenses for the office. These include report forms, office supplies, computer supplies, overnight mail expenses, janitorial services, telephone expense, electrical expense, employee expenses, credit line fees, bank service charges, and other miscellaneous general office expenses.
[556] Sheila A. Miller, Pre-Filed Direct Testimony, p. 15 (September 23, 2010).
[557] *Id.* at 14.

period reflected only eleven months of the increase.[558] The second was to eliminate a $180 duplicate payment of membership dues.[559] The third was to add $52 for miscellaneous postage expense to reflect an increase that had been effective as of May 2009.[560] Then the Company applied an inflation factor of 3.58% to all expenses excluding postage. The result of these adjustments was a net adjustment in General Office Expense of $7,472.

The CAPD projected General Office Expense of $218,450 for the attrition period.[561] The CAPD began its calculations using the book value General Office Expense as it is reported in TAWC's Income Statements as of September 30, 2010, and made two normalizing adjustments. The first normalizing adjustment eliminated duplicate payments of membership dues in the amount of $80.[562] The second adjustment normalized Janitorial Expense to include an additional month of service in the amount of $449.[563] The CAPD then applied an inflation factor and a growth factor to the normalized test period for a net increase to the test period of $3,249.[564] The CAPD subsequently corrected and applied its growth factor to 1.40%.[565] This adjustment caused General Office Expense to decrease from $218,450 to $218,213.[566] In its amended testimony filed on March 1, 2011, the CAPD changed the residential customer growth factor it utilized in projecting revenues from 0.89% to 1.05%.[567] This caused the CAPD's growth/inflation factor to

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[558] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, Question 92, TN-TRA-02-Q092d, p. 18 of 28 (December 1, 2010).
[559] *Id.*
[560] *Id.*
[561] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[562] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-GO (January 5, 2011).
[563] *Id.*
[564] *Id.*
[565] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-GO (January 31, 2011).
[566] *Id.*
[567] John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

change from 1.40% to 1.48%[568] and increased its figure for General Office Expense from $218,213 to $218,374.[569]

The panel adopts General Office Expense of $218,374 for the attrition year because it is based upon a later test period, includes normalizing adjustments, and better reflects anticipated expenses incurred during the attrition period.

V(B)15. MISCELLANEOUS EXPENSE

The Company projected Miscellaneous Expense of $2,005,675 for the attrition period. The Company started with its actual Miscellaneous Expense of $1,945,947 as of March 31, 2010 and made six adjustments to this category.[570] The Company's overall net adjustment to Miscellaneous Expense was $59,728[571]

The CAPD forecasted Miscellaneous Expense of $1,956,125 for the attrition period.[572] The CAPD started by using the book values listed in TAWC's Income Statements for the twelve months ended September 30, 2010 and making five normalizing adjustments. The CAPD subsequently corrected its growth factor to 1.40%.[573] The effect of this adjustment was to decrease Miscellaneous Expense from $1,956,125 to $1,954,046.[574] The CAPD filed amended testimony on March 1, 2011, which changed the residential customer growth factor it utilized in projecting revenues from 0.89% to 1.05%.[575] This resulted in a change in the CAPD's

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[568] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-GO (Hearing Exhibit 90) (March 8, 2011).
[569] *Id.*
[570] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 15-16 (September 23, 2010).
[571] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 3 (February 22, 2011).
[572] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[573] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-MISC (January 31, 2011).
[574] *Id.*
[575] John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).

growth/inflation factor from 1.40% to 1.48%,[576] which increased Miscellaneous Expense from $1,954,046 to $1,955,463.[577]

The Authority, whenever possible, strives to use known and measurable information in forecasting for the attrition period. In calculating Miscellaneous Expense, the CAPD did not make normalizing adjustments for the increase in fuel cost. That being the case, the Company's forecast of $2,005,675 forms a better basis for Miscellaneous Expense, as it reflects the actual increases in gasoline cost.

The Company and the CAPD proposed including amortization of the Management Audit of $190,000 over five years (or $38,000 per year) as part of their forecast of Miscellaneous Expense for the attrition period. The Company, the CAPD, and the City all agreed to split equally the $6,960 deposition costs incurred in deposing Ms. Schumaker in preparation for the Hearing. The CRMA did not question the witness and did not agree to split the costs of the deposition.[578] In addition, the costs of Ms. Schumaker's appearance at the Hearing totaled $6,160.[579] Accordingly, Miscellaneous Expense should include the actual cost of the Management Audit ($184,964),[580] the Company's portion of the deposition cost ($2,320), and $6,160 for Ms. Schumaker's hearing expenses, all of which are amortized over five years. Therefore, the panel adopts Miscellaneous Expense for the attrition period in the amount of $2,006,364.

V(B)16. OTHER MAINTENANCE EXPENSE

The Other Maintenance Expense category includes costs associated with maintaining the property of the Company, including repair of parts and tools, maintenance supplies, contracted

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[576] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-MISC (Hearing Exhibit 90) (March 8, 2011).
[577] *Id.*
[578] Transcript of Proceedings, Vol.VII B, p. 136 (March 08, 2011).
[579] *Id.*
[580] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q131-ATTACHMENT (December 1, 2010).

services, paving, maintenance agreements, and other miscellaneous maintenance expenses. The Company projected Other Maintenance Expense of $1,110,317 for the attrition period. Maintenance Expense for the historical test year was $1,042,628. The Company made one adjustment in the amount of $44,838 for an anticipated increase in paving expenses due to new materials that are now required by the City. The Company then applied its inflation factor of 3.58% to the normalized test year balance, for an adjustment of $22,851.[581]

The CAPD forecasted $1,143,925 in Other Maintenance Expense for the attrition period.[582] The CAPD started with the book balance of Other Maintenance Expense for the twelve months ended September 30, 2010[583] and increased it by one half of the customer growth of 0.89% plus the annual GDP Chained Price Deflator growth rate of 0.76%.[584] The CAPD subsequently adjusted its growth factor to 1.40%.[585] The effect of this adjustment was a decrease in Other Maintenance Expense from $1,143,925 to $1,142,685.[586] In amended testimony, the CAPD made a change to the residential customer growth factor it utilized to project revenues from 0.89% to 1.05%.[587] This changed the CAPD's growth/inflation factor from 1.40% to 1.48%.[588] The effect of this adjustment was an increase in General Office Expense from $1,142,685 to $1,143,531.[589]

Accordingly, the panel adopts $1,143,531 for Other Maintenance Expense because this calculation is based upon a later test year and more accurately reflects inflation.

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[581] Sheila A. Miller, Pre-Filed Direct Testimony, p. 16 (September 23, 2010).
[582] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 5, p. 5 of 9 (January 5, 2011).
[583] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-MAINT (January 5, 2011).
[584] Terry Buckner, Pre-Filed Direct Testimony, p. 12 (January 5, 2011).
[585] Terry Buckner, Non-Confidential Direct Testimony Amendment, Workpaper AMENDED E-MAINT (January 31, 2011).
[586] *Id.*
[587] John Hughes, Amendment to Amended Testimony filed February 25, 2011, Workpaper R-Customer Growth (March 1, 2011).
[588] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED E-MAINT (Hearing Exhibit 90) (March 8, 2011).
[589] *Id.*

V(B)17. Depreciation Expense

TAWC projected Depreciation and Amortization Expense for the attrition period of $4,880,048.[590] TAWC's projection was based upon its March 31, 2010 Plant in Service balances and forecasted additions and retirements through the attrition period, using current depreciation rates.

The CAPD projected Depreciation and Amortization Expense of $4,703,804[591] for the attrition period. The CAPD's projection was based upon the Company's September 31, 2010 Plant in Service balances, forecasted additions and retirements through the attrition period,[592] and the current depreciation rates multiplied by a thirteen-month average of depreciable property through the end of the attrition year.[593]

The Authority adopts the CAPD's projected amount of $4,703,804 for the attrition period Depreciation Expense because it is based upon more recent actual balances as of September 30, 2010, including forecasted additions and retirements provided by the Company through the attrition period and does not depreciate the fully depreciated accounts.

V(C). Taxes and Fees

The category of Taxes other than Income includes the following: Gross Receipts Tax, TRA Inspection Fee, Property Tax, Franchise Tax, FICA Tax, and Unemployment Tax. These taxes are discussed in the following sections.

V(C)1. Gross Receipts Tax

The Company projected $529,961 for the attrition period in Gross Receipts Tax.[594] The Company stated that its Gross Receipts Tax was based on projected jurisdictional revenues for

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[590] TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 1 (February 22, 2010).
[591] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-DEPRECIATION, p. 54 (January 5, 2011).
[592] Terry Buckner, Pre-Filed Direct Testimony, pp. 45-46 (January 5, 2011).
[593] *Id.*
[594] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-GENERAL TAXES, p. 8 (September 24, 2010).

TAWC including Other Operating revenues. The revenues, adjusted for the Franchise Tax, Excise Tax, and a $5,000 exemption, were multiplied by the current 3% tax rate to arrive at the attrition year level. The forecasted amount was calculated using 50% of the Gross Receipts Tax Return based on 2009 revenues. This return was due July 2010 for the taxable period ended June 2011. The remaining 50% was based on 2010 budgeted revenues. This approach properly matched the Gross Receipts Tax with the attrition period in this case.[595]

The CAPD projected $704,308 for the attrition period in Gross Receipts Tax.[596] The CAPD based its calculation of gross receipts for the first half of the attrition period on state gross receipts tax paid in August 2010, which are derived from gross receipts for the fiscal year ended December 31, 2009.[597] The CAPD forecasted the second half of the attrition period gross receipts based on actual gross receipts for the twelve months ended September 30, 2010, as stated on the Company's September 2010 TRA 3.06 Report. The CAPD then adjusted revenues by the $5,000 exemption and multiplied the remaining taxable receipts by the current 3% tax rate. The CAPD adjusted taxes payable by deducting the amount of Franchise Tax, but did not apply any State Excise Tax. The CAPD calculated $0 State Excise Taxes due in 2009, based on the effect of offsetting net operating losses from prior years.[598]

The panel adopts $704,308 for the attrition period forecast for Gross Receipts tax, because this amount is calculated using the proper and most accurate methodology.

V(C)2. TRA INSPECTION FEES

The panel determines that the TRA Inspection Fee for the attrition period revenue at current rates is $116,262. This projection for the TRA Inspection Fee is based on forecasted

[595] Sheila A. Miller, Pre-Filed Direct Testimony, p. 18 (September 23, 2011).
[596] Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX7 (January 5, 2011).
[597] *Id.*
[598] *Id.*

revenue of $37,921,589 for the attrition period, reduced by uncollectibles of $198,122 and a $5,000 exemption to arrive at taxable revenues, and then multiplied by the statutory rate.

V(C)3. Property Taxes

The Company projected Property Taxes of $2,936,068 for the attrition period.[599] The Company started its calculation of Property Taxes for the test year in the amount of $2,380,025. The Company then normalized the test period by increasing this figure by 19% to account for a known property tax increase enacted by the City of Chattanooga which is effective in the attrition year resulting in a normalized adjustment of $242,895.[600] The Company calculated an effective property tax, which included that increase, and applied the effective rate to the thirteen-month average attrition year Construction Work in Progress ("CWIP")[601] for the attrition period adjustment of $313,148, to arrive at $2,936,068 in property taxes for the attrition period.[602] In Rebuttal Testimony, the Company adjusted its 13-month average attrition year CWIP due to a retirement error in the original filing.[603] This correction to CWIP changed Property Taxes for the attrition period from $2,936,068 to $2,800,043.[604]

The CAPD projected Property Taxes of $2,572,725 for the attrition period.[605] In its calculation, the CAPD used a ratio of 2009/2010 taxes paid for the Company's Georgia property and a ratio of 2009/2010 assessments for its Tennessee property, multiplied by the 2010 tax rates.[606]

The Authority adopts Property Taxes for the attrition period of $2,572,725 as projected by the CAPD because it utilizes a later, more timely assessment period.

[599] *Petition*, Exhibit No. 2, Schedule 5 (September 23, 2010).
[600] Sheila A. Miller, Pre-Filed Direct Testimony, p. 17 (September 23, 2010).
[601] *Id.*
[602] *Id.*
[603] Sheila A. Miller, Pre-Filed Rebuttal Testimony, pp. 14-15 (February 8, 2011).
[604] TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 2, Schedule 5 (February 16, 2011).
[605] Terry Buckner, Pre-Filed Direct Testimony, p. 47 (January 5, 2011).
[606] *Id.*

V(C)4. Franchise Taxes

The Company projected Franchise Taxes of $377,690 for the attrition year.[607] The Company utilized its taxable basis as of December 2010 for five-sixths of the attrition year tax, and its projected taxable basis as of December 2011 for one sixth of the attrition year tax. Those values were then multiplied by the statutory rate of $.25 per $100.[608]

The CAPD projected Franchise Taxes of $391,255 for the attrition period.[609] The CAPD calculated Franchise Tax using a forecasted December 31, 2011 plant in service and accumulated depreciation net of forecasted plant additions and retirements.[610] The CAPD then multiplied its calculation for projected taxable basis by the statutory rate of $.25 per $100.

The Authority adopts Franchise Taxes of $391,255 for the attrition period, as projected by the CAPD, because it is based upon more recent data.

V(C)5. FICA Tax

The Company projected FICA Tax of $421,089[611] utilizing applicable wages that are subject to payroll taxes, then applied the appropriate tax rates to arrive at its total for FICA Tax. A capitalization percentage of 15.83% was applied to the total FICA Tax to arrive at its normalized year FICA Tax.[612]

The CAPD projected FICA Tax of $370,627 by forecasting its attrition period FICA Tax and applying the current tax rates to its calculation of attrition period Salaries and Wages. The CAPD then applied a capitalization rate of 20.57%.[613]

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[607] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 13, TN-TRA-01-Q013-GENERAL TAXES, p. 2 (September 24, 2010).
[608] *Id.*
[609] Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX8 (January 5, 2011).
[610] Terry Buckner, Pre-Filed Direct Testimony, p. 48 (January 5, 2011).
[611] TAWC's Responses To The TRA's Second Data Requests Dated October 26, 2010, TN-TRA-02-Q92f-ATTACHMENT, Exhibit No. 2, Schedule 5, p. 1 of 9 (December 1, 2010).
[612] *Id.* at 9 of 9.
[613] Terry Buckner, Pre-Filed Direct Testimony, Workpaper T-OTAX3 (January 5, 2011).

The Authority adopts $397,217 for FICA Tax for the attrition period because this forecast is consistent with the price-out calculation for Salaries and Wages Expense for 110 employees and applies a capitalization percentage of 20.57%.

V(C)6. UNEMPLOYMENT TAX

The Company projected Unemployment Tax of $17,685.[614] The Company forecasted its attrition period Unemployment Tax by multiplying 110 employees by the appropriate tax base, and applying the current tax rate. The Company then applied a capitalization percentage of 15.83%.

The CAPD projected Unemployment Tax of $15,778.[615] The CAPD performed empirical calculations on a forecasted average of 104 Tennessee employees for the test period ended September 2010. The CAPD multiplied 104 employees by the appropriate tax base and current tax rate, and applied a capitalization percentage of 20.57%.[616]

The Authority adopts $16,688 for Unemployment Tax for the attrition period. This forecast is consistent with the forecast of Salaries and Wages Expense for 110 employees and a capitalization percentage of 20.57%.

V(C)7. STATE EXCISE TAX

The Authority adopts an Excise Tax amount of $223,534 for the attrition period. This amount is calculated using forecasted results from operations at current rates for the attrition period, and adjusted for interest expense, permanent differences, and applies the statutory tax rate of 6.5%. Additionally, the state excise tax was included on the amount of the projected revenue deficiency.

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[614] *Petition*, Exhibit No. 2, Schedule 5 (September 23, 2011).
[615] Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 6, p. 6 of 9 (Hearing Exhibit 90) (March 8, 2011).
[616] Terry Buckner, Pre-Filed Direct Testimony, Workpaper E-PAY-4A, p.7 (January 5, 2011).

V(C)8. FEDERAL INCOME TAX

The Authority adopts Federal Income Tax of $1,672,871 for the attrition period. This amount is calculated using the forecasted results from operations at current rates for the attrition period, and adjusted for interest expense, permanent differences, excise tax, ITC amortization, then applies the statutory tax rate of 35%, and recognizes the reversal of the FAS 109 regulatory asset in the amount of $623,832. The FIT tax is also included on the amount of the projected revenue deficiency.

V(C)9. ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)

CWIP may be appropriately included in utility rate base, and the Company is allowed to earn a return on this type of investment. The return, or income, generated by this investment, however, will not be realized until a future date, which is beyond the attrition period. Therefore, it is necessary to remove the return (the cost of debt) on CWIP from the attrition period so that current customers do not pay for expenses related to future income. Here, the Company's budgeted capital additions were used in its calculations of CWIP. As this is the case, the Company's associated budgeted AFUDC should also be adopted.

The Company proposed the amount of $204,000 for AFUDC for the attrition period. This adjustment was made to reflect the AFUDC as an above the line item for ratemaking purposes.[617] The CAPD concurred with the Company's position.[618]

Therefore, the TRA adopts $204,000 for AFUDC for the attrition period, as proposed by both the Company and the CAPD.

[617] *Petition*, Exhibit No. 2, Schedule 3 (September 23, 2010).
[618] Terry Buckner, Pre-Filed Direct Testimony, Exhibit 1, Schedule 3, p. 3 of 9 (January 5, 2011).

V(D). NET OPERATING INCOME

Based on the foregoing determinations, the Authority finds that TAWC's Net Operating Income is $5,937,860 for the attrition period prior to the application of taxes for additional attrition period revenues.

V(E). RATE BASE

Rate base is the total of the investor funded or supplied plant, facilities, and other investments used by the utility in providing service to its customers. Rate base is the investment base to which a fair rate of return is applied in order to determine the Company's net operating income requirement. Relying on its revised accounting exhibits, TAWC proposed a rate base amount of $120,967,931.[619] In its *Petition*, the Company stated that it used a test period ending March 31, 2010, made normalizing adjustments, and then projected the results to determine an attrition year of the twelve months ended December 31, 2011.[620] The Consumer Advocate asserted that the Authority should approve an attrition year rate base of $115,042,041.[621] For the reasons set forth below, the Authority adopts a rate base of $118,459,808 for the attrition year ended December 31, 2011.

V(E)1. UTILITY PLANT IN SERVICE ("UPIS")

In direct testimony, the Company projected an average attrition period balance for Utility Plant in Service ("UPIS") of $226,384,490.[622] TAWC President, Mr. Watson, testified that the projected UPIS will be used and useful and attributed the majority of the increase to two major projects. The first project is an upgrade of the Citico Treatment Plant that the Company states is necessary due to the Tennessee Department of Environment and Conservation's findings

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[619] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 1 (February 22, 2011).
[620] *Petition*, p. 4 (September 23, 2010).
[621] Terry Buckner, Second Amendment to Direct Testimony, Amended Exhibit 1, Schedule 1, p. 1 of 9 (Hearing Exhibit 90) (March 8, 2011).
[622] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 2, p. 1 of 3 (February 22, 2011).

regarding the need for a chemical off-loading facility. The second project consists of the replacement of one eight-inch steel water main and one twelve-inch water main in the Lookout Mountain service area. The total cost for both projects is $8.3 million.[623]

To calculate its UPIS, TAWC used account balances as of March 31, 2010 and included projected net additions and retirements. The Company then utilized its projected monthly account balances for the period December 1, 2010 through December 31, 2011 to calculate a thirteen-month average and forecast an attrition year balance of $226,384,490.[624]

The CAPD's calculation used test year balances as of September 30, 2010 and then applied the forecasted additions and retirements provided by TAWC in order to determine monthly amounts for plant in service through the attrition period ended December 31, 2011. The CAPD also used a thirteen-month average to arrive at a projected amount of $225,496,165.[625]

Although TAWC is correct in its assertion that the use of an alternative test year, such as proposed by an Intervenor, requires more work on the part of the utility in providing more recent financial information, the Authority disagrees that differing test years, after application of the proper adjustments, would result in "essentially the same"[626] attrition year amounts. In order for these amounts to be the same, all projections would have to be almost identical to the actual recorded amount, which is highly unlikely to occur for every account. The panel agrees with the CAPD that the use of more recent information often provides results that are a more accurate representation of what can be expected to occur on a going-forward basis.

For these reasons, the TRA finds that the later test period and normalizing adjustments made by the CAPD are likely to be more representative of future amounts for UPIS. Therefore,

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[623] John S. Watson, Pre-Filed Direct Testimony, pp. 5-6 (September 23, 2010).
[624] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 19-20 (September 23, 2010).
[625] Terry Buckner, Non-Confidential Direct Testimony Amendment, p. 50 (January 31, 2011).
[626] Michael A. Miller, Pre-Filed Direct Testimony, p. 18 (September 23, 2010).

the panel adopts UPIS in the amount of $225,496,165 for the attrition period ending December 31, 2011.[627]

V(E)2. Construction Work In Progress

TAWC initially reported CWIP as $4,201,421, but later filed amended exhibits that decreased its CWIP amount by $1,165,021 to account for certain retirements.[628] Additional adjustments were made to CWIP expenditures in the amount of $1,545,192 in order to reflect an accurate amount actually spent during the annual period.[629] TAWC asserts that the CAPD did not appropriately consider the timing of the Company's capital spending throughout the year. Specifically, the CAPD utilized a later test period ending September 30, 2010, but failed to adjust for capital expenditures that had not taken place by the end of December 2010.

TAWC made adjustments to increase the capital expenditure amounts for CWIP by the difference between what TAWC projected would be spent by the end of December 2010 ($11,974,692) and the actual expenditures made by the end of December 2010 ($10,429,500) and spread the difference ($1,545,192) over the twelve months ended December 31, 2011.[630]

The CAPD forecasted CWIP in the amount of $2,681,318, using the later test period ending September 30, 2010.[631] In its post-hearing brief, the CAPD asserted that because of the interrelationship between CWIP and UPIS, capital spending projects should be accounted for in CWIP as they are being constructed and moved from CWIP to UPIS once the asset is placed into service.[632]

[627] Director Roberson voted that the capital additions for the Citico treatment plant project of $5,301,305 be removed from rate case calculations, and that such an adjustment will reduce the overall revenue requirement by $753,736, including the reduced depreciation expense, accumulated depreciation, and the resulting tax effects (not including any adjustments to the accumulated deferred income taxes). He also stated that such projects will be allowed as it is implemented and a Hearing Officer will review and approve such requests by TAWC. Transcript of Proceedings, pp. 73-75 (April 4, 2011).
[628] Sheila A. Miller, Pre-Filed Rebuttal Testimony, p. 14 (February 8, 2011).
[629] *Id.*
[630] *Id.*
[631] Terry Buckner, Pre-Filed Direct Testimony, p. 50 (January 5, 2011).
[632] *Consumer Advocate and Protection Division's Post-Hearing Brief*, pp. 61-62 (March 21, 2011).

After all of the final exhibits and testimony had been filed, the parties' use of different test periods and treatment of capital projects, which the Company stated had not yet occurred as of the end of December 2010, revealed that the difference between the parties amounted to approximately $1.5 million. Upon review of the record, the TRA finds that TAWC did not provide any verifiable documentation to demonstrate that $1.5 million was not spent and, therefore, should be added to CWIP during the attrition period. Therefore, the panel agrees with the CAPD that moving the amounts from CWIP to UPIS is not necessary to prevent double counting for this projected amount.[633] Additionally, the Authority agrees that using a later test period as used by the CAPD is appropriate and adopts a CWIP balance of $2,681,318.

V(E)3. Utility Plant Capital Lease

The Company projected an average attrition period balance of $1,590,500 for Utility Plant Capital Lease. TAWC's booked amounts for the period ended March 31, 2010, were adjusted to reflect through the end of the attrition period and averaged for the thirteen months ending December 31, 2011.[634] As the known amount of annual leases does not fluctuate and would not be affected by using different test periods, no difference exists between the parties as to the calculation of Utility Plant Capital Lease. After reviewing the financial data, the TRA determines that Utility Plant Capital Lease for the attrition period is $1,590,500.

V(E)4. Working Capital

Working capital consists of the amount of funds needed to meet the Company's daily expenditures and a variety of non-plant investments. Working capital is necessary to sustain the ongoing operations of the utility until those expenditures can be recovered through revenues received from customers.

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[633] *Id.*
[634] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 21-22 (September 23, 2010).

TAWC included Prepaid Taxes, Materials and Supplies, Deferred Regulatory Expense, Unamortized Debt Expense, Other Deferred Debits, Lead-Lag Study and Incidental Collections in Working Capital.[635] The following schedule shows the respective positions of the parties:

	TAWC[636]	CAPD[637]	Difference
Prepaid Taxes	284,235	414,322	(130,087)
Materials and Supplies	254,110	215,798	38,312
Deferred Regulatory Exp.	1,228,535	458,486	770,049
Unamortized Debt Exp.	460,845	460,842	3
Other Deferred Debits	280,983	280,997	(14)
Lead-Lag Study	987,000	640,976	346,024
Incidental Collections	(1,562,812)	(1,562,481)	(331)
Total Working Capital	1,932,896	908,940	1,023,955

TAWC projected Prepaid Taxes of $284,235 based upon a thirteen-month average balance for the test year ending March 31, 2010.[638] The CAPD projected Prepaid Taxes using a test period ended September 30, 2010 and a thirteen-month average, resulting in Prepaid Taxes of $414,322.[639]

TAWC projected Material and Supplies based upon a thirteen-month average balance for the test year ended March 31, 2010, which resulted in $254,110.[640] The CAPD projected Materials and Supplies of $215,798 using a test period ending September 30, 2010 and a thirteen-month average.[641]

In rebuttal testimony, TAWC increased its Deferred Regulatory Expense to $1,228,535[642] and asserted that this revised amount was a better projection and included the additional costs it anticipated incurring as a result of the Hearing having been located in Chattanooga. TAWC's

[635] Sheila A. Miller, Pre-Filed Direct Testimony, pp. 20-21 (September 23, 2010).
[636] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).
[637] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-WORKING CAPITAL REQUIREMENT (Hearing Exhibit 90) (March 8, 2011).
[638] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).
[639] Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-PREPAID TAXES, p. 99 (January 5, 2011).
[640] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).
[641] Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-M&S, p. 98 (January 5, 2011).
[642] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).

revised expense of $1,228,535 reflected a thirteen month average of unamortized balances as of December 31, 2011. To calculate this amount, TAWC used $1.2 million as the total cost for this rate case, and added $275,000 from its prior rate case (Docket No. 08-00039),[643] the unamortized balance of $23,773 for its cost of service study, and $3,010 for its depreciation study.[644]

In its amended schedules, Consumer Advocate projected $458,486 for Deferred Regulatory Expense. Nevertheless, the supporting schedule it filed consisted of $458,486 in Deferred Rate Case Expense, $3,009 for the Deferred Depreciation Study, and $12,533 for the Deferred Cost of Service Study, which totals $474,028.[645] The CAPD attributed the difference primarily to TAWC's having used $1.2 million as the rate case cost for this docket and adding the $275,000 rate case costs incurred in Docket No. 08-00039; whereas, the CAPD used the rate case costs approved by the Authority. The CAPD asserted that TAWC should not be allowed to include excessive rate case expenses that the TRA had not approved.[646] TAWC responded that rate cases benefit shareholders as well as utilities.[647]

As noted above, Director Roberson expressed concern during the Hearing regarding regulatory fees and moved to require additional information be filed to substantiate TAWC's request in this case.[648] Director Roberson further proposed that an expedited hearing be held on this matter, which was approved unanimously by the panel.[649] Subsequently, on March 16, 2011, the parties filed a Joint Motion for Approval of Rate Case Expense stipulating to the Company's recovery of $645,000 in rate case expense. This stipulated amount includes a total Deferred Regulatory Expense in the amount of $630,897, which consists of $589,165 for rate

[643] Discussed supra; *see Tenn. Amer. Water Co. v. TRA*, 2011 WL 334678 (Tenn. Ct. App. Jan. 28, 2011).
[644] TAWC's Responses To The TRA's Fifth Data Request Dated Feb. 15, 2011, Question 170, TN-TRA-05-Q170-ATTACHMENT (February 22, 2011).
[645] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-DEFERRED REGULATORY (Hearing Exhibit 90) (March 8, 2011).
[646] Terry Buckner, Pre-Filed Direct Testimony, p. 51 (January 5, 2011).
[647] Michael A. Miller, Pre-Filed Rebuttal Testimony, pp. 76-79 (February 8, 2011).
[648] Transcript of Proceedings, Vol. VII B, pp. 126-127 (March 8, 2011).
[649] *Id.* at 127.

case expense, $38,723 for the cost of service study expense, and $3,010 for depreciation study expense.

TAWC projected its Unamortized Debt Expense based upon an account balance as of March 31, 2010, adding its new debt, and subtracting cumulative amortizations to arrive at monthly amounts for a thirteen-month average.[650] The CAPD used the same methodology as the Company with a starting account balance as of September 30, 2010.[651]

TAWC projected its Other Deferred Debits using a thirteen-month average of the unamortized monthly transition costs of the Customer Call Center, which totals $204,399, and the Shared Services Center costs in the amount of $76,584.[652] The CAPD projected close to the same amount of Other Deferred Debits using the actual booked amounts of the Company.[653]

Testifying for TAWC, Mr. Miller stated that Working Capital was calculated consistent with the Authority's ruling on this category in Docket No. 08-00039. He further noted that the amount projected included a provision based on the Lead-Lag Study performed by the Company in this case totaling $987,000.[654] The CAPD utilized the amount of the Lead-Lag Study provided by the Company but adjusted it to reflect a thirty-seven-day lag for the payment of state excise tax and federal income tax. The CAPD's witness, Mr. Buckner, stated that this methodology would align the payments with the corresponding statutory requirements. Using its forecasted revenue, expenses, and the tax lag adjustment, CAPD forecasted the Lead-Lag total to be $640,976.[655]

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[650] Sheila A. Miller, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).
[651] Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-UNAMORTIZED DEBT EXPENSE, p. 100 (January 5, 2011).
[652] Sheila A. Miller, Pre-Filed Direct Testimony, p. 21 (September 23, 2010).
[653] Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-OTHER DEFERRED DEBITS, p. 97 (January 5, 2011).
[654] TAWC's February 22nd Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 3, p. 1 of 6 (February 22, 2011).
[655] Terry Buckner, Second Amendment to Direct Testimony, Workpaper AMENDED RB-WORKING CAPITAL REQUIREMENT (Hearing Exhibit 90) (March 8, 2011).

Mr. Gorman, who testified for the City, asserted that Working Capital should be reduced by $2 million because the adjustment is necessary to reflect the removal of the unamortized debt expense, elimination of the non-cash items, and the use of different expense lag for various expenses, including management fees, in the Lead-Lag Study. Further, Mr. Gorman asserted that the unamortized debt expense was already included in the debt interest, and thus, its inclusion in working capital would allow TAWC double recovery of this expense. Further, Mr. Gorman set the expense lag for Depreciation and Amortization, Deferred Taxes, Net Earnings, Amortizations and Uncollectibles equal to the revenue lag. He then used a different expense lag for Management Fees and Gross Receipts taxes, asserting that the charges from the parent company should not be prepaid. Finally, Mr. Gorman asserted that Depreciation and Amortization, Deferred Taxes, Net Earnings, Amortizations and Uncollectibles should be removed from the Lead-Lag study because they are not cash expenses and, therefore, do not create a Cash Working Capital requirement.[656]

In rebuttal, TAWC asserted that the CAPD's adjustments to the Lead-Lag for income tax payments were inaccurate because they were based upon textbook recommendations that do not reflect the Company's current payment schedule.[657] TAWC also disagreed with Mr. Gorman's position, noting that its management contract with AWWSC requires advance payments. Further, TAWC asserted that Mr. Gorman failed to consider that if there were a lag in the payment to AWWSC, AWWSC would incur a lag in revenues that would then be passed back to TAWC. TAWC contended that the adjustment for uncollectibles that Mr. Gorman proposed was incorrect and represented the same position proposed by the CRMA in Docket No. 08-00039, which was not accepted by the TRA.[658] In addition, TAWC stated that it outlays cash when it purchases the non-cash items for depreciation and amortization and, therefore, the depreciation and

[656] Michael Gorman, Pre-Filed Direct Testimony, pp. 14-20 (January 5, 2011).
[657] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 52 (February 8, 2011).
[658] *Id.* at 53-54.

amortization allotment has already recovered the Company's initial cash investment. Finally, TAWC conceded that the gross receipts shown on the Lead-Lag were incorrect and corrected the service period in its rebuttal testimony.[659]

Considering the above, the panel adopts working capital in the amount of $1,675,829, broken down as follows:

Prepaid Taxes	$414,322
Materials and Supplies	215,798
Deferred Regulatory Expense[660]	852,847
Unamortized Debt Exp.	460,842
Other Deferred Debits	280,997
Lead-Lag Study	1,013,504
Incidental Collections	(1,562,481)
Total Working Capital	$1,675,829

With regard to these components, other than the Deferred Regulatory Expense and Lead-Lag amounts, the difference between the parties is attributable to the use of different test periods.

The category of Deferred Regulatory Expense consists of the unamortized balances of Regulatory Fees, Depreciation Study Expense, Management Audit Costs, deposition costs, and Cost of Service Studies. The panel finds that Regulatory Fees should be calculated using a thirteen-month average of the unamortized approved regulatory fees from Dockets No. 06-00290 and No. 08-00039, plus the thirteen-month average of the unamortized balance of the stipulated amount of $645,000. The panel further finds that Depreciation Study Expense should be calculated using the thirteen-month average of the unamortized balances from Docket Nos. 06-00290, 08-00039, and this docket. The use of these methods results in the panel's adoption of $852,847 for Deferred Regulatory Expenses within Working Capital.

Based upon the record, contrary to the CRMA's arguments, the panel finds that it is appropriate to include uncollectibles as an offset to revenues, the prepayment of Management charges, and Gross Receipt Taxes in the Lead-Lag Study. The panel does not agree that

[659] *Id.* at 55-56.
[660] This figure includes the cost of the management audit and the cost of Ms. Schumaker's deposition.

depreciation does not require a cash outlay and, therefore, should not be included in the Lead-Lag Study. Therefore, the panel adopts $1,013,504 for the Lead-Lag Study expense within Working Capital.

V(E)5. ACCUMULATED DEPRECIATION

The Company projected $72,578,044 for a thirteen-month average of Accumulated Depreciation. To calculate this amount, TAWC started with the historical balance of Accumulated Depreciation as of March 31, 2010 and applied actual depreciation rates to project monthly balances for the period ending December 31, 2011.[661]

The CAPD used the historical booked Accumulated Depreciation as of September 30, 2010, then applied current depreciation rates to determine monthly amounts through December 31, 2011. A thirteen-month average was calculated resulting in $73,137,622 as the final amount for Accumulated Depreciation.[662]

The differences between the parties as to Accumulated Depreciation are attributable to the use of different test periods. The Authority adopts the projection of $73,137,622 for Accumulated Depreciation based upon the later test period used by the CAPD.

V(E)6. ACCUMULATED AMORTIZATION OF UTILITY CAPITAL LEASE

There was no difference calculated between the parties on Accumulated Amortization of Utility Plant Capital Lease. Just as with the Capital Lease amounts, this amount agrees because the lease amounts are known and do not fluctuate. Therefore, this amount is not affected as a result of the use of different test periods. After reviewing the financial data, the Authority adopts $1,387,268 for the attrition period.

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[661] Sheila A. Miller, Pre-Filed Direct Testimony, pp.21-22 (September 23, 2010).
[662] Terry Buckner, Pre-Filed Direct Testimony, Workpaper RB-ACCUMULATED DEPRECIATION, p. 102 (January 5, 2011).

V(E)7. ACCUMULATED DEFERRED INCOME TAXES (ADIT)

In its *Petition*, TAWC filed Accumulated Deferred Income Taxes ("ADIT") on a non-SFAS 109 basis and asserted that the Authority recognized SFAS 109 accounting as to ADIT. Nonetheless, TAWC did not recognize the amortizations associated in calculating the federal income tax expense in the 2008 rate case. In addition, TAWC included a deferred expense and an expense related to the tax accounting treatment of "Capitalized Repairs" consistent with FIN 48.[663] Subsequently, on February 22, 2011, TAWC revised its estimated ADIT amount to be consistent with SFAS 109. The subsequent filing resulted in two primary differences between TAWC and the CAPD related to ADIT: the treatment of SFAS 109[664] and FIN 48[665] recognition.

As summarized by TAWC, SFAS 109 addresses the flow-through rate recovery of pre-1981 property.[666] The difference between straight-line method depreciation and the accelerated depreciation that is allowed by the IRS creates a timing difference.[667] As the ratepayers received the benefit of accelerated depreciation, a regulatory asset must be established to account for the timing difference and to facilitate the appropriate reversal in subsequent years.[668]

Until the reversal of depreciation, SFAS 109 allows the Company to reduce its ADIT by the amount of the regulatory assets, which allows the Company to earn a return on the timing difference until reversal.[669] As the timing difference reverses, the regulatory asset account steadily is reduced and the income tax expense steadily increases.[670] Because the Company's current taxes for rate recovery have always included the additional income taxes paid to the IRS

[663] Michael Miller, Pre-Filed Direct Testimony, p. 58 (September 23, 2010).
[664] Financial Accounting Standards Board (FASB) Statement No. 109.
[665] Financial Accounting Standards Board Interpretation No. 48.
[666] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 36 (February 8, 2011).
[667] *Id.* at 35.
[668] Accelerated depreciation temporarily reduces current income tax expense, thus reducing the expense that must be recovered from ratepayers. *Id.* at 39.
[669] *Id.*
[670] *Id.*

on the reversal of the pre-1981 property by the TRA under the APB11[671] approach to rate recovery, the Company established the SFAS 109 tax assets as regulatory assets under the provisions of SFAS 71, which allows regulatory assets to be established if future rate recovery is probable.[672]

In accordance with FIN 48, AWWC changed the accounting method it used for recording repairs and maintenance. Instead of capitalizing the costs, as it had previously done, TAWC deducted the costs in the current year.[673] This change creates an uncertainty regarding the lawfulness of the deduction.[674] FIN 48 allows the creation of a reserve for a portion of the capitalized repairs in order to allow payment of any future potential tax liability.[675] FIN 48 requires the Company to identify any uncertain tax positions, evaluate them, and determine whether the IRS is likely to sustain a deduction.[676] If uncertainty exists, FIN 48 allows the Company to exclude this amount as a deduction from rate base, thus earning a return on a potential repayment.[677]

The CAPD originally filed a calculation of ADIT that did not adjust the amount of regulatory assets or include capitalized repairs.[678] Later, the CAPD amended its ADIT calculation to include the regulatory assets, but continued to include capitalized repairs in ADIT.[679] Additionally, the CAPD included a timing difference for Capitalized Repairs and Post-80 depreciation in its calculations. The CAPD did not offer testimony to explain why these adjustments were necessary.

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[671] Accounting Principles Board Opinion 11.
[672] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 39 (February 8, 2011).
[673] *Id.* at 41.
[674] FIN 48, § A26.
[675] James I. Warren, Pre-Filed Rebuttal Testimony, p. 35 (February 8, 2011).
[676] *Id.*
[677] Michael A. Miller, Pre-Filed Rebuttal Testimony, p. 41 (February 8, 2011).
[678] *Id.*
[679] *Id.*

The TRA agrees with TAWC that the CAPD's amended filing appropriately reduced rate base by the total of the Company's ADITs (liabilities) as is reflected on the Company's financial statements using the SFAS 109 approach. Nevertheless, the CAPD failed to appropriately offset this amount by the SFAS 109 (regulatory) assets to account for reversal of the timing differences related to the pre-1981 flow-through property.

The TRA, therefore, agrees with both TAWC and the CAPD that, consistent with SFAS 109 and SFAS 71, regulatory asset accounts should be recognized when computing ADIT, and adopts the SFAS 109 approach to calculating income taxes, which recognizes regulatory assets in determining the ADIT balance. The TRA also agrees with TAWC that FIN 48 amounts represent a tax that the Company owes, with interest, as to previously filed tax returns. No documentation or justification was provided that the repairs deduction for federal income tax expense is uncertain or may not result in reversal. Further, there were no challenges made to the calculation of this FIN 48 amount. Therefore, the TRA concludes that the capitalized repairs deduction should not be used to reduce rate base. Thus, utilizing the regulatory assets in its determination of the ADIT balance and applying FIN 48, the TRA adopts Accumulated Deferred Income Tax in the amount of $22,638,057.

V(E)8. Customer Advances for Construction

Initially, TAWC and the CAPD disagreed as to the proper amount for Customer Advances for Construction. On February 8, 2011, although TAWC filed rebuttal testimony on its projected attrition period amount, which included exhibits, a discrepancy remained between TAWC's calculation and the CAPD's proposed amounts. On February 22, 2011, TAWC filed a revised exhibit that contained an updated amount of $5,786,757 for Customer Advances for Construction, but did not include any testimony to support the change.[680] Nevertheless these

[680] TAWC's Supplemental Revised Accounting Exhibits and Workpapers, Revised Exhibit No. 1, Schedule 2, p. 1 (February 22, 2011).

revisions demonstrate an agreement between the TAWC and CAPD on the amount. Based on a review of the financial data, and considering that the parties are now in agreement, and the reasons noted previously concerning the appropriate test period, the Authority adopts $5,786,757 as the total of Customer Advances for Construction.

V(E)9. CONTRIBUTIONS IN AID OF CONSTRUCTION

TAWC and the CAPD also initially disagreed regarding the amount to be used for Contributions in Aid of Construction ("CIAC"). On February 8, 2011, TAWC filed rebuttal testimony with exhibits, wherein TAWC's revised amount still differed from the amount projected by the CAPD. On February 22, 2011, TAWC filed a revised exhibit with an updated amount of $9,932,550 for CIAC, without any testimony to support the change.[681] With the second revision, TAWC and the CAPD agree as to the projected total. Considering the financial data, the fact that the parties are now in agreement, and the reasons noted previously as to the appropriate test period, the Authority adopts $9,932,550, as proposed by TAWC and the CAPD, for the CIAC amount.

V(E)10. UNAMORTIZED INVESTMENT TAX CREDIT ("UITC")

Initially, there was disagreement between TAWC and the CAPD regarding the proper amount to be used for Unamortized Investment Tax Credits. Nonetheless, on February 8, 2011, TAWC filed a rebuttal exhibit that contained an attrition period amount that is identical to that determined by the CAPD, but did not file supporting testimony.[682] Based on a review of the financial data, the fact that the parties are now in agreement, and reasons previously noted as to the appropriate test period, the TRA adopts $26,899 for Unamortized Investment Tax Credits.

V(E)11. UTILITY PLANT ACQUISITION ADJUSTMENT

The differences between the parties as to the Utility Plant Acquisition Adjustment are due

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[681] *Id.*
[682] Michael A. Miller, Pre-Filed Rebuttal Testimony, Exhibit MAM-9 (February 8, 2011).

to the use of different test periods. Upon review of the financial data and for the reasons previously noted regarding the appropriate test period, the Authority adopts $74,850 for Utility Plant Acquisition Adjustment.

V(F). REVENUE CONVERSION FACTOR

Based upon the CAPD's methodology, the panel adopts an overall Revenue Conversion Factor of 1.643037 for the attrition year, a Forfeited Discount Factor of 0.0081 to reflect the CAPD's Normalized Test Year Late Payment Penalty/CAPD's Normalized Test Year Total Sales of Water, an Uncollectible Factor of 0.0066 to reflect the CAPD's Normalized Test Year Uncollectibles/CAPD's Normalized Test Year Total Sales of Water, a state excise tax of 6.5%, and an FIT of 35%.

V(G). RATE OF RETURN

To establish a fair rate of return, the following three steps are performed: (1) determination of an appropriate capital structure; (2) calculation of the cost rates of each component of the capital structure: (i) short-term debt, (ii) long-term debt, (iii) preferred equity, and (iv) common equity; and (3) computation of the overall cost of capital using a weighted average of the component rates to account for the proportion of each component.[683]

TAWC requested an overall rate of return of 8.38%.[684] The Company's request was based upon the capital structure of TAWC. The Company proposed a capital structure for TAWC that consisted of: 51.386% long-term debt; 3.453% short-term debt; 1.126% preferred equity; 24.345% common equity in the form of common stock; and 19.690% common equity in the form of retained earnings.[685] TAWC proposed a short-term debt cost of 1.9% based upon market forecasts for 2011 and recent short-term debt rates from American Water Capital

[683] The legal basis on which the Authority determines a utility's fair rate of return is set forth in Section III, above.
[684] Michael A. Miller, Pre-Filed Direct Testimony, Exhibit MAM-5 (September 23, 2010).
[685] *Id.*

Corporation ("AWCC").[686] The proposed cost of long-term debt is 6.2% and includes a proposed $9 million debt offering at 6.212%, which is anticipated to be issued in late 2010, and an $8.0 million issue at 6.612% targeted for November 2011.[687]

In deriving its recommended cost of capital of 8.38%, TAWC claimed that its return on equity should be set at 11.5%, as it is within the range of equity returns suggested by Company witness Dr. Vander Weide.[688] Dr. Vander Weide used the Capital Asset Pricing Model ("CAPM") and the Discounted Cash Flow ("DCF") model to determine the appropriate cost of capital for TAWC.[689] Dr. Vander Weide also employed risk premium models based upon the required spread above a fixed income instrument, like a utility bond, to form his cost of equity recommendation.[690]

When choosing growth rates for use in the DCF analysis, Dr. Vander Weide used forecasts by stock analysts, rather than historical measures, in reliance on economic research suggesting that analyst forecasts are the best estimates of investors' expectations.[691] He also included a 5% allowance for flotation costs in his DCF analysis.[692]

Dr. Vander Weide used a sample of water companies and found that the average DCF cost of equity is 12.3%,[693] which was found to increase to 13.3% when the average is computed with weights based upon market capitalization.[694] When the DCF model is applied to his sample of natural gas utilities, the average cost of equity is 11.1%, and falls to 10.9% when calculated on a market weighted basis.[695] He proposed a cost of equity estimate of 11.2% using the ex post

[686] *Id.*
[687] *Id.*
[688] *Id.*
[689] Dr. James H. Vander Weide, Pre-Filed Direct Testimony, p.3 (September 23, 2010).
[690] *Id.* at 29.
[691] *Id.* at 18.
[692] *Id.* at 20.
[693] *Id.* at 25.
[694] *Id.* at 25-26.
[695] Dr. James H. Vander Weide, Pre-Filed Direct Testimony, p. 28 and Schedule 2-1 (September 23, 2010).

risk premium method.[696] Based upon the results of his DCF analysis of water and natural gas companies, and using an ex ante risk premium and ex post risk premium analysis, Dr. Vander Weide determined a cost of equity for TAWC is in the range of 10.9% to 12.3%[697]

Dr. Vander Weide criticized CAPD witness Dr. Klein's DCF analysis and claimed that it is inappropriate to use an annual DCF model instead of a quarterly DCF model.[698] Dr. Vander Weide further stated that the CAPD did not properly implement the DCF model because it did not adjust the current yield component of the calculation by the expected growth rate,[699] which, in his view, leads to an understatement of the cost of equity of 25 basis points.[700] He also criticized Dr. Klein's use of Value Line forecasts of dividend growth, asserting that they are inferior to analysts' estimates of earnings growth.[701] He argued that the CAPD should have used earnings growth estimates instead of dividend growth forecasts, claiming that earnings growth forecasts are more accurate.[702]

Dr. Vander Weide argued that the use of double-leverage is inconsistent with financial theory.[703] Additionally, TAWC witness Mr. Miller asserted that the use of double-leverage is inappropriate and could prevent the Company from recovering its true cost of capital.[704] Mr. Miller noted that Dr. Klein did not implement double leverage in the same way the TRA has done in previous TAWC rate cases.[705] Mr. Miller asserted that Dr. Klein used the stand-alone capital structure for TAWC, adjusted to impose the cost of capital for AWW Parent (i.e. a non-consolidated entity) to total equity of TAWC,[706] which, in Mr. Miller's opinion resulted in a

[696] *Id.* at 37.
[697] *Id.* at 44-45.
[698] *Id.* at 7-8.
[699] *Id.* at 8-9.
[700] Dr. James H. Vander Weide, Pre-Filed Rebuttal Testimony, pp. 8-9 (February 8, 2011).
[701] *Id.* at 9.
[702] *Id.* at 9-10.
[703] *Id.* at 24-30.
[704] Michael Miller, Revised Pre-Filed Rebuttal Testimony Amendment, p. 19 (February 17, 2011).
[705] *Id.* at 21-22.
[706] *Id.* at 18.

drastic decrease in the equity ratio of the capital structure relative to the approach adopted by the TRA in previous cases.[707] Mr. Miller further stated that the CAPD's use of a historical average capital structure is inappropriate because it is not consistent with the known and measurable test,[708] and that the CAPD's technique artificially inflates the impact of low-cost short term debt on TAWC's capital structure.[709]

As stated above, CAPD witness Dr. Chris Klein utilized a double-leverage methodology that imputed the capital structure and associated cost of capital of TAWC's parent AWWC to the equity portion of TAWC's capital structure.[710] Dr. Klein recommended using the historical capital structures of both TAWC and AWWC in his double-leverage calculation.[711] Dr. Klein's historical capital structure for TAWC contains 6.45% short-term debt, 48.71% long-term debt, 1.24% preferred stock and 43.6% equity.

Dr. Klein adopted the costs of short-term debt, long-term debt, and preferred stock for TAWC, as was proposed by Company witness Mr. Miller,[712] and posited the cost of long-term debt for TAWC's parent to be 6.27%.[713] The CAPD estimated the cost of equity for AWWC using the familiar DCF and CAPM models. Like TAWC witness Dr. Vander Weide, Dr. Klein used proxy groups from both the water and natural gas industry.[714]

For his DCF estimates, Dr. Klein uses historical dividend data to estimate dividend growth of 5% for AWWC.[715] Using the dividend yield range of 3.5% to 3.7%, Dr. Klein computes DCF cost of equity estimates for AWWC with a range of 8.5% to 8.7%.[716] Dr. Klein

[707] *Id.* at 21-22.
[708] *Id.* at 25.
[709] *Id.*
[710] Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, p. 5 (January 24, 2011).
[711] *Id.*
[712] *Id.*
[713] *Id.* at Corrected Exhibit p. 2 of 19; *see also* Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, p. 9 (January 24, 2011).
[714] Dr. Christopher C. Klein, Corrected Pre-Filed Direct Testimony, pp. 10-11 (January 24, 2011).
[715] *Id.* at 12.
[716] *Id.*

indicates that the "... minimum DCF cost of equity for AWWC is approximately 8.6%. This is similar to the midpoint of the DCF range for natural gas utilities (8.65%) and just lower than the midpoint for large water companies (9.1%)."[717]

For the CAPM, Dr. Klein selects his proxy for risk-free interest rates to be the yield on 5 year Treasury bonds which was 2.1% at the time his testimony was filed.[718] Dr. Klein sets the market risk premium at 7.1% using data taken from the familiar 2010 Ibbotson SBBI Stocks, Bonds, Bills and Inflation Valuation Yearbook. Dr. Klein indicates that the BETA statistic of AWWC, as reported by Value Line, is 0.65.[719] Using this data, Dr. Klein calculates an equity return of 6.72% for AWWC. Dr. Klein notes that "... the comparable water and natural gas utilities all have very similar CAPM cost of equity estimates between 6.36% and 7.78%."[720] Dr. Klein notes that current low interest rates may lead to an understatement of the required equity return.[721] Dr. Klein further notes that there is some evidence that the CAPM may underestimate the cost of equity for firms, like utilities, that have BETA statistic less than one.[722] Dr. Klein observes that it is reasonable to expect that the cost of equity for utilities is still less than the market portfolio (BETA =1) which he calculates as 9.2%.[723]

Dr. Klein ultimately recommends a 9.0% ROE for AWWC as it is the midpoint of the range his CAPM and DCF estimates taken as a group.[724] Dr. Klein also notes that his 9.0% equity return recommendation is within the bounds of his DCF estimates for water utilities (9.1%) and natural gas utilities (8.65%).[725]

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[717] *Id.*
[718] *Id.* at 14-15.
[719] *Id.* at 7 of 19.
[720] *Id.* at 15.
[721] *Id.*
[722] *Id.*
[723] *Id.* at 14-15.
[724] *Id.* at 15-16.
[725] *Id.*

Dr. Klein disputed several of the conclusions reached by Dr. Vander Weide. First, Dr. Klein stated that some of the companies used in TAWC's comparison group were not representative of TAWC or AWWC.[726] He also took issue with the risk premium analysis that formed the basis of TAWC's CAPM estimates. He questioned TAWC's reliance on long-term Treasury bonds, which, he stated introduces interest rate risk and, thus, cannot be risk free.[727] Finally, Dr. Klein criticized TAWC's use of quarterly dividend payments and flotation costs.

CRMA Witness, Mr. Gorman, noted that the TRA has a long-standing practice of using a double-leveraged capital structure in setting TAWC's overall cost of capital.[728] Mr. Gorman argued that TAWC's requested 11.5% equity return is not reasonable relative to the 10.2% equity return awarded in the last rate case.[729] To support his argument, Mr. Gorman provided data to show that authorized returns on equity for electric and gas utilities, as well as utility bond yields on "A" and "Baa" rated instruments, have decreased since TAWC's last rate filing.[730]

The Union suggested that TAWC's equity return should be penalized if it does not maintain the staffing levels established by the TRA. Mr. Lewis opined, ". . . [if] the Company fails to maintain a workforce level consistent with its authorized level, absent a showing of exigent circumstances, TAWC should be subject to a penalty. The penalty, could, for example, take the form of a reduction in the return on equity component of its rates."[731]

V(G)1. <u>Capital Structure</u>

The TRA traditionally recognizes the importance of the parent-subsidiary relationship when determining capital structure. To reflect the relationship between TAWC and its parent company, the panel uses double-leverage capital structure methodology. The TRA was not persuaded by the Company's witnesses, Dr. Vander Weide's and Mr. Miller's, criticism of the

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726 *Id.* at 16-17.
727 *Id.* at 17-18.
728 Michael Gorman, Pre-Filed Direct Testimony, p. 22 (January 5, 2011).
729 *Id.*
730 *Id.*
731 James Lewis, Pre-filed Direct Testimony (Public Version), p. 20 (January 5, 2011).

use of the double-leverage methodology. The Company failed to offer any new arguments in this case that would persuade the Authority to depart from its well-established precedent.

To implement the double-leverage calculation, it is necessary to determine the elements of TAWC's capitalization that are held by AWWC and those held by outside parties. In making these calculations, the TRA adopts the calculation of Mr. Miller that 6.81% of TAWC's capitalization is debt held by entities outside the AWWC corporate family. The next step in implementing the double-leverage methodology is to determine the capital structure of the TAWC's parent company, AWWC. The calculated historical capital structure for AWWC, set forth by CAPD Witness Dr. Klein, is deemed to be the appropriate structure to use in this proceeding.[732] Therefore, the TRA finds that the capital structure for AWWC is composed of 2.63% short-term debt, 53.13% long-term debt, 0.25% preferred stock, and 43.99% common equity. Given the impact of the crisis in the financial markets, the use of a historical capital structure for AWWC will be more reflective of its long run capital structure than using a single point in time to determine its capital structure.

V(G)2. <u>Cost of Debt</u>

TAWC witness Mr. Miller's approach of measuring spreads between the Federal Funds rate and rates for outstanding short-term debt and then applying those spreads to forecasts of the Federal Funds rate, is inherently reasonable and provides a mechanism for incorporating prospective changes in often volatile short-term interest rates into the rate-setting process. Mr. Miller used the same approach in forecasting short-term debt rates as was used in the previous TAWC rate case. CAPD witness Dr. Klein deemed Mr. Miller's estimates to be reasonable for use in his own analysis. Thus, the TRA adopts a short-term debt rate of 1.9% for use in this proceeding. Additionally, the panel adopts a long-term debt rate of 6.27% as proposed by Dr. Klein, who concluded that this percentage represents that 6.27% is the embedded cost of

[732] Dr. Christopher C. Klein, Corrected Pre-filed Direct Testimony, Corrected Exhibit p. 4 of 19 (January 24, 2011).

AWWC's debt. The rate is very similar to the 6.2% figure for the subsidiary, TAWC, which would be expected to have a cost of debt that is very similar to that of its parent.

V(G)3. Return on Equity

Finally, the last piece of information needed to determine the weighted cost of capital for AWWC is the appropriate equity return. TAWC requested an 11.5% equity return. CAPD witness Dr. Klein proposed a 9% equity return. CRMA witness Mr. Gorman does not make a specific recommendation, but he argued that the Company's requested return is unreasonable. There is no simple single-step process for setting the appropriate equity return. Therefore, the TRA looks at the results of the parties' models, prevailing economic conditions, and other factors that may provide evidence about the risk of investing in either AWWC or TAWC.

The TRA considered the CAPM result for AWWC. For its CAPM calculation, the Authority adopts a risk-free return of 4.75% for use in the CAPM calculation as proposed by Dr. Vander Weide and used in his CAPM analysis. For the market risk premium, the Authority uses the 7.1% long-run risk premium produced by Ibbotson Associates and referenced by Dr. Klein. This risk premium statistic is slightly below the mid-point of the two risk premium statistics, 6.7% and 7.75%, used by Dr. Vander Weide in his CAPM analysis. Finally, the Authority uses the Beta value of 0.65 for AWWC found in Dr. Klein's testimony. With the information described above, the result is an equity return for TAWC's parent of 9.4%, which is 80 basis points below the 10.2% equity return adopted by the TRA in the last TAWC rate case. This figure increases to 9.8% when using the Beta statistic used in Dr. Vander Weide's analysis. The TRA considers the 9.4% equity return estimate to be a useful floor in setting the equity return in this proceeding.

The TRA disagrees with Dr. Vander Weide's complete rejection of the CAPM and finds that the low Beta statistics associated with comparable companies and AWWC, provides useful information as to the risk of water companies relative to the market. While both witnesses assert that the CAPM may underestimate the cost of equity for firms with low Beta statistics, the TRA has used the CAPM with such values in the past and no new theory or empirical evidence has been presented to discourage the TRA from adopting the practice again in this case.

The Authority does not adopt Dr. Vander Weide's use of the quarterly DCF model, and instead uses the simple annual DCF model because unlike the quarterly model, the annual model does not inflate the implied cost of equity. The Authority does not adopt the ex ante and ex post risk premium results reached by Dr. Vander Weide because they are not specific to AWWC, the water proxy group, or the natural gas proxy group upon which he based his analysis. The TRA and its predecessor, the Tennessee Public Service Commission, have rejected adding flotation costs to the return on equity when there is no accompanying stock issuance.[733] During the hearing, TAWC witness Mr. Miller indicated that he is unaware of an offering by AWW.[734] According to TAWC, it planned to issue $0.622 million and $2 million in equity in both 2011 and 2012, respectively.[735] Since AWW holds the common stock of TAWC, the equity issuance is an internal transaction and, therefore, it is not necessary to include flotation costs.

The Authority does not agree with the CAPD's CAPM calculations because CAPD used short-term interest rates as a proxy for risk-free return. Instead, the Authority prefers to use longer-term interest rates as a proxy for risk-free return as it more closely matches the expected life of a security, such as a stock or an investment in utility plant. Further, short-term interest rates are likely to increase from the current unprecedented low levels that have been set by the Federal Reserve to combat the recent economic downturn.

TAWC witness Mr. Miller suggested that there has been a predictable spread between A-rate utility bonds and equity returns awarded by state commissions. Using this relationship,

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[733] *See In re: Petition of Chattanooga Gas Company for Approval of Adjustment of its Rates and Charges and Revised Tariff*, Docket No. 04-00034, *Order*, pp. 57-58 (October 20, 2004).
[734] Transcript of Proceedings, Vol. VI B, pp.171-172 (March 7, 2011).
[735] TAWC's Responses to the TRA's Data Requests Dated September 20, 2010, Question 82 (October 4, 2010).

based on current bond rates, Mr. Miller calculated a 10.36% equity return if the average spread is maintained.[736] The Authority finds Mr. Miller's testimony to be useful in setting the equity return, as it provided useful information on equity returns awarded to comparable companies. Mr. Miller calculated the average equity return awarded since June 2009 to AWWC subsidiaries to be 10.36%.[737] When restricting Mr. Miller's analysis to decisions with orders issued in 2010, the average awarded equity return decreased to 9.95%. In the most recent decision listed in Mr. Miller's exhibit, Kentucky American was awarded a 9.7% return on December 14, 2010.[738]

Given the range of equity estimates provided by the witness and recent decisions reached by other state regulatory commission, the Authority adopts a 10% equity return in this proceeding. Relative to the last TAWC rate proceeding, AWWC has become less risky as measured by its Beta statistic, thus implying that the required equity return has decreased since the last case. While the most recent decision in the Kentucky American case was a 9.7% equity return, the TRA is concerned that interest rates will generally be increasing as government monetary policy normalizes.

The Authority rejects the Union's suggestion that equity return be adjusted if employment levels fall below the level authorized by the TRA. First, many factors outside the control of TAWC, such as retirements, can alter employment levels. The Company demonstrated at the Hearing that a lengthy process is required to hire for union positions, which can result in vacancies and could result in further delays in meeting authorized employment levels. Secondly, altering base rates to account for employment levels will be costly to implement. Finally, the Authority was concerned that implementing an equity return adjustment

[736] Michael A. Miller, Pre-Filed Rebuttal Testimony, Rebuttal Exhibit MAM-5 (February 8, 2011).
[737] *Id.*
[738] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2010-00036, Kentucky Public Service Commission, *Order*, p. 71 (December 14, 2010).

to employment levels might introduce inefficiencies into the operations of TAWC by requiring the Company to maintain specific employment levels even when not warranted.

Based on its analysis of relevant debt and equity costs, The Authority determines that an equity return of 10% and overall cost of capital of 7.83% based upon a double-leveraged capital structure is just and reasonable.[739]

V(H). Revenue Deficiency

Based upon the preceding findings, a majority of the panel[740] determines that the Revenue Deficiency is $5,551,013 for the attrition period.[741]

V(I). Rate Design

The Company requested a $9.984 million increase in annual revenues, which is approximately equal to a 26.77% increase in rates. The requested rates would increase the Chattanooga tariff rates, the Lakeview tariff rates, and the Lookout Mountain tariff rates.[742] With few exceptions, the base rate for these areas would increase approximately 27% to 28%. The Company also recommended merging the mountain-serving areas into one tariff to reflect the similar characteristics of those areas.[743] The proposed volumetric usage increases vary greatly for these three locations depending on the service area and rate band.[744] The Company requested that tariff rates be established for Suck Creek and Lone Oak.[745] In addition, the Company recommended that it be allowed to merge the tariffs for Lone Oak and Suck Creek into the Mountain Tariff by adopting the basic blocking structure and volumetric rates.[746]

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[739] Director Roberson dissented and voted that the return on equity be set at 9.65% and an overall rate of return of 7.68%. This would reduce the revenue increase necessary by $282,961. Transcript of Proceedings, p. 76 (April 4, 2011).
[740] Director Roberson dissented from the majority's calculation of the dollar amount, but agrees with the methodology used to perform the calculation.
[741] Director Roberson voted to adopt a revenue deficiency for the Company of $4,242,134, thereby reducing the total rate increase from 14.76% to 11.29% for customers. Transcript of Proceedings, p. 76 (April 4, 2011).
[742] John S. Watson, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).
[743] Paul R. Herbert, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).
[744] *Petition*, Exhibit No. 4, Schedule 2 (September 23, 2010).
[745] John S. Watson, Pre-Filed Direct Testimony, p. 4 (September 23, 2010).
[746] Paul R. Herbert, Pre-Filed Direct Testimony, p. 11 (September 23, 2010).

Further, the Company requested that individual rates be set for four large resale customers that receive service under special contracts approved by the TRA. The sale for resale customers are the Town of Signal Mountain, Tennessee, Walden's Ridge Utility District, Tennessee, City of Fort Oglethorpe, Georgia, and the Catoosa Utility District Authority, Catoosa County, Georgia.[747] The CAPD asserted that ". . . any change in revenue requirements ordered by the TRA in this docket [should] be spread uniformly to all customer classes and customer locations."[748]

Following the initial announcement by TAWC and the CRMA on February 28, 2011 that a settlement had been reached between them, the CRMA later submitted a summary of the proposed settlement agreement during the conclusion of the hearing on March 8, 2011, a copy of which was attached to that day's transcript [749] The settlement agreement proposed to increase the meter charges and volumetric rates of TAWC's small industrial customers, while, in turn, decreasing the meter charges and volumetric rates of larger industrial customers. The settlement affirmed that the other parties actively involved in this case do not object to the proposed settlement. As proposed, the settlement agreement applied exclusively between TAWC and the members of the CRMA. In its petition to intervene, the CRMA stated that it represents ". . . 250 manufacturers and businesses supporting and servicing the local area's manufacturing sector."[750]

On March 25, 2011, a *Notice of Convening Panel* was issued, providing public notice that the panel would be convening on April 4, 2011 to deliberate the merits of the *Petition.*[751] During the proceedings held on April 4, 2011, as to the proposed settlement agreement, the panel determined that not all industrial customers of TAWC were also members of the CRMA, and that filing the proposed settlement during the hearing did not provide adequate notice or

[747] John S. Watson, Pre-Filed Direct Testimony, p. 3 (September 23, 2010).
[748] Terry Buckner, Pre-Filed Direct Testimony, pp. 62-63 (January 5, 2011).
[749] *Summary of Settlement between CRMA and TAWC* (March 28, 2011).
[750] *Petition to Intervene by the Chattanooga Manufacturers Association* (October 4, 2010).
[751] *Notice of Convening Panel* (March 25, 2011).

opportunity for response to non-members. In addition, the settlement was submitted late during the hearing proceedings, and neither party had presented a witness to testify as to the terms and conditions of the settlement, thereby preempting an opportunity for the Authority to ask questions concerning the proposed settlement agreement.[752]

While it appeared that the proposed settlement would likely be revenue neutral within the industrial class of consumers, except insofar as it seems that smaller users will absorb a higher percentage of the revenue increase than larger users, the panel was not able to determine its effects on individual users within the class. This issue had not been discussed by the parties, and the proposals included within the settlement were not raised during the discovery process. TAWC is the only party that provided testimony as to possible rate designs, but its testimony related more to what a minimal impact its requested rate increase would have on existing customers and did not provide a comparison of rates or a proper distribution of any potential revenue changes.

After due consideration and review of the record, the Authority declined to approve the proposed settlement because it was filed improperly as an exhibit, failed to include necessary information as to the structure and impacts of the proposals therein, and was designed to affect only rates within the industrial customer class.[753] As a result, the Authority requested that the Company file two separate price-out tariffs that reflected the impacts of the proposed rate results and approved revenue changes: one tariff that demonstrated the impacts to rates in the event that the settlement agreement was denied, and one tariff that showed the impacts to rates should the panel approve the settlement agreement.[754] On April 6, 2011, TAWC filed both price-out tariffs as ordered by the Authority.

[752] The parties later filed a *Summary of Settlement between CRMA and TAWC* in the docket file on March 28, 2011.
[753] Transcript of Proceedings, pp. 8-9 (April 4, 2011).
[754] *Id.* at 84.

On April 7, 2011, the UWUA filed an objection to the tariffs and asserted that both of the proposed tariffs failed to incorporate the reporting conditions related to staffing and valve maintenance issues that had been previously ordered by the Authority during its April 4, 2011, Authority Conference. On April 14, 2011, TAWC filed its response in opposition to the UWUA's objection. During its regularly scheduled Authority Conference held on April 18, 2011, the Authority overruled the UWUA's objection to the tariffs with regard to TAWC's failure to incorporate staffing and valve maintenance reporting requirements, and based on TAWC's agreement with a request by the UWUA, the panel ordered that the semiannual staffing and valve maintenance reports be filed on April 5th and October 5th of each year. The panel reasoned that the reporting requirements will be included in the Final Order and it is inappropriate and contrary to past practices of the TRA to include such terms in the tariff. Subsequently, the Authority approved the proposed settlement agreement filed by the CRMA and TAWC and the filed tariff that reflected the terms of the settlement agreement.[755]

Next, the Authority denied the Company's originally proposed tariff and ordered the Company to file a new tariff within thirty (30) days with new rates sufficient to produce incremental revenues in the amount of the revenue deficiency, as noted above. The Authority ordered that the tariff filing must be accompanied by a detailed price-out reflecting the new rates based upon attrition year billing determinates and accurately producing incremental revenues in the amount of the revenue deficiency approved by the Authority when compared to attrition year billing determinates at current rates.

IT IS THEREFORE ORDERED THAT:

1. The rates filed by the Tennessee American Water Company on September 23, 2010, are denied.

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[755] Director Kyle voted against the settlement agreement and moved to adopt the tariff to reflect an across-the-board increase to all customer classes and individual rates. Transcript of Proceedings, p. 12 (April 18, 2011).

2. For purposes of the rates set forth herein:

(a) The test period utilized shall vary according to the Authority's determinations herein as to the period that best fits each of the individual items being forecasted.

(b) The attrition period shall be for the twelve months ended December 31, 2011.

(c) The rate base is set at $118,459,808 and the net operating income is $5,937,860 at current rates.

(d) Capitalization of debt held by parties outside of the American Water Works Company, the corporate parent of Tennessee American Water Company, system is 6.81%, with a cost of 8.30%.

(e) The capital structure for American Water Works Company is composed of 43.99% common equity, 53.13% long-term debt, 2.63% short-term debt, and 0.25% preferred stock.

(f) An equity return of 10%[756] and an overall rate of return of 7.83% based upon a double-leveraged capital structure, are just and reasonable and hereby set for Tennessee American Water Company.

3. The Revenue Conversion Factor is 1.643037, and results in a Revenue Deficiency of $5,551,013, which allows the Company an opportunity to earn a fair return on its investment during the attrition year.[757]

4. The Revenue Deficiency shall be implemented by uniform percentage increases to base rates and volumetric rates for all customer classes.

5. (a) Tennessee American Water Company shall submit semi-annual staffing level reports to the Utility Division Chief on April 5th and October 5th of each year. Such reports shall include (1) the actual number of full-time equivalent employees for the previous period, by

[756] Director Roberson dissented from the decision of the majority of the panel.
[757] Director Roberson dissented from the decision of the majority of the panel.

month, (2) an explanation concerning any differences between the authorized and actual full-time equivalent employees, and (3) a date by which Tennessee American Water Company expects to fill any vacant positions.

(b) Tennessee American Water Company shall also semi-annually report to the Utility Division Chief concerning the progress of its valve operation and maintenance program. The report shall include (1) the current number of employees assigned to the valve program, by month, (2) the number of larger and smaller valves targeted for inspection, operation, and maintenance during the previous period, by month, (3) the number of valves actually inspected, operated, and maintained during the current period, by month, (4) the number of valves discovered or known to be in need of repair or replacement, by month, (5) the date of repair or replacement of such valves, and (6) in the event that Tennessee American Water Company did not to repair or replace certain valves, the number of valves that were not repaired or replaced and a detailed explanation of the reason(s) that action was not taken.

6. Tennessee American Water Company is hereby directed to file a tariff with the Authority that implements recovery of $275,000 in regulatory expense through a separate line item charge that will be reflected on customer bills in all customer classes for a six-month period and will automatically cease upon full recovery.

7. Tennessee American Water Company is hereby directed to file with the Authority tariffs that produce an increase of $5,551,013 in incremental revenues for service rendered, and any other tariffs necessary and consistent with this Order.

8. All tariffs shall be filed within thirty days.

9. Any party aggrieved by the decision of the Tennessee Regulatory Authority in this matter may file a Petition for Reconsideration within fifteen days of the date of this Order.

10. Any party aggrieved by the decision in this matter has the right to judicial review by filing a Petition for Review in the Tennessee Court of Appeals, Middle Section, within sixty

days of the date of this Order.

Mary W. Freeman, Chairman

* * *

Eddie Roberson, Director[758]

Sara Kyle, Director

[758] Director Roberson declined to vote with the majority in granting TAWC a revenue requirement in the amount of $37,614,978 for the reasons set forth in his *Concurrence and Dissent of Director Eddie Roberson* filed herewith. Director Roberson voted with the majority in approving the rate design as set forth above.

STATE OF NEW JERSEY

Board of Public Utilities
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WATER

IN THE MATTER OF NEW JERSEY AMERICAN WATER COMPANY FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE, CHANGE IN DEPRECIATION RATES AND OTHER TARIFF MODIFICATIONS	)	ORDER ADOPTING INITIAL DECISION/STIPULATION DOCKET NOS. BPU WR15010035 AND OAL PUC 01166-15

Parties of Record:

Ira G. Megdal, Esq. and Stacey A. Mitchell, Esq., Cozen O'Connor on behalf of New Jersey-American Water Company, Inc., Petitioner
Stefanie A. Brand, Esq., Director, on behalf of the Division of Rate Counsel
Steven B. Genzer, Esq., Saul Ewing LLP, Intervenor, on behalf of Aqua New Jersey, Inc.
Bradford M. Stern, Esq., Intervenor, on behalf of Cogen Technologies Linden Venture L.P., Phillips 66 Company, Johanna Foods, Inc., Princeton University and Rutgers, The State University of New Jersey
Anthony R. Francioso, Esq., Fornaro Francioso, Intervenor, on behalf of the Mount Laurel Township Municipal Utilities Authority
James H. Laskey, Esq., Norris McLaughlin & Marcus, P.A. Intervenor, on behalf of the Manasquan Customer Group
Jay L. Kooper, Esq., Intervenor, on behalf of Middlesex Water Company
William R. Holzapfel, Esq., Intervenor, on behalf of the City of Elizabeth
Stuart A. Platt, Esq., Platt & Riso, P.C., Intervenor, on behalf of the Township of Haddon

BY THE BOARD:[1]

On January 9, 2015, New Jersey-American Water Company ("Company" or "Petitioner"), a public utility of the State of New Jersey filed with the Board of Public Utilities ("Board") pursuant to N.J.S.A. 48:2-18, N.J.S.A. 48:2-21, N.J.S.A. 48:2-21.1[2], N.J.A.C. 14:1-5.7 and N.J.A.C. 14:1-5.12, a petition ("Petition") seeking to increase rates for water and wastewater service. The combined proposed rates would increase the Company's annual revenues by $66.2 million or

[1] Commissioners Richard S. Mroz and Uprenda J. Chivukula recused themselves due to a potential conflict of interest and as such took no part in the discussion or deliberation of this matter.
[2] The Board notes that although the petition cites N.J.S.A. 48:2-21.1, the petition does not include a request for an adjustment of rates during the pendency of the hearing.

approximately 9.96% over pro-forma present rate revenues. The Petitioner also sought to roll in to rate base the assets related to the Company's current Distribution System Improvement Charge ("DSIC") program and reset the DSIC rate to $0. The Company also proposed that it would separately be making a new Foundational Filing and requested it be effective concurrent with the new base rates herein established.

In the Petition, the Company proposed a test-year ending July 31, 2015. The Petition as originally filed was based upon four (4) months of actual and eight (8) months of estimated data,[3] which was subsequently updated on March 2, 2015 based on six (6) months actual and six (6) months estimated data. As the case progressed, the estimated data were replaced by actual data, and on April 17, 2015, the Company filed its update consisting of eight (8) months of actual data. The Company filed an additional update consisting of twelve (12) months of actual data on August 12, 2015.

The following Parties were granted intervention status - Rutgers, The State University (filed February 9, 2015); Princeton University (filed February 9, 2015); Phillips 66 Company (filed February 9, 2015); Johanna Foods, Inc. (filed February 9, 2015); and Cogen Technologies Linden Venture, L.P. (filed February 19, 2015) (collectively, the "Optional Industrial Wholesale Customer Coalition" or "OIW"); Manasquan Customers Group ("MCG") (filed February 12, 2015); Middlesex Water Company ("Middlesex") (filed February 13, 2015); Township of Haddon (filed February 23, 2015); Mount Laurel Township Municipal Utilities Authority ("MLTMUA") (filed February 25, 2015); Aqua New Jersey, Inc. ("Aqua") (filed April 30, 2015); and City of Elizabeth ("Elizabeth") (filed May 19, 2015). These motions were granted by Orders dated April 17, 2015 (as to OIW, Middlesex, MLMUA, MCG and Township of Haddon). By letter dated June 5, 2015 the Township of Haddon withdrew its Motion to Intervene in this proceeding.

By this Order, the Board considers the Initial Decision recommending adoption of the Stipulation of Settlement ("Stipulation") executed by the Company, the Division of Rate Counsel, OIW, MCG, MLTMUA, Aqua, Elizabeth, and Board Staff (collectively the "Signatory Parties"), agreeing to an overall increase in revenues in the amount of $22,000,000 representing a 3.59% increase[4] over Company revenues totaling $612,919,006. The Signatory Parties propose that these rates will be effective on September 21, 2015. The remaining party, namely Middlesex submitted a letter not objecting to the Stipulation.

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[3] Board Staff and Rate Counsel do not agree that a water filing may be based upon four months of actual and eight months of estimated data. Board Staff and Rate Counsel believe that the filing must be based upon a minimum of five months of actual data. See: In Re Elizabethtown Water Co. Rate Case, Docket No. WR850433085 (May 23, 1985).

[4] The overall percentage increase of 3.59% excludes the impact of the PWAC/PSTAC, but includes DSIC. As set forth in the stipulation, the percentage increase including the PWAC/PSATC and DSIC would be 3.32%. Furthermore, the Company is aware that its new Foundational Filing, submitted June 12, 2015 in Docket No. WR15060724 must be approved by the Board before any new DSIC investment and/or DSIC rate recovery can occur and that the DSIC rate shall be reset to zero at the conclusion of this base rate case.

BACKGROUND/PROCEDURAL HISTORY

Petitioner serves approximately 612,791 water and fire service customers and approximately 35,987 sewer service customers in all or part of 189 municipalities in 18 of the State's 21 counties. The increase in rates was proposed to become effective on February 8, 2015. On January 14, 2015, the Company filed a letter with the Board stating that it will not implement rates on an interim basis prior to March 18, 2015. By Order dated February 11, 2015, with an effective date of February 21, 2015, the Board suspended the Company's proposed rate increase until June 8, 2015, and by Order dated June 17, 2015, with an effective date of June 27, 2015, the Board further suspended the Company's proposed rate increase until October 8, 2015.[5] The Petitioner did not seek interim rate relief pending final determination on the Petition.

According to the petition, the rate increase is required to enable the Petitioner to establish an income level that will permit the Company to finance essential and continuing plant investment; to permit the Company to earn a fair and adequate rate of return on its net investment in used and useful property; to establish rates which will be sufficient to enable the Company to maintain and support its financial integrity; to offset increases in operating expenses; to provide earnings sufficient to attract investors and provide sufficient cash flow to fund the Company's operations; and to enable the Company to provide safe, adequate and proper service to its customers.

This matter was transmitted to the Office of Administrative Law ("OAL") on January 23, 2015, and was assigned to Administrative Law Judge ("ALJ") Barry E. Moscowitz. ALJ Moscowitz conducted a pre-hearing conference on February 25, 2015, and on March 9, 2015, ALJ Moscowitz issued a pre-hearing Order establishing procedures, as well as evidentiary and public hearing dates for the conduct of this case. A first amended prehearing order was issued on April 15, 2015.

Pursuant to appropriate notice in newspapers of general circulation within the Company's service territory, and the serving of notice upon affected municipalities and counties within the Company's service area, four public hearings were held. Two public hearings were held on April 21, 2015 at 2:00 PM in Ocean City, New Jersey and at 6:00 PM in Westampton, New Jersey; one public hearing was held on April 22, 2015 at 2:00 PM in Howell Township, New Jersey; and one public hearing was held on April 23, 2015 at 7:00 PM in Mount Olive, New Jersey. Members of the public attended and spoke at the Howell Township and Mount Olive public hearings, and the comments generally involved opposition to rate increases, adverse economic impact and financial hardships that any increase would have on the average Company ratepayer, particularly those on a fixed income. No members of the public attended the Ocean City or Westampton public hearings.

Subsequent to the public hearings, the Parties to the proceeding engaged in settlement negotiations. As a result of these discussions and extensive discovery, the Signatory Parties reached a Stipulation on all issues. On August 13, 2015, Middlesex submitted a letter neither opposing nor adopting the Stipulation among the Signatory Parties.

[5] By letter dated May 11, 2015, the Company stated that it would not seek to implement rates prior to the effective date of the Board's Further Suspension Order resulting from the June 17, 2015 Board agenda meeting.

On August 21, 2015, ALJ Moscowitz issued his Initial Decision in this matter recommending adoption of the Stipulation executed by the Signatory Parties, finding that the Signatory Parties had voluntarily agreed to the Stipulation and that the Stipulation fully disposes of all issues and is consistent with the law.

DISCUSSION AND FINDINGS

Among the provisions of the Stipulation,[6] the Signatory Parties recommend the Company's base rates should be increased by $22,000,000 representing a 3.59% increase over Company revenues totaling $612,919,006. The Signatory Parties further recommend a rate base of $2.39 billion, with a test year ending July 31, 2015, adjusted for known and measurable changes, and that the Company be authorized a return on equity of 9.75%. The overall rate of return is 7.55% calculated by using the Company's current capital structure consisting of 52.00% common equity and 48.00% long-termed debt ratios.

The Signatory Parties to this Stipulation agree that the $22.0 million revenue increase set forth earlier in this Stipulation of Settlement reflects a consolidated tax adjustment to rate base due to the Company's affiliation with a parent company and the filing of a consolidated federal income tax return.

The Signatory Parties also further recommend the following:

- The Company incurred rate case expenses for this proceeding. Said rate case expense will be shared 50/50 between the Company and ratepayers, and normalized over two and one half years.

- The depreciation rates to be utilized by the Company as a result of this Stipulation reflect the updating of the Company's previously approved depreciation rates to adjust the net salvage allowance component. The net salvage allowance is being reduced by $3 million, from $6,417,876 as approved in Board Docket No. WR11070460 to $3,417,876. The newly adjusted depreciation rates for water and the previously approved and unadjusted sewer depreciation rates are attached as Schedule B to the Stipulation.

- The Company sought ratemaking recognition in rate base and on the income statement for the acquisition of the Haddonfield Water and Wastewater Systems (the "Acquisition"). The Acquisition did not close until more than four months after the current rate case was filed. It is therefore agreed that the Parties have not had enough time to fully evaluate the Acquisition. As a result, the Company agrees to withdraw its request for ratemaking recognition of the Acquisition, without prejudice. It may be renewed in a future base rate case proceeding, and if the Company demonstrates that the purchase price for the Acquisition was reasonable and prudent in such future proceeding, the Signatory Parties will agree to ratemaking recognition to the extent that reasonableness and prudence is demonstrated.

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[6] Although described in the Order at some length, should there be any conflict between this summary and the Stipulation, the terms of the Stipulation control, subject to the findings and conclusions in this Order.

Pursuant to the Stipulation, the customer revenue rate impacts are as follows:

Class Revenue Increases:

The Signatory Parties stipulate the General Metered Service ("GMS") rates for a typical residential customer using 6,000 gallons per month (includes PWAC) for Service Area-1 ("SA-1") shall increase by $1.59 per month; for SA-2, SA-3 Main, SA-1A by $3.15 per month; for SA-2 Manville by $3.71 per month; for SA-3 Southampton by $4.60 per month; for SA-1B Pennsgrove by $4.21 per month; and for SA-1D by $4.19 per month. Rates of commodity-demand shall increase 0.03% overall. Rates for the OIW customers will increase 4.30% overall. Rates for the Manasquan customers shall increase approximately 2.00% overall. Rates for the Sales to Other Systems ("SOS") customers will increase 4.35% overall.

Private Fire Protection Service:

The overall revenue increase for Private Fire Protection Service is 2.90%. The rate increases will vary within the rate classification depending upon the rate schedules and the type of service contracted for.

Public Fire Protection Service:

The overall revenue increase for Public Fire Protection Service is 1.85%. The rate increases will vary within the rate classification depending upon the rate schedules and the type of service contracted for.

Customer Charges (Fixed Service Charges):

The monthly customer charges for all service areas will be set at $13.60 per month (non-exempt) for a ⅝ inch meter.

Sewer Service Revenue:

The Signatory Parties stipulate that sewer service revenues for the Company's Adelphia Sewer Service Area, the Lakewood Sewer Service Area, the Ocean City Service Area and the Haddonfield Sewer Service Area will have no increases. The Signatory Parties stipulate that the Pottersville-Flat Rate as well as the Pottersville-Volumetric rate will decrease 47.10% and 46.59% respectively to $1,185.60 per year. Jensen's Deep Run sewer customers with an average residential customer using 36,000 gallons annually will see an increase of $1.44 or 0.26% per year. Homestead Volumetric Rate with an average residential customer using 36,000 gallons annually will see a decrease of $46.20 or (5.05%) to $868.80 per year.

Applied Community On-Site Wastewater Systems:

The Applied Community On-Site Wastewater Systems rate decreases within the rate classifications are as follows:

Applied Class B/Flat - 19.45% decrease to $1,185.60 annually
Applied 2BR Class A/Flat -13.78% decrease to $974.40 annually
Applied 1BRTH Class A/ Flat - 12.20% decrease to $974.40 annually
Applied 2BRTH Class A/ Flat - 16.29% decrease to $974.40 annually
Applied Class A/Volumetric - 16.84% decrease to $974.40 annually
Applied Class B/ Volumetric – 26.14% decrease to $1,185.60 annually

After the Initial Decision was issued, it was discovered that Schedule E, attached to the Stipulation and adopted by ALJ Moscowitz in his Initial Decision, had a few minor typographical errors. These errors did not affect the rates or the terms of the Stipulation. The corrected schedule is attached hereto and noted as revised. All Parties have been notified of the change to Schedule E.

The Board is mindful of the impact any rate increase has on its customers. However, having reviewed the record in this matter, including ALJ Moscowitz's Initial Decision, the Stipulation, and letter from the Non-Signatory Party indicating that MWC does not oppose the Stipulation, the Board **FINDS** that the Signatory Parties have voluntarily agreed to the Stipulation, and that the Stipulation fully disposes of all issues in this proceeding and is consistent with the law. In reaching this decision, the Board must balance the needs of the ratepayer to receive safe, adequate and proper service at reasonable rates, while allowing the utility the opportunity to earn a fair rate of return. See FPC v. Hope Natural Gas, 320 U.S. 591 (1944); N.J.S.A. 48:2-21 and N.J.S.A. 48:3-1. Therefore, the Board **FINDS** the Initial Decision, which adopts the Stipulation to be reasonable, in the public interest, and in accordance with the law. Therefore, the Board **HEREBY ADOPTS** the Initial Decision and the Stipulation, attached hereto, including all attachments and schedules, as its own, incorporating by reference the terms and conditions of the Stipulation, as if they were fully set forth at length herein, subject to the following:

a. The tariff sheets attached to the Stipulation containing rates and charges conforming to the Stipulation and designed to produce the additional revenues to which the Signatory Parties have stipulated herein are **HEREBY ACCEPTED;** and

b. The stipulated increase and the tariff design allocations for each customer classification are **HEREBY ACCEPTED**.

The interim rate increase implemented through the October 23, 2012 Foundational Filing as an interim DSIC surcharge have been included in base rates. Pursuant to N.J.A.C. 14:9-10.1, et seq. the Board **HEREBY ORDERS** that Petitioner's DSIC Rate under its October 23, 2012 Foundational Filing shall be and is hereby reset to zero. All DSIC rates contained therein have been moved into rate base incorporated through the Stipulation agreed to by the Signatory Parties. As such, the Company may no longer implement or seek to recover through DSIC Rates pursuant to the October 23, 2012 Foundational Filing.

Based upon the forgoing, the Board **HEREBY APPROVES** an overall increase in revenues in the amount of $22,000,000 representing a 3.59% increase over Company revenues totaling $612,919,006.

The Board **HEREBY ORDERS** the Company to submit complete revised tariffs conforming to the terms and conditions of the Stipulation and this Order within five (5) days from the date of this Order.

This Order shall be effective on September 21, 2015.

DATED: 9/11/15

BOARD OF PUBLIC UTILITIES
BY:

JOSEPH L. FIORDALISO
COMMISSIONER

MARY-ANNA HOLDEN
COMMISSIONER

DIANNE SOLOMON
COMMISSIONER

ATTEST:

IRENE KIM ASBURY
SECRETARY

I HEREBY CERTIFY that the within document is a true copy of the original in the files of the Board of Public Utilities

Docket Nos. BPU WR15010035 and OAL PUC 01166-15 – In the Matter of New Jersey American Water Company for Approval of Increased Tariff Rates and Charges for Water and Sewer Service, Change in Depreciation Rates and Other Tariff Modifications

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January 14, 2015

VIA EMAIL AND REGULAR MAIL
Kenneth Sheehan, Acting Secretary
New Jersey Board of Public Utilities
44 South Clinton Avenue, 9th Floor
PO Box 350
Trenton, New Jersey 08625-0350

Re: IN THE MATTER OF THE PETITION OF NEW JERSEY-AMERICAN WATER COMPANY, INC. FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE, CHANGE IN DEPRECIATION RATES AND OTHER TARIFF MODIFICATIONS
BPU Docket No. WR15010035

Dear Acting Secretary Sheehan:

New Jersey American Water Company ("NJAWC" or the "Company") hereby updates the information contained within its rate case petition as follows. The rates-effective date set forth within Paragraph 28 of the Company's petition is revised from February 8, 2015 to March 18, 2015. As set forth within the Company's petition, the effective date of the proposed tariff included within the Company's rate case filing as Exhibit P-1 is similarly revised from February 8, 2015 to March 18, 2015. This revised date of March 18, 2015 is more than thirty (30) days from NJAWC's January 9, 2015 rate case filing date. However although we are revising the effective date of February 8 to March 18, 2015, the four month suspension period will still run from February 8, 2015 through June 8, 2015.

Please do not hesitate to contact me should you have any questions regarding this issue.

Very truly yours,

/s/ Robert J. Brabston

Robert J. Brabston

RJB:dlc

cc: Maria Moran, Director, Division of Water and Wastewater
Matthew J. Koczur, Division of Water and Wastewater
Stefanie A. Brand, Director, Division of Rate Counsel
Debra F. Robinson, Managing Attorney, Division of Rate Counsel
Alex Moreau, Deputy Attorney General
Ira Megdal, Esq.
Frank Simpson, Director of Rates and Regulation, NJAWC

NEW JERSEY
AMERICAN WATER

Robert J. Brabston
Corporate Counsel
167 J.F. Kennedy Parkway
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P 973 564 5716
F 973 564 5708

May 11, 2015

VIA EMAIL AND REGULAR MAIL
Kenneth Sheehan, Acting Secretary
New Jersey Board of Public Utilities
44 South Clinton Avenue, 9th Floor
PO Box 350
Trenton, New Jersey 08625-0350

Re: **IN THE MATTER OF THE PETITION OF NEW JERSEY-AMERICAN WATER COMPANY, INC. FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE, CHANGE IN DEPRECIATION RATES AND OTHER TARIFF MODIFICATIONS**
BPU Docket No. WR15010035

Dear Acting Secretary Sheehan:

New Jersey American Water Company ("NJAWC" or the "Company") hereby updates the information contained within its rate case petition as follows. By correspondence dated January 14, 2015, the Company revised the rates-effective date set forth within Paragraph 28 of the Company's petition from February 8, 2015 to March 18, 2015. This will confirm that NJAWC will not implement rates prior to the effective date of the Board's further suspension order expected to result from the June 17, 2015 Board agenda meeting.

Please do not hesitate to contact me should you have any questions regarding this issue.

Very truly yours,

/s/ Robert J. Brabston

Robert J. Brabston

RJB:dlc

cc: Service list (via email)

State of New Jersey
OFFICE OF ADMINISTRATIVE LAW

INITIAL DECISION
SETTLEMENT
OAL DKT. NO. PUC 01166-15
AGENCY DKT. NO. WR15010035

IN THE MATTER OF THE PETITION OF NEW JERSEY AMERICAN WATER COMPANY, INC., FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE; CHANGE IN DEPRECIATION RATES AND OTHER TARIFF MODIFICATIONS.

Ira G. Megdal, Esq., and **Stacy A. Mitchell**, Esq., (Cozen O'Connor) and **Robert J. Brabston**, Corporate Counsel, for Petitioner New Jersey-American Water Company, Inc.

Debra F. Robinson, Deputy Rate Counsel, **Susan E. McClure**, Assistant Deputy Rate Counsel, and **Christine Juarez**, Assistant Deputy Rate Counsel, for the New Jersey Division of Rate Counsel (Stefanie A. Brand, Director of the Division of Rate Counsel, attorney)

Alex Moreau, Deputy Attorney General, and **Carolyn McIntosh**, Deputy Attorney General, for the Staff of the New Jersey Board of Public Utilities (John J. Hoffman, Acting Attorney General of New Jersey, attorney)

Stephen B. Genzer, Esq., for Intervenor Aqua New Jersey, Inc. (Saul Ewing, LLP, attorneys)

Bradford M. Stern, Esq., for Intervenors, Cogen Technologies Linden Venture, L.P., Phillips 66 Company, Johanna Foods, Inc., Princeton University, and Rutgers, the State University of New Jersey (Law Offices of Bradford M. Stern LLC, attorneys)

Anthony R. Francioso, Esq., for Intervenor the Mount Laurel Township Municipal Utilities Authority (Fornaro Francioso, attorneys)

James H. Laskey, Esq., for Intervenor, Manasquan Customer Group (Norris McLaughlin & Marcus, P.A., attorneys)

Jay L. Kooper, Esq., for Intervenor, Middlesex Water Company;

William R. Holzapfel, Esq., for Intervenor, City of Elizabeth

Stuart A. Platt, Esq., for Intervenor, Township of Haddon (Platt & Riso, P.C., attorneys)

Record Closed: August 14, 2015 Decided: August 21, 2015

BEFORE BARRY E. MOSCOWITZ, ALJ:

On January 9, 2015, New Jersey American Water Company ("NJAWC", "Petitioner", or "Company") filed with the New Jersey Board of Public Utilities ("Board") a Petition, Testimony and Exhibits (the "Petition") requesting an increase in operating revenues of approximately $66.2 million, or approximately 9.96%, over projected test year operating revenues.

On January 23, 2015, this proceeding was transmitted by the Board to the Office of Administrative Law ("OAL") as a contested case. On February 6, 2015, the matter was assigned to me for a hearing. On February 25, 2015, I conducted a prehearing conference and on March 9, 2015, I issued a prehearing order establishing procedures and hearing dates for the conduct of this case. A First Amended Prehearing Order was issued April 15, 2015.

The signatory parties ("Parties") to this case include Petitioner, the Division of Rate Counsel ("Rate Counsel"), and the Staff of the Board ("Staff"). Motions to intervene filed by the following parties were unopposed: Rutgers, the State University (filed February 9, 2015); Princeton University (filed February 9, 2015); Phillips 66 Company (filed February 9, 2015); Johanna Foods, Inc. (filed February 9, 2015); and Cogen Technologies Linden Venture, L.P. (filed February 19, 2015) (collectively, the "Optional Industrial Wholesale Customer Coalition" or "OIW"); Manasquan Customers Group ("MCG") (filed February 12, 2015); Middlesex Water Company ("Middlesex") (filed February 13, 2015); Township of Haddon (filed February 23, 2015); Mount Laurel Township Municipal Utilities Authority ("MLTMUA") (filed February 25, 2015); Aqua New Jersey, Inc. ("Aqua") (filed April 30, 2015); and City of Elizabeth (filed May 19, 2015). These motions were granted by orders dated April 17, 2015 (as to OIW, Middlesex, MLMUA, MCG and Township of Haddon). By letter dated June 5, 2015 the Township of Haddon withdrew its Motion to Intervene in this proceeding.

Discovery involving approximately 700 requests, many with multiple parts, was answered by the Company.

The Company filed supplemental direct testimony on April 17, 2015.

Evidentiary hearings were scheduled for September 2015. Prior to the commencement of such hearings, the Parties conducted meetings to discuss settlement, and as a result, a Stipulation of Settlement was agreed upon by the Parties. All parties have either executed the Stipulation of Settlement, or have sent letters indicating that they had no objection to the Stipulation of Settlement. A copy of the Stipulation of Settlement is attached to this Initial Decision as Exhibit "A".

I reviewed the record and the terms of the Stipulation of Settlement and **FIND**:

1. The parties to the Stipulation of Settlement have voluntarily agreed to a settlement as evidenced by their signatures. Other parties have indicated that they have no objection to the Stipulation of Settlement.

2. The Stipulation of Settlement has been executed by all parties of record, except for those indicating no objection.

I **CONCLUDE** that this agreement meets the requirements of N.J.A.C. 1:1-19.1, and accordingly, I approve the settlement and **ORDER** that the parties comply with the terms of the settlement and that these proceedings be **CONCLUDED**.

I hereby **FILE** my initial decision with the **BOARD OF PUBLIC UTILITIES** for consideration.

This recommended decision may be adopted, modified or rejected by the **BOARD OF PUBLIC UTILITIES,** which by law is authorized to make a final decision in this matter. If the Board of Public Utilities does not adopt, modify or reject this decision within forty-five days and unless such time limit is otherwise extended, this recommended decision shall become a final decision in accordance with N.J.S.A. 52:14B-10.

August 21, 2015	Barry E. Moscowitz
DATE	**BARRY E. MOSCOWITZ**, ALJ
Date Received at Agency:	August 21, 2015
Date Mailed to Parties:	

dr

STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTRATIVE LAW

IN THE MATTER OF THE PETITION OF NEW JERSEY-AMERICAN WATER COMPANY, INC. FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE, CHANGE IN DEPRECIATION RATES AND OTHER TARIFF MODIFICATIONS	:	BPU DOCKET NO.WR15010035 OAL DOCKET NO. PUC01166-2015N **STIPULATION OF SETTLEMENT**

APPEARANCES:

Ira G. Megdal, Esq., and **Stacy A. Mitchell, Esq.**, Cozen O'Connor, and **Robert J. Brabston, Esq.**, Corporate Counsel, Counsel for Petitioner, New Jersey-American Water Company, Inc.;

Debra F. Robinson, Esq., Deputy Rate Counsel, **Susan E. McClure, Esq.**, Assistant Deputy Rate Counsel, and **Christine Juarez., Esq.**, Assistant Deputy Rate Counsel, for the New Jersey Division of Rate Counsel (**Stefanie A. Brand, Esq.**, Director);

Alex Moreau, Deputy Attorney General, and **Carolyn McIntosh,** Deputy Attorney General, for the Staff of the New Jersey Board of Public Utilities (**John J. Hoffman,** Acting Attorney General of New Jersey);

Stephen B. Genzer, Esq., Saul Ewing, LLP, Counsel for Intervenor, Aqua New Jersey, Inc.

Bradford M. Stern, Esq., Law Offices of Bradford M. Stern LLC, Counsel for Intervenors Cogen Technologies Linden Venture, L.P., Phillips 66 Company, Johanna Foods, Inc., Princeton University, and Rutgers, the State University of New Jersey;

Anthony R. Francioso, Esq., Fornaro Francioso, Counsel for Intervenor the Mount Laurel Township Municipal Utilities Authority

James H. Laskey, Esq., Norris McLaughlin & Marcus, P.A., Counsel for Intervenor, Manasquan Customer Group;

Jay L. Kooper, Esq., Middlesex Water Company, Counsel for Intervenor, Middlesex Water Company;

William R. Holzapfel, Esq., City of Elizabeth, Counsel for Intervenor, City of Elizabeth; and

Stuart A. Platt, Esq., Platt & Riso, P.C., Counsel for Intervenor, Township of Haddon

TO: THE HONORABLE BARRY E. MOSCOWITZ, ALJ

BACKGROUND

On January 9, 2015, New Jersey American Water Company ("NJAWC", "Petitioner", or "Company") filed with the New Jersey Board of Public Utilities ("Board") a Petition, Testimony and Exhibits (the "Petition") requesting an increase in operating revenues of approximately $66.2 million, or approximately 9.96%, over projected test year operating revenues.

In the Petition, NJAWC proposed a test-year ending July 31, 2015. The Petition as originally filed was based upon four (4) months of actual and eight (8) months of estimated data[1], which was subsequently updated on March 2, 2015 based on six (6) months actual and six (6) months estimated data. As the case progressed, the estimated data were replaced by actual data, and on April 17, 2015, the Company filed its update consisting of eight months of actual data. The Company filed an additional update consisting of twelve months of actual data on August 12, 2015.

On January 23, 2015, this proceeding was transmitted by the Board to the Office of Administrative Law ("OAL") as a contested case. The matter was assigned to Administrative Law Judge Barry E. Moscowitz. On February 25, 2015, a prehearing conference was conducted by Judge Moscowitz and on March 9, 2015, Judge Moscowitz issued a prehearing order establishing procedures and hearing dates for the conduct of this case. A First Amended Prehearing Order was issued April 15, 2015.

The signatory parties ("Parties") to this case include Petitioner, the Division of Rate Counsel ("Rate Counsel"), and the Staff of the Board ("Staff"). Motions to intervene filed by the following parties were unopposed: Rutgers, the State University (filed February 9, 2015); Princeton University (filed February 9, 2015); Phillips 66 Company (filed February 9, 2015);

[1] Board Staff and Rate Counsel do not agree that a water filing may be based upon four months of actual and eight months of estimated data. Board Staff and Rate Counsel believe that the filing must be based upon a minimum of five months of actual data. See In Re Elizabethtown Water Co. Rate Case, Docket No. WR850433085 (May 23, 1985).

Johanna Foods, Inc. (filed February 9, 2015); and Cogen Technologies Linden Venture, L.P. (filed February 19, 2015) (collectively, the "Optional Industrial Wholesale Customer Coalition" or "OIW"); Manasquan Customers Group ("MCG") (filed February 12, 2015); Middlesex Water Company ("Middlesex") (filed February 13, 2015); Township of Haddon (filed February 23, 2015); Mount Laurel Township Municipal Utilities Authority ("MLTMUA") (filed February 25, 2015); Aqua New Jersey, Inc. ("Aqua") (filed April 30, 2015); and City of Elizabeth (filed May 19, 2015). These motions were granted by orders dated April 17, 2015 (as to OIW, Middlesex, MLMUA, MCG and Township of Haddon). By letter dated June 5, 2015 the Township of Haddon withdrew its Motion to Intervene in this proceeding.

Pursuant to appropriate notice in newspapers of general circulation within the Company's service territory, and the serving of notice upon affected municipalities and counties within the Company's service area, four public hearings were held. Two public hearings were held on April 21, 2015 at 2:00 PM in Ocean City, New Jersey and at 6:00 PM in Westampton, New Jersey; one public hearing was held on April 22, 2015 at 2:00 PM in Howell Township, New Jersey; and one public hearing was held on April 23, 2015 at 7:00 PM in Mt. Olive, New Jersey. Members of the public attended and spoke at the Howell Township and Mount Olive, New Jersey public hearings, and the comments generally involved opposition to rate increases. No members of the public attended the Ocean City or Westampton, New Jersey public hearings.

Discovery involving approximately 700 requests, many with multiple parts, was answered by the Company.

The Company filed supplemental direct testimony on April 17, 2015.

Evidentiary hearings were scheduled for September, 2015. Prior to the commencement of such hearings, the Parties conducted meetings to discuss settlement, and as a result, this

Stipulation of Settlement was agreed upon by the Parties. As a result of those settlement conferences, the undersigned Parties **AGREE AND STIPULATE AS FOLLOWS:**

REVENUE REQUIREMENTS

1. The Parties agree to recommend to the Board that Petitioner's revenues from base rates should be increased by $22.0 million, effective for service rendered on and after September 11, 2015, or as soon thereafter as the Board deems appropriate. The revenue requirement is portrayed on Schedule A to this Stipulation.

2. The Parties stipulate that the 12-month period ending July 31, 2015, as adjusted for known and measurable changes, shall be the test year in this case.

3. The Parties stipulate that pro forma present rate revenues including DSIC and excluding PWAC/PSTAC are $612,919,006. As a result of the recommended $22.0 million rate increase, rates emanating from this proceeding will be designed to yield total base rate revenues of $634,919,006. Present rate revenues including PWAC/PSTAC and DSIC are $663,529,882.[2] The total rate increase excluding PWAC/PSTAC but including DISC is 3.59%. The overall rate increase is 3.32% based upon total present rate revenues (including DSIC, PWAC/PSTAC). Furthermore, the Company is aware that its new Foundational Filing, submitted June 12, 2015 in Docket No. WR15060724 must be approved by the Board before any new DISC investment and/or DISC rate recovery can occur and that the DISC rate shall be reset to zero at the conclusion of this base rate case.

4. The Parties stipulate that the Company's rate base for use in this proceeding is set at $2.39 billion.

5. The Parties to this Stipulation agree that the $22.0 million revenue increase set forth earlier in this Stipulation of Settlement reflects a consolidated tax adjustment to rate base due to the Company's affiliation with a parent company and the filing of a consolidated federal income tax return.

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[2] Total PWAC/PSTAC revenues are $50.611 million per BPU Order in Docket No. WR14111278.

6. Rate of Return. The Parties agree to the following rate of return for use in this case:

	Ratios	Cost Rates	Weighted Cost Rates
1. Long-Term Debt	48.00%	5.17%	2.48%
3. Common Equity	52.00%	9.75%	5.07%
4. Total	100.00%		7.55%

7. Amortizations. The Parties agree that the rate increase set forth earlier in this Stipulation reflects an amortization of unamortized balance sheet accounts, in accordance with the following schedule:

Account	Balance at 7/31/2015	Monthly Amortization	Amortization Start / Revised Date	Amortization Ending Date	
Deferred Pension Expense	4,057,184.42	39,390.14	3/1/2004	2/28/2024	
FAS 109 (SA-1)	$9,189,055.00	$48,878.00	Various	3/31/2031	
FAS 109 (SA-2)	$5,677,624.96	$38,105.00	Various	12/31/2027	
FAS 109 (SA-3)	$30,877.00	$346.00	Various	12/31/2022	
FAS 112	$83,370.00	$2,084.25	12/1/2008	11/30/2018	
Gain on Land Sales	(315,733.63)	($13,155.57)	10/1/2015	9/30/2017	(a)
Acquisition Adjustments	$3,575,938.86	14,562.30	Various	Various	
South Jersey Services	$3,939,060.00	$9,847.65	12/1/2008	11/30/2048	
Mt Ephraim	$49,192.00	$122.98	12/1/2008	11/30/2048	
Pelican Island	$6,196.00	$15.49	12/1/2008	11/30/2048	
Sick Bank Amortization - 2008	$740,801.60	$18,520.04	12/1/2008	11/30/2018	
Sick Bank Amortization - 2010	$123,843.20	$1,905.28	1/1/2011	12/31/2020	
BPU Management Audit	77,244.35	2,575.00	10/1/2015	3/31/2018	(b)
2014 Rate Case Expense	568,446.00	18,948.00	10/1/2015	3/31/2018	(c)
Pre 1971 Investment Credit	$367,238.59	$2,987.52	Various	Various	
Regulatory Liability/Asset for Excess/Deficit Deferred Income	($2,906,608.00)	($13,321.00)	Various	Various	
MTBE	($9,650,292.80)	(22,706.57)	1/1/2011	12/31/2050	
Refund of COR	($40,000,000.00)	($100,000.00)	12/1/2008	11/30/2048	
DSIC	$1,737,412.58	72,392.17	10/1/2015	9/30/2017	(d)
Severance Costs	$969,125.58	32,304.19	10/1/2015	3/31/2018	(e)

Notes:
(a) Monthly amortization derived from Mar, 2015 balance divided into 24 months/2 years
(b) Monthly amortization derived from Jan, 2016 balance divided into 30 months/2.5 years
(c) Monthly amortization derived from the company's projection of rate case expense, shared 50/50, and amortized over 30 months/2.5
(d) Monthly amortization derived from projected unrecovered DSIC through Dec, 2015 balance divided into 30 months/2.5 years
(e) Monthly amortization derived from severance costs per settlement discussions divided into 30 months/2.5 years

8. Normalization of Regulatory Commission Expense. The Parties stipulate that the Company incurred rate case expenses for this proceeding. Said rate case expense will be shared 50/50 between the Company and ratepayers, and normalized over two and one half years.

9. Depreciation Expense. The Parties agree that the depreciation rates to be utilized by the Company as a result of this Stipulation reflect the updating of the Company's previously approved depreciation rates to adjust the net salvage allowance component. The net salvage allowance is being reduced by $3 million, from $6,417,876 as approved in Board Docket No. WR11070460 to $3,417,876. The newly adjusted depreciation rates for water and the previously approved and unadjusted sewer depreciation rates are attached as Schedule B to this Stipulation.

In its next base rate proceeding, the Company will submit a depreciation study for water, and if the data below is then available using reasonable efforts, for sewer as well. That study will contain the following minimum requirements for both water and sewer:

1. Statistical Life Studies per 1996 NARUC Study Guide Chapters: VI, VII, VIII and IX.
2. Life span analyses per 1996 NARUC Study Guide Chapter X.
3. Theoretical Reserve Studies per 1996 NARUC Study Guide Chapter XIII.
4. Straight-line whole life and remaining life rates: BG/VG.
5. 20-year historical summaries of:
    a. Gross salvage
    b. Cost of removal
    c. Annual additions
    d. Annual retirements
    e. Annual maintenance expense

10. Haddonfield. NJAWC sought ratemaking recognition in rate based and on the income statement for the acquisition of the Haddonfield Water and Wastewater Systems (the "Acquisition"). The Acquisition did not close until more than four months after the current rate case was filed. It is therefore agreed that the Parties have not had enough time to fully evaluate the Acquisition. As a result, the Company agrees to withdrawal its request for ratemaking

recognition of the Acquisition, without prejudice. It may be renewed in a future base rate case proceeding, and if the Company demonstrates that the purchase price for the Acquisition was reasonable and prudent in such future proceeding, the Parties will agree to ratemaking recognition to the extent that reasonableness and prudence is demonstrated.

TARIFF AND RATE DESIGN

11. Pro Forma Present Revenues. The Parties stipulate that the pro forma present rate revenues to be used by rate class are those reflected on Schedule C, attached to this Stipulation.

12. Stipulated Rate Increases, By Customer Class. Also contained on Schedule C are the stipulated revenue increases by customer class.

13. Stipulated Tariff Pages. Attached to this Stipulation as Schedule D is the tariff depicting changes implementing the revenue increase and other tariff changes agreed upon in this Stipulation, in clean and black-line format. The Parties stipulate that within ten (10) days of an Order accepting this Stipulation, the Company will make a compliance filing relative to said tariff.

14. Present and Stipulated Rates. Attached to this Stipulation as Schedule E is a schedule entitled "New Jersey American Water Company, Base and Total Revenues at Present and Proposed Rates". The Parties stipulate that this schedule represents the present rates and the stipulated rates to be utilized in this matter.

15. Trend in SA-1/SA-2 Residential and Commercial Consumption Decline. The Parties acknowledge that the rate relief set out in this stipulation recognizes the near-term change in the Petitioner's revenue caused by a continuing, declining trend in base consumption per customer.

16. Service of Board Order. The Parties understand that service of the Board Order approving this Stipulation shall be in accordance with N.J.S.A. 48:2-40.

17. The undersigned Parties hereby agree that this Settlement has been made exclusively for the purpose of this proceeding and that this Settlement, in total or by specific item, is in no way binding upon them in any other proceeding, except to enforce the terms of the Settlement.

18. The undersigned Parties agree that this Settlement contains a mutual balancing of interests, contains interdependent provisions and, therefore, is intended to be accepted and approved in its entirety. In the event any particular aspect of this Settlement is not accepted and approved in its entirety by the Board, or modified by the Board, each party that is adversely affected by the modification can either accept the modification or declare this Settlement to be null and void, and the Parties shall be placed in the same position that they were in immediately prior to its execution.

19. It is the intent of the undersigned Parties that the provisions hereof be approved by the Board as being in the public interest. The undersigned Parties further agree that they consider the Settlement to be binding on them for all purposes herein.

20. It is specifically understood and agreed that this Settlement represents a negotiated agreement and has been made exclusively for the purpose of this proceeding. Except as expressly provided herein, the undersigned Parties shall not be deemed to have approved, agreed to, or consented to any principle or methodology underlying or supposed to underlie any agreement provided herein, in total or by specific item. The undersigned Parties further agree that this Settlement is in no way binding upon them in any other proceeding, except to enforce the terms of this Settlement.

21. This Stipulation may be executed in as many counterparts as there are Signatory Parties of this Stipulation, and each such counterpart shall be considered an original; however all such counterparts will constitute one and the same instrument.

WHEREFORE, the undersigned Parties respectfully submit this Settlement to the Presiding Administrative Law Judge and Board of Public Utilities and request (1) the Presiding Administrative Law Judge issue an Initial Decision approving this Stipulation of Settlement in its entirety in accordance with the terms contained herein, and (2) the Board approve this Stipulation of Settlement in its entirety in accordance with the terms contained herein.

NEW JERSEY-AMERICAN WATER COMPANY, INC.

By: Ira G. Megdal

Ira G. Megdal, Esq.

STEFANIE A. BRAND, ESQ., DIRECTOR, DIVISION OF RATE COUNSEL

By:____________________

Susan E. McClure, Esq.
Assistant Deputy Rate Counsel

JOHN J. HOFFMAN, ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for the Staff of the Board of Public Utilities

By:____________________

Alex Moreau,
Deputy Attorney General

Aqua New Jersey, Inc.

By:____________________

Stephen B. Genzer, Esq.

Mount Laurel Township Municipal Utilities Authority

By:____________________

Anthony R. Francioso, Esq.

WHEREFORE, the undersigned Parties respectfully submit this Settlement to the Presiding Administrative Law Judge and Board of Public Utilities and request (1) the Presiding Administrative Law Judge issue an Initial Decision approving this Stipulation of Settlement in its entirety in accordance with the terms contained herein, and (2) the Board approve this Stipulation of Settlement in its entirety in accordance with the terms contained herein.

NEW JERSEY-AMERICAN WATER COMPANY, INC.

By:______________________________
Ira G. Megdal, Esq.

STEFANIE A. BRAND, ESQ., DIRECTOR, DIVISION OF RATE COUNSEL

By:______________________________
Susan E. McClure, Esq.
Assistant Deputy Rate Counsel

JOHN J. HOFFMAN, ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for the Staff of the Board of Public Utilities

By:______________________________
Alex Moreau,
Deputy Attorney General

Aqua New Jersey, Inc.

By:______________________________
Stephen B. Genzer, Esq.

Mount Laurel Township Municipal Utilities Authority

By:______________________________
Anthony R. Francioso, Esq.

WHEREFORE, the undersigned Parties respectfully submit this Settlement to the Presiding Administrative Law Judge and Board of Public Utilities and request (1) the Presiding Administrative Law Judge issue an Initial Decision approving this Stipulation of Settlement in its entirety in accordance with the terms contained herein, and (2) the Board approve this Stipulation of Settlement in its entirety in accordance with the terms contained herein.

NEW JERSEY-AMERICAN WATER COMPANY, INC.

By: Ira G. Megdal
Ira G. Megdal, Esq.

STEFANIE A. BRAND, ESQ., DIRECTOR, DIVISION OF RATE COUNSEL

By:________________________
Susan E. McClure, Esq.
Assistant Deputy Rate Counsel

JOHN J. HOFFMAN, ACTING ATTORNEY GENERAL OF NEW JERSEY
Attorney for the Staff of the Board of Public Utilities

By:________________________
Alex Moreau,
Deputy Attorney General

Aqua New Jersey, Inc.

By: Stephen B. Genzer CH
Stephen B. Genzer, Esq.

Mount Laurel Township Municipal Utilities Authority

By:________________________
Anthony R. Francioso, Esq.

LEGAL\24026952\1

Manasquan Customer Group

By: ______________________
James H. Laskey, Esq.

Cogen Technologies Linden Venture, L.P., Phillips 66 Company, Johanna Foods, Inc., Princeton University, and Rutgers, the State University of New Jersey

By: ______________________
Bradford M. Stern, Esq.

City of Elizabeth

By: ______________________
William R. Holzapfel, Esq.

DATED: August 13, 2015

Manasquan Customer Group

By: ______________________
James H. Laskey, Esq.

Cogen Technologies Linden Venture, L.P., Phillips 66 Company, Johanna Foods, Inc., Princeton University, and Rutgers, the State University of New Jersey

By: ______________________
Bradford M. Stern, Esq.

City of Elizabeth

By: ______________________
William R. Holzapfel, Esq.

DATED: August 13, 2015

MIDDLESEX
WATER COMPANY

August 13, 2015

The Honorable Barry E. Moscowitz
Administrative Law Judge
New Jersey Office of Administrative Law
33 Washington Street
Newark, NJ 07102

RE: IN THE MATTER OF THE PETITION OF NEW JERSEY-AMERICAN WATER COMPANY, INC. FOR APPROVAL OF INCREASED TARIFF RATES AND CHARGES FOR WATER AND SEWER SERVICE, CHANGE IN DEPRECIATION RATES, AND OTHER TARIFF MODIFICATIONS

BPU DOCKET NO.: WR15010035
OAL DOCKET NO.: PUC 01166-2015N

Dear Judge Moscowitz:

Please be advised that Middlesex Water Company ("Middlesex Water"), an Intervenor in the above-referenced matter, has reviewed the proposed final Stipulation of Settlement provided today. Although Middlesex Water will not be a signatory to the Stipulation of Settlement, it has no objection to the same.

Respectfully submitted,
Jay Kooper
Jay L. Kooper
Vice President, General Counsel & Secretary

JLK:rk
cc: Service List attached (via e-mail)

Revised Schedule E

NEW JERSEY-AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-1

Customer Charges, per Month:

Meter	Present Rates		Stipulated Rates	
Size	Non-Exempt	Exempt	Non-Exempt	Exempt
5/8	$ 10.60	$ 9.14	$ 13.60	$ 11.73
3/4	15.90	13.71	20.40	17.59
1	26.50	22.85	34.00	29.32
1-1/2	53.00	45.71	68.00	58.64
2	84.80	73.13	108.80	93.82
3	159.00	137.12	204.00	175.91
4	265.00	228.53	340.00	293.19
6	530.00	457.06	680.00	586.38
8	848.00	731.90	1,088.00	938.21
10	1,060.00	914.11	1,360.00	1,172.76
12	1,325.00	1,142.63	1,700.00	1,465.95
16	2,120.00	1,828.22	2,720.00	2,345.52

Consumption Charges,
per Thousand Gallons:

All Usage - GMS	$ 5.9405	$ 5.1504	$ 6.1998	$ 5.3462
All Usage - Regular SFR	5.8905	5.1071	6.1498	5.3031
All Usage - Peaking Rate SFR	$ 8.3644	$ 7.2519	$ 9.0331	$ 7.7894

Private Fire Connections (Monthly):

	Present Monthly Rates		Stipulated
Size	Sch. L-1,L-8	Schedule L-2	State-Wide
2-inch	$ 19.03		$ 19.94
3-inch	42.82		44.87
4-inch	76.12		79.76
6-inch	171.27		179.46
8-inch	304.48		319.04
10-inch	475.75		498.50
12-inch	685.08		717.84
16-inch	1,165.63		1,221.58
Sprinkler Heads		$0.88	0.92
Private Hydrant		25.32	28.86

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-1

Public Fire Hydrant (Annually):		Present	Stipulated
State-Wide	M-1	$ 523.20	$ 541.20
Logan/Ortley	M-2	400.44	418.44
Adelphia	M-3	469.56	487.56

Sales for Resale

	Present Rates		Stipulated Rates	
	Non-Exempt	Exempt	Non-Exempt	Exempt
Rates Applicable to Commodity-Damand Tariff:				
Customer Charges, per Month:				
By Meter Size	Same as GMS		Same as GMS	
Consumption Charges, per Thousand:				
All Usage	$ 0.5264	$ 0.4539	$ 0.5264	$ 0.4539
Demand Charge per Month:				
Per Thousand Gallons of				
Maximum Day Nomination	$ 62.49	$ 53.90	$ 62.49	$ 53.89
Off-Peak Demand Charge per Month:				
Per Thousand Gallons of				
Maximum Day Nomination	$ 57.47	$ 49.57	$ 57.47	$ 49.57
Rates Applicable to Manasquan:				
Customer Charges, per Month:				
By Meter Size	Same as GMS		Same as GMS	
Consumption Charges, per Thousand:				
Uninterruptible Sales	$ 1.8453	$ 1.5913	$ 1.8848	$ 1.6253
Regular Sales	5.8905	5.1071	6.1498	5.3031

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-2

Customer Charges, per Month:

Meter Size	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
5/8	$ 10.60	$ 13.60
3/4	15.90	20.40
1	26.50	34.00
1-1/2	53.00	68.00
2	84.80	108.80
3	159.00	204.00
4	265.00	340.00
6	530.00	680.00
8	848.00	1,088.00
10	1,060.00	1,360.00
12	1,325.00	1,700.00
16	2,120.00	2,720.00

Consumption Charges,	Present Rates		Stipulated Rates	
per Thousand Gallons:	Non-Exempt	Exempt	Non-Exempt	Exempt
All Non-seasonal Usage - GMS	$ 5.5331	$ 4.7717	$ 6.0533	$ 5.2199
All Usage - GMS, Manville	5.0057	4.3169	$ 5.6185	$ 4.8450
All Usage - OIW	3.3604	2.8979	$ 3.5144	$ 3.0305
All Usage - SOS	2.6542	2.2889	2.7698	2.3885
All Usage - GMS-SOS	5.4884	4.7332	6.0033	5.1768

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-2

Private Fire Connections (Monthly):

Size	Present Rates	Stipulated Rates
2 inch	$ 40.47	$ 40.47
3-inch	79.48	79.48
4-inch	128.18	128.18
6-inch	237.75	237.75
8-inch	406.07	406.07
10-inch	482.68	499.50
12-inch	704.93	719.28
16-inch	1,500.17	1,500.17
20-inch	2,733.96	2,733.96
Private Hydrant	25.17	33.87

Public Fire Hydrant (Annually):

Fire Hydrants Zone 2A	$454.92	$472.92
Fire Hydrants Zone 2C	528.72	541.20
Fire Hydrants Zone 2D	555.48	555.48
Fire Hydrants Zone 2E	597.00	597.00
Fire Hydrants Zone 2F	645.00	645.00
Fire Hydrants Zone 2G	698.76	698.76
Fire Hydrants Zone 2H	750.00	750.00
Fire Hydrants Zone 2I	800.04	800.04
Fire Hydrants Zone 2J	850.08	850.08
Fire Hydrants Zone 2K	900.00	900.00
Fire Hydrants Zone 2L	949.92	949.92

Revised Schedule E

NEW JERSEY-AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-3, SOUTH HAMPTON

Customer Charges, per Month:

Meter Size	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
5/8	$ 10 60	$ 13 60
3/4	15.90	20.40
1	26 50	34 00
1-1/2	53 00	68.00
2	84.80	108 80
3	159.00	204 00
4	265.00	340.00
6	530 00	680.00
8	848 00	1,088 00
10	1 060.00	1,360.00
12	1,325 00	1,700.00
16	2,120 00	2,720 00

Consumption Charges, per Thousand Gallons:		
All Usage - South Hampton GMS	$ 4.4814	$ 5.2433

Private Fire Connections (Monthly):

Size	Present Rates	Stipulated Rates
2-inch	$ 19 03	$ 19 94
3-inch	42.82	44.87
4-inch	76.12	79.76
6-inch	171.27	179.46
8-inch	304.48	319.04
10-inch	475.75	498.50
12-inch	685.08	717.84
Private Hydrant	9.05	10.41

Public Fire Hydrant (Annually):

Fire Hydrants Zone 3A	$264.48	$282.48
Fire Hydrants Zone 3B	317.28	335.28
Fire Hydrants Zone 3C	370.20	388.20
Fire Hydrants Zone 3D	423.12	441.12
Fire Hydrants Zone 3G	502.32	520.32

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-1A

Private Fire Connections (Monthly):

Size	Present Rates	Stipulated Rates
2-inch	$ 19.03	$ 19.94
3-inch	42.82	44.87
4-inch	76.12	79.76
6-inch	171.27	179.46
8-inch	304.48	319.04
Private Hydrant	5.22	10.41
Public Fire Hydrant (Annually):	366.72	384.72

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-1B, PENNSGROVE

Customer Charges, per Month:

Meter Size	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
5/8	$ 9.00	$ 13.60
3/4	13.50	20.40
1	22.50	34.00
1-1/2	45.00	68.00
2	72.00	108.80
3	135.00	204.00
4	225.00	340.00
6	450.00	680.00
8	720.00	1,088.00
10	900.00	1,360.00
12	1,125.00	1,700.00

Consumption Charges, per Thousand Gallons:

All Non-seasonal Usage - GMS	$ 4.0682	$ 4.4988

Private Fire Connections (Monthly):

Size	Present Rates	Stipulated Rates
2-inch	$ 27.51	$ 27.51
3-inch	61.89	61.89
4-inch	110.03	110.03
6-inch	247.64	247.64
8-inch	440.12	440.12
10-inch	687.69	687.69
12-inch	990.28	990.28
Private Hydrant	25.32	28.86

Public Fire Hydrant (Annually):	288.48	306.48

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SERVICE AREA SA-1D, APPLIED

Customer Charges, per Month:

Meter Size	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
5/8	$ 9 00	$ 13 60
3/4	13.50	20 40
1	22.50	34 00
1-1/2	45 00	68 00
2	72.00	108 80

Consumption Charges, per Thousand Gallons:

	Present Rates	Stipulated Rates
All Non-seasonal Usage - GMS	$ 5.1912	$ 5 6185
All Usage - Irrigation	$ 7 0792	$ 7 6619

Private Fire Connections (Annually):

Size	Present Rates	Stipulated Rates
Private Hydrant	$ 266.76	$ 304.08

	Present Rates	Stipulated Rates
Public Fire Hydrant (Annually):	$ 234.12	$ 252.12

Revised Schedule E

NEW JERSEY-AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SEWER SERVICE

ADELPHIA

Customer Charges, per Month:

Meter Size	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
5/8	$5.69	$5.69
3/4	8.54	8.54
1	14.23	14.23
1-1/2	28.45	28.45
2	45.52	45.52
3	85.35	85.35
4	142.25	142.25
6	284.50	284.50
8	455.20	455.20
10	569.00	569.00
12	711.25	711.25
Sewer Usage Charge, per Thousand Gallons:	$5.5060	$5.5060

LAKEWOOD

	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
Customer Charges, per Month:		
All meter sizes	$15.06	$15.06
Sewer Usage Charge, per Thousand Gallons:	$3.4102	$3.4102

OCEAN CITY

	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
Minimum Service Charge per Thousand Gallons:	$11.1038	$11.1038
Sewer Usage Charge, per Thousand Gallons:	$1.8698	$1.8698

POTTERSVILLE

	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
Flat Rate Billed Customers		
Flat Rate Fixed Service Charge, per Month	$186.77	see 5-A Flat Rate
General Metered Service Customers		
Fixed Service Charge, per Month	$125.47	see 6-A GMS
Sewer Usage Charge, per Thousand Gallons:	$9.9200	see 6-A GMS

Revised Schedule E

NEW JERSEY AMERICAN WATER COMPANY

COMPARATIVE SCHEDULE OF PRESENT AND STIPULATED RATES
SEWER SERVICE

STATEWIDE	Present Rates Non-Exempt	Stipulated Rates Non-Exempt
Flat Rate Charges - Rate Schedule 5-A (Cows)		
Detached Single Family - Monthly	$122.66	$98.80
2 Bedroom Age Restricted - Monthly	94.18	81.20
3 Bedroom Age Restricted - Monthly	97.00	81.20
4 Bedroom Age Restricted - Monthly	97.00	81.20
1 Bedroom Townhouse - Monthly	92.48	81.20
2 Bedroom Townhouse - Monthly	97.00	81.20
3 Bedroom Townhouse - Monthly	122.66	98.80
3 Bedroom Townhouse Age Restricted - Monthly	97.00	81.20
General Metered Service Customers		
Fixed Service Charge, per Month		
Class A	$60.44	see 6-A GMS
Class B	77.96	see 6-A GMS
Sewer Usage Charge, per Thousand Gallons:	$9.3000	see 6-A GMS
Flat Rate Charges - Rate Schedule 6-A (Homestead)		
Detached Single Family - Monthly	$81.01	see 5-A Flat Rate
2 Bedroom Age Restricted -Monthly	81.01	see 5-A Flat Rate
General Metered Service Customers		
Fixed Service Charge, per Month	$48.35	$46.00
Sewer Usage Charge, per Thousand Gallons:	$9.3000	$8.8000
Non-Residential Sewer Custs. - Rate Schedule 7-A		
Customer Charges, per Month:		
5/8" Meter	$31.81	see 6-A GMS
3/4" Meter	31.81	see 6-A GMS
1" Meter	79.53	see 6-A GMS
1 1/2" Meter	159.05	see 6-A GMS
2" Meter	254.48	see 6-A GMS
4" Meter		see 6-A GMS
Sewer Usage Charge, per Thousand Gallons:	$10.3896	see 6-A GMS
Other Contracts - Rate Schedule 8-A		
Schools (per formula)	$117.21	$99.93
Other (per Equivilent Dwelling Unit)	117.21	99.93
Jensen's - Rate Schedule 10-A		
Fixed Service Charge, per Month	$33.42	$20.00
Sewer Usage Charge, per Thousand Gallons:	$4.2880	$8.8000

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on March 15, 2012

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman
Patricia L. Acampora
Maureen F. Harris
James L. Larocca

CASE 11-W-0200 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Long Island Water Corporation d/b/a Long Island American Water for Water Service.

ORDER DETERMINING REVENUE REQUIREMENT AND RATE DESIGN

(Issued and Effective March 20, 2012)

BY THE COMMISSION:

This order adopts terms set forth in a Joint Proposal submitted for our review by Long Island Water Corporation d/b/a Long Island American Water (LIAW, the company), trial staff of the Department of Public Service (Staff), and the Utility Intervention Unit of the New York Department of State’s Consumer Protection Division (UIU). We thereby establish a rate plan and other provisions governing the company’s water services, to remain in effect for the three years starting April 1, 2012.

BACKGROUND

Procedural History

LIAW serves about 75,000 customers (200,000 people) in the Town of Hempstead, Nassau County.[1] We initiated this case to consider an April 29, 2011 filing in which the company proposed a base rate increase calculated to increase annual revenues from metered and fire protection services by $9.6 million (19.5%) for a rate year ending March 31, 2013. After reducing or eliminating various surcharges separate from base rates, the net effect of the proposal would have been an increase of $8.0 million (15.8%). The company claimed to require additional revenue to provide an opportunity to earn a fair return on plant investment after allowing for increased costs, primarily property taxes and depreciation and capital costs associated with major plant additions. We suspended the company's proposed rates through March 27, 2012.[2]

On September 12, 2011, after reviewing the company's application and testimony and conducting additional discovery, Staff filed responsive testimony and exhibits to show that the base revenue increase for the 2012-13 rate year should be limited to $1.0 million (2.0%).[3] LIAW presented rebuttal on October 3, 2011, and subsequent updates.

The parties' testimony became a basis for intermittent settlement discussions starting September 15, 2011, pursuant to

[1] LIAW is a wholly-owned subsidiary of American Water Works, Inc. (AWW). At the time of LIAW's previous rate case, AWW was a wholly-owned subsidiary of RWE Aktiengesellschaft which, however, became only a minority shareholder in 2009. AWW describes itself as the largest investor owned water and wastewater utility holding company in the United States.

[2] Notices issued May 11 and August 10, 2011.

[3] After adjustments submitted October 5, 2011.

public notice in compliance with our rules in 16 NYCRR 3.9. At a conference and evidentiary hearing in Albany on October 20, the parties' testimony and exhibits were made available for cross-examination and incorporated into the record, and the parties reported on the status of the negotiations.

The discussions led to an agreement in principle in late November 2011. The negotiations culminated in the Joint Proposal under review here, which was filed November 29, 2011 (with a correction filed February 14, 2012). Under the proposed terms, if approved, base rates would increase on April 1 of 2012, 2013, and 2014. The new rates would be calculated to increase the company's annual base revenues by $3.0 million (6.0%), $1.4 million (2.6%), and $1.2 million (2.2%) in the first, second, and third years respectively. For metered customers, however, the net effect in the first year would be a base rate increase of $1.4 million (2.8%) because surcharges now paid only by those customers would be discontinued.

As an additional factor affecting the annual revenue allowances, the Joint Proposal includes procedures to capture, for LIAW customers' benefit, synergy savings that would accrue should we approve the acquisition of Aqua New York Inc. by LIAW's parent corporation, American Water Works, Inc.[4]

Each of the Joint Proposal's sponsoring parties has submitted a statement supporting it,[5] and none of the parties filed an opposing or reply statement.

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[4] Case 11-W-0472, *American Water Works Co., Inc., et al. – Acquisition of Aqua New York, Inc.*

[5] Staff, the company, and UIU filed statements on, respectively, December 7, 8, and 12, 2012.

PUBLIC INPUT

Afternoon and evening public statement hearings on the Joint Proposal were held in Hempstead on December 13, 2011.[6] Notices were published in which we encouraged the public to make statements at the hearings and to comment by mail, e-mail, or telephone. In response, 14 customers and public officials made statements at the hearings, and we received 19 written comments either before or after the Joint Proposal was filed, primarily expressing dissatisfaction with water quality in parts of the service territory and opposition to a rate increase generally .[7] As discussed below, the Joint Proposal attempts to respond to both concerns.

Water Quality

One of the main subjects raised in public statements and written comments has been the quality of water provided by LIAW, primarily in the Village of Malverne. Customers complain of brown discoloration, seemingly caused by iron content, which they say permeates bath water; damages laundry, appliances,

[6] Commissioner James L. Larocca and Administrative Law Judge Rafael A. Epstein presided at the public statement hearings.

[7] In addition to individual customers, those speaking or commenting included the following or their representatives: N.Y.S. Senate Majority Leader Dean G. Skelos, N.Y.S. Senator Charles J. Fuschillo, N.Y.S. Assembly Member Harvey Weisenberg, Nassau County Legislator David Denenberg, Village of Lynbrook (William J. Hendrick, Mayor), Village of Malverne (Patricia Ann Norris-McDonald, Mayor), Village of Valley Stream (Edwin A. Fare, Mayor), Nassau County Association of Fire Districts, Lakeview Fire District, South Hempstead Fire District, Lynbrook Chamber of Commerce, and Merrick Chamber of Commerce.

heating systems, and exterior grounds; and reduces property values as customers post complaints on the internet.[8]

Public dissatisfaction was heightened about a year ago when LIAW publicized the completion of a new filtration plant designed to ameliorate the excess iron condition, but failed to communicate that the plant did not become operational until March 8, 2011 despite a widely publicized opening ceremony on October 28, 2010. Complaints reported in news media, and possibly those presented at the December 2011 public statement hearings, include many related to the period immediately preceding the March 8, 2011 in-service date.

In addition to the public statements and comments presented directly, other material was offered during or after the hearings, including, *e.g.*, minutes and videotape of a community meeting with company officers about the water discoloration on February 10, 2011; related correspondence among customers, LIAW, and elected officials; and results of tests performed by a firm retained by customers and other tests performed by LIAW. Summaries of the test results were circulated for comment by parties and the public.[9]

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[8] The most recent comments filed by customers and LIAW, invited by the Judge to help develop a record regarding iron content, have also raised for the first time questions about unrelated water treatment practices which cannot effectively be addressed on the basis of the limited information submitted at the post-hearing stage.

[9] E-mails submitted initially by Thomas Grech, on behalf of customers, December 15, 2011 and February 27, 2012; and by LIAW, January 30, 2012. In addition, a reply to Mr. Grech’s February 27 e-mail was submitted by LIAW February 29, 2012 but is not a factor in our conclusions.

In parts of Long Island, including Malverne, naturally occurring iron content in groundwater is a persistent problem that demands filtration and treatment efforts increasing from year to year. Iron content can be measured by reference to an industry standard known as a “secondary” maximum contaminant level (MCL), so-called because “primary” MCLs are promulgated only for foreign substances that have been scientifically established as a health risk at a specific concentration. Because secondary MCLs are adopted for substances that have no established health risk but are aesthetically objectionable, secondary MCLs also are referred to as “aesthetic objectives” (AOs). For oxidized iron, the industry standard generally is a secondary MCL or AO of 0.30 milligrams per liter (mg/L), meaning that oxidized iron in cold water should be limited to that maximum concentration to avoid creating aesthetic issues. For total iron content, the corresponding secondary MCL is 1.50 mg/L. Related water quality criteria are turbidity, *i.e.*, relative clarity versus cloudiness, measured in nephelometric turbidity units (NTU) which describe the extent to which light can penetrate the water sample; and relative intensity of color in a water sample, measured on a color units scale. Under typical industry standards, turbidity exceeding 5.0 NTU is considered cloudy, and the recommended maximum color in potable water is 15 units.[10] However, turbidity levels are not directly

[10] As noted in the test results summary submitted on behalf of the customers, the criteria of 0.30 mg/L, 1.50 mg/L, 5.0 NTU, and 15 color units have been adopted by the Nassau County Department of Health.

correlated with iron content.[11]

In this case, all the available quantitative measures indicate that the water supplied to LIAW customers in the Malverne area (as distinguished from the “raw,” untreated supply obtained by LIAW) has satisfied all relevant criteria for iron content at least since activation of the new treatment facility on March 8, 2011. Indeed, although all the test results submitted by the customers predate March 8, 2011, they likewise indicate satisfactory quality. Specifically, the customers’ experts report that all the samples were taken February 24 or March 4, 2011, and only one sample exceeded the 0.30 mg/L criterion for oxidized iron in cold water, with a result of 0.61 mg/L. No samples reached the 1.50 mg/L total iron concentration level, the 5.0 NTU turbidity threshold, or the 15 unit color threshold.

LIAW of course is aware of the discoloration issue and has taken steps to address it. The March 8, 2011 plant addition was an important investment that has materially improved the water quality. For example, LIAW’s January 30, 2012 submission shows that total iron at its Malverne sampling station had improved to 0.03 mg/L, as compared with the 0.73 mg/L and 0.60 mg/L in the customers’ data for February 24 or March 4, 2011. We would expect that the improvements after the March 8, 2011 plant addition, as compared with water that already had met county health department standards in almost every instance,

[11] Turbidity varies according to the form of iron in the sample, because dissolved iron may become visible as particles only after water is allowed to stand for a period of time; iron particles washed from corroded equipment, or iron oxidized by exposure to air before the water is drawn, may be visible immediately when water is drawn; colloidal iron appears as a colored, but non-particulate, solution; and iron bacteria, while harmless, may be visible primarily as a stain or coating on surfaces exposed to water.

would include improvements in the aesthetic condition of the water; and that expectation is confirmed by many of the customer comments posted on their website and cited by their representative.

Thus, the remaining issue involves negative customer comments posted during the same period. As the customers' website mentions, one possible cause of discoloration is that heat in individual household water systems reduces the effectiveness of sequestration agents added by LIAW, allowing dissolved iron to precipitate out and settle in the system. Although the company was able to reduce its reliance on sequestration agents because it added iron removal facilities in 2005 and 2011, precipitated iron may remain in individual household systems that have not been flushed since that time.[12] Localized, transient discoloration also can result from a water company's occasional repair or maintenance projects; for example, tuberculated material from the inner surfaces of aged, ductile iron mains can be dislodged by the company's seasonal flushing. In any event, given that some customers report dramatic improvement in water quality since the March 2011 treatment plant expansion, and that the laboratory test results are satisfactory, the evidence does not point to deficiencies in LIAW's treatment procedures as a cause of discoloration.[13]

We therefore conclude that LIAW must accelerate its efforts to determine the reasons for instances where

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[12] Water heaters should be maintained at or below 120°F, and flushed at regular intervals as recommended by the manufacturer.

[13] Temporary discoloration also can be caused by LIAW's flushing program. The company's system is flushed twice per year, once in spring (typically March through May) and again in the fall. The company provides notice of flushing activity in specific areas via local media, door tags, bill messages, and signs posted in the neighborhood.

discoloration, from iron or other possible sources, persists despite the company's filtration plants, so that additional remedies can be implemented where needed. As a response to the most immediate problems, we are directing LIAW to collaborate with our staff as well as interested customers and community representatives, initially in Malverne and then elsewhere as appropriate, to clarify exactly when and where discoloration is a problem and thus identify reasonable and effective remedies.

LIAW will be required to initiate the collaborative within 30 days after today's order. In addition to ongoing collaboration, we will require that LIAW submit written reports so that customers and our staff can analyze and comment on whether adequate progress is being made. These will include an interim response outlining and describing the company's initial plan for diagnosing and addressing discoloration through the collaborative, by letter due June 30, 2012, followed by reports due quarterly on September 30, 2012 and thereafter unless and until we determine that less frequent reports will suffice.

Additionally, to help ensure that LIAW makes effective use of all available data to rapidly detect and resolve water quality issues elsewhere in the service territory as well,[14] we are directing the company to renew and expand cost effective mechanisms by which customers can alert the company to such problems. These approaches must include a customer reporting feature on the company's website, and surveys in bill inserts, designed to obtain comprehensive information regarding the entire range of possible water quality issues. The company will be required to submit a plan for continually obtaining customer input on water quality issues through such measures, as part of

[14] For example, the record includes one complaint and a news report regarding discolored water in villages served by LIAW other than Malverne.

the outreach and education plan set forth in the Joint Proposal.[15] The information obtained from customers and any responsive actions by the company are to be reported in the quarterly filings described above.

When setting rates in proceedings such as this, we seek to ensure that any costs ultimately borne by customers are reasonably necessary for the provision of service. Toward that end, we continually consider whether the regulated company should be making additional efforts or investments to improve its performance and, if so, what additional measures would be worthwhile and cost effective from the customers' standpoint. It was this type of analysis that led to construction of the iron removal plant added in March 2011 and our approval, in today's order, of further treatment facility expansion during the term of the new rate plan. To the extent that the additional water quality review described above discloses a need for other system improvements besides these major plant additions, LIAW's ongoing capital planning process is sufficiently flexible that investment can be directed toward other, more localized engineering measures to maintain or improve water quality as the need becomes apparent.

In theory, if we allowed LIAW to make unlimited expenditures for water quality remediation, at some point the authorized expenditures would surpass the necessary level and begin to err in the direction of excessive expenditures and rates. However, the current test results and even, to some extent, the individual customers' posted comments over the past year tend to show that the recent and planned growth in LIAW's treatment capacity is reasonably proportioned to the filtration

[15] P. 14, Para. I. The Joint Proposal specifies that the plan will be filed for review by our Office of Consumer Policy within 30 days after today's order.

requirements associated with the condition of LIAW's raw water supply as it evolves over time. Indeed, the more recent test data in LIAW's January 30, 2012 e-mail show a significant improvement in water quality as compared with the customers' February 24 and March 4, 2011 data. Nevertheless, continued monitoring will determine whether the treatment facility expansion contemplated in the rate plan, combined with the March 8, 2011 expansion, will need to be supplemented yet again, either with additional iron removal facilities or through other remedial projects.

Rate Impacts

Aside from water quality, the other primary concern expressed by the public is the burden of rate increases for customers and for the service territory overall. This is a theme not only in the comments addressing LIAW's original rate request, but also in comments on the smaller increases advocated in the Joint Proposal.

Here as in rate cases generally, we are responding to that concern by deciding the case in accordance with the statutory requirement of "just and reasonable" rates. Under this standard, a regulated company is allowed only enough revenues to provide it a reasonable opportunity of earning a return sufficient to attract capital on terms similar to other, comparably risky enterprises.[16] To meet that test of reasonableness, factors we consider include the relatively low risk profile of a regulated monopoly as contrasted with other investments under current market conditions, the company's opportunities to minimize its costs of business through austerity and efficiencies, the customers' lack of opportunity to choose alternate suppliers and their limited ability to

[16] *FPC v. Hope Natural Gas Co.*, 320 US 591 (1944).

reduce consumption, and the special burdens on customers and communities in a period of adverse economic conditions such as the present.

In this instance, we conclude that the Joint Proposal properly reflects these concerns because the opposing parties developed it through a process in which they were able to identify LIAW's legitimate revenue requirements as they conducted detailed audits and discovery to prepare for litigation. Moreover, while other acceptable results might be achievable by allocating the revenue allowance on some schedule different from the approximately equal annual base rate increases proposed here, we find this proposal optimal because it avoids abrupt rate increases for metered customers during the rate plan's minimum period of three years, and avoids "backloading" the revenue increases onto the later years when customers also may be confronted with imminent revenue requirement increases after the end of the rate plan.

A further objection to rate increases, somewhat unique to the public comments in this proceeding, has been that they violate the goals or spirit of the recently enacted state law limiting local property tax increases to 2% annually unless the taxing entity expressly votes to waive that cap. The argument seems to be premised on an implied analogy between voting on taxes and setting utility rates, or a view that the tax legislation uses the 2% limit as a proxy for a reasonable inflation estimate. However, any such analogy between local taxation and rate regulation is misplaced. The purpose of the tax legislation is to confront the taxing authority with a choice between waiving the cap or reducing the costs it incurs from vendors when providing services. Rate regulation, in contrast, is a method by which we set the vendor's price, on the basis of the legal criteria noted above.[17]

Finally, another distinctive issue arising from the rate increases proposed in this case concerns the impact on fire districts and other taxing authorities that pay LIAW fixed rates rather than volumetric charges. Fire protection service provided by utility companies generally is not priced volumetrically, and therefore is unmetered, because water consumption for that purpose is too limited and intermittent to recover the substantial fixed costs of making the service constantly available on demand.

As a result, some comments from unmetered customers object that the Joint Proposal's terms would assign them a 6.02% bill increase in the first year of the rate plan, whereas that increase would be mitigated to 2.77% for residential and other metered customers because their volumetric payments for the present Distribution System Improvement Charge (DSIC) and System Improvement Charge (SIC) would be discontinued. (Thereafter, unmetered and metered customers alike would receive base rate increases of 2.64% for year two and 2.17% for year three.) Nevertheless, we conclude that this result is equitable because only the metered customers have been paying the DSIC and SIC until now, even though the system improvements funded through those surcharges have benefited unmetered customers as well.

[17] A related point in some comments is that LIAW's revenue requirements may decrease insofar as the 2% cap may reduce the tax expense to be recovered from customers through the company's rates. Under the Joint Proposal's terms, at least 90% of any such savings will be captured for the customers' benefit.

PROVISIONS OF THE JOINT PROPOSAL[18]

Rate Plan Term

Under the Joint Proposal's provisions, we would establish rates for LIAW for a three-year period from April 1, 2012 through March 31, 2015. Staff and the company point out that this term is consistent with what we have approved in prior LIAW rate cases.[19] LIAW adds that a multi-year plan provides stability for both customers and the company and provides an incentive for the utility to control its costs.[20]

Base Rate Increases

Adoption of the Joint Proposal's terms would result in annual base rate increases of $2,955,218 (6.02%) for the year ending March 31, 2013 (Rate Year 1); $1,375,826 (2.64%) for the year ending March 31, 2014 (Rate Year 2); and 1,160,601 (2.17%), for the year ending March 31, 2015 (Rate Year 3). With the rolled-in annual revenues from the current DSIC and SIC surcharges excluded, the increases in base rate revenues would be $1,402,212 (2.77%), $1,375,826 (2.64%), and $1,160,602 (2.17%) for Rate Years 1 through 3, respectively. According to Staff, the annual bill for a residential customer with a 5/8" meter using 72,000 gallons per year would increase 2.45%, to $391.73, in the first rate year; 2.63%, to $402.05, in the second year; and 2.17%, to $410.78, in the third year.[21]

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[18] The points noted here are simply highlights of the Joint Proposal. For a complete statement of its terms, one should rely on the proposal itself, which accompanies this order as Attachments A and B and constitutes a part of the order.

[19] Staff Statement in Support, p. 5; LIAW Statement in Support, p. 4.

[20] Id.

[21] Staff Statement in Support, p. 6.

Staff says that the principal driver of the need for a rate increase in the initial year is the carrying cost, including depreciation, for capital improvements that LIAW has made to its water system. The increases in years two and three primarily reflect further additions to plant, the effect of inflation on operating expenses, and projected increases in property taxes.[22]

LIAW points out that it has not received an increase in base rates since March of 2008. It says that the increases proposed in the Joint Proposal represent a fair compromise between the roughly $1.0 million originally proposed by Staff for the initial rate year and the $9.6 million requested by the company. That compromise, it argues, is well within the range of possible outcomes from a fully litigated case.

Rate of Return

In its original filing, LIAW proposed a rate of return on equity (ROE) for the year ending March 31, 2013 of 11.67% with an equity ratio of 43.38%. Staff initially supported a one-year ROE of 8.9% and an equity ratio of 43.76%. After an update using the latest financial data available, Staff increased its ROE recommendation to 9.1%. Staff states that its calculation of the cost of equity is based upon our well established methodology employing a two-third/one-third weighting of the discounted cash flow model and the capital pricing model applied to a surrogate group of companies.

The Joint Proposal adopts an ROE for LIAW of 9.65% consisting of three elements. First, the base cost of equity is set at 9.1% as determined by Staff. Second, a "stay-out" premium of 30 basis points is added in recognition of the three-year term of the rate plan. Finally, the resultant total of

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[22] Id.

9.4% is adjusted upward by 25 basis points in exchange for a reduction in the allowed equity ratio from Staff's recommended 43.76% to 42%. The result of this last adjustment, Staff says, is revenue neutral. It has no effect on revenue requirement, overall rate of return, or the rates to be paid by customers.[23]

Staff argues that the overall rate of return proposed for LIAW in the Joint Proposal is consistent with those we have approved or are considering in other recent rate cases.[24] It notes that the stay-out premium is also similar to those found in recent rate cases and is consistent with our usual practice of basing such premiums on half the historic spread between one- and three-year Treasury bond rates over a five-year period.

Earnings Sharing

The Joint Proposal includes an earnings sharing mechanism that will directly benefit ratepayers if LIAW's actual earnings exceed the expectations on which the proposal is based. The mechanism provides that up to and including an ROE of 10.2%, the company will be permitted to retain all earnings. Above the 10.2% threshold, earnings will be shared equally between LIAW and ratepayers up to 10.7%; thereafter, 75% of earnings will be credited to customers and 25% retained by the company.

Earnings sharing mechanism calculations will be based on the company's actual earned return on equity determined on an aggregate basis for the three-year period ending March 31, 2015. That aggregate return will be calculated as the average of the returns achieved in each of the three years of the rate plan. For earnings sharing purposes, calculation of the earned return will be based on the lower of the company's actual common equity ratio or the 42.0% ratio adopted for revenue requirement

[23] Staff Statement in Support, p. 9.

[24] Id.

purposes. The Joint Proposal provides that the earnings sharing mechanism will remain in effect beyond the term of the rate plan until the company’s rates are reset in a subsequent proceeding. Ratepayers’ allocation of shared earnings will be held by LIAW for the benefit of ratepayers and will be used to reduce the company’s revenue requirement in the next general rate case or for such other purposes as we may direct.

Staff and UIU suggest that this mechanism includes features that are of significant benefit to ratepayers. First, they note, the initial 55 basis point “deadband” between the authorized ROE of 9.65% and the 10.2% level at which sharing begins is smaller than normal. This, they say, was deliberately intended to ensure that if LIAW earnings receive a boost as a result of greater than anticipated synergies derived from the proposed acquisition of Aqua New York, Inc. by American Water Works, ratepayers will realize a benefit immediately, rather than having to wait until rates are reset in the future.[25] Similar ratepayer protection is provided by continuation of the sharing mechanism beyond the end of the rate plan itself.

Overall, Staff argues the earnings sharing mechanism reasonably balances customer and company interests. The equal sharing in the first earnings tier ensures that LIAW will continue to have an incentive to manage costs and improve earnings, while the final tier with 75% of earnings going to customers provides a safeguard against excessive utility earnings.

<u>Revenue, Production Costs and Property Tax Reconciliation Mechanism</u>

LIAW currently operates under a mechanism that allows it to defer and recover (or refund) differences between the

[25] Staff Statement in Support, p. 10; UIU Statement in Support, p. 1.

level of actual revenues it realizes and the level included in rates, and changes in costs associated with production, such as the fuel, power and chemicals required to deliver water to the system, referred to by the parties as the RPCRC.[26] It also includes a property tax reconciliation mechanism. Under the terms of the Joint Proposal, these mechanisms would be continued, with updated targets specified for each of the three years of the rate plan. The RPCRC would continue beyond the term of the rate plan until rates are reset. Targets would continue at Rate Year 3 levels except that if LIAW does not file for rate relief to be effective April 1, 2015, the revenue target will be adjusted using a formula based on monthly average metered revenue over the most recent five years for which data are available.

The property tax reconciliation mechanism will permit LIAW to recover 90% of any increase in taxes above target levels. The company will bear the remaining 10%. If property taxes decrease, LIAW will be able to retain 10% of the savings only if it can demonstrate that the reduction in taxes was the direct result of its efforts. Under any circumstances, 90% will go to ratepayers.

Staff says that permitting LIAW to recover 90% of property tax increases above the target levels will allow the company to recover additional revenues needed to cover these escalating expenses while continuing to give it a strong incentive to monitor and challenge such property tax increases.[27] LIAW points out that its efforts to aggressively challenge tax assessments returned over $11.5 million to ratepayers during the period from 2007 through 2010 and have helped reduce the overall

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[26] The acronym originally stood for Revenue and Production Cost Reconciliation Clause.

[27] Staff Statement in Support, p. 11.

property tax burden from 36.2% of revenues in 2003 to 22.8% in the test year for this case.[28] Although it originally sought full reconciliation of property taxes, LIAW says the Joint Proposal's sharing requirements adequately recognize the company's property tax expense reduction efforts.

System Improvement Charge

The SIC in place under the terms of the company's current rate plan is proposed to be continued under the Joint Proposal. The mechanism allows the company to utilize surcharges to recover carrying costs for specific capital improvement projects that have been fully reviewed and approved by Staff, when those projects are put in service during the term of the rate plan. The surcharges will continue until rates are reset, at which time all costs will be fully accounted for.

The projects to which the SIC will apply are specified in the Joint Proposal. According to Staff, if all projects are completed on schedule, the potential maximum surcharges for each project range from 0.44% to 1.9%.[29] To establish a surcharge, the company must provide Staff with detailed project information within 30 calendar days of its in-service date, and Staff will have 60 days to analyze and verify the data and the surcharge calculation.

Under the SIC approach, Staff says, LIAW has the financial flexibility to undertake significant plant construction without the need to apply for rate increases. At the same time, ratepayers are protected against the possibility of slippage in scheduled construction, because no allowance for carrying charges on the designated projects is included in

[28] Company Statement in Support, p. 10.

[29] Staff Statement in Support, p. 12.

rates, and the surcharges cannot be imposed until all work is completed and verified by Staff.[30]

Distribution System Improvement Charge

The DSIC surcharge currently in effect allows LIAW to recover carrying costs associated with distribution and transmission mains installed as replacements or reinforcements; cleaning and lining of mains; and related valves, services and hydrants. Under the terms of the Joint Proposal, the DSIC would be terminated on April 1, 2012, the effective date of new rates. Carrying costs for the types of investments previously covered by the surcharge are instead included in base rates, subject to the company's commitment to spend $7.75 million annually. If LIAW fails to make the required expenditures, carrying costs on the shortfall will be deferred for the benefit of ratepayers.

The Joint Proposal provides for a final reconciliation between the authorized and actual collections of the current DSIC surcharge to be made via a reconciliation filing for the period ending March 31, 2012. The resulting final DSIC reconciliation amount will be recovered or refunded via a one-time surcharge or credit.

Acquisition Savings

On September 1, 2011, American Water Works, the corporate parent of LIAW, and Aqua Utilities, Inc. (Aqua) petitioned for our approval of a transfer of Aqua's New York holdings to American Water Works.[31] Under the terms of the Joint Proposal, LIAW's revenue requirement includes a reduction of

[30] Id.

[31] Case 11-W-0472, *Aqua Utilities, Inc. et al. – Acquisition.* Aqua owns three New York water companies: Aqua New York, Inc., New York Water Service Corporation (NYWS) and Aqua New York of Sea Cliff, Inc.

$901,331 over the three years of the plan to reflect potential synergy savings arising from the acquisition.

UIU comments that it is particularly supportive of the Joint Proposal’s treatment of synergy savings resulting from the proposed acquisition. It believes that given the proximity of the service territories of the companies, it is reasonable to expect that, if we approve the acquisition, the companies will experience operational efficiencies from which ratepayers should benefit.[32] Also, both UIU and Staff again point out that the narrow deadband in the earnings sharing mechanism helps ensure that ratepayers will benefit if synergy savings realized are reflected in increased LIAW income.

Outreach and Education

The Joint Proposal recites that LIAW will continue to develop and implement customer outreach and education programs and materials to increase awareness and understanding of water issues, policies, and initiatives such as water quality, cost, system improvements, conservation techniques, customer rights and customer service matters. Within 30 days after issuance of this order, LIAW will file, for review by the Director of our Office of Consumer Policy (“OCP Director"), a plan that details the outreach and education program's goals and objectives, target audiences, source of funding, core messages, and implementation strategies, methods, and schedule for the coming year. The annual plan may be reviewed and updated based on significant changes in company services or programs. LIAW will review the plan each year of the rate term and send a letter to the OCP Director within 30 days after the end of the rate year, identifying any change the company proposes.

[32] UIU Statement in Support, p. 2.

Pensions and OPEBs

LIAW's employees participate in the consolidated pension and other post-employment benefits (OPEBs) plans of the company's parent, American Water Works. Our Policy Statement on Pensions and OPEBs (Policy Statement)[33] requires that utilities compute pension and OPEBs expense for ratemaking purposes on a stand-alone basis when the employees of the utility participate in a consolidated plan.

In its rebuttal testimony, LIAW requested permission pursuant to Section N of the Policy Statement to calculate its expense on a consolidated basis, contending that continuing to compute pension and OPEBs expense on a stand-alone basis would significantly increase the cost to ratepayers and that consolidation would better align the amount of pension and OPEBs expense allowed in rates with the amount actually funded and paid out, which is done on a consolidated basis.

Under the Joint Proposal, LIAW will be allowed to calculate its expense on a consolidated basis for accounting and ratemaking purposes during the three-year term of the rate plan, but it will also be required to calculate pension and OPEBs expense on a stand-alone basis. The Joint Proposal provides an allowance in revenue requirement to cover the expected actuarial expense of the extra stand-alone calculation. At the end of the rate plan term, we may require the company to return to a stand-alone basis for calculation of pension and OPEBs expense.

LIAW contends that this provision is beneficial to ratepayers because it has demonstrated that costs are lower on a

[33] Case 91-M-0890, *Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions* (issued September 7, 1993).

consolidated basis, and calculating them on a stand-alone basis would increase rates with no corresponding benefit.[34] Staff supports the Joint Proposal approach because the company will continue to perform the stand-alone computations, permitting verification of the claimed benefits of consolidation, and we may require the company to return to the stand-alone calculations at the end of the three years if those benefits are not evident.

STANDARD OF REVIEW

Our obligation in reviewing any joint proposal submitted for our consideration is to ensure that its terms, viewed as a whole, produce a result that is in the public interest. Our Settlement Guidelines describe the factors we take into account in making that assessment.[35]

In general, a desirable settlement should balance protection of consumers, fairness to investors, and the long-term viability of the utility. It should be consistent with the environmental, social, and economic policies of the Commission and the State; and it should produce results that are within the range of reasonable results that would have likely arisen from a Commission decision in a litigated proceeding. In determining whether the compromises incorporated in a joint proposal have been fairly arrived at and are well-supported, we look at the opportunity provided the parties to participate in negotiations and the adequacy of the record underlying their decisions.

In this case, Staff points out that all parties received the notice of settlement negotiations required by our rules. In addition, it reports that LIAW circulated e-mails to

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[34] Company Statement in Support, p. 13.

[35] Cases 90-M-0255 *et al., Procedures for Settlements and Stipulation Agreements*, Opinion No. 92-2 (issued March 24, 1992).

all active parties advising them of upcoming dates for negotiating sessions, and that telephone conferencing was made available to all parties for every session. Staff also notes that the record developed in this case includes testimony and exhibits filed by the company and Staff from which the basis for the key compromises incorporated in the Joint Proposal can readily be ascertained.

We conclude, therefore, that the Joint Proposal was developed through a fair process with full opportunity for participation by all interested parties. It is, therefore, properly before us for a determination of its consistency with the public interest.

DISCUSSION

We find that the Joint Proposal's sponsors have satisfied their burden of showing that adoption of the proposed terms would satisfy the Public Service Law's requirement of safe and adequate service at just and reasonable rates. The proposed terms also meet the criteria set forth in our Settlement Guidelines in that they have won the support of ordinarily adversarial parties and have been submitted for examination in an evidentiary hearing.[36] Moreover, the proposals result from a process that began with a fully documented rate application, followed by Staff and intervenor discovery and review at a level of scrutiny typically associated with preparation of testimony such as Staff submitted for litigation in this case.

Regarding the Guidelines' additional criterion that the negotiated outcome fall within the likely range of litigated outcomes, the proposed revenue allowance meets that test insofar as it exceeds the level that would have resulted from the revenue increase advocated as part of Staff's initial litigating

[36] Id., Appendix B, p. 8.

position, yet falls short of the levels the company sought to justify in its initial filing or its updates upon rebuttal.

In addition, the proposals comport with the Guidelines in that their adoption would reasonably balance the interests of protecting customers while supporting the utility's long-term viability, and would promote relevant public policies. These conclusions are justified by the public benefits inherent in adopting the various provisions summarized above.[37]

In particular, we note that the proposed base rate increases would be the first we have authorized since four years ago, when we initiated a rate plan designed to meet the company’s reasonable revenue requirements for only three years ending March 2011. The company’s forbearance during the fourth, most recent year reflects successful cost control on LIAW’s part, which in turn has benefited customers and the service territory by minimizing the economic burden associated with rate increases. This extended period of rate stability has helped LIAW to maintain rates in the mid-range of those charged by comparable companies that we regulate. Nevertheless, LIAW also has managed to fund the system improvements needed to meet service quality requirements.

The proposed terms would carry this pattern forward, enabling the company to hold its base rate increases to a predictable level, below 3% for metered customers, for at least three years, even as it invests another $15.8 million in necessary additional plant. The SIC mechanism will reasonably accommodate the competing requirements that investors have a reasonable and timely opportunity to recover capital costs incurred in maintaining a physically adequate system, while

[37] The statements in support of the Joint Proposal comprehensively summarize its benefits, so as to illustrate in more detail why adoption of the proposed terms would serve the public interest.

customers are assured that the capital program will be adequately reviewed and well suited to maintaining service quality.

The proposed rates reflect much of Staff’s litigation position regarding operating expenses. Going forward, the proposed terms we adopt include significant assurances that major cost drivers, such as pension and OPEBs expense and property tax expense, will be constrained to reasonable levels. The allowed equity return likewise will be set at a reasonable level, by relying on adequate record evidence of the cost of capital; and by using a formula that will provide customers a fair share of potential earnings, while maintaining an incentive for the company to continue pursuing efficiencies even if earnings reach a level subject to sharing. The proposed allowance for synergy savings assures LIAW customers a fair share of all benefits that may accrue from acquisition of Aqua New York’s operating companies by American Water Works, Inc.

CONCLUSION

For the reasons stated, we find that our adoption of the proposed terms will serve the public interest and satisfy our statutory obligation to ensure safe and adequate service at just and reasonable rates. Accordingly, we direct the company to file tariff revisions consistent with this finding.

The Commission orders:

1. In accordance with the foregoing discussion, the terms of the Joint Proposal dated and filed in this proceeding November 29, 2011, included in this order as Attachment A, as modified by the correction dated February 14, 2012 and included as Attachment B, are adopted in their entirety and are incorporated as part of this order.

2. Within 30 days after issuance of today’s order, Long Island Water Corporation d/b/a Long Island American Water (the company) shall (1) file its outreach and education plan pursuant to Para. I of the Joint Proposal as further interpreted in the above discussion; and (2) initiate the water quality collaborative described above, including quarterly reports starting June 30, 2012, which will incorporate the water quality information gathered in the Para. I outreach effort.

3. No later than 4:45 p.m. EDT on March 22, 2012, the company must submit a written statement of complete and unconditional acceptance of this order and its terms and conditions, signed and acknowledged by a duly authorized officer and filed with the Secretary of the Commission and served contemporaneously on all active parties in this proceeding.

4. The company is directed to file a cancellation supplement, effective March 27, 2012, on not less than one day’s notice, canceling the tariff leaves and supplements listed in Attachment C to this order.

5. The company is authorized to file on not less than one day's notice, to take effect on or after April 1, 2012, the tariff leaves in the appendices to the Joint Proposal. The requirement of Public Service Law §89-c(10)(b) and 16 NYCRR 720-8.1 that newspaper publication be completed before the effective date of the amendments authorized above is waived. However, for each year during the term of the rate plan ordered herein, the company shall file with the Secretary not later than April 30, 2012, March 15, 2013 and March 15, 2014, proof that a notice to the public of the changes and their effective date has been published once a week for four successive weeks in one or more newspapers of general circulation in its service territory.

6. The Secretary is authorized to extend the deadlines set forth in this order.

7. This proceeding is continued, but shall be closed by the Commission after the compliance filings have been made in response to order clauses 2 and 5 above, unless the Secretary finds good cause to continue the proceeding further.

By the Commission,

JACLYN A. BRILLING
Secretary

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Long Island Water Corporation d/b/a Long Island American Water for Water Service.

Case 11-W-0200

JOINT PROPOSAL

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Dated: November 28, 2011

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JOINT PROPOSAL

THIS JOINT PROPOSAL is made as of November 28, 2011, by and between Long Island Water Corporation, d/b/a Long Island American Water ("LIAW" or the "Company"), the Staff of the New York State Department of Public Service ("Staff") and the Utility Intervention Unit ("UIU") of the New York State Department of State's Division of Consumer Protection. It sets forth the terms of a Rate Plan for the three-year period beginning April 1, 2012, and ending March 31, 2015. This Joint Proposal is intended, by the signatory parties, to settle all issues in the above-referenced rate proceeding and to be presented to the Public Service Commission ("Commission") for approval in its entirety since each provision is in consideration and support of all of the other provisions.

I. <u>PROCEDURAL HISTORY</u>

LIAW provides various types of water service to approximately 74,000 customers in Nassau County, New York. On April 29, 2011, LIAW filed amendments to its tariff schedule P.S.C. No. 1 – Water, with supporting testimony and exhibits, to increase annual base rates for all customer classes by $9,563,146 or 19.49% for the rate year ending March 31, 2013.[1] According to the Company, the proposed increase in revenue requirement is necessary for LIAW

[1] The Company's filing stated that taking into account the resetting of certain surcharges, however, the net impact of the rate increase was 13.23%.

to meet increasing costs of providing safe, reliable and quality service including increases in the costs of operation, including property taxes, depreciation expense and capital expenditures associated with major plant additions and also allowing the Company an opportunity to earn a fair rate of return on its plant dedicated to providing public service.

By notice issued May 5, 2011, the Commission suspended LIAW's tariff amendments through September 27, 2011. The UIU filed a request to become a party to the proceeding on May 6, 2011. The Village of Lynbrook filed a request to become a party on October 17, 2011.

Comprehensive discovery requests were exchanged among the parties. Staff and the UIU served approximately 177 and 35 formal information requests on the Company, respectively.

Staff filed its Direct Testimony with exhibits on September 12, 2011. Also on September 12, the Commission further suspended the proposed tariff amendments through March 27, 2012.

Staff, LIAW and the UIU began exploratory discussions on September 15, 2011. A Notice of Impending Settlement Negotiations was also filed with Commission on September 15, 2011, pursuant to Section 3.9 of the Commission's rules (16 NYCRR §3.9) and the Commission's Settlement Guidelines contained in Opinion 92-2.2. Staff, LIAW and the UIU continued settlement discussions on September 16, 2011.

The Company filed rebuttal testimony, with exhibits, on October 3, 2011. Staff, LIAW and the UIU continued settlement discussions on October 11 and 12, 2011. An agreement in principle on the major terms of the Joint Proposal was reached on October 14, 2011. The agreement addressed the first year revenue requirement and provided for a three-year rate plan.

A status conference and an evidentiary hearing were held before Administrative Law Judge ("ALJ") Rafael Epstein on October 20, 2011 at the Commission's offices in Albany. The parties advised ALJ Epstein that an agreement in principle had been reached and that evidentiary hearings would not be required except to mark into evidence the testimony, exhibits and other supporting documents filed in this proceeding.

This Joint Proposal formalizes the agreement reached on October 14, 2011, with some modifications also agreed to by the parties. Attached to this Joint Proposal as Appendix A are income statements and associated schedules, developed jointly by the parties, setting forth in detail the revenue requirements for the Company for the term of the three-year rate plan.

II. SIGNATORIES TO JOINT PROPOSAL

Staff, LIAW and the UIU (the "Signatories") have joined in this Joint Proposal.

III. PROVISIONS OF JOINT PROPOSAL

A. Term

a. The Joint Proposal covers the three-year period commencing April 1, 2012, and ending March 31, 2015. New Rates will become effective on April 1 of each rate year as described in subsection III.A.b, below. The terms and conditions in this Joint proposal regarding this three-year period and upon which rates will become effective are referred to as the "Rate Plan."

b. The following terminology is used to describe the one-year period of each of the three years of the Rate Plan:

Year One: Twelve months ending March 31, 2013

Year Two: Twelve months ending March 31, 2014

Year Three: Twelve months ending March 31, 2015

B. Revenue, Production Costs and Property Tax Reconciliation (RPCRC) Mechanisms

The existing RPCRC Mechanisms are continued with revisions updated for new target levels. The effects of differences in the level of actual revenues versus the level of revenues in rates, production costs (fuel, power and chemicals) and property taxes versus the targets presented below in each rate year for the period April 1, 2012 through March 31, 2015, will be deferred and recovered or refunded through the RPCRC Mechanisms on an annual (rate year) basis. The reconciliations and associated tariff leaves will be submitted annually to the Secretary to the Commission within 60 days after the end of the term of each Rate Year. The submitted net surcharge or credit will go into effect 45 days after submittal unless Staff submits a letter to the Company indicating that the reconciliation amounts should be adjusted.

a. For purposes of reconciliation under the RPCRC, the target levels for Year One will be as follows:

i.	Metered Revenues	$47,549,412
ii.	Fuel, power and chemicals	$3,953,224
iii.	Property Taxes	$11,893,414

b. The target level for revenues reconciled under the RPCRC for Year Two is $48,807,844, and for Year Three is $49,869,621.

c. The target level for fuel, power and chemicals is $4,032,684 for Year Two and $4,118,580 for Year Three. Changes to these items will be determined in accordance with the current methodology employed for RPCRC Mechanism.

d. The target level for property taxes in Year Two is $12,132,472 and the target level for property taxes in Year Three is $12,390,893. The treatment of property taxes is further described in Section I, below.

e. The RPCRC Mechanisms will continue beyond the term of the Rate Plan set out within this Joint Proposal at the Year Three target levels until new target levels are set in the Company's next rate proceeding. If the Company decides to voluntarily not file for rate relief to be effective by April 1, 2015, the Year Three monthly target levels will set using the monthly averages of metered revenue for the most-recent five years applied to the Year Three target level of $49,869,621. These monthly target levels are for calculating the RPCRC for any period of time not equivalent to a normal rate year for LIAW.

C. Base Rates

a. The percentage increases, dollar increases and revenue forecasts for the base rates in each year for the term of the Rate Plan are as follows:

	% Increase	Increase	Revenues
Year One	6.02%	$2,955,218	$52,018,377
Year Two	2.64%	$1,375,826	$53,394,203
Year Three	2.17%	$1,160,601	$54,554,804

b. The revenue requirement calculations for each year and any adjustments contained in this Joint Proposal are contained in Appendix A.

c. The effect of this proposal on customers' bills is summarized in Appendix B.

d. Appendix C contains the proposed tariff leaves detailing the base rate increase and the effective date for Rate Years One, Two and Three.

D. Acquisition Considerations

a. Currently, LIAW's corporate parent is in the process of acquiring the New York assets of Aqua New York, Inc. (Aqua NY) (Case 11-W-0472). The JP revenue requirement recognizes $901,331 of ratepayer synergy savings throughout the three-year period of the rate plan ($133,777 + 383,777 + 383,777 for rate year 1, rate year 2 and rate year 3, respectively). This amount represents the Company's best estimate for the three-year rate plan.

b. Staff intends to examine synergy savings in Case 11-W-0472 and the savings identified above may be subject to adjustment based on the determination of the Commission in the acquisition proceeding. Any adjustment would be taken care of through the RPCRC Mechanism.

c. If the acquisition does not occur the Company will recover the $901,331 in synergy savings through the RPCRC Mechanism.

E. System Improvement Charge ("SIC")

The Company is authorized to continue the use of its SIC mechanism. The SIC mechanism applies to specific reviewed and approved projects. The mechanism will allow recovery of carrying costs (i.e., return and depreciation expense) on specific projects placed in service in Rate Year Two, Rate Year Three and beyond. The use of the SIC mechanism is approved for the following projects and associated capital expenditures:

- Iron removal facilities at Plant 15 - $8,450,000
- Storage tank rehabilitation at Plant 13 - $1,900,000
- Plant 5 common suction well rehabilitation, Phase 2 -$525,000
- Business transformation EAM/CIS - $4,926,481

The Company must make a compliance filing with the Secretary to the Commission after each project is placed in service. Further, after the Company makes its initial SIC filing, it must also make annual filing within 60 days of the end of each rate year to reconcile authorized compared to actual collections and update the surcharge for any accumulated depreciation associated with the projects in service. The submitted surcharge will go into effect 60 days after submittal unless Staff submits a letter to the Company indicating that the surcharge should be adjusted.

After LIAW has incurred actual capital expenditures for the projects listed above and the new facilities have been placed in service, then the amount of those expenditures (net of associated (i) retirements, (ii) accumulated deferred income taxes ("ADIT"), and (iii) accumulated depreciation reserve, i.e., the net rate base ("NRB")) will constitute the incremental rate base investment subject to the SIC.

LIAW will be entitled to assess a SIC surcharge on customers' bills based on a pre-tax rate of return of 10.14% applied to the net rate base increase. The cost of annual depreciation expense will be added to that amount, and the total will be divided by projected annual water revenues as defined below.

The SIC surcharge will be a percentage, carried to two decimal places, and will be applied to the customer service charge and the volumetric charges billed to each Residential, Commercial & Industrial and Lawn Sprinkler customer. The formula of the calculation is as follows:

SIC surcharge = [(NRB x Pre-tax ROR) + D] / AR

Where:

NRB = the cost of the specific approved facilities listed above, net of associated (i) retirements, including cost of removal and any related tax benefits, (ii) ADIT and (iii) accumulated depreciation reserve

Pre-tax ROR = 10.14%

D = the annual depreciation expense on the net additions

AR = LIAW's projected annual metered revenues

The SIC surcharge will be used for the pre-approved applicable facilities placed in service during the Rate Plan and beyond. LIAW will provide Staff with detailed project information within 30 calendar days regarding the SIC (such as in service dates, actual paid capital expenditures, replacements and retirements). Staff will have 60 days to analyze and verify such data.

A reconciliation between authorized collections and actual collections related to the SIC surcharge will be conducted annually and filed with the Secretary to the Commission within 60 days of the end of each rate year. Any under-collections or over-collections will accrue interest at the customer deposit interest rate established by the Commission each year. Adjustments of under-collections or over-collections, as well as updates for accumulated depreciation reserve, will be reflected in the subsequent SIC surcharge filing. The submitted surcharge will go into effect 60 days after the submittal unless Staff submits a letter to the Company indicating that the surcharge should be adjusted.

The SIC surcharge will remain in place until the Commission issues a decision in the Company's next general rate case, at which time all costs previously collected through the SIC will be accounted for and included in base rates. Those new base rates will recover the costs that had been recouped previously via the SIC surcharge.

F. Distribution System Improvement Charge ("DSIC")

a. The DSIC surcharge, as described in the Settlement Agreement approved by the Commission in Case 04-W-0577,[2] and extended with some

[2] Case 04-W-0577, Order Establishing Rate Plan (Mar. 21, 2005).

modification by the Commission in Case 07-W-0508,[3] shall end on the effective date new rates are implemented in the instant proceeding.

b. The Company agrees to spend $7.75 million per rate year on distribution system related work, including but not limited to, mains, services, hydrants, valves over the term of the rate plan. The carrying costs associated with the $7.75 million capital investment in each of the rate years have been included in the base rates for each of those years. A list of water main replacement projects anticipated to be completed as part of the distribution system improvement program in this rate plan is included in Appendix F.

c. Within 60 days after each Rate Year, the Company will submit to the Secretary to the Commission the capital expenditures for distribution system related projects under accounts 343, 344, 345 and 348. If the Company spends less than the authorized yearly amounts ($7.75 million per year), the Company will defer the revenue requirement impact of any shortfall below the target levels for the benefit of ratepayers. Such analysis will be done on a cumulative basis at the conclusion of the rate plan.

d. The existing DSIC surcharge, as described in the Settlement Agreement approved by the Commission in Case 04-W-0577, was subject to an annual reconciliation between the authorized collections and actual collections. The annual reconciliation was required to be filed within 60

[3] Case 07-W-0508, Order Determining Revenue Requirement and Rate Design (Mar. 5, 2008).

days of the end of each rate year. Any reconciliation amount, with applicable interest, was then included in the next DSIC filing. Another reconciliation filing for this DSIC surcharge is required for the twelve month period ending March 31, 2012. Accordingly, with the expiration of the DSIC surcharge upon adoption of this JP, the Company will file with the Secretary to the Commission a single and final DSIC reconciliation for the twelve month period ending March 31, 2012. The resulting final DSIC reconciliation amount will be recovered or refunded via a one–time surcharge or credit 45 days from the date of the filing via operation of the Final DSIC Reconciliation Statement No. 1 ("FDR"). Staff will have the 45 days from the final reconciliation filing date to review the Company's submission and calculations. A template for the FDR is shown in Appendix G.

G. Rate Structure

The rate increases authorized for Years One, Two and Three will be calculated as follows: In each year of the rate plan, the full percentage increase needed to reach the authorized revenue requirement is applied equally to Service Classification No. 1 (Residential), No. 1A (Commercial & Industrial), No. 2 (Private Fire Hydrant Service), No.3 (Lawn Sprinklers), No. 4 (Public Fire Protection), No. 5 (Construction and Other Purposes) and No. 6 (Private Fire Protection).

H. Earnings Sharing

a. The Signatories have agreed to an Earnings Sharing Mechanism ("ESM"). The capital structure used in determining the overall rate of return is reflected in Appendix A. The debt-to-equity ratio and the cost of debt used in such calculation are as follows:

	Ratio	Cost	Weighted Average Cost	Pre-Tax Return
Long-Term Debt	57.11%	5.81%	3.32%	3.318%
Preferred Stock	0.89%	4.50%	0.04%	0.067%
Common Equity	42.00%	9.65%	4.05%	6.757%
Total	100%		7.41%	10.14%

b. LIAW's actual earned Return on Equity ("ROE") for earning purposes will be calculated on an aggregate basis for the three years ending March 31, 2015.

c. LIAW will be permitted to retain 100% of earnings attributable to an achieved return up to and including 10.2%. All earnings attributable to an achieved ROE above 10.2% and up to 10.7% will be shared 50%/50% between customers and shareholders. All earnings attributable to an achieved ROE above 10.7% will be shared on the basis of 75% to the customers and 25% to the shareholders. This Earnings Sharing Mechanism will continue beyond the end of the Rate Plan until LIAW's rates are reset in the next rate proceeding.

d. The sharing of revenues under this ESM will be determined in the following manner:

    a. For each of the three rate years provided for in this Joint Proposal, the earned return will be determined based upon the Company's regulated Net Income divided by Average Common Equity. The Common Equity ratio will be based on the lower of LIAW's actual common equity ratio or a hypothetical 42.00% common equity ratio. If the 42.0% hypothetical common equity ratio is used it, will be applied to the total capital structure (long term debt, short term debt, preferred stock and common equity) at the end of June, September, December and March of each rate year. These four numbers will then be averaged to determine the Average Common Equity for this calculation.

b. The aggregate achieved ROE for the three-year period ending March 31, 2015 will be the average of the achieved ROE for each of the three rate years ending March 31, 2013, March 31, 2014, and March 31, 2015. Any earnings to be shared with customers will include carrying charges computed at the "other customer capital rate" in effect beginning October 1 2013 (mid-point of the three rate years covered by this rate plan) and will continue until these net any over-earnings are passed back to customers.

c. The following items and methodologies will be included in the earnings sharing calculation:

- LIAW's total operating water revenues;
- Gains and losses on the sale of real property included in net income;
- The earnings impact of the System Improvement Charge ("SIC") surcharge revenues;

- For those items subject to reconciliation (actual metered revenues, fuel, power, chemicals, pension, OPEBs and property tax), the regulated net income will only reflect the rate year target amounts set forth herein;

- All other revenues and prudently incurred utility expenses considered part of the utility cost of service earnings.

d. The following items are excluded from the earnings sharing calculation:

- All other income (*i.e.*, revenues not generated from utility assets) and deductions and related taxes;

- Revenues and/or expenses resulting from any audit addressing the Company's past treatment of pensions and OPEBs with respect to the Commission's Policy Statement[4];

- All changes in accounting not contemplated in setting the revenue requirement;

- Shareholder portion of property tax refunds;

e. Any earnings due customers under this earnings sharing mechanism will be reflected in the revenue requirement in the Company's next general rate case or as directed by the Commission.

f. Within 90 days after the end of each year for the stay-out period, the Company will file with the Secretary to the Commission an earnings report and supporting documentation that will be used for the Earnings Sharing mechanism provided for in this Joint Proposal. In the third rate year report the Company will show the amount of any net over earnings are to be shared with ratepayers.

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[4] Case 91-M-0890, *Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Postretirement Benefits Other Than Pensions* (Issued September 7, 1993) ("Policy Statement").

I. Outreach and Education

a. The Company will continue to develop and implement customer outreach and education programs and materials to increase awareness and understanding of water issues, policies, and initiatives such as water quality, cost, system improvements, conservation techniques, customer rights and customer service matters. Within 30 days after the Commission issues an order adopting the terms of the Joint Proposal, the Company will file a plan with the Director of the Department of Public Service's Office of Consumer Policy ("OCP Director") for Staff review that details the outreach and education program's goals and objectives, target audiences, source of funding, core messages and implementation strategies, methods and schedule for the coming year. The annual plan may be reviewed and updated as appropriate and necessary based on significant changes in Company services or programs. The Company will review the plan each year of the rate term and send a letter to the Director within 30 days after the end of the Rate Year stating whether any change to the plan is warranted, and, if a change is warranted, describing the change.

J. Property Taxes

a. The Company's property tax expense for Rate Year One has been updated to reflect the actual amount of school taxes of $6,079,053, an increase of $1,032,785 over Staff's filed position.

b. For each of Year One, Year Two and Year Three, the variance between forecast and actual property taxes will be tracked. The Company will absorb or retain 10% of such variance, and the remaining variance (90%) shall be deferred and fully recovered or passed back to customers in the succeeding 12-month period as part of the RPCRC Mechanism. The Company will be allowed to retain the 10% of such variance only if it can successfully demonstrate that the reduction in property tax expense was a direct result of the Company's intervention and action (for the purpose of this paragraph, sale of property is not action that would trigger any potential sharing). The Company will absorb 10% of all property tax increases above the reconciliation levels set forth in section I, subsection d below, with the remainder paid by customers. This reconciliation will continue beyond the end of the Rate Plan.

c. Any such amounts that are deferred will accrue interest, net of tax, at the Commission-established other customer capital rate.

d. The forecasted property tax levels for utility assets for Year One, Year Two and Year Three are \$11,893,414; \$12,132,472 and \$12,390,893, respectively. Property tax refunds will not be reflected in the RPCRC. For such refunds, the Company will notify the Commission pursuant to Public Service Law ("PSL") § 113(2) and Part 89 of the Commission's Codes, Rules and Regulations (16 NYCRR Part 89). LIAW will accrue interest net of tax, at the other customer capital rate established by the Commission each year, from the date it received the refund until disposition.

K. Pension and OPEBs

a. The Company filed an update through December 31, 2010 in regard to the Internal Reserves for Pension and Other Post Retirement Benefits (OPEBs) on April 1, 2011 pursuant to Case 05-W-0339, Proceeding on Motion of the Commission to Examine the Accounting Practices of Long Island Water Corporation with Respect to its Pension and Other Post-Employment Benefit Plans. Staff is in the process of reviewing the filing and will provide the Company a draft report discussing the results of its examination and its preliminary recommendations for resolution of the filing when it completes its review. If the Staff and the Company are able to reach agreement on the appropriate resolution of the filing in a timely manner, the Company will submit a letter to the Secretary of the Commission recommending the agreement be incorporated in this Joint Proposal.

b. As a general matter, the Commission's Pension/OPEB Policy Statement[5] does not allow companies to accrue interest on Pension/OPEB Internal Reserve debit balances but does allow companies to seek prospective interest accruals or rate base treatment for debit balances.[6] The Company has made such a request in this proceeding for its Pension Internal Reserve, Staff is currently reviewing the support provided by the Company. If Staff agrees such treatment is appropriate before the

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[5] Case 91-7 M-0890, Statement of Policy and Order Concerning the 4 Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions (issued September 7, 1993) (Pension/OPEB Policy Statement).

[6] Id., Appendix A, p. 6, fn. 3.

Commission addresses this Joint Proposal, Staff will submit a letter recommending a provision be added to the Joint Proposal allowing the Company to accrue interest on its Pension Internal Reserve.

c. The Pension/OPEB Policy Statement requires that Pension/OPEB expense be computed on a stand-alone basis. The Company, in its rebuttal testimony, formally filed to be transitioned to a consolidated basis, pursuant to section N of the text of the Pension/OPEB Policy Statement. For the three-year term covered by this agreement, the Company's Pension/OPEB expense will be computed on a consolidated basis for accounting and ratemaking purposes. The Commission may require the Company to revert to computing Pension/OPEB expense on stand-alone basis for accounting and ratemaking purposes at the end of the three-year term. The Company will continue to compute the amount of Pension/OPEB on a stand-alone basis for the three-year term covered by this Joint Proposal, see subsection e, below, which covers the ongoing costs of the stand-alone calculation from the Company's actuary.

d. For the term of this Joint Proposal, the target amount of O&M expense reflected in rates for pensions will be $888,830 which is the combination of the consolidated FAS 87 expense and disability payments after capitalization and the target amount of O&M expense reflected in rates for OPEBs will be $501,120 which is the consolidated FAS 106 expense after capitalization for all three Rate Years.

e. The Company is allowed to recover $36,000 in actuarial costs for the stand-alone calculation per rate year in base rates.

L. <u>Rate Case Amortization</u>

The Company is authorized to amortize rate case expense of $232,000 over 3 years or $77,333.33 annually.

M. <u>Tariff and Regulatory Filings</u>

1. As part of its compliance filing, the Company will file the following revisions to its PSC No. 1 – Water:

   a. Consecutively numbered Cancellation Supplement canceling:

      Leaf No. 60, Revision 3
      Leaf No. 61, Revision 3
      Leaf No. 62, Revision 3
      Leaf No. 63, Revision 3
      Leaf No. 64, Revision 3
      Leaf No. 65, Revision 3
      Leaf No. 66, Revision 3
      Leaf No. 67, Revision 3
      Leaf No. 68, Revision 3
      Leaf No. 69, Revision 3

      Distribution System Improvement Charge (DSIC) Statement No. 7

      Suspension Supplement No. 1
      Suspension Supplement No. 2

   b. Leaves as set forth in Appendix C**,** to become effective April 1, 2012, April 1, 2013 and April 1, 2014:

      4th Revised Leaves Nos. 60 through 69

      5th Revised Leaves Nos. 60 through 69

      6th Revised Leaves Nos. 60 through 69

   c. Revenue and Production Cost Reconciliation Adjustment Clause and Property Tax Clause #1 (RPCRC) Statement No. 3 as set forth in Appendix D.

d. System Improvement Charge (SIC) Statement No. 3 as set forth in Appendix E.

2. The Parties have all had the opportunity to review the rates contained on the proposed tariff leaves and statements listed in 1(b) above. These leaves and statements should be allowed to go into effect on a permanent basis.

N. Stayout Provision

In the event this Joint Proposal is adopted by the Commission, LIAW commits that it will not file a base rate increase application, except as provided herein, before April 1, 2014, for a rate to go into effect before April 1, 2015, after being suspended for the maximum period under the statutes. However, this commitment will not prohibit LIAW from seeking temporary rate relief pursuant to Sections 89-j and 114 of the Public Service Law ("PSL"), as the same may be amended from time to time, if such temporary rate relief is needed to preserve the financial integrity of the Company. This section will not prevent the Company from filing tariffs or tariff amendments reflecting new or revised service offerings that are revenue neutral.

O. Legislative, Regulatory and Related Actions

The Signatories recognize that any law, rule, regulation, order, or other requirement (or any repeal or amendment of an existing law, rule, regulation, order, or other requirement) of the State, local, or federal governments may result in a change in the Company's revenues, expenses and rate base (including income or other federal or State tax expense and local property taxes) not anticipated in the forecasts for the Rate Plan. If such an event results in an annual revenue requirement impact greater than \$420,000, which would be in excess of the Commission's materiality threshold for deferral accounting (5% of net income available to common shareholders), the Company may or the Commission may require the Company to file a petition for deferral of the full revenue requirement effect of any such event. Any such approved deferrals will be reflected in rates in the next annual period or in a manner as otherwise directed by the Commission. No regulatory asset deferrals in this Section will be authorized to the extent that the Company's earnings before sharing exceed an ROE of 10.65% for Year One, 10.0% for Year Two and 9.90% for Year Three.

P. Reservation of Commission Authority

The Signatories hereby acknowledge and agree that the Commission, pursuant to its statutory responsibility, reserves the authority to act on the level of the Company's rates in the event of unforeseen circumstances that, in the opinion of the Commission, establish rates that exceed just and reasonable rates for service or have such a substantial impact upon the range of earnings levels or equity returns envisioned by this Joint Proposal so as to render the Company's actual return in any Rate Year unreasonable or insufficient for the provision of safe and adequate service at just and reasonable rates. No provision of this Joint Proposal or the Commission's adoption of the terms of this Joint Proposal shall in any way abrogate or limit the Commission's statutory authority under the PSL. The Signatories recognize that any Commission adoption of the terms of this Joint Proposal does not waive the Commission's ongoing rights and responsibilities to enforce its orders and effectuate the goals expressed therein, nor the rights and responsibilities of Staff to conduct investigations or take other actions in furtherance of its duties and responsibilities.

Q. Non-Severability and Non-Precedential Value of Provisions

Each provision of this Joint Proposal is in consideration of and supports all other provisions, and each provision is expressly conditioned upon acceptance by the Commission of the Joint Proposal in its entirety. If the Commission fails to adopt the Joint Proposal in its entirety and according to the Joint Proposal's terms, the Signatories will be free to pursue their respective positions in this proceeding without prejudice. The terms and conditions of the Joint Proposal apply solely to, and are binding only in the context of, the purposes and results of the Joint Proposal. None of the terms and provisions of the Joint Proposal, and none of the positions taken herein by any party, may be referred to, cited, or relied upon by any other party in any fashion as precedent or in any other proceedings before this Commission, or any other regulatory agency, or before any court of law for any purpose except: (a) in furtherance of the purposes and results of the Joint Proposal, or (b) in negotiation, litigation, or other proceedings in any case arising from or related to the Joint Proposal.

R. Dispute Resolution

Any disagreement over the interpretation of the Joint Proposal or the implementation of any of the provisions of the Joint Proposal that cannot be resolved informally among the Signatories will be resolved as follows. The Signatories promptly will confer and in good faith attempt to resolve such disagreement. If the disagreement cannot be resolved by the Signatories, the matter will be submitted to an ALJ designated by the Chief ALJ for a determination on an expedited basis using alternative dispute resolution techniques or such other procedures as the ALJ decides are appropriate under the circumstances. Within 15 days from the ALJ's decision, any party may petition the Commission for relief from the ALJ's determination on the disputed matter.

S. Submission of Joint Proposal

The Signatories agree to submit this Joint Proposal to the Commission and to individually support and request its adoption by the Commission as set forth herein. The Signatories hereto believe that the Joint Proposal will satisfy the requirements of PSL § 89-b(1) that LIAW provide safe and adequate service at just and reasonable rates.

T. Further Assurances

The Signatories recognize that certain provisions of this Joint Proposal require that actions be taken in the future to fully effectuate this Joint Proposal. Accordingly, the Signatories agree to cooperate with each other in good faith in taking such actions.

U. Execution

This Joint Proposal may be executed in counterpart originals and will be binding upon each signatory party when its executed counterpart is filed with the Secretary of the Commission.

IV. CONCLUSION

The Signatories believe this Joint Proposal is in the public interest and urge the Commission to adopt its terms.

The foregoing Joint Proposal in Case 11-W-0200 is Adopted and Agreed to by:

Staff of the Department of Public Service

JOSEPH DOWLING, Esq.
Assistant Counsel

Dated: November 27, 2011

The foregoing Joint Proposal in Case 11-W-0200 is Adopted and Agreed to by:

Long Island Water Corporation d/b/a
Long Island American Water

Steven D. Wilson, Esq.
Harris Beach PLLC
Attorneys for LIWC and LIAW

Dated: November 28, 2011

The foregoing Joint Proposal in Case 11-W-0200 is Adopted and Agreed to by:

By: DOS Division of Consumer Protection

____
Lisa R. Harris, Esq. Division Director

Date: November 28, 2011

Appendix A

Long Island American Water
Statement of Operating Income
For the Rate Year Ending March 31, 2013

	Per Company As Initially Filed	Adj. No.	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Operating Revenues						
Water Sales	$ 48,871,673		$ -	$ 48,871,673	$ 2,945,886	$ 51,817,559
Other Revenue	191,486		-	191,486	9,332	200,818
Total Operating Revenues	49,063,159		-	49,063,159	2,955,218	52,018,377
O & M Expenses (from page 2)	23,943,730	1	(1,632,506)	22,311,224	25,175	22,336,399
Depreciation Expense	4,373,069	2	(261,519)	4,111,550	-	4,111,550
Taxes Other Than Income Taxes						
Property Taxes	14,365,278	3	(2,471,864)	11,893,414	-	11,893,414
Payroll Taxes	538,791	4	(36,507)	502,284	-	502,284
Other Taxes	-		-	-	-	-
Total Taxes Other Than Income Taxes	14,904,069		(2,508,371)	12,395,698	-	12,395,698
Total Operating Revenue Deductions	43,220,868		(4,402,396)	38,818,472	25,175	38,843,647
Net Operating Income Before SIT	5,842,291		4,402,396	10,244,687	2,930,043	13,174,730
State Income Tax Expense	129,790	5	364,573	494,363	252,863	747,226
Net Operating Income Before FIT	5,712,501		4,037,823	9,750,324	2,677,180	12,427,504
Federal Income Tax Expense	766,848	6	1,198,789	1,965,637	910,241	2,875,878
Net Income Available for Return	$ 4,945,653		$ 2,839,034	$ 7,784,687	$ 1,766,939	$ 9,551,626
Rate Base	$ 126,945,552	7	$ 1,935,614	$ 128,881,166	$ 827	$ 128,881,993
Rate of Return	3.90%			6.04%		7.41%

Case No. 11-W-0200

Exhibit__(ACL-1)
Schedule 2
Page 1 of 1

Long Island American Water
Schedule of Operating and Maintenance Expenses
For the Rate Year Ending March 31, 2013

Operating & Maintenance Expenses	Per Company As Initially Filed	Adj. No. 1	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Payroll	$ 7,033,860	a	$ (477,211)	$ 6,556,649	$ -	$ 6,556,649
Productivity Adjustment	(100,619)	b	6,581	(94,038)	-	(94,038)
Purchased Power	2,396,573	c	18,976	2,415,549	-	2,415,549
Fuel	432,344	d	2,056	434,400	-	434,400
Chemicals	1,101,987	e	1,288	1,103,275	-	1,103,275
Invoices	2,566,311	f	(64,991)	2,501,320	-	2,501,320
Leased Vehicles	565,426	g	(94,288)	471,138	-	471,138
Service Company	5,374,394	h	(668,372)	4,706,022	-	4,706,022
Postage	333,023		-	333,023	-	333,023
Rents	16,826		-	16,826	-	16,826
Group Insurance	866,875	i	-	866,875	-	866,875
OPEBs	498,777	j	2,343	501,120	-	501,120
Pension	884,674	k	4,156	888,830	-	888,830
401k Expense	132,786	l	(6,484)	126,302	-	126,302
Deferred Contribution Plan	96,315	m	(7,410)	88,905	-	88,905
Insurance Other Than Group	800,189	n	2,971	803,160	-	803,160
Uncollectible Accounts	307,892		-	307,892	18,559	326,451
PSC Assessment	117,312		-	117,312	6,616	123,928
Employee Stock Purchase Plan	3,163	o	(3,163)	-	-	-
Retiree Medical	6,642		-	6,642	-	6,642
Customer Outreach and Education Program	84,821	p	1,263	86,084	-	86,084
Amort. of Deferred Rate Case costs	233,333	q	(156,000)	77,333	-	77,333
Amort. of Deferred Tank Painting costs	32,884		-	32,884	-	32,884
Amort. of Deferred Pension/OPEB expense	-		-	-	-	-
Amortization of Actuarial Studies	96,444	r	(96,444)	-	-	-
Audit Fees	61,498		-	61,498	-	61,498
Actuarial Fees	-	s	36,000	36,000	-	36,000
Synergy Savings	-	t	(133,777)	(133,777)	-	(133,777)
Total O & M Expenses	$ 23,943,730		$ (1,632,506)	$ 22,311,224	$ 25,175	$ 22,336,399

Long Island American Water
Calculation of State Income Tax Expense
For the Rate Year Ending March 31, 2013

	Per Company As Initially Filed	Adj. No. 5	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Net Operating Income Before SIT	$ 5,842,291	a	$ 4,402,396	$ 10,244,687	$ 2,930,043	$ 13,174,730
Additions/Deductions						
Interest Expense	(4,278,065)	b	(238,195)	(4,516,260)	-	(4,516,260)
Depreciation Differences	(705,249)		-	(705,249)	-	(705,249)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(422,944)	c	(671,682)	(1,094,626)	-	(1,094,626)
Excess Deferred SIT	-		-	-	-	-
Total Adjustments for SIT	(5,406,258)		(909,877)	(6,316,135)	-	(6,316,135)
Taxable Income for SIT	436,033		3,492,519	3,928,552	2,930,043	6,858,595
Current SIT Expense @ 7.1%	30,958	d	247,969	278,927	208,033	486,960
MTA Surcharge on SIT @ (9% of 17%)	6,671	e	53,436	60,107	44,830	104,937
Current SIT w/ MTA Surcharge	37,630		301,404	339,034	252,863	591,897
Deferred SIT Expense						
Depreciation Differences	60,863		-	60,863	-	60,863
Amortization of Rate Case	20,137	f	(20,137)	-	-	-
Amortization of Tank Painting	2,838	f	(2,838)	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	8,323	f	(8,323)	-	-	-
Reduction to Taxable Income for Repairs Expens	-	g	94,466	94,466	-	94,466
Excess Deferred SIT	-		-	-	-	-
Deferred SIT Expense	92,161		63,169	155,329	-	155,329
Total State Income Tax Expense	$ 129,790		$ 364,573	$ 494,363	$ 252,863	$ 747,226

Long Island American Water
Calculation of Federal Income Tax Expense
For the Rate Year Ending March 31, 2013

	Per Company As Initially Filed	Adj. No. 6	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Net Operating Income Before FIT	$ 5,712,501	a	$ 4,037,823	$ 9,750,324	$ 2,677,180	$ 12,427,504
Additions/Deductions						
Deferred State Income Tax	92,161	b	63,169	155,329	-	155,329
Interest Expense	(4,278,065)	c	(238,195)	(4,516,260)	-	(4,516,260)
Depreciation Differences	(4,983,026)		-	(4,983,026)	-	(4,983,026)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(422,944)	d	(671,682)	(1,094,626)	-	(1,094,626)
Excess Deferred FIT	-		-	-	-	-
Total Adjustments for FIT	(9,591,874)		(846,708)	(10,438,583)	-	(10,438,583)
Taxable Income for FIT	(3,879,374)		3,191,115	(688,259)	2,677,180	1,988,921
Current FIT Expense @ 34%	(1,318,987)	e	1,084,979	(234,008)	910,241	676,233
Deferred FIT Expense						
Deferred State Income Tax	(31,335)	f	(21,477)	(52,812)	-	(52,812)
Depreciation Differences	1,694,229		-	1,694,229	-	1,694,229
Amortization of Flow Through Tax Depr	324,519	g	(113,581)	210,938	-	210,938
Amortization of Rate Case	79,333	h	(79,333)	-	-	-
Amortization of Tank Painting	11,181	h	(11,181)	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	32,791	h	(32,791)	-	-	-
Reduction to Taxable Income for Repairs Expens	-	i	372,173	372,173	-	372,173
Excess Deferred FIT	(9,883)		-	(9,883)	-	(9,883)
Deferred FIT Expense	2,100,835		113,810	2,214,645	-	2,214,645
Amortization of ITC	(15,000)		-	(15,000)	-	(15,000)
Total Federal Income Tax Expense	$ 766,848		$ 1,198,789	$ 1,965,637	$ 910,241	$ 2,875,878

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Long Island American Water
Rate Base Summary
For the Rate Year Ending March 31, 2013

	Per Company As Initially Filed	Adj. No. 7	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Net Utility Plant						
Water Plant in Service	$ 194,615,892	a	$ (520,000)	$ 194,095,892	$ -	$ 194,095,892
Non-Interest Bearing CWIP	262,553		-	262,553	-	262,553
Plant Held For Future Use	110,933		-	110,933	-	110,933
Less Accumulated Depreciation	(52,188,969)	b	64,115	(52,124,854)	-	(52,124,854)
Total Net Utility Plant	142,800,409		(455,885)	142,344,524	-	142,344,524
Customer Advances for Construction	(65,427)		-	(65,427)	-	(65,427)
Working Capital						
Cash Allowance	2,886,976	c	(150,337)	2,736,639	827	2,737,466
Materials and Supplies	617,481	d	4,889	622,370	-	622,370
Prepayments	1,562,789	e	636	1,563,425	-	1,563,425
Total Working Capital	5,067,246		(144,812)	4,922,434	827	4,923,261
Regulatory Deferrals						
Tank Painting (net of tax)	148,729		-	148,729	-	148,729
Rate Case Expense (net of tax)	231,166	f	(99,692)	131,474	-	131,474
Deferred Pensions/OPEB expense	-		-	-	-	-
Pension Actuarial Study (net of tax)	145,400	g	(145,400)	-	-	-
Total Regulatory Deferrals	525,295		(245,092)	280,203	-	280,203
Accumulated Deferred Income Taxes	(20,181,145)	h	3,587,839	(16,593,306)	-	(16,593,306)
Earnings Base Capitalization Adj.	(1,200,826)	i	(806,436)	(2,007,262)	-	(2,007,262)
Total Rate Base	$ 126,945,552		$ 1,935,614	$ 128,881,166	$ 827	$ 128,881,993

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Long Island American Water
Summary of Cash Working Capital Allowance
For the Rate Year Ending March 31, 2013

	Per Company As Initially Filed	Joint Proposal Adjustments	Rate Year 1 As Adjusted	Rate Year 1 Revenue Requirement Adjustment	Rate Year 1 As Adjusted Revenue Requirement
Total O & M Expenses	$ 23,826,418	$ (1,515,194)	$ 22,311,224	$ 25,175	$ 22,336,399
Adjustments:					
Uncollectible Accounts Expense	(367,949)	60,057	(307,892)	(18,559)	(326,451)
Amort. of Deferred Rate Case costs	(233,333)	156,000	(77,333)	-	(77,333)
Amort. of Deferred Tank Painting costs	(32,884)	-	(32,884)	-	(32,884)
Amort. of Deferred Pension/OPEB exp	-	-	-	-	-
Amort. of Pension Actuarial Study	(96,444)	96,444	-	-	-
Total Adjustments	(730,610)	312,501	(418,109)	(18,559)	(436,668)
Sub-total for Cash W/C allowance	23,095,808	(1,202,693)	21,893,115	6,616	21,899,731
Weighted Billing factor - 1/8 (45 days)	12.50%	12.50%	12.50%	12.50%	12.50%
Total Cash W/C Allowance	$ 2,886,976	$ (150,337)	$ 2,736,639	$ 827	$ 2,737,466

Long Island American Water
Cost of Capital
For the Rate Year Ending March 31, 2013

	Percent	Cost Rate	Weighted Cost	Pre-Tax Return
Long-Term Debt	57.11%	5.81%	3.318%	3.318%
Preferred Stock	0.89%	4.50%	0.040%	0.067%
Common Equity	42.00%	9.65%	4.053%	6.757%
Totals	100.00%		7.41%	10.14%

Long Island American Water
Computation of Revenue Requirement
For the Rate Year Ending March 31, 2013

	Rate Year 1 Per JP
Average Rate Base	$ 128,881,993
Rate of Return on Rate Base	7.41%
Required Net Income	9,551,626
Net Income before Revenue Requirement	7,784,687
Earnings Deficiency	1,766,939
Retention Factor	59.98%
Revenue Increase	$ 2,945,886

Calculation of Retention ("Gross-Up") Factor:	Percentages	Rate Year 1 Revenue Requirement
Sales Revenues	100.00%	$ 2,945,886
Late Payment Charges	0.32%	9,332
PSC Assessment	0.22%	6,616
Uncollectible Accounts Expense	0.63%	18,559
Retention Factor before Income Taxes	99.46%	2,930,043
SIT Expense @7.1% plus (9% times 17%) MTA Surcharge on SIT	8.58%	252,863
FIT Expense @ 34%	30.90%	910,242
Retention Factor	59.98%	$ 1,766,939

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness		Amount
1	Operating & Maintenance Expenses			
a.	Payroll			
	1) To reflect the removal of three vacant union employee positions	Leung / Water Rates	$	(211,353)
	Adjust to allow one union employee	JP		55,978
	Correction for error of Supervisor Field Operations	JP		33,632
	2) To reflect payroll adjusted for general inflation	Leung		(187,367)
	Corrections to reflect 2012 wage increase and update to 2012 general inflation	Correction		61,002
	3) To reflect HTY overtime (OT) adjusted for general inflation	Leung		(121,031)
	Corrections to reflect update to 2012 general inflation	Correction		(568)
	4) To remove incentive compensation	Leung		(260,010)
	5) To adjust payroll with HTY capitalized payroll percentage	Leung		162,530
	Tracks corrections to payroll	Correction		(10,024)
	Total Adjustments to Payroll		$	(477,211)
b.	Productivity Adjustment			
	Tracking Staff's adjustments to payroll	Leung		6,734
	Tracks corrections to payroll	Correction		366
	Adjust to allow one union employee	JP		(519)
	Total Adjustments to Productivity			6,581
c.	Purchased Power			
	Adjusted for inflation	JP		18,976
d.	Fuel			
	Adjusted for inflation	JP		2,056
e.	Chemicals			
	Adjusted for inflation	JP		1,288
f.	Invoices			
	To reflect Staff's adjustments to invoices expense	Bailey		(183,231)
	To allow inflation on invoices	JP		70,000
	Adjust to allow the public relation employee	JP		48,240
	Total Adjustments to Invoices			(64,991)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
g.	Leased Vehicles		
	To reflect Staff's adjustments to leased vehicles expense	Simpson	(136,777)
	Adjust fuel to reflect 3 yr avg of consumptions @$3.861 per gallon	JP	42,489
	Total Adjustments to Leased Vehicles		(94,288)
h.	Service Company Expense		
	To reflect Staff's adjustments to service company expense	Bailey	(940,929)
	Modify Staff's normalization adjustment based on company's rebuttal testimony	JP	272,557
	Total Adjustments to Service Company Expense		(668,372)
i.	Group Insurance		
	Correction to reflect latest known cost rates + inflation and limit health insurance to 89 employees	Correction	(92,660)
	Update to reflect 2011 cost rates	JP	92,660
	Total Adjustments to Group Insurance		-
j.	Post-Retirement Other than Pensions (OPEBs)		
	To adjust OPEBs expense with HTY capitalized payroll percentage	Bailey	2,343
k.	Pension Expense		
	To adjust pension expense with HTY capitalized payroll percentage	Bailey	4,156
l.	401(k) Plan Expense		
	Tracking Staff's adjustments to payroll	Leung	(9,853)
	Tracks corrections to payroll	Correction	1,130
	Adjust to allow one union employee	JP	2,239
	Total Adjustments to 401(k) Expense		(6,484)
m.	Defined Contribution Plan (DCP)		
	Tracking Staff's adjustments to payroll	Leung	(11,042)
	Tracks corrections to payroll	Correction	693
	Adjust to allow one union employee	JP	2,939
	Total Adjustments to DCP Expense		(7,410)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
n.	Insurance Other Than Group		
	Adjusted for inflation	JP	2,971
o.	Employee Stock Purchase Plan (ESPP)		
	To remove ESPP costs from operating expense	Leung	(3,163)
p.	Customer Outreach and Education Program		
	Adjusted for inflation	JP	1,263
q.	Amortization of Deferred Rate Case Expense		
	To adjust the forecast of rate case expense amortized over three years	Simpson	(171,000)
	Adjust to allow $30,000 total for rev req panel and $15,000 for King	JP	15,000
	Total Adjustments to Rate Case Expense		(156,000)
r.	Amortization of Actuarial Studies		
	To disallow the amortization of expense to perform stand-alone pension and OPEB	Bailey	(96,444)
s.	Actuarial Fees		
	To allow actuarial fees to calculate pension and OPEBs on a stand alone basis	JP	36,000
t.	Synergy Savings		
	To reflect company's estimate of rate year 1 synergy savings	JP	(133,777)
	Total Adjustments to Operating & Maintenance Expense		(1,632,506)

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Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
2	Depreciation Expense		
	To reflect Staff's adjustments to book depreciation expense	Water Rates	(6,419)
	Correction to reflect actual depreciation expense	JP	(255,100)
	Total Adjustments to Depreciation Expense		**(261,519)**
	Taxes Other Than Income Taxes		
3	Property Taxes		
	To adjust property tax forecast to reflect latest known amounts plus inflation	Bailey	(3,504,649)
	Tracks update to school property taxes	JP	1,032,785
	Total Adjustments to Depreciation Expense		**(2,471,864)**
4	Payroll Taxes		
	Tracking Staff's adjustments to payroll	Leung	(38,638)
	Tracks corrections to payroll	Correction	3,884
	Track adjustments to payroll	JP	(1,753)
			(36,507)
	Total Adjustments to Taxes Other Than Income Taxes		**(2,508,371)**

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
5	State Income Taxes		
a.	Net Operating Income before SIT		
	To reflect Staff's adjustments to operating revenues and expenses		$ 4,402,396
	Adjustments to Taxable Income		
b.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP	Leung	(238,195)
c.	Reduction to Taxable Income for Repairs Expense		
	To reflect LIAW's correction to the repairs expense deduction	Leung	(671,682)
	Total Adjustments to Taxable Income - SIT		(909,877)
d.	State Income Tax		
	To reflect state income tax expense at the current rate of 7.1%		247,969
e.	MTA Tax Surcharge		
	To reflect MTA tax surcharge at the current rate of 17%		53,436
	Deferred State Incomes Taxes		
f.	Removal of Deferred SIT for Rate Case, Tank Painting and Pension Study		
	To remove deferred SIT from items that are not supported by tax deductions	Leung	(31,298)
g.	Amortization of Deferred Repairs Expense Deduction		
	To correct omission of deferred SIT on repairs expense deduction	Leung	94,466
	Total Deferred SIT		63,169

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj. No.		Witness	Amount
6	Federal Income Taxes		
a.	Net Operating Income before FIT		
	To reflect Staff's adjustments made to operating revenues and expenses		$ 4,037,823
	Adjustments to Taxable Income		
b.	Deferred State Income Tax		
	Tracking Staff's deferred state income tax calculation		63,169
c.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP	Leung	(238,195)
d.	Reduction to Taxable Income for Repairs Expense		
	To reflect LIAW's correction to the repairs expense deduction	Leung	(671,682)
	Total Adjustments to Taxable Income - FIT		(846,708)
e.	Federal Income Tax		
	To reflect federal income taxes at the current 34% tax rate		1,084,979
	Deferred Federal Incomes Taxes		
f.	Deferred State Income Taxes		
	Tracking Staff's adjustment of deferred SIT		(21,477)
g.	Amortization of Flow-Through Tax Depreciation		
	To correct deferred FIT on the amortization of flow-through tax depreciation	Leung	(113,581)
h.	Removal of Deferred FIT for Rate Case, Tank Painting and Pension Study		
	To remove deferred FIT from items that are not supported by tax deductions	Leung	(123,305)
i.	Amortization of Deferred Repairs Expense Deduction		
	To correct omission of deferred FIT on repairs expense deduction	Leung	372,173
	Total Deferred FIT		113,810

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
7	Rate Base		
a.	Water Plant In Service		
	To reflect Staff's correction to Water Plant in Service based on IR-171, MVH-15	Water Rates	$ (520,000)
b.	Accumulated Provision for Depreciation		
	Tracking Staff's plant in service adjustments	Water Rates	5,070
	Tracks update to Water Plant in Service	JP	59,045
	Total Adjustments to Depreciation Expense		64,115
	Working Capital		
c.	Cash Allowance		
	Tracking the Staff's adjustments to O & M expenses		(150,337)
	Materials and Supplies		
d.	Adjusted for inflation	JP	4,889
	Prepayments		
e.	Adjusted for inflation	JP	636
	Total Adjustments to Working Capital		(144,812)
	Regulatory Deferrals		
f.	Deferred Rate Case Expense		
	Tracking Staff's recommended rate year amortization	Simpson	(137,192)
	Adjust to reflect total rate case allowance of $232,000	JP	37,500
	Total Adjustments to Deferred Rate Case Exp.		(99,692)
g.	Deferred Pension Actuarial Study		
	Tracking Staff's recommended rate year amortization	Bailey	(145,400)
	Total Adjustments to Regulatory Deferrals		(245,092)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2013

Adj No.		Witness	Amount
7	Rate Base		
h.	Accumulated Deferred Income Taxes (ADIT)		
	Tracking Staff's correction to Water Plant in Service based on IR-171, MVH-15	Leung / Water Rates	524,546
	Corrections to reflect RY impact of HTY differences	Correction	2,908,546
	Tracks update to Water Plant in Service	JP	154,747
	Total Adjustments to Accumulated Deferred Income Taxes		**3,587,839**
i.	Earnings Base vs. Capitalization Adjustment (EBCap)		
	1) To reflect Staff's adjustment to capitalization	Leung	(458,006)
	2) To reflect Staff's corrections to HTY accumulated deferred income taxes	Leung	(2,908,546)
	Correction to ADIT to reflect HTY balance instead of RY balance	Correction	2,560,116
	Total Adjustments to EBCap		**(806,436)**
	Total Adjustments to Rate Base		**1,935,614**

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Long Island American Water
Statement of Operating Income
For the Rate Year Ending March 31, 2014

	Rate Year 1 Revenue Requirement	Adj. No.	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Operating Revenues						
Water Sales	$ 51,817,559		$ -	$ 51,817,559	$ 1,371,481	$ 53,189,040
Other Revenue	200,818		-	200,818	4,345	205,163
Total Operating Revenues	52,018,377		-	52,018,377	1,375,826	53,394,203
O & M Expenses (from page 2)	22,336,399	1	162,697	22,499,096	11,720	22,510,816
Depreciation Expense	4,111,550	2	333,303	4,444,853	-	4,444,853
Taxes Other Than Income Taxes						
Property Taxes	11,893,414	3	239,058	12,132,472	-	12,132,472
Payroll Taxes	502,284	4	10,082	512,366	-	512,366
Other Taxes	-		-	-	-	-
Total Taxes Other Than Income Taxes	12,395,698		249,139	12,644,838	-	12,644,838
Total Operating Revenue Deductions	38,843,647		745,140	39,588,787	11,720	39,600,507
Net Operating Income Before SIT	13,174,730		(745,140)	12,429,590	1,364,106	13,793,696
State Income Tax Expense	747,226	5	(81,846)	665,380	117,722	783,102
Net Operating Income Before FIT	12,427,504		(663,293)	11,764,211	1,246,384	13,010,594
Federal Income Tax Expense	2,875,878	6	(294,626)	2,581,252	423,771	3,005,023
Net Income Available for Return	$ 9,551,626		$ (368,667)	$ 9,182,959	$ 822,613	$ 10,005,572
Rate Base	$ 128,881,993	7	$ 6,124,795	$ 135,006,788	$ 385	$ 135,007,173
Rate of Return	7.41%			6.80%		7.41%

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Long Island American Water
Schedule of Operating and Maintenance Expenses
For the Rate Year Ending March 31, 2014

Operating & Maintenance Expenses	Rate Year 1 Revenue Requirement	Adj. No. 1	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Payroll	$ 6,556,649	a	$ 131,789	$ 6,688,438	$ -	$ 6,688,438
Productivity Adjustment	(94,038)	b	(1,638)	(95,676)	-	(95,676)
Purchased Power	2,415,549	c	48,553	2,464,102	-	2,464,102
Fuel	434,400	d	8,731	443,131	-	443,131
Chemicals	1,103,275	e	22,176	1,125,451	-	1,125,451
Invoices	2,501,320	f	50,277	2,551,597	-	2,551,597
Leased Vehicles	471,138	g	9,470	480,608	-	480,608
Service Company	4,706,022	h	94,591	4,800,613	-	4,800,613
Postage	333,023	i	6,694	339,717	-	339,717
Rents	16,826	j	338	17,164	-	17,164
Group Insurance	866,875	k	17,424	884,299	-	884,299
OPEBs	501,120		-	501,120	-	501,120
Pension	888,830		-	888,830	-	888,830
401k Expense	126,302	l	2,539	128,841	-	128,841
Deferred Contribution Plan	88,905	m	1,787	90,692	-	90,692
Insurance Other Than Group	803,160	n	16,144	819,304	-	819,304
Uncollectible Accounts	326,451		-	326,451	8,640	335,091
PSC Assessment	123,928		-	123,928	3,080	127,008
Employee Stock Purchase Plan	-		-	-	-	-
Retiree Medical	6,642	o	134	6,776	-	6,776
Customer Outreach and Education Program	86,084	p	1,730	87,814	-	87,814
Amort. of Deferred Rate Case costs	77,333		-	77,333	-	77,333
Amort. of Deferred Tank Painting costs	32,884		-	32,884	-	32,884
Amort. of Deferred Pension/OPEB expense	-		-	-	-	-
Amortization of Actuarial Studies	-		-	-	-	-
Audit Fees	61,498	q	1,236	62,734	-	62,734
Actuarial Fees	36,000	r	724	36,724	-	36,724
Synergy Savings	(133,777)	s	(250,000)	(383,777)	-	(383,777)
Total O & M Expenses	$ 22,336,399		$ 162,697	$ 22,499,096	$ 11,720	$ 22,510,816

Long Island American Water
Calculation of State Income Tax Expense
For the Rate Year Ending March 31, 2014

	Rate Year 1 Revenue Requirement	Adj. No. 5	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Net Operating Income Before SIT	$ 13,174,730	a	$ (745,140)	$ 12,429,590	$ 1,364,106	$ 13,793,696
Additions/Deductions						
Interest Expense	(4,516,260)	b	(203,254)	(4,719,514)	-	(4,719,514)
Depreciation Differences	(705,249)		-	(705,249)	-	(705,249)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(1,094,626)		-	(1,094,626)	-	(1,094,626)
Excess Deferred SIT	-		-	-	-	-
Total Adjustments for SIT	(6,316,135)		(203,254)	(6,519,389)	-	(6,519,389)
Taxable Income for SIT	6,858,595		(948,393)	5,910,202	1,364,106	7,274,308
Current SIT Expense @ 7.1%	486,960	c	(67,336)	419,624	96,852	516,476
MTA Surcharge on SIT @ (9% of 17%)	104,937	d	(14,510)	90,426	20,871	111,297
Current SIT w/ MTA Surcharge	591,897		(81,846)	510,050	117,722	627,773
Deferred SIT Expense						
Depreciation Differences	60,863		-	60,863	-	60,863
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	94,466		-	94,466	-	94,466
Excess Deferred SIT	-		-	-	-	-
Deferred SIT Expense	155,329		-	155,329	-	155,329
Total State Income Tax Expense	$ 747,226		$ (81,846)	$ 665,380	$ 117,722	$ 783,102

Long Island American Water
Calculation of Federal Income Tax Expense
For the Rate Year Ending March 31, 2014

	Rate Year 1 Revenue Requirement	Adj. No. 6	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Net Operating Income Before FIT	$ 12,427,504	a	$ (663,293)	$ 11,764,211	$ 1,246,384	$ 13,010,594
Additions/Deductions						
Deferred State Income Tax	155,329		-	155,329	-	155,329
Interest Expense	(4,516,260)	b	(203,254)	(4,719,514)	-	(4,719,514)
Depreciation Differences	(4,983,026)		-	(4,983,026)	-	(4,983,026)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(1,094,626)		-	(1,094,626)	-	(1,094,626)
Excess Deferred FIT	-		-	-	-	-
Total Adjustments for FIT	(10,438,583)		(203,254)	(10,641,836)	-	(10,641,836)
Taxable Income for FIT	1,988,921		(866,547)	1,122,374	1,246,384	2,368,758
Current FIT Expense @ 34%	676,233	c	(294,626)	381,607	423,771	805,378
Deferred FIT Expense						
Deferred State Income Tax	(52,812)		-	(52,812)	-	(52,812)
Depreciation Differences	1,694,229		-	1,694,229	-	1,694,229
Amortization of Flow Through Tax Depr	210,938		-	210,938	-	210,938
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	372,173		-	372,173	-	372,173
Excess Deferred FIT	(9,883)		-	(9,883)	-	(9,883)
Deferred FIT Expense	2,214,645		-	2,214,645	-	2,214,645
Amortization of ITC	(15,000)		-	(15,000)	-	(15,000)
Total Federal Income Tax Expense	$ 2,875,878		$ (294,626)	$ 2,581,252	$ 423,771	$ 3,005,023

Long Island American Water
Rate Base Summary
For the Rate Year Ending March 31, 2014

	Rate Year 1 Revenue Requirement	Adj. No. 7	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Net Utility Plant						
Water Plant in Service	$ 194,095,892	a	$ 10,715,367	$ 204,811,259	$ -	$ 204,811,259
Non-Interest Bearing CWIP	262,553		-	262,553	-	262,553
Plant Held For Future Use	110,933		-	110,933	-	110,933
Less Accumulated Depreciation	(52,124,854)	b	(3,932,201)	(56,057,055)	-	(56,057,055)
Total Net Utility Plant	142,344,524		6,783,166	149,127,690	-	149,127,690
Customer Advances for Construction	(65,427)		-	(65,427)	-	(65,427)
Working Capital						
Cash Allowance	2,737,466	c	20,337	2,757,803	385	2,758,188
Materials and Supplies	622,370	d	12,510	634,880	-	634,880
Prepayments	1,563,425	e	31,425	1,594,850	-	1,594,850
Total Working Capital	4,923,261		64,272	4,987,533	385	4,987,918
Regulatory Deferrals						
Tank Painting (net of tax)	148,729	f	(19,840)	128,889	-	128,889
Rate Case Expense (net of tax)	131,474	g	(61,526)	69,948	-	69,948
Deferred Pensions/OPEB expense	-		-	-	-	-
Pension Actuarial Study (net of tax)	-		-	-	-	-
Total Regulatory Deferrals	280,203		(81,366)	198,837	-	198,837
Accumulated Deferred Income Taxes	(16,593,306)	h	(641,277)	(17,234,583)	-	(17,234,583)
Earnings Base Capitalization Adj.	(2,007,262)		-	(2,007,262)	-	(2,007,262)
Total Rate Base	$ 128,881,993		$ 6,124,795	$ 135,006,788	$ 385	$ 135,007,173

Long Island American Water
Summary of Cash Working Capital Allowance
For the Rate Year Ending March 31, 2014

	Rate Year 1 Revenue Requirement	Joint Proposal Adjustments	Rate Year 2 As Adjusted	Rate Year 2 Revenue Requirement Adjustment	Rate Year 2 As Adjusted Revenue Requirement
Total O & M Expenses	$ 22,336,399	$ 162,697	$ 22,499,096	$ 11,720	$ 22,510,816
Adjustments:					
Uncollectible Accounts Expense	(326,451)	-	(326,451)	(8,640)	(335,091)
Amort. of Deferred Rate Case costs	(77,333)	-	(77,333)	-	(77,333)
Amort. of Deferred Tank Painting costs	(32,884)	-	(32,884)	-	(32,884)
Amort. of Deferred Pension/OPEB exp	-	-	-	-	-
Amort. of Pension Actuarial Study	-	-	-	-	-
Total Adjustments	(436,668)	-	(436,668)	(8,640)	(445,308)
Sub-total for Cash W/C allowance	21,899,731	162,697	22,062,428	3,080	22,065,508
Weighted Billing factor - 1/8 (45 days)	12.50%	12.50%	12.50%	12.50%	12.50%
Total Cash W/C Allowance	$ 2,737,466	$ 20,337	$ 2,757,803	$ 385	$ 2,758,188

Long Island American Water
Cost of Capital
For the Rate Year Ending March 31, 2014

	Percent	Cost Rate	Weighted Cost	Pre-Tax Return
Long-Term Debt	57.11%	5.81%	3.318%	3.318%
Preferred Stock	0.89%	4.50%	0.040%	0.067%
Common Equity	42.00%	9.65%	4.053%	6.757%
Totals	100.00%		7.41%	10.14%

Long Island American Water
Computation of Revenue Requirement
For the Rate Year Ending March 31, 2014

	Rate Year 2 Per JP
Average Rate Base	$ 135,007,173
Rate of Return on Rate Base	7.41%
Required Net Income	10,005,572
Net Income before Revenue Requirement	9,182,959
Earnings Deficiency	822,613
Retention Factor	59.98%
Revenue Increase	$ 1,371,481

Calculation of Retention ("Gross-Up") Factor:	Percentages	Rate Year 2 Revenue Requirement
Sales Revenues	100.00%	$ 1,371,481
Late Payment Charges	0.32%	4,345
PSC Assessment	0.22%	3,080
Uncollectible Accounts Expense	0.63%	8,640
Retention Factor before Income Taxes	99.46%	1,364,106
SIT Expense @7.1% plus (9% times 17%) MTA Surcharge on SIT	8.58%	117,722
FIT Expense @ 34%	30.90%	423,770
Retention Factor	59.98%	$ 822,613

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
a.	Payroll		
	Adjusted for inflation in rate year 2014	JP	$ 131,789
b.	Productivity Adjustment		
	Tracks changes related to inflation	JP	(1,638)
c.	Purchased Power		
	Adjusted for inflation in rate year 2014	JP	48,553
d.	Fuel		
	Adjusted for inflation in rate year 2014	JP	8,731
e.	Chemicals		
	Adjusted for inflation in rate year 2014	JP	22,176
f.	Invoices		
	Adjusted for inflation in rate year 2014	JP	50,277
g.	Leased Vehicles		
	Adjusted for inflation in rate year 2014	JP	9,470
h.	Service Company Expense		
	Adjusted for inflation in rate year 2014	JP	94,591
i.	Postage		
	Adjusted for inflation in rate year 2014	JP	6,694
j.	Rents		
	Adjusted for inflation in rate year 2014	JP	338
k.	Group Insurance		
	Adjusted for inflation in rate year 2014	JP	17,424
l.	401(k) Plan Expense		
	Adjusted for inflation in rate year 2014	JP	2,539

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
m.	Defined Contribution Plan (DCP)		
	Adjusted for inflation in rate year 2014	JP	1,787
n.	Insurance Other Than Group		
	Adjusted for inflation in rate year 2014	JP	16,144
o.	Retiree Medical		
	Adjusted for inflation in rate year 2014	JP	134
p.	Customer Outreach and Education Program		
	Adjusted for inflation in rate year 2014	JP	1,730
q.	Audit Fees		
	Adjusted for inflation in rate year 2014	JP	1,236
r.	Actuarial Fees		
	Adjusted for inflation in rate year 2014	JP	724
s.	Synergy Savings		
	To reflect company's estimate of rate year 2 synergy savings	JP	(250,000)
	Total Adjustments to Operating & Maintenance Expense		162,697

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj No.		Witness	Amount
2	Depreciation Expense		
	Adjusted to reflect plant balance additions and retirements	JP	333,303
	Taxes Other Than Income Taxes		
3	Property Taxes		
	Adjusted for inflation in rate year 2014	JP	239,058
4	Payroll Taxes		
	Adjusted for inflation in rate year 2014	JP	10,082
	Total Adjustments to Taxes Other Than Income Taxes		249,139

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj No.		Witness	Amount
5	State Income Taxes		
a.	Net Operating Income before SIT		
	To reflect Staff's adjustments to operating revenues and expenses		$ (745,140)
	Adjustments to Taxable Income		
b.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP		(203,254)
	Total Adjustments to Taxable Income - SIT		(203,254)
c.	State Income Tax		
	To reflect state income tax expense at the current rate of 7.1%		(67,336)
d.	MTA Tax Surcharge		
	To reflect MTA tax surcharge at the current rate of 17%		(14,510)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj No.		Witness	Amount
6	Federal Income Taxes		
a.	Net Operating Income before FIT		
	To reflect Staff's adjustments made to operating revenues and expenses		$ (663,293)
	Adjustments to Taxable Income		
b.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP		(203,254)
	Total Adjustments to Taxable Income - FIT		(203,254)
c.	Federal Income Tax		
	To reflect federal income taxes at the current 34% tax rate		(294,626)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2014

Adj. No.		Witness	Amount
7	Rate Base		
a.	Water Plant In Service		
	To reflect Water Plant in Service additions for rate year 2014	JP	$ 10,715,367
b.	Accumulated Provision for Depreciation		
	Tracks update to Water Plant in Service	JP	(3,932,201)
	Working Capital		
c.	Cash Allowance		
	Tracking the Staff's adjustments to O & M expenses		20,337
	Materials and Supplies		
d.	Adjusted for inflation in rate year 2014	JP	12,510
	Prepayments		
e.	Adjusted for inflation in rate year 2014	JP	31,425
	Total Adjustments to Working Capital		64,272
	Regulatory Deferrals		
f.	Deferred Tank Painting Expense		
	Adjust to reflect amortization of tank painting expense	JP	(19,840)
g.	Deferred Rate Case Expense		
	Adjust to reflect amortization of rate case expense	JP	(61,526)
	Total Adjustments to Regulatory Deferrals		(81,366)
h.	Accumulated Deferred Income Taxes (ADIT)		
	Tracks update to Water Plant in Service	JP	(641,277)
	Total Adjustments to Rate Base		6,124,795

Case No. 11-W-0200

Exhibit__(ACL-1)
Schedule 1
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Long Island American Water
Statement of Operating Income
For the Rate Year Ending March 31, 2015

	Rate Year 2 Revenue Requirement	Adj. No.	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Operating Revenues						
Water Sales	$ 53,189,040		$ -	$ 53,189,040	$ 1,156,936	$ 54,345,976
Other Revenue	205,163		-	205,163	3,665	208,828
Total Operating Revenues	53,394,203		-	53,394,203	1,160,601	54,554,804
O & M Expenses (from page 2)	22,510,816	1	446,126	22,956,942	9,887	22,966,829
Depreciation Expense	4,444,853	2	96,539	4,541,392	-	4,541,392
Taxes Other Than Income Taxes						
Property Taxes	12,132,472	3	258,422	12,390,893	-	12,390,893
Payroll Taxes	512,366	4	10,898	523,265	-	523,265
Other Taxes	-		-	-	-	-
Total Taxes Other Than Income Taxes	12,644,838		269,320	12,914,158	-	12,914,158
Total Operating Revenue Deductions	39,600,507		811,985	40,412,492	9,887	40,422,379
Net Operating Income Before SIT	13,793,696		(811,985)	12,981,711	1,150,714	14,132,425
State Income Tax Expense	783,102	5	(79,673)	703,429	99,307	802,736
Net Operating Income Before FIT	13,010,594		(732,313)	12,278,282	1,051,407	13,329,689
Federal Income Tax Expense	3,005,023	6	(286,802)	2,718,221	357,478	3,075,699
Net Income Available for Return	$ 10,005,572		$ (445,511)	$ 9,560,061	$ 693,929	$ 10,253,990
Rate Base	$ 135,007,173	7	$ 3,351,631	$ 138,358,804	$ 325	$ 138,359,129
Rate of Return	7.41%			6.91%		7.41%

Long Island American Water
Schedule of Operating and Maintenance Expenses
For the Rate Year Ending March 31, 2015

Operating & Maintenance Expenses	Rate Year 2 Revenue Requirement	Adj. No. 1	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Payroll	$ 6,688,438	a	$ 142,464	$ 6,830,901	$ -	$ 6,830,901
Productivity Adjustment	(95,676)	b	(1,770)	(97,446)	-	(97,446)
Purchased Power	2,464,102	c	52,485	2,516,587	-	2,516,587
Fuel	443,131	d	9,439	452,570	-	452,570
Chemicals	1,125,451	e	23,972	1,149,423	-	1,149,423
Invoices	2,551,597	f	54,349	2,605,946	-	2,605,946
Leased Vehicles	480,608	g	10,237	490,845	-	490,845
Service Company	4,800,613	h	102,253	4,902,866	-	4,902,866
Postage	339,717	i	7,236	346,953	-	346,953
Rents	17,164	j	366	17,530	-	17,530
Group Insurance	884,299	k	18,836	903,135	-	903,135
OPEBs	501,120		-	501,120	-	501,120
Pension	888,830		-	888,830	-	888,830
401k Expense	128,841	l	2,744	131,585	-	131,585
Deferred Contribution Plan	90,692	m	1,932	92,624	-	92,624
Insurance Other Than Group	819,304	n	17,451	836,755	-	836,755
Uncollectible Accounts	335,091		-	335,091	7,289	342,380
PSC Assessment	127,008		-	127,008	2,598	129,606
Employee Stock Purchase Plan	-		-	-	-	-
Retiree Medical	6,776	o	144	6,920	-	6,920
Customer Outreach and Education Program	87,814	p	1,870	89,685	-	89,685
Amort. of Deferred Rate Case costs	77,333		-	77,333	-	77,333
Amort. of Deferred Tank Painting costs	32,884		-	32,884	-	32,884
Amort. of Deferred Pension/OPEB expense	-		-	-	-	-
Amortization of Actuarial Studies	-		-	-	-	-
Audit Fees	62,734	q	1,336	64,070	-	64,070
Actuarial Fees	36,724	r	782	37,506	-	37,506
Synergy Savings	(383,777)	s	-	(383,777)	-	(383,777)
Total O & M Expenses	$ 22,510,816		$ 446,126	$ 22,956,942	$ 9,887	$ 22,966,829

Long Island American Water
Calculation of State Income Tax Expense
For the Rate Year Ending March 31, 2015

	Rate Year 2 Revenue Requirement	Adj. No. 5	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Net Operating Income Before SIT	$ 13,793,696	a	$ (811,985)	$ 12,981,711	$ 1,150,714	$ 14,132,425
Additions/Deductions						
Interest Expense	(4,719,514)	b	(111,223)	(4,830,737)	-	(4,830,737)
Depreciation Differences	(705,249)		-	(705,249)	-	(705,249)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(1,094,626)		-	(1,094,626)	-	(1,094,626)
Excess Deferred SIT	-		-	-	-	-
Total Adjustments for SIT	(6,519,389)		(111,223)	(6,630,612)	-	(6,630,612)
Taxable Income for SIT	7,274,308		(923,208)	6,351,099	1,150,714	7,501,813
Current SIT Expense @ 7.1%	516,476	c	(65,548)	450,928	81,701	532,629
MTA Surcharge on SIT @ (9% of 17%)	111,297	d	(14,125)	97,172	17,606	114,778
Current SIT w/ MTA Surcharge	627,773		(79,673)	548,100	99,307	647,406
Deferred SIT Expense						
Depreciation Differences	60,863		-	60,863	-	60,863
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	94,466		-	94,466	-	94,466
Excess Deferred SIT	-		-	-	-	-
Deferred SIT Expense	155,329		-	155,329	-	155,329
Total State Income Tax Expense	$ 783,102		$ (79,673)	$ 703,429	$ 99,307	$ 802,736

Long Island American Water
Calculation of Federal Income Tax Expense
For the Rate Year Ending March 31, 2015

	Rate Year 2 Revenue Requirement	Adj. No. 6	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Net Operating Income Before FIT	$ 13,010,594	a	$ (732,313)	$ 12,278,282	$ 1,051,407	$ 13,329,689
Additions/Deductions						
Deferred State Income Tax	155,329		-	155,329	-	155,329
Interest Expense	(4,719,514)	b	(111,223)	(4,830,737)	-	(4,830,737)
Depreciation Differences	(4,983,026)		-	(4,983,026)	-	(4,983,026)
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	(1,094,626)		-	(1,094,626)	-	(1,094,626)
Excess Deferred FIT	-		-	-	-	-
Total Adjustments for FIT	(10,641,836)		(111,223)	(10,753,059)	-	(10,753,059)
Taxable Income for FIT	2,368,758		(843,535)	1,525,222	1,051,407	2,576,630
Current FIT Expense @ 34%	805,378	c	(286,802)	518,576	357,478	876,054
Deferred FIT Expense						
Deferred State Income Tax	(52,812)		-	(52,812)	-	(52,812)
Depreciation Differences	1,694,229		-	1,694,229	-	1,694,229
Amortization of Flow Through Tax Depr	210,938		-	210,938	-	210,938
Amortization of Rate Case	-		-	-	-	-
Amortization of Tank Painting	-		-	-	-	-
Amortization of Deferred Pension/OPEBs	-		-	-	-	-
Amortization of Pension Actuarial Study	-		-	-	-	-
Reduction to Taxable Income for Repairs Expens	372,173		-	372,173	-	372,173
Excess Deferred FIT	(9,883)		-	(9,883)	-	(9,883)
Deferred FIT Expense	2,214,645		-	2,214,645	-	2,214,645
Amortization of ITC	(15,000)		-	(15,000)	-	(15,000)
Total Federal Income Tax Expense	$ 3,005,023		$ (286,802)	$ 2,718,221	$ 357,478	$ 3,075,699

Long Island American Water
Rate Base Summary
For the Rate Year Ending March 31, 2015

	Rate Year 2 Revenue Requirement	Adj. No. 7	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Net Utility Plant						
Water Plant in Service	$ 204,811,259	a	$ 7,625,000	$ 212,436,259	$ -	$ 212,436,259
Non-Interest Bearing CWIP	262,553		-	262,553	-	262,553
Plant Held For Future Use	110,933		-	110,933	-	110,933
Less Accumulated Depreciation	(56,057,055)	b	(4,367,984)	(60,425,039)	-	(60,425,039)
Total Net Utility Plant	149,127,690		3,257,016	152,384,706	-	152,384,706
Customer Advances for Construction	(65,427)		-	(65,427)	-	(65,427)
Working Capital						
Cash Allowance	2,758,188	c	55,766	2,813,954	325	2,814,279
Materials and Supplies	634,880	d	13,523	648,403	-	648,403
Prepayments	1,594,850	e	33,970	1,628,820	-	1,628,820
Total Working Capital	4,987,918		103,259	5,091,177	325	5,091,502
Regulatory Deferrals						
Tank Painting (net of tax)	128,889	f	(19,829)	109,060	-	109,060
Rate Case Expense (net of tax)	69,948	g	(46,632)	23,316	-	23,316
Deferred Pensions/OPEB expense	-		-	-	-	-
Pension Actuarial Study (net of tax)	-		-	-	-	-
Total Regulatory Deferrals	198,837		(66,461)	132,376	-	132,376
Accumulated Deferred Income Taxes	(17,234,583)	h	57,817	(17,176,766)	-	(17,176,766)
Earnings Base Capitalization Adj.	(2,007,262)		-	(2,007,262)	-	(2,007,262)
Total Rate Base	$ 135,007,173		$ 3,351,631	$ 138,358,804	$ 325	$ 138,359,129

Long Island American Water
Summary of Cash Working Capital Allowance
For the Rate Year Ending March 31, 2015

	Rate Year 2 Revenue Requirement	Joint Proposal Adjustments	Rate Year 3 As Adjusted	Rate Year 3 Revenue Requirement Adjustment	Rate Year 3 As Adjusted Revenue Requirement
Total O & M Expenses	$ 22,510,816	$ 446,126	$ 22,956,942	$ 9,887	$ 22,966,829
Adjustments:					
Uncollectible Accounts Expense	(335,091)	-	(335,091)	(7,289)	(342,380)
Amort. of Deferred Rate Case costs	(77,333)	-	(77,333)	-	(77,333)
Amort. of Deferred Tank Painting costs	(32,884)	-	(32,884)	-	(32,884)
Amort. of Deferred Pension/OPEB exp	-	-	-	-	-
Amort. of Pension Actuarial Study	-	-	-	-	-
Total Adjustments	(445,308)	-	(445,308)	(7,289)	(452,597)
Sub-total for Cash W/C allowance	22,065,508	446,126	22,511,634	2,598	22,514,232
Weighted Billing factor - 1/8 (45 days)	12.50%	12.50%	12.50%	12.50%	12.50%
Total Cash W/C Allowance	$ 2,758,188	$ 55,766	$ 2,813,954	$ 325	$ 2,814,279

Case No. 11-W-0200

Exhibit__(ACL-1)
Schedule 7
Page 1 of 1

Long Island American Water
Cost of Capital
For the Rate Year Ending March 31, 2015

	Percent	Cost Rate	Weighted Cost	Pre-Tax Return
Long-Term Debt	57.11%	5.81%	3.318%	3.318%
Preferred Stock	0.89%	4.50%	0.040%	0.067%
Common Equity	42.00%	9.65%	4.053%	6.757%
Totals	100.00%		7.41%	10.14%

Case No. 11-W-0200

Exhibit__(ACL-1)
Schedule 8
Page 1 of 1

Long Island American Water
Computation of Revenue Requirement
For the Rate Year Ending March 31, 2015

	Rate Year 3 Per JP
Average Rate Base	$ 138,359,129
Rate of Return on Rate Base	7.41%
Required Net Income	10,253,990
Net Income before Revenue Requirement	9,560,061
Earnings Deficiency	693,929
Retention Factor	59.98%
Revenue Increase	$ 1,156,936

Calculation of Retention ("Gross-Up") Factor:	Percentages	Rate Year 3 Revenue Requirement
Sales Revenues	100.00%	$ 1,156,936
Late Payment Charges	0.32%	3,665
PSC Assessment	0.22%	2,598
Uncollectible Accounts Expense	0.63%	7,289
Retention Factor before Income Taxes	99.46%	1,150,714
SIT Expense @7.1% plus (9% times 17%) MTA Surcharge on SIT	8.58%	99,307
FIT Expense @ 34%	30.90%	357,479
Retention Factor	59.98%	$ 693,929

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
a.	Payroll		
	Adjusted for inflation in rate year 2015	JP	$ 142,464
b.	Productivity Adjustment		
	Tracks changes related to inflation	JP	(1,770)
c.	Purchased Power		
	Adjusted for inflation in rate year 2015	JP	52,485
d.	Fuel		
	Adjusted for inflation in rate year 2015	JP	9,439
e.	Chemicals		
	Adjusted for inflation in rate year 2015	JP	23,972
f.	Invoices		
	Adjusted for inflation in rate year 2015	JP	54,349
g.	Leased Vehicles		
	Adjusted for inflation in rate year 2015	JP	10,237
h.	Service Company Expense		
	Adjusted for inflation in rate year 2015	JP	102,253
i.	Postage		
	Adjusted for inflation in rate year 2015	JP	7,236
j.	Rents		
	Adjusted for inflation in rate year 2015	JP	366
k.	Group Insurance		
	Adjusted for inflation in rate year 2015	JP	18,836
l.	401(k) Plan Expense		
	Adjusted for inflation in rate year 2015	JP	2,744

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj No.		Witness	Amount
1	Operating & Maintenance Expenses		
m.	Defined Contribution Plan (DCP)		
	Adjusted for inflation in rate year 2015	JP	1,932
n.	Insurance Other Than Group		
	Adjusted for inflation in rate year 2015	JP	17,451
o.	Retiree Medical		
	Adjusted for inflation in rate year 2015	JP	144
p.	Customer Outreach and Education Program		
	Adjusted for inflation in rate year 2015	JP	1,870
q.	Audit Fees		
	Adjusted for inflation in rate year 2015	JP	1,336
r.	Actuarial Fees		
	Adjusted for inflation in rate year 2015	JP	782
s.	Synergy Savings		
	To reflect company's estimate of rate year 3 synergy savings	JP	-
	Total Adjustments to Operating & Maintenance Expense		446,126

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj No.		Witness	Amount
2	Depreciation Expense		
	Adjusted to reflect plant balance additions and retirements	JP	96,539
	Taxes Other Than Income Taxes		
3	Property Taxes		
	Adjusted for inflation in rate year 2015	JP	258,422
4	Payroll Taxes		
	Adjusted for inflation in rate year 2015	JP	10,898
	Total Adjustments to Taxes Other Than Income Taxes		269,320

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj No.		Witness	Amount
5	State Income Taxes		
a.	Net Operating Income before SIT		
	To reflect Staff's adjustments to operating revenues and expenses		$ (811,985)
	Adjustments to Taxable Income		
b.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP		(111,223)
	Total Adjustments to Taxable Income - SIT		(111,223)
c.	State Income Tax		
	To reflect state income tax expense at the current rate of 7.1%		(65,548)
d.	MTA Tax Surcharge		
	To reflect MTA tax surcharge at the current rate of 17%		(14,125)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj No.		Witness	Amount
6	Federal Income Taxes		
a.	Net Operating Income before FIT		
	To reflect Staff's adjustments made to operating revenues and expenses		$ (732,313)
	Adjustments to Taxable Income		
b.	Interest Expense		
	To reflect Staff's calculation of interest expense including interest on IBCWIP		(111,223)
	Total Adjustments to Taxable Income - FIT		(111,223)
c.	Federal Income Tax		
	To reflect federal income taxes at the current 34% tax rate		(286,802)

Long Island American Water
Summary of Joint Proposal Adjustments
For the Rate Year Ending March 31, 2015

Adj. No.		Witness	Amount
7	Rate Base		
a.	Water Plant In Service		
	To reflect Water Plant in Service additions for rate year 2015	JP	$ 7,625,000
b.	Accumulated Provision for Depreciation		
	Tracks update to Water Plant in Service	JP	(4,367,984)
	Working Capital		
c.	Cash Allowance		
	Tracking the Staff's adjustments to O & M expenses		55,766
	Materials and Supplies		
d.	Adjusted for inflation in rate year 2015	JP	13,523
	Prepayments		
e.	Adjusted for inflation in rate year 2015	JP	33,970
	Total Adjustments to Working Capital		103,259
	Regulatory Deferrals		
f.	Deferred Tank Painting Expense		
	Adjust to reflect amortization of tank painting expense	JP	(19,829)
g.	Deferred Rate Case Expense		
	Adjust to reflect amortization of rate case expense	JP	(46,632)
	Total Adjustments to Regulatory Deferrals		(66,461)
h.	Accumulated Deferred Income Taxes (ADIT)		
	Tracks update to Water Plant in Service	JP	57,817
	Total Adjustments to Rate Base		3,351,631

Appendix B

Long Island American Water

5/8" Residential Customer

		DSIC	SIC	Total	6.02%		2.64%		2.17%	
Meter Charge:										
Effective	3/30/2011	2.44%	1.06%	3/30/2011	4/1/2012		4/1/2013		4/1/2014	
Monthly	$9.39	$9.62	$9.72	$9.72	$9.96	6.07%	$10.22	2.61%	$10.44	2.15%
Consumption										
Summer Usage										
First 5,000 Gal	$0.35046	$0.35906	$0.36276	$0.36276	$0.37160	6.03%	$0.38142	2.64%	$0.38974	2.18%
Over 5,000 Gal	$0.43838	$0.44908	$0.45368	$0.45368	$0.46480	6.03%	$0.47711	2.65%	$0.48751	2.18%
Winter Usage	$0.35046	$0.35906	$0.36276	$0.36276	$0.37160	6.03%	$0.38142	2.64%	$0.38974	2.18%

Annual Customer Usage	Average Monthly Usage	Average Res w/o DISC & SIC	Average Res w/ DISC	Average Res w/ DISC & SIC	Current Rates	4/1/2012		4/1/2013		4/1/2014	
12,000	1,000	$154.74	$158.53	$160.17	$160.17	$164.11	2.46%	$168.41	2.62%	$172.05	2.16%
13,000	1,083	$158.24	$162.12	$163.80	$163.80	$167.83	2.46%	$172.22	2.62%	$175.95	2.17%
14,000	1,167	$161.74	$165.71	$167.43	$167.43	$171.54	2.45%	$176.04	2.62%	$179.84	2.16%
15,000	1,250	$165.25	$169.30	$171.05	$171.05	$175.26	2.46%	$179.85	2.62%	$183.74	2.16%
16,000	1,333	$168.75	$172.89	$174.68	$174.68	$178.98	2.46%	$183.67	2.62%	$187.64	2.16%
17,000	1,417	$172.26	$176.48	$178.31	$178.31	$182.69	2.46%	$187.48	2.62%	$191.54	2.17%
18,000	1,500	$175.76	$180.07	$181.94	$181.94	$186.41	2.46%	$191.30	2.62%	$195.43	2.16%
19,000	1,583	$179.27	$183.66	$185.56	$185.56	$190.12	2.46%	$195.11	2.62%	$199.33	2.16%
20,000	1,667	$182.77	$187.25	$189.19	$189.19	$193.84	2.46%	$198.92	2.62%	$203.23	2.17%
21,000	1,750	$186.28	$190.84	$192.82	$192.82	$197.56	2.46%	$202.74	2.62%	$207.13	2.17%
22,000	1,833	$189.78	$194.43	$196.45	$196.45	$201.27	2.45%	$206.55	2.62%	$211.02	2.16%
23,000	1,917	$193.29	$198.02	$200.07	$200.07	$204.99	2.46%	$210.37	2.62%	$214.92	2.16%
24,000	2,000	$196.79	$201.61	$203.70	$203.70	$208.70	2.45%	$214.18	2.63%	$218.82	2.17%
25,000	2,083	$200.30	$205.21	$207.33	$207.33	$212.42	2.46%	$218.00	2.63%	$222.72	2.17%
26,000	2,167	$203.80	$208.80	$210.96	$210.96	$216.14	2.46%	$221.81	2.62%	$226.61	2.16%
27,000	2,250	$207.30	$212.39	$214.59	$214.59	$219.85	2.45%	$225.62	2.62%	$230.51	2.17%
28,000	2,333	$210.81	$215.98	$218.21	$218.21	$223.57	2.46%	$229.44	2.63%	$234.41	2.17%
29,000	2,417	$214.31	$219.57	$221.84	$221.84	$227.28	2.45%	$233.25	2.63%	$238.30	2.17%
30,000	2,500	$217.82	$223.16	$225.47	$225.47	$231.00	2.45%	$237.07	2.63%	$242.20	2.16%
31,000	2,583	$221.32	$226.75	$229.10	$229.10	$234.72	2.45%	$240.88	2.62%	$246.10	2.17%
32,000	2,667	$224.83	$230.34	$232.72	$232.72	$238.43	2.45%	$244.69	2.63%	$250.00	2.17%
33,000	2,750	$228.33	$233.93	$236.35	$236.35	$242.15	2.45%	$248.51	2.63%	$253.89	2.16%
34,000	2,833	$231.84	$237.52	$239.98	$239.98	$245.86	2.45%	$252.32	2.63%	$257.79	2.17%
35,000	2,917	$235.34	$241.11	$243.61	$243.61	$249.58	2.45%	$256.14	2.63%	$261.69	2.17%
36,000	3,000	$238.85	$244.70	$247.23	$247.23	$253.30	2.46%	$259.95	2.63%	$265.59	2.17%
37,000	3,083	$242.35	$248.29	$250.86	$250.86	$257.01	2.45%	$263.77	2.63%	$269.48	2.16%
38,000	3,167	$245.85	$251.88	$254.49	$254.49	$260.73	2.45%	$267.58	2.63%	$273.38	2.17%
39,000	3,250	$249.36	$255.47	$258.12	$258.12	$264.44	2.45%	$271.39	2.63%	$277.28	2.17%
40,000	3,333	$252.86	$259.06	$261.74	$261.74	$268.16	2.45%	$275.21	2.63%	$281.18	2.17%
41,000	3,417	$256.37	$262.65	$265.37	$265.37	$271.88	2.45%	$279.02	2.63%	$285.07	2.17%
42,000	3,500	$259.87	$266.25	$269.00	$269.00	$275.59	2.45%	$282.84	2.63%	$288.97	2.17%
43,000	3,583	$263.38	$269.84	$272.63	$272.63	$279.31	2.45%	$286.65	2.63%	$292.87	2.17%
44,000	3,667	$266.88	$273.43	$276.25	$276.25	$283.02	2.45%	$290.46	2.63%	$296.77	2.17%
45,000	3,750	$270.39	$277.02	$279.88	$279.88	$286.74	2.45%	$294.28	2.63%	$300.66	2.17%
46,000	3,833	$273.89	$280.61	$283.51	$283.51	$290.46	2.45%	$298.09	2.63%	$304.56	2.17%
47,000	3,917	$277.40	$284.20	$287.14	$287.14	$294.17	2.45%	$301.91	2.63%	$308.46	2.17%
48,000	4,000	$280.90	$287.79	$290.76	$290.76	$297.89	2.45%	$305.72	2.63%	$312.36	2.17%
49,000	4,083	$284.41	$291.38	$294.39	$294.39	$301.60	2.45%	$309.54	2.63%	$316.25	2.17%
50,000	4,167	$287.91	$294.97	$298.02	$298.02	$305.32	2.45%	$313.35	2.63%	$320.15	2.17%
55,000	4,583	$305.43	$312.92	$316.16	$316.16	$323.90	2.45%	$332.42	2.63%	$339.64	2.17%
60,000	5,000	$322.96	$330.88	$334.30	$334.30	$342.48	2.45%	$351.49	2.63%	$359.12	2.17%
65,000	5,417	$341.54	$349.91	$353.53	$353.53	$362.18	2.45%	$371.71	2.63%	$379.79	2.17%
70,000	5,833	$360.12	$368.95	$372.76	$372.76	$381.88	2.45%	$391.94	2.63%	$400.45	2.17%
72,000	6,000	$369.41	$378.46	$382.37	$382.37	$391.73	2.45%	$402.05	2.63%	$410.78	2.17%
75,000	6,250	$383.34	$392.74	$396.80	$396.80	$406.51	2.45%	$417.21	2.63%	$426.28	2.17%
75,000	6,250	$383.34	$392.74	$396.80	$396.80	$406.51	2.45%	$417.21	2.63%	$426.28	2.17%
80,000	6,667	$401.92	$411.78	$416.03	$416.03	$426.21	2.45%	$437.44	2.63%	$446.94	2.17%
85,000	7,083	$420.50	$430.81	$435.26	$435.26	$445.91	2.45%	$457.66	2.64%	$467.60	2.17%
90,000	7,500	$439.08	$449.85	$454.49	$454.49	$465.61	2.45%	$477.88	2.64%	$488.27	2.17%
95,000	7,917	$457.66	$468.88	$473.72	$473.72	$485.31	2.45%	$498.10	2.64%	$508.93	2.17%
100,000	8,333	$476.24	$487.92	$492.95	$492.95	$505.01	2.45%	$518.32	2.64%	$529.59	2.17%
104,000	8,667	$494.83	$506.95	$512.18	$512.18	$524.71	2.45%	$538.55	2.64%	$550.26	2.17%
105,000	8,750	$499.47	$511.71	$516.99	$516.99	$529.64	2.45%	$543.60	2.64%	$555.42	2.17%
110,000	9,167	$518.05	$530.75	$536.22	$536.22	$549.34	2.45%	$563.82	2.64%	$576.08	2.17%
115,000	9,583	$536.63	$549.78	$555.45	$555.45	$569.04	2.45%	$584.04	2.64%	$596.75	2.18%
120,000	10,000	$555.21	$568.82	$574.68	$574.68	$588.74	2.45%	$604.27	2.64%	$617.41	2.17%
125,000	10,417	$573.79	$587.85	$593.91	$593.91	$608.44	2.45%	$624.49	2.64%	$638.07	2.17%
130,000	10,833	$592.37	$606.89	$613.14	$613.14	$628.14	2.45%	$644.71	2.64%	$658.74	2.18%
135,000	11,250	$615.60	$630.68	$637.18	$637.18	$652.77	2.45%	$669.99	2.64%	$684.56	2.17%
140,000	11,667	$634.18	$649.72	$656.41	$656.41	$672.47	2.45%	$690.21	2.64%	$705.23	2.18%
145,000	12,083	$652.76	$668.75	$675.64	$675.64	$692.17	2.45%	$710.43	2.64%	$725.89	2.18%
150,000	12,500	$671.34	$687.79	$694.88	$694.88	$711.87	2.45%	$730.65	2.64%	$746.55	2.18%
155,000	12,917	$689.92	$706.82	$714.11	$714.11	$731.57	2.45%	$750.88	2.64%	$767.22	2.18%
160,000	13,333	$708.50	$725.86	$733.34	$733.34	$751.27	2.44%	$771.10	2.64%	$787.88	2.18%
165,000	13,750	$731.73	$749.65	$757.38	$757.38	$775.90	2.45%	$796.38	2.64%	$813.71	2.18%
170,000	14,167	$750.31	$768.69	$776.61	$776.61	$795.60	2.45%	$816.60	2.64%	$834.37	2.18%
175,000	14,583	$768.89	$787.72	$795.84	$795.84	$815.30	2.45%	$836.82	2.64%	$855.03	2.18%
200,000	16,667	$866.44	$887.66	$896.80	$896.80	$918.73	2.45%	$942.98	2.64%	$963.51	2.18%

Appendix C

SERVICE CLASSIFICATION NO. 1

Applicable to the Use of Service for: General Water Service – Residential
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 5,000 gal.	$0.37156 per 100 gal.
	Over 5,000 gal.	0.46477 per 100 gal.
Winter		
October 1 through April 30	All consumption	$0.37156 per 100 gal.

The allowed water quantities in the first block will be prorated on a daily basis.

Meter Size	Customer Service Charge Monthly
5/8”	$9.96
3/4"	11.37
1”	13.53
1 ½”	26.32
2”	29.55

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 61**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 4**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 2**
INITIAL EFFECTIVE DATE: APRIL 1, 2012

SERVICE CLASSIFICATION NO. 1A

Applicable to the Use of Service for: General Water Service – Commercial & Industrial
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 34,000 gal.	$0.46477 per 100 gal.
	Over 34,000 gal.	0.37156 per 100 gal.
Winter		
October 1 through April 30	First 34,000 gal.	$0.37156 per 100 gal.
	Over 34,000 gal.	0.30980 per 100 gal.

Meter Size	Customer Service Charge Monthly
5/8”	$9.96
3/4"	11.37
1”	13.53
1 ½”	26.32
2”	29.55
3”	64.48
Compound 3”	101.31
Compound 4”	115.41
Compound 6”	115.11
Compound 8”	155.59
5/8” & 2”	31.10
1” & 1½”	32.24
1½” & 1½”	39.87
1 ½” & 2”	43.10
2” & 2”	46.32
3” & 3”	179.88
4” & 4”	208.04

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 1A (Continued)

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Service may be discontinued on 48 hours notice to the Corporation.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

SERVICE CLASSIFICATION NO. 2

Applicable to the Use of Service for:

Private Fire Hydrant Service when the existing facilities (mains, etc.) of the Company are adequate for supply, and where the hydrant is to be used for fire purposes only.

Character of Service:

Continuous

Rate: $695.89 per hydrant per year

Terms of Payment:

Upon acceptance of customer's application for service, a sum of $695.89 is to be paid covering the first year of service, and thereafter $695.89 is to be paid annually in advance.

A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

Five years minimum, thereafter until cancelled by 60 days written notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 64**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 4**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 2**
INITIAL EFFECTIVE DATE: APRIL 1, 2012

SERVICE CLASSIFICATION NO. 3

Applicable to the Use of Service for: Lawn Sprinkler Service

A. Lawn Sprinkler Systems supplied by an existing service line installed prior to March 15, 1947 which supplies both lawn sprinkling systems and general service.

B. Lawn Sprinkler Systems installed on or after March 15, 1947.

Character of Service: Seasonal (May 1st through October 31st)
See Section VII for Lawn Sprinkler responsibility and details.
For all quantities used in each season, the following rate applies: $0.46477 per 100 gallons.

Customer Service Charge Season: May 1st to October 31st Meter Size	Per Season
1"	$147.19
1½"	260.38
2"	299.09

TERMS OF PAYMENT:

New Service: Service construction costs, inspection fee and non-refundable Customer Service Charge are payable upon acceptance of Application for Service. If a new service is installed during the season, the Customer Service Charge will be applied on a prorated basis. Thereafter, the Customer Service Charge is payable in advance before service is connected for the season.

Existing Services: A Customer Service Charge is payable in advance before service is connected for the season. The Customer Service Charge shall be prorated for customers not taking lawn sprinkler service for the entire season. Whenever a customer has been found to have activated their lawn sprinkler service without having paid the appropriate Customer Service Charge in advance, the Customer Service Charge will be retroactive to May 1st.

Charge for water consumed is payable upon presentation of bill. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Meters may be read monthly, quarterly or seasonally at the option of the Corporation.
The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 65**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 4**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 2**
INITIAL EFFECTIVE DATE: APRIL 1, 2012

SERVICE CLASSIFICATION NO. 4

Applicable to the Use of Service for:

Public Fire Protection

Character of Service:

Continuous

Rate:

Public Fire Hydrants $695.89 per hydrant per year

Minimum Charge:

None

Terms of Payment:

In arrears, monthly or quarterly, at the option of the Corporation. If hydrants are installed within the billing period, the charges will be prorated. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

One year and to continue from year to year thereafter, unless terminated by thirty days notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 5

Applicable to the Use of Service for:

Construction and other purposes when the supply of water is not metered.

Character of service: Continuous

1 - Water used in constructing one or two story dwellings:

	Unit	Rate
Frame	Each Structure	$77.09
Frame and half stucco	Each Structure	102.78
All stucco, cement or cinder block, hollow tile, brick veneer or various combinations	Each Structure	$128.47
Brick	Each Structure	154.15

2 - Structures other than dwellings

Concrete, stone, terra cotta Other masonry	Per cu. yd. of masonry	$0.87
Brick	Per 1,000 bricks	1.63

3 - Road Construction

Concrete, macadam or other roads	Per 100 sq. ft.	$3.00
Sidewalk	Per 100 sq. ft.	3.00
Curbing	Per 100 sq. ft.	3.20

4 - Flooding Ditches

Ditch 2 ft by 3 ft - $16.14 per 100 lineal feet
(Proportionate charges for excess of above)

5 - Jetting Planks

Minimum rate - $17.01 for four or less planks
First four planks $17.01, thereafter $1.20

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 5 (Continued)

6 - Jetting Spiles

Minimum rate $17.01 four or less spiles
First four spiles $17.01, thereafter $2.57

7 - Water drawn from hydrants for the purposes other than fire protection and for purposes other than specified above.

Rate: $0.42200 per 100 gallons

Minimum charge of $84.47 payable in advance for which the customer will be entitled to use 20,000 gallons of water in the period stated in the permit. Water in excess of such allowances will be billed at the rate above stated, at the expiration of the permit, and the bill thereof will be due and payable when rendered. The quantities of water used will be estimated.

Hydrant Permits

(In addition to above charges)

Per hydrant	$17.01 per day
For services of Inspector (when required by Company)	128.47 per day

Terms of Payment:
Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: None

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 68**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 4**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 2**
INITIAL EFFECTIVE DATE: APRIL 1, 2012

SERVICE CLASSIFICATION NO. 6

Applicable to the Use of Service for:
Private Fire Protection – Risers for hose connections and/or sprinkler heads.
Character of Service: Continuous

Rate: Flat

Through 2" fire service connection or less	$42.05 per quarter
Through 3" fire service connection or less	$105.11 per quarter
Through 4" fire service connection or less	$210.25 per quarter
Through 6" fire service connection or less	$420.50 per quarter
Through 8" fire service connection or less	$840.93 per quarter
Through 10" fire service connection or less	$1,682.00 per quarter
Through 12" fire service connection or less	$3,364.00 per quarter
Through 16" fire service connection or less	$6,728.00 per quarter

Minimum Charge: As above

Terms of Payment: Quarterly in advance. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Agreement effective for a term of not less than one year. Service may be discontinued after one year upon ten (10) days prior notice to the Corporation.

Special Provisions:
(a) Each fire service installation is to be used solely and exclusively for fire protection. Water for any other purpose shall not be drawn from a private fire service connection, except that the Corporation will permit the use of water for test purposes upon three (3) days prior notification to the Corporation. The use of water in violation of the terms of this provision shall result in cancellation of service under this classification, whereupon the customer shall be rendered service under General Water Service Classification No. 1 and shall pay the rates set forth therein.
(b) The Corporation reserves the right to install a meter at any time.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 6 (Continued)

(c) The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 60**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 1

Applicable to the Use of Service for: General Water Service – Residential
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 5,000 gal.	$0.38142 per 100 gal.
	Over 5,000 gal.	0.47711 per 100 gal.
Winter		
October 1 through April 30	All consumption	$0.38142 per 100 gal.

The allowed water quantities in the first block will be prorated on a daily basis.

Meter Size	Customer Service Charge Monthly
5/8"	$10.22
3/4"	11.67
1"	13.89
1 ½"	27.02
2"	30.33

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 61**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 1A

Applicable to the Use of Service for: General Water Service – Commercial & Industrial
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 34,000 gal.	$0.47711 per 100 gal.
	Over 34,000 gal.	0.38142 per 100 gal.
Winter		
October 1 through April 30	First 34,000 gal.	$0.38142 per 100 gal.
	Over 34,000 gal.	0.31802 per 100 gal.

Meter Size	Customer Service Charge Monthly
5/8”	$10.22
3/4"	11.67
1”	13.89
1 ½”	27.02
2”	30.33
3”	66.19
Compound 3”	104.00
Compound 4”	118.47
Compound 6”	118.17
Compound 8”	159.72
5/8” & 2”	31.93
1” & 1½”	33.10
1½” & 1½”	40.93
1 ½” & 2”	44.24
2” & 2”	47.55
3” & 3”	184.65
4” & 4”	213.56

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 1A (Continued)

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Service may be discontinued on 48 hours notice to the Corporation.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 63**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 2

Applicable to the Use of Service for:

Private Fire Hydrant Service when the existing facilities (mains, etc.) of the Company are adequate for supply, and where the hydrant is to be used for fire purposes only.

Character of Service:

Continuous

Rate: $714.36 per hydrant per year

Terms of Payment:

Upon acceptance of customer's application for service, a sum of $714.36 is to be paid covering the first year of service, and thereafter $714.36 is to be paid annually in advance.

A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

Five years minimum, thereafter until cancelled by 60 days written notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 64**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 3

Applicable to the Use of Service for: Lawn Sprinkler Service
A. Lawn Sprinkler Systems supplied by an existing service line installed prior to March 15, 1947 which supplies both lawn sprinkling systems and general service.
B. Lawn Sprinkler Systems installed on or after March 15, 1947.

Character of Service: Seasonal (May 1st through October 31st)
See Section VII for Lawn Sprinkler responsibility and details.
For all quantities used in each season, the following rate applies: $0.47711 per 100 gallons.

Customer Service Charge Season: May 1st to October 31st Meter Size	Per Season
1"	$151.10
1½"	267.29
2"	307.03

TERMS OF PAYMENT:

New Service: Service construction costs, inspection fee and non-refundable Customer Service Charge are payable upon acceptance of Application for Service. If a new service is installed during the season, the Customer Service Charge will be applied on a prorated basis. Thereafter, the Customer Service Charge is payable in advance before service is connected for the season.

Existing Services: A Customer Service Charge is payable in advance before service is connected for the season. The Customer Service Charge shall be prorated for customers not taking lawn sprinkler service for the entire season. Whenever a customer has been found to have activated their lawn sprinkler service without having paid the appropriate Customer Service Charge in advance, the Customer Service Charge will be retroactive to May 1st.

Charge for water consumed is payable upon presentation of bill. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Meters may be read monthly, quarterly or seasonally at the option of the Corporation.
The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 65**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 4

Applicable to the Use of Service for:

Public Fire Protection

Character of Service:

Continuous

Rate:

Public Fire Hydrants $714.36 per hydrant per year

Minimum Charge:

None

Terms of Payment:

In arrears, monthly or quarterly, at the option of the Corporation. If hydrants are installed within the billing period, the charges will be prorated. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

One year and to continue from year to year thereafter, unless terminated by thirty days notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 66**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 5

Applicable to the Use of Service for:

Construction and other purposes when the supply of water is not metered.

Character of service: Continuous

1 - Water used in constructing one or two story dwellings:

	Unit	Rate
Frame	Each Structure	$79.14
Frame and half stucco	Each Structure	105.51
All stucco, cement or cinder block, hollow tile, brick veneer or various combinations	Each Structure	$131.88
Brick	Each Structure	158.24

2 - Structures other than dwellings

Concrete, stone, terra cotta Other masonry	Per cu. yd. of masonry	$0.89
Brick	Per 1,000 bricks	1.67

3 - Road Construction

Concrete, macadam or other roads	Per 100 sq. ft.	$3.08
Sidewalk	Per 100 sq. ft.	3.08
Curbing	Per 100 sq. ft.	3.28

4 - Flooding Ditches

Ditch 2 ft by 3 ft - $16.57 per 100 lineal feet
(Proportionate charges for excess of above)

5 - Jetting Planks

Minimum rate - $17.46 for four or less planks
First four planks $17.46, thereafter $1.23

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 5 (Continued)

6 - Jetting Spiles

Minimum rate $17.46 four or less spiles
First four spiles $17.46, thereafter $2.64

7 - Water drawn from hydrants for the purposes other than fire protection and for purposes other than specified above.

Rate: $0.43300 per 100 gallons

Minimum charge of $86.71 payable in advance for which the customer will be entitled to use 20,000 gallons of water in the period stated in the permit. Water in excess of such allowances will be billed at the rate above stated, at the expiration of the permit, and the bill thereof will be due and payable when rendered. The quantities of water used will be estimated.

Hydrant Permits

(In addition to above charges)

Per hydrant	$17.46 per day
For services of Inspector (when required by Company)	131.88 per day

Terms of Payment:
Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: None

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

SERVICE CLASSIFICATION NO. 6

Applicable to the Use of Service for:
Private Fire Protection – Risers for hose connections and/or sprinkler heads.
Character of Service: Continuous

Rate: Flat

Through 2" fire service connection or less	$43.17 per quarter
Through 3" fire service connection or less	$107.90 per quarter
Through 4" fire service connection or less	$215.83 per quarter
Through 6" fire service connection or less	$431.66 per quarter
Through 8" fire service connection or less	$863.25 per quarter
Through 10" fire service connection or less	$1,726.64 per quarter
Through 12" fire service connection or less	$3,453.29 per quarter
Through 16" fire service connection or less	$6,906.57 per quarter

Minimum Charge: As above

Terms of Payment: Quarterly in advance. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Agreement effective for a term of not less than one year. Service may be discontinued after one year upon ten (10) days prior notice to the Corporation.

Special Provisions:
(a) Each fire service installation is to be used solely and exclusively for fire protection. Water for any other purpose shall not be drawn from a private fire service connection, except that the Corporation will permit the use of water for test purposes upon three (3) days prior notification to the Corporation. The use of water in violation of the terms of this provision shall result in cancellation of service under this classification, whereupon the customer shall be rendered service under General Water Service Classification No. 1 and shall pay the rates set forth therein.
(b) The Corporation reserves the right to install a meter at any time.

PSC No. 1 - WATER **LEAF NO.: 69**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 5**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 4**
INITIAL EFFECTIVE DATE: APRIL 1, 2013

SERVICE CLASSIFICATION NO. 6 (Continued)

(c) The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 60**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 1

Applicable to the Use of Service for: General Water Service – Residential
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 5,000 gal.	$0.38974 per 100 gal.
	Over 5,000 gal.	0.48751 per 100 gal.
Winter		
October 1 through April 30	All consumption	$0.38974 per 100 gal.

The allowed water quantities in the first block will be prorated on a daily basis.

Meter Size	Customer Service Charge Monthly
5/8"	$10.44
3/4"	11.92
1"	14.19
1 ½"	27.61
2"	30.99

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 61**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 1A

Applicable to the Use of Service for: General Water Service – Commercial & Industrial
Character of Service: Continuous

Rates:	Meters Read and Billed Monthly	
Summer		
May 1 through September 30	First 34,000 gal.	$0.48751 per 100 gal.
	Over 34,000 gal.	0.38974 per 100 gal.
Winter		
October 1 through April 30	First 34,000 gal.	$0.38974 per 100 gal.
	Over 34,000 gal.	0.32495 per 100 gal.

Meter Size	Customer Service Charge Monthly
5/8”	$10.44
3/4"	11.92
1”	14.19
1 ½”	27.61
2”	30.99
3”	67.63
Compound 3”	106.27
Compound 4”	121.05
Compound 6”	120.75
Compound 8”	163.20
5/8” & 2”	32.63
1” & 1½”	33.82
1½” & 1½”	41.82
1 ½” & 2”	45.20
2” & 2”	48.59
3” & 3”	188.68
4” & 4”	218.22

The customer service charge applies to both seasons, will be included in each bill and will be charged on a daily basis if meter reading is outside of the billing window.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 1A (Continued)

Terms of Payment: Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Service may be discontinued on 48 hours notice to the Corporation.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

SERVICE CLASSIFICATION NO. 2

Applicable to the Use of Service for:

Private Fire Hydrant Service when the existing facilities (mains, etc.) of the Company are adequate for supply, and where the hydrant is to be used for fire purposes only.

Character of Service:

Continuous

Rate: $729.93 per hydrant per year

Terms of Payment:

Upon acceptance of customer's application for service, a sum of $729.93 is to be paid covering the first year of service, and thereafter $729.93 is to be paid annually in advance.

A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

Five years minimum, thereafter until cancelled by 60 days written notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

PSC No. 1 - WATER **LEAF NO.: 64**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 3

Applicable to the Use of Service for: Lawn Sprinkler Service
A. Lawn Sprinkler Systems supplied by an existing service line installed prior to March 15, 1947 which supplies both lawn sprinkling systems and general service.
B. Lawn Sprinkler Systems installed on or after March 15, 1947.

Character of Service: Seasonal (May 1st through October 31st)
See Section VII for Lawn Sprinkler responsibility and details.
For all quantities used in each season, the following rate applies: $0.48751 per 100 gallons.

Customer Service Charge Season: May 1st to October 31st Meter Size	Per Season
1”	$154.39
1½”	273.12
2”	313.72

TERMS OF PAYMENT:

New Service: Service construction costs, inspection fee and non-refundable Customer Service Charge are payable upon acceptance of Application for Service. If a new service is installed during the season, the Customer Service Charge will be applied on a prorated basis. Thereafter, the Customer Service Charge is payable in advance before service is connected for the season.

Existing Services: A Customer Service Charge is payable in advance before service is connected for the season. The Customer Service Charge shall be prorated for customers not taking lawn sprinkler service for the entire season. Whenever a customer has been found to have activated their lawn sprinkler service without having paid the appropriate Customer Service Charge in advance, the Customer Service Charge will be retroactive to May 1st.

Charge for water consumed is payable upon presentation of bill. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Meters may be read monthly, quarterly or seasonally at the option of the Corporation.
The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 65**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 4

Applicable to the Use of Service for:

Public Fire Protection

Character of Service:

Continuous

Rate:

Public Fire Hydrants $729.93 per hydrant per year

Minimum Charge:

None

Terms of Payment:

In arrears, monthly or quarterly, at the option of the Corporation. If hydrants are installed within the billing period, the charges will be prorated. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term:

One year and to continue from year to year thereafter, unless terminated by thirty days notice.

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 66**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 5

Applicable to the Use of Service for:

Construction and other purposes when the supply of water is not metered.

Character of service: Continuous

1 - Water used in constructing one or two story dwellings:

	Unit	Rate
Frame	Each Structure	$80.87
Frame and half stucco	Each Structure	107.81
All stucco, cement or cinder block, hollow tile, brick veneer or various combinations	Each Structure	$134.76
Brick	Each Structure	161.69

2 - Structures other than dwellings

Concrete, stone, terra cotta Other masonry	Per cu. yd. of masonry	$0.91
Brick	Per 1,000 bricks	1.71

3 - Road Construction

Concrete, macadam or other roads	Per 100 sq. ft.	$3.15
Sidewalk	Per 100 sq. ft.	3.15
Curbing	Per 100 sq. ft.	3.35

4 - Flooding Ditches

Ditch 2 ft by 3 ft - $16.93 per 100 lineal feet
(Proportionate charges for excess of above)

5 - Jetting Planks

Minimum rate - $17.84 for four or less planks
First four planks $17.84, thereafter $1.26

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **LEAF NO.: 67**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **REVISION: 6**
LONG ISLAND AMERICAN WATER **SUPERSEDING REVISION: 5**
INITIAL EFFECTIVE DATE: APRIL 1, 2014

SERVICE CLASSIFICATION NO. 5 (Continued)

6 - Jetting Spiles

Minimum rate $17.84 four or less spiles
First four spiles $17.84, thereafter $2.70

7 - Water drawn from hydrants for the purposes other than fire protection and for purposes other than specified above.

Rate: $0.44200 per 100 gallons

Minimum charge of $88.60 payable in advance for which the customer will be entitled to use 20,000 gallons of water in the period stated in the permit. Water in excess of such allowances will be billed at the rate above stated, at the expiration of the permit, and the bill thereof will be due and payable when rendered. The quantities of water used will be estimated.

Hydrant Permits

(In addition to above charges)

Per hydrant	$17.84 per day
For services of Inspector (when required by Company)	134.76 per day

Terms of Payment:
Net Cash. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: None

The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

SERVICE CLASSIFICATION NO. 6

Applicable to the Use of Service for:
Private Fire Protection – Risers for hose connections and/or sprinkler heads.
Character of Service: Continuous

Rate: Flat

Through 2” fire service connection or less	$44.11 per quarter
Through 3” fire service connection or less	$110.25 per quarter
Through 4” fire service connection or less	$220.54 per quarter
Through 6” fire service connection or less	$441.07 per quarter
Through 8” fire service connection or less	$882.07 per quarter
Through 10” fire service connection or less	$1,764.28 per quarter
Through 12” fire service connection or less	$3,528.57 per quarter
Through 16” fire service connection or less	$7,057.14 per quarter

Minimum Charge: As above

Terms of Payment: Quarterly in advance. A late payment charge of 1.5% per month will be assessed on the balance of any bill for service which has not been paid in full within 20 calendar days of the date payment was due.

Term: Agreement effective for a term of not less than one year. Service may be discontinued after one year upon ten (10) days prior notice to the Corporation.

Special Provisions:
(a) Each fire service installation is to be used solely and exclusively for fire protection. Water for any other purpose shall not be drawn from a private fire service connection, except that the Corporation will permit the use of water for test purposes upon three (3) days prior notification to the Corporation. The use of water in violation of the terms of this provision shall result in cancellation of service under this classification, whereupon the customer shall be rendered service under General Water Service Classification No. 1 and shall pay the rates set forth therein.
(b) The Corporation reserves the right to install a meter at any time.

SERVICE CLASSIFICATION NO. 6 (Continued)

(c) The above rates are subject to the state and applicable local gross revenue taxes as set forth in the current tax statements with this Schedule.

Appendix D

PSC No. 1 - WATER **STATEMENT TYPE: RPCRC**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **STATEMENT No.: 2**
LONG ISLAND AMERICAN WATER
INITIAL EFFECTIVE DATE: APRIL 1, 2012

GENERAL INFORMATION

STATEMENT #1

Revenue and Production Cost Reconciliation Adjustment Clause and Property Tax Clause #1

Applicable to all Metered Customers in Service Classifications 1, 1A and 3.

Commission Order in Case 07-W-0508, dated March 5, 2008, directed that the rates applicable to all metered customer accounts, as defined above, be subject to automatic adjustment by way of a surcharge, or credit, based on the difference between the actual net revenues (operating revenues less production costs) for the preceding rate year and the net revenue target as estimated in the most recent rate case. The difference is then surcharged (or credited) to be recovered (or refunded) over the ensuing year. In the following proceeding, Case 11-W-0200, target levels for revenues, production costs and property taxes were set for future years as follows, with the levels from the third rate year carrying forward for all future years until new target levels are set in the next rate proceeding (the revenue numbers below do not include net RAC adjustments for the rate year ending March 31, 2013 of ($40,303) ($8,977 for the Service Centers and ($49,280) for Demutualization) from the Commission decision on 11/20/2002 in Cases 02-W-0054 and 02-W-0056):

Year Ending	March 31, 2013	March 31, 2014	March 31, 2015
Revenues	$47,549,412	$48,807,844	$49,869,621
Production Costs	$3,953,224	$4,032,684	$4,118,580
Property Taxes	$11,893,414	$12,132,472	$12,390,893

The surcharge/credit for the year ending March 31, 2013 is calculated as follows:

The actual net revenues for the year ended March 31, 2013 of $ was compared to the target level set forth above. The difference, including accrued interest, results in a surcharge/credit to customers of $

The net amount to be surcharged/refunded to customers derived from the calculation described above, during the ensuing year ending March 31, 2014 is: $

Since the total number of metered customers is:

The surcharge/credit per customer amounts to: $

In accordance with the property tax mechanism set forth in the settlement agreement approved by the Commission in Case 07-W-0508, the PSC has permitted the company to reconcile property taxes. For the rate year ended March 31, 2013, such reconciliation resulted in a surcharge/credit to customer of $
As a result, the net surcharge/credit to each customer's bill amounts to $

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **STATEMENT TYPE: RPCRC**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a LONG ISLAND AMERICAN WATER **STATEMENT No.: 2**
INITIAL EFFECTIVE DATE: APRIL 1, 2012

GENERAL INFORMATION

STATEMENT #1

Revenue and Production Cost Reconciliation Adjustment Clause and Property Tax Clause #1 (cont'd)

Any refunds due ratepayers from any net over-recovery in the rate year will be credited to customers' bills in the earliest month, as administratively practical, of the following rate year. Customer bills will be surcharged, no greater than $4 per customer per month, to recover any deferral of cost recovery in the rate year beginning in the earliest month, as administratively practical, of the following rate year and continue each month thereafter, as necessary, until the entire deferral is recovered. Should the $4 per customer per month surcharge limit be inadequate to fully recover any deferred costs prior to the end of the following rate year, the limit will be waived. For sprinkler customers there will be a one time credit/surcharge. Any credit/surcharge is subject to the applicable local gross revenue taxes as set forth in the current tax statements.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

Appendix E

PSC No. 1 - WATER **STATEMENT TYPE: SIC**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **STATEMENT No.: 3**
LONG ISLAND AMERICAN WATER
INITIAL EFFECTIVE DATE: APRIL 1, 2012

GENERAL INFORMATION
SYSTEM IMPROVEMENT CHARGE (SIC)

The SIC mechanism will apply to costs associated with the construction of specific reviewed and approved projects. The mechanism will allow recovery of carrying costs (i.e., return and depreciation expense) on specific projects placed in service in Rate Year Two, Rate Year Three and beyond. The use of the SIC mechanism is approved for the following projects:

- Iron removal facilities at Plant 15
- Storage tank rehabilitation at Plant 13
- Plant 5 common suction well rehabilitation, Phase 2 and
- Business transformation EAM/CIS

System Improvement Charge

When the Company has incurred actual expenditures for projects listed above and the new facilities have been placed in service, then the amount of those expenditures (net of the associated (1) retirements, including cost of removal and any related tax benefits, (2) accumulated deferred income taxes ("ADIT"), and (3) accumulated depreciation reserve, i.e., the net rate base ["NRB"]) will constitute the incremental rate base investment subject to the SIC.

The SIC filing will be made within 30 days after the project has been placed into service. The Company will provide Staff with detailed project information regarding the SIC (such as in-service dates, actual expenditures incurred, retirements, etc.). Staff will have 60 days to analyze and verify such data.

The formula for the calculation of the SIC surcharge is as follows:

SIC surcharge = ((NRB x Pre-tax ROR) + D) / AR

Where:

NRB	=	the cost of the specific approved facilities listed above, net of associated (1) retirements, including cost of removal and any related tax benefits, (2) ADIT and (3) accumulated depreciation reserve
Pre-tax ROR	=	10.14%
D	=	the annual depreciation expense on the net additions
AR	=	LIAW's projected annual metered revenues.

Effective with this statement, the SIC surcharge is X.XX%.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

PSC No. 1 - WATER **STATEMENT TYPE: SIC**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **STATEMENT No.: 3**
LONG ISLAND AMERICAN WATER
INITIAL EFFECTIVE DATE: APRIL 1, 2012

GENERAL INFORMATION

SYSTEM IMPROVEMENT CHARGE (SIC) – (cont'd.)

Safeguards

A reconciliation between authorized collections and actual collections related to the SIC surcharge will be conducted annually and filed with the Secretary to the Commission within 60 days of the end of each rate year. Any under collections or over collections will accrue interest at the customer deposit interest rate established by the Commission each year. Adjustments of under collections and over collections, as well as updates related to accumulated depreciation reserve, will be reflected in the next SIC surcharge filing.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

Appendix F

Long Island American Water
DSIC Main Replacement Program 2012-2014

Job #	Street Name	Town	Pipe Diameter	Estimated Footage
1	Acapulco St	Atlantic Beach	16	330
2	Park St	Atlantic Beach	8	725
3	Ocean Blvd - Phase III - (Suffolk Blvd to Yates Ave)	Atlantic Beach	12	1,575
4	Oneida Ave	Atlantic Beach	8	680
5	Bayfront Dr	Baldwin	8	550
6	Brook Ct	Baldwin	6	300
7	Brookside Dr	Baldwin	6	375
8	Laurel Ct	Baldwin	6	300
9	Lincoln Ave	Baldwin	8	3,560
10	Marion Pl	Baldwin	6	250
11	Miller Pl	Baldwin	8	550
12	Northern Blvd - Harbor Ct	Baldwin	8	1,000
13	N. Seaman Ave	Baldwin	8	775
14	Southard St	Baldwin	8	470
15	Stowe Ave	Baldwin	8	75
16	Chatham Ct	Bay Park	6	215
17	Cooke St East	Bay Park	6	230
18	Court St West	Bay Park	6	150
19	Evans St West	Bay Park	6	190
20	Hudson St West	Bay Park	6	180
21	Kirgan Court	Bay Park	6	315
22	Lawrence St - Phase II - (East of Lawson Ave.)	Bay Park	8	1,050
23	Martin St West	Bay Park	6	175
24	Sampson St West	Bay Park	6	225
25	Sperry St West	Bay Park	6	220
26	Teaticket Ct	Bay Park	6	235
27	West Blvd	Bay Park	6	185
28	Yarmouth Rd	Bay Park	6	175
29	Central Pl	Cedarhurst	6	180
30	Columbia St	Cedarhurst	16	1
31	Fifth Ave	Cedarhurst	8	360
32	Grove Ave	Cedarhurst	8	350
33	Linwood Ave	Cedarhurst	8	1,050
34	Madison Ave	Cedarhurst	8	400
35	Cail Dr	East Rockaway	12	980
36	Franklin St - Phase II	East Rockaway	8	1,410
37	Lester Dr	East Rockaway	6	190
38	Malecon St	East Rockaway	8	210
39	Roxbury Rd	East Rockaway	8	300
40	Daub Av	Hewlett	8	260
41	Franklin Pl	Hewlett	8	200
42	Hewlett Parkway	Hewlett	8	305
43	Westervelt Pl	Hewlett	8	495
44	12" Transmission Main Cedar Ave	Hewlett Bay Park	12	1,235
45	12" Transmission Main Harbor Rd	Hewlett Harbor	12	3,815
46	Smith Ln S/O Hewlett Neck Rd	Hewlett Neck	6	1,000
47	Christina St	Inwood	8	415
48	Doughty Blvd	Inwood	8	360
49	Gates St	Inwood	12	490
50	Lawrence Ave	Inwood	8	880
51	Zavatt St	Inwood	8	920
52	Beach Ave Shopping Center	Island Park	8	800
53	Hastings Rd	Island Park	8	460
54	Nassau Ln.	Island Park	8	3,875
55	Newport Rd	Island Park	8	620
56	Quebec Rd - Phase II	Island Park	12	1,500
57	Quebec Rd - Phase III (S/O Lancaster Pl)	Island Park	8	1,380
58	Redfield Rd	Island Park	8	360
59	Suffolk Rd	Island Park	12	2,800
60	Hempstead Ave (Walker Pl)	Lakeview	8	50
61	Bannister Ln.	Lawrence	8	850
62	Barrett Rd - Phase I	Lawrence	8	1,500
63	Barrett Rd - Phase II	Lawrence	8	1,500
64	Briarwood Crossing	Lawrence	8	850
65	Burton Lane	Lawrence	8	1,350

Long Island American Water
DSIC Main Replacement Program 2012-2014

Job #	Street Name	Town	Pipe Diameter	Estimated Footage
66	Chauncey Ln - Phase I	Lawrence	8	800
67	Chauncey Ln - Phase II	Lawrence	8	1,000
68	Herrick Dr.	Lawrence	8	200
69	Longwood Crossing - Phase II	Lawrence	8	850
70	Lord Ave	Lawrence	12	1,600
71	Muriel Ave & Donmoor Rd	Lawrence	8	1,850
72	Ocean Ave	Lawrence	8	1,100
73	Sealy Ct	Lawrence	8	525
74	Sterling Pl	Lawrence	6	200
75	Elm St	Lynbrook	8	1,000
76	Evergreen Ave	Lynbrook	8	300
77	Irwin Ct - Phase II - (Peninsula Blvd)	Lynbrook	12	1,025
78	Langdon Pl	Lynbrook	8	920
79	Ocean Ave	Lynbrook	20	500
80	Olive Pl	Lynbrook	6	635
81	Peninsula Blvd	Lynbrook	12	1,025
82	Horton St	Malverne	8	1,200
83	Lexington Ave	Malverne	8	1,360
84	Nassau Blvd	Malverne	8	1,475
85	Harold St / Anchor Pl	Oceanside	6	1,375
86	Lake St	Oceanside	6	300
87	Montgomery Ave	Oceanside	8	550
88	Moore Ave	Oceanside	6	100
89	Oceanside Rd	Oceanside	8	5,500
90	Perkins Ave	Oceanside	6	120
91	Ralph Ave	Oceanside	6	170
92	Riverside Dr	Oceanside	8	350
93	W. Cortland Ave	Oceanside	6	165
94	Brookside Ave	Roosevelt	8	300
95	Benedict Ave	Valley Stream	8	1,175
96	Clinton St.	Valley Stream	6	110
97	Dean St	Valley Stream	6	350
98	E. Argyle St.	Valley Stream	8	1,300
99	E. Fairview Ave	Valley Stream	6	390
100	E. Maujer St.	Valley Stream	8	1,200
101	E. Mineola Ave.	Valley Stream	6	425
102	E. Oxford St.	Valley Stream	6	175
103	E. St. Marks Pl.	Valley Stream	8	1,025
104	E. Valley Stream Blvd	Valley Stream	6	100
105	Fraser Pl	Valley Stream	6	400
106	Fulton Pl	Valley Stream	8	200
107	Gold St	Valley Stream	8	325
108	Gordon Rd	Valley Stream	8	1,000
109	Gregory St	Valley Stream	6	160
110	Hicks St	Valley Stream	6	190
111	Manor Rd.	Valley Stream	6	175
112	Melrose St	Valley Stream	6	50
113	Peninsula Blvd & Rockaway Tpke	Valley Stream	24	1
114	South Dr.	Valley Stream	8	1,300
115	Spruce Ln.	Valley Stream	6	260
116	W. Argyle St.	Valley Stream	6	650
117	W. Chester St.	Valley Stream	6	460
118	W. Euclid St.	Valley Stream	6	400
119	W. Fairview Ave.	Valley Stream	8	315
120	W. Jamaica Ave	Valley Stream	6	310
121	W. Lincoln Ave. & Hicks St.	Valley Stream	6	530
122	W. Oxford St.	Valley Stream	8	510
123	W. St. Marks Pl.	Valley Stream	8	1,000
124	Chapman Ave	Woodmere	8	620

Appendix G

PSC No. 1 - WATER **STATEMENT TYPE: FDR**
COMPANY: LONG ISLAND WATER CORPORATION d/b/a **STATEMENT No.: 1**
LONG ISLAND AMERICAN WATER
INITIAL EFFECTIVE DATE: APRIL 1, 2012

GENERAL INFORMATION

DISTRIBUTION SYSTEM IMPROVEMENT CHARGE
FINAL RECONCILIATION SURCHARGE STATEMENT (FDR)

Applicable to all Metered Customers

As authorized in Case No. 04-W-0577 and later amended in Case No. 07-W-0508, the Distribution System Improvement Charge (DSIC) Surcharge is subject to an annual reconciliation between authorized collections and actual collections to be filed within 60 days of the end of the rate year. Any over/(under) collections with accrued interest will be reflected in the next surcharge filings. Effective April 1, 2012 in Case No. 11-W-0200, the DSIC Surcharge will cease to exist.

As authorized in this case, the following reconciled amount will be surcharged or credited:

DSIC Over/(Under) Collected Cumulative Balance with Interest:

Period Ended 03/31/12 $ XX,XXX

The total amount of $ XX,XXX (which includes accrued applicable interest) will be surcharged or credited via a one-time surcharge or credit, calculated by dividing the total DSIC Over/(Under) Collected Cumulative Balance with Interest by the total number of metered customers. The one-time, final surcharge or credit will commence 45 days from the date of the filing. The FDR calculation with workpapers will be submitted to the Secretary to the Commission within 60 days of March 31, 2012. The submitted surcharge or credit will be reviewed by Staff and go into effect 45 days after the submittal unless Staff submits a letter to the Company indicating that the reconciliation amount should be adjusted.

The one-time FDR surcharge to be applied to all Metered Customer bills shall be $ X.XX and be subject to all revenue-based taxes.

Issued in compliance with Commission Order issued and effective March XX, 2012 in Case 11-W-0200.

Issued by: William M. Varley, President, 733 Sunrise Highway, Lynbrook, NY

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February 14, 2012

Honorable Jaclyn A. Brilling
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, NY 12223

Re: Case 11-W-0200: Long Island Water Corporation, d/b/a Long Island American Water – Errata Notice

Dear Secretary Brilling:

On November 29, 2011, Long Island Water Corporation ("LIWC"), Department of Public Service Staff and the Utility Intervention Unit of the New York State Department of State's Division of Consumer Protection (collectively, the "Signatories") executed and filed a Joint Proposal ("JP") for a three-year settlement of LIWC's current rate proceeding. An error was recently discovered in the text of the JP which this letter corrects.

On page 20 of the JP, the last sentence of Section III (O), *Legislative, Regulatory and Related Actions*, reads:

> No regulatory asset deferrals in this Section will be authorized to the extent that the Company's earnings before sharing exceed an ROE of 10.65% for Year One, 10.0% for Year Two and 9.90% for Year Three.

The sentence should read:

> No regulatory asset deferrals in this Section will be authorized in a year that the achieved ROE for the Company before earnings sharing exceeds an ROE of 10.2%.

The Signatories acknowledge acceptance of this change by their signature below.

Very truly yours,

Steven D. Wilson, Esq.
Attorney for Long Island Water Corporation
d/b/a Long Island American Water

Joseph Dowling, Esq.
Assistant Counsel
Department of Public Service

Lisa R. Harris, Esq.
Division Director
DOS Division of Consumer Protection

The Signatories acknowledge acceptance of this change by their signature below.

Very truly yours,

Steven D. Wilson, Esq.
Attorney for Long Island Water Corporation
d/b/a Long Island American Water

Joseph Dowling, Esq.
Assistant Counsel
Department of Public Service

Lisa R. Harris

Lisa R. Harris, Esq.
Division Director
DOS Division of Consumer Protection

The Signatories acknowledge acceptance of this change by their signature below.

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Attorney for Long Island Water Corporation
d/b/a Long Island American Water

Joseph Dowling, Esq.
Assistant Counsel
Department of Public Service

Lisa R. Harris, Esq.
Division Director
DOS Division of Consumer Protection

CASE 11-W-0200

SUBJECT: Filing by Long Island Water Corporation d/b/a Long Island American Water

Amendments to P.S.C. No. 1 – Water

Leaf No. 60, Revision 3
Leaf No. 61, Revision 3
Leaf No. 62, Revision 3
Leaf No. 63, Revision 3
Leaf No. 64, Revision 3
Leaf No. 65, Revision 3
Leaf No. 66, Revision 3
Leaf No. 67, Revision 3
Leaf No. 68, Revision 3
Leaf No. 69, Revision 3

STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: IOWA-AMERICAN WATER COMPANY	DOCKET NO. RPU-2013-0002

FINAL DECISION AND ORDER

(Issued February 28, 2014)

I. PROCEDURAL HISTORY AND INTRODUCTION

On April 30, 2013, Iowa-American Water Company (Iowa-American) filed with the Utilities Board (Board) proposed water tariffs, identified as TF-2013-0069 and TF-2013-0070. In TF-2013-0069, Iowa-American proposed a temporary annual increase in its Iowa retail water revenue of approximately $2.68 million, or about 7.5 percent over current Iowa retail water revenue. Pursuant to Iowa Code § 476.6(10), Iowa-American implemented its proposed temporary rates ten days after its April 30, 2013, filing; the rates are subject to refund. In TF-2013-0070, Iowa-American proposed a permanent annual increase in its Iowa retail water revenue of approximately $6.4 million, or about 18 percent over its current revenues.

Iowa-American's filing indicates that the primary drivers for the requested increase are new utility plant investments of about $16.1 million, increased capital costs of about $2.2 million, and increased operations and maintenance expenses of about $0.8 million. Iowa-American is also asking that the Board approve a surcharge that would allow Iowa-American to earn a return of and return on its investments in future infrastructure replacement without a rate proceeding, an automatic adjustment clause that would allow purchased power and chemical costs to be flowed through to customers on an automatic basis, and a declining usage adjustment to address declining water usage.

The Board issued an order on May 29, 2013, docketing the proposed filing and setting a procedural schedule. Two consumer comment hearings were held, one in Bettendorf on June 3, 2013, and the other in Clinton on June 4, 2013. The Consumer Advocate Division of the Department of Justice (Consumer Advocate) is the only other party to the proceeding.

On July 19, 2013, the Board issued an order denying a motion for issue preclusion filed by Consumer Advocate. Consumer Advocate said that in this proceeding Iowa-American said it qualifies for an exception to the application of double leverage, an issue that was litigated in Iowa-American's last rate proceeding (Docket No. RPU-2011-0001, "Final Order" issued February 23, 2012) and decided adversely to Iowa-American. Because the Board's decision was issued only 14 months prior to the filing of the current rate case, Consumer Advocate said issue preclusion applied.

The Board denied the motion for issue preclusion because in a rate proceeding, the Iowa Supreme Court has said the Board functions in a legislative capacity, where application of issue preclusion is not appropriate. However, the Board did share Consumer Advocate's concern about the costs of re-litigating the same issues in multiple dockets and noted that Consumer Advocate could raise arguments that any rate case expense associated with the double leverage issue should not be recovered from ratepayers.

The Board held a hearing in this case on October 30-31, 2013. Iowa-American and Consumer Advocate filed post-hearing initial and reply briefs.

Iowa-American filed several exhibits after the hearing in response to requests for information by the Board. Consumer Advocate filed an objection to four of these (Exhibits 3, 4, 8, and 9) on November 14, 2013. In an order issued December 16, 2013, the Board sustained the objection, stating that the narrative, explanation, or testimony provided by Iowa-American in the four exhibits at issue went beyond the Board's requests for additional information and Iowa-American used these exhibits as an additional opportunity to submit explanatory testimony or argument. The Board noted that if the exhibits were admitted, Consumer Advocate would need time for discovery, filing rebuttal testimony, and perhaps cross-examination, which would necessitate extending the 10-month deadline. Neither party requested an extension to accommodate the four exhibits.

Consumer Advocate filed an objection to Iowa-American's report of actual rate case expense on January 2, 2014, alleging that it lacked the detail required by 199 IAC 26.4(6). Iowa-American filed additional expense support on January 10, 2014.

On January 16, 2014, Consumer Advocate filed a motion for reduction of recoverable rate case expense. Iowa-American filed a resistance to Consumer

Advocate's motion on January 24, 2014, and Consumer Advocate filed a reply to the resistance on January 29, 2014. The Board will address the motion and resistance after it has addressed issues raised in the rate case.

II. RATE BASE ISSUES

A. Business Transformation

Iowa-American and Consumer Advocate agreed that $4,939,942 associated with Iowa-American's business transformation program should remain in plant in-service. The corresponding amounts in accumulated depreciation and depreciation expense are to be as reflected in Iowa-American's filing. (Tr. 6-7; 700-701) Iowa-American's business transformation program includes computer hardware and software upgrades.

B. Cash Working Capital

Cash working capital is a reflection of the amount of investor-supplied capital used to cover the day-to-day cash needs of a utility. Calculation of the cash working capital is necessary because the utility provides a service but does not receive payment for the service for a certain number of days, which is called the revenue lag. Cash working capital also accounts for the fact that the utility receives a service from a vendor or employee but does not pay for the service for a certain number of days after it is provided, which is the payment lag. Iowa-American performed a lead/lag study to analyze Iowa-American's receipts and payments based on data for the twelve months ended December 31, 2012, in order to determine Iowa-American's cash working capital requirement. (Tr. 544)

Consumer Advocate disagreed with several adjustments made by Iowa-American for such things as revenue lag days, federal income tax expense lead days, property tax expense lead days, state income tax expense lead days, and miscellaneous expense lead days. Consumer Advocate said that the adjustments made by Iowa-American reduce test year revenue, creating the potential for windfall profits for Iowa-American at the expense of Iowa-American's ratepayers.

1. Bill Collection Days

Iowa-American's lead/lag study was based on daily accounts receivable balances and resulted in a calculation showing 26.58 bill collection days. Consumer Advocate argued it was appropriate to cut off bill collections days after 24 days, because after 23 days Iowa-American charges a late fee.

The Board will adopt Iowa-American's 26.58 bill collection days. Regardless of whether Iowa-American charges a late fee, cash is not available to Iowa-American for working capital from revenue that is uncollected and a late payment fee does not make up for uncollected revenue in the cash working capital calculation. This results in total revenue lag days of 72.05 days, which is composed of the 26.58 bill collection days and three uncontested figures: service lag days of 39.72 days, billing lag days of 4.97 days, and lockbox collection lag of 0.78 days.

2. Federal and State Income Tax Expense Lead Days

In calculating federal income tax expense lead days, Consumer Advocate used a method based on monthly accruals while Iowa-American's method was based on actual payment dates. (Tr. 557) Iowa-American pays its income taxes quarterly.

Iowa-American counts the days until the tax payment and does not use monthly accruals. Because over 94 percent of Iowa-American's customers are billed on a quarterly basis (Thakadiyil Ex. 2), the average service period for Iowa-American's customers is 39.72 days. Consumer Advocate uses 15.2 days, a number that might be appropriate if Iowa-American's customers were billed monthly like most customers of Iowa's rate-regulated electric and gas utilities, but Consumer Advocate has not provided evidence to convince the Board that its monthly accrual method is more appropriate when most customers are billed quarterly. The Board will use Iowa-American's 37.0 tax expense lead days for federal income tax.

Consumer Advocate argued that its federal method should also be used to compute state income tax expense lead days. However, because the Board has determined it will use Iowa-American's computations for federal income tax expense lead days, it will also use Iowa-American's method for the state computation, which results in 52.25 lead days for state income taxes.

3. Property Tax Expense Lead Days

Similar to the tax calculations, Consumer Advocate uses a method based on monthly accruals for each of the 12 months of the test year to calculate property tax expense lead days; Iowa-American does not use a monthly accrual and counts the days until tax payment. As discussed above, Iowa-American's method of calculating cash working capital is most appropriate, and it results in lead days of 332.86 days for property tax expense.

4. Miscellaneous Expense Lead Days

Consumer Advocate used Iowa-American's 38.4 miscellaneous expense lead days for all expenses other than labor and fuel. Iowa-American prepared an analysis for each expense category. Iowa-American's method provides a more accurate result by analyzing each expense category and will be used to calculate cash working capital for other operations and maintenance expenses.

III. INCOME STATEMENT ISSUES

A. Unbilled Revenue

Iowa-American said that unbilled revenue should be removed from the calculation of test year revenue, stating that unbilled revenue is an accounting entry recorded for financial statement purposes to account for services provided but not yet billed at the end of an accounting period. (Tr. 516) Iowa-American noted that all customer meters are not read and billed on the last day of each month and, therefore, there is always a certain amount of revenue left unbilled that is related to services provided prior to the end of the month.

Consumer Advocate argued that Iowa-American's proposed unbilled revenue adjustment creates a mismatch between test year revenue and test year expenses, violating the matching principle. (Tr. 987) Consumer Advocate said a similar adjustment was rejected by the Board in a prior Iowa-American case. Iowa-American Water Company, "Final Decision and Order," Docket No. RPU-90-10 (10/21/1991), p. 27.

The proposed adjustment for unbilled revenue would result in a mismatch of revenues and expenses, violating the matching principle. Iowa-American proposed an adjustment for revenues because under the accrual method of accounting unbilled revenue is included as revenue in the test year. However, Iowa-American failed to make any corresponding adjustment for expenses. The proposed unbilled revenue adjustment will be rejected.

B. Uncollectible Expense

There are two issues related to uncollectible expense. The first is the amount of the test year adjustment to create a normalized amount of uncollectible expense to include in rates determined in this proceeding. Iowa-American and Consumer Advocate both agree an adjustment should be made, but disagree on the amount.

The second issue is whether there should be an additional adjustment to uncollectible expense, as proposed by Iowa-American, to account for uncollectible expense associated with the rate increase in this proceeding. Consumer Advocate opposed this adjustment.

1. Adjustment to Test Year

Iowa-American used an average of 2010, 2011, and 2012 data to calculate its uncollectible adjustment to the test year, which is the first issue. Iowa-American calculated the adjustment by first taking the ratio of the three-year average of net charge-offs to billed revenue and then applying the ratio to the pro forma present and proposed revenues. (Tr. 465, 472)

Consumer Advocate averaged three years of uncollectible expense (2009, 2010, and 2011) to determine its proposed adjustment to test year uncollectible expenses. Consumer Advocate said the use of the test year in the average carries any abnormal amounts forward.

Iowa-American's method produces an adjustment of ($60,512) and Consumer Advocate's method produces an adjustment of ($102,084) to uncollectible expenses. There are problems with both methods.

Iowa-American did not use the general ledger account expense for its calculation for uncollectible accounts expense, but instead used net charge-offs that include accruals, or a reserve, in its calculation for uncollectible accounts expense. The reserve includes an amount that Iowa-American is not certain of at the time Iowa-American books the expense. (Tr. 478-479) Consumer Advocate used the general ledger account balance, which is the appropriate starting point because this balance does not include a reserve and more accurately reflects the uncollectible expense.

However, in calculating the adjustment using a three-year average, the test year should normally be included to reflect the most recent uncollectible levels. No persuasive evidence was presented to exclude the test year from the average. Using a three-year simple average for the years 2010, 2011, and 2012, the adjustment to unbilled revenue reflected in Iowa-American's new rates will be ($72,696).[1] A simple average more accurately measures the account experience than a ratio method.

2. Adjustment Based on Proposed Rates

Iowa-American argued that to the extent revenues are increased as a result of this proceeding, an adjustment should be made to reflect the fact that a portion of these revenues will also be uncollectible. Iowa-American said that there was a direct correlation between uncollectible expenses and revenues and that when revenues increase, uncollectible expenses also increase, with the ratio of uncollectible expense to revenue being about one percent over the past five years. (Tr. 481, 484) Iowa-American's method would result in a test year increase of $63,530 to uncollectible expense to account for additional amounts that will not be collected under the new rates.

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[1] The three year-average is $333,075, which requires a decrease of test year expense of $72,696 ($333,075-$405,771).

Consumer Advocate opposed any adjustment to uncollectible expense to reflect new revenues that will not be collected. Consumer Advocate argued that the adjustment is speculative and not known and measureable, citing Iowa Code § 476.33(4).

The Board will not make an additional adjustment to account for any increase in uncollectible revenue based on the rates approved in this proceeding. Any adjustment based on other than present rates is speculative and not known and measureable; it is also an adjustment for something that will occur more than nine months after the end of the test year. A similar adjustment was rejected in another Iowa-American proceeding, Docket No. RPU-90-10.

The Board notes that Iowa-American included an increase in uncollectible expense based on new rates in the number that it grossed-up for taxes. Because that proposed adjustment will be rejected by the Board, the amount of this proposed adjustment will be removed before the gross-up for taxes.

C. Interest Synchronization

Interest synchronization is an adjustment to recognize the income tax effect of differences between the test period interest expense reported by Iowa-American and the interest expense included in the overall return on rate base. (Tr. 990) Iowa-American and Consumer Advocate agree that such an adjustment needs to be made and they also agree on the method used for the adjustment. Their differences are based on the size of rate base, weighted cost of debt, and the double leverage adjustment. The interest synchronization adjustment will be recalculated to reflect the Board's decisions on these three issues and reflected in the schedules attached to this order.

D. Weather Normalization and Declining Usage

Iowa-American proposed to decrease test year revenues for declining usage and weather normalization. Consumer Advocate did not make either of these adjustments to test year revenues. These issues will be discussed in detail later under Rate Design—Billing Units.

E. Fuel and Power, Chemicals, and Waste Disposal Expense

Iowa-American proposed an adjustment to certain test year expense levels to reflect a decrease in power consumption, chemical usage, and waste disposal; these adjustments are tied to Iowa-American's proposal to adjust test year sales for declining usage and weather normalization. Whether such adjustments to power consumption, chemical usage, and waste disposal are appropriate depends on the Board's decisions regarding declining usage and weather normalization. These issues will be discussed in detail later under Rate Design—Billing Units.

F. Property Tax

Iowa-American and Consumer Advocate agreed that the appropriate adjustment to test year property tax expense is $263,006. The Board will reflect this adjustment to test year property tax expense.

G. Rate Case Expense

Historically, the Board has typically amortized rate case expense over a three-year period. In this proceeding, Iowa-American has asked for a two-year amortization of current rate case expense and the unamortized balance from its prior rate case proceeding, Docket No. RPU-2011-0001. Iowa-American said a two-year amortization is consistent with its historic rate case pattern; Iowa-American filed rate proceedings in 2007, 2009, 2011, and 2013. Iowa-American said using a two-year amortization period would prevent rate case expense obligations being shifted to future customers.

Consumer Advocate recommended the Board use a three-year amortization, consistent with past practice in Iowa-American rate filings. Consumer Advocate pointed out that in 2011, Iowa-American's rate case expense totaled nearly 40 percent of the allowed revenue increase. Arguing that Iowa-American is relitigating in this proceeding issues lost in past decisions, Consumer Advocate also filed a motion to disallow some rate case expense.

Consumer Advocate's motion to disallow some of the rate case expense will be addressed in a separate section of this order after all regular rate case issues are decided. The Board here will only address the appropriate amortization period for current rate case expense and any unamortized balance.

The Board has expressed concern about the frequency of Iowa-American's rate cases and, like the Consumer Advocate, the Board is also concerned about the amount of rate case expense, particularly as a percentage of the overall revenue increase. While the Board does not want to encourage Iowa-American to file rate cases every two years, the Board acknowledges that a three-year amortization period for rate case expense, given Iowa-American's historic rate case pattern, shifts more of the rate case expense obligation to future customers. The Board will adopt in this proceeding a two-year amortization period for current and unamortized rate case expense, but this decision should not be taken as an indication that the Board is supportive of Iowa-American's current rate case cycle or that future rate case expense will be amortized over a similar period.

IV. COST OF CAPITAL ISSUES

A. Overall Cost of Capital

1. Return on Equity

In setting an allowed rate of return on equity investment, the Board is to balance investor and consumer interests. For example, if rates produce earnings that are below a fair and reasonable level, they are unjust or confiscatory to the owners of the utility property; if rates produce earnings that are above a fair and reasonable level, the rates are oppressive to the utility's ratepayers. Davenport Water Co., v. Iowa State Commerce Comm'n, 190 N.W.2d 583, 604-05 (Iowa 1971). In addition, the U.S. Supreme Court in Federal Power Commission v. Hope Natural Gas Company, 320 US 591 (1944) held that "the return to the equity owner [the utility] should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital ...."

In determining the allowed return, the various models generally produce a range for the Board to consider. There is no precise return on equity that is accurate or the only one that is appropriate, but a range of reasonable returns. Within that range, the Board determines the most appropriate return, balancing the interests of shareholders and ratepayers.

Iowa-American and Consumer Advocate each presented return on equity (ROE) testimony. Both of the ROE witnesses used the discounted cash flow (DCF) model. Iowa-American also used the risk premium method and capital asset pricing model (CAPM) to develop its recommendation; Consumer Advocate used the capital asset pricing model (CAPM) only as a check on its DCF result, but did not rely on CAPM in its analysis.

Iowa-American's witness recommended a 10.8 percent ROE, which included a 40 basis point adjustment for the small size of the company and a 30 basis point adjustment for flotation costs. The two adjustments will be addressed later. Without these adjustments, Iowa-American's ROE recommendation is 10.1 percent. (Tr. 200) Consumer Advocate recommended a 9.3 percent ROE with no adjustments.

In presenting the various ROE models, there were arguments presented not only with respect to the final recommendation but also with respect to some of the inputs and the validity of some of the models. One of the disagreements between Iowa-American and Consumer Advocate was with respect to the DCF models used. Consumer Advocate used the compounding form of the DCF model where the dividend yield does not reflect additional growth, while Iowa-American used the constant growth DCF model where the dividend yield is increased (1 + g (expected rate of growth in dividends per share)). Under the Board's preferred DCF method, the Federal Energy Regulatory Commission (FERC) model, the dividend yield is increased by 1 + .5g, or half of what was used by Iowa-American. Iowa-American and Consumer Advocate agreed on the proxy group used in their respective DCF analyses, and the Board will consider the ROE results produced by the proxy group.

In the past, the Board has placed more reliance on the FERC DCF version because it represents a compromise between the continuous compounding and constant growth models, with some of the strengths and weaknesses of each approach. There is, however, no perfect DCF model, and the Board looks at the results of all the DCF models as one tool in determining Iowa-American's ROE.

Iowa-American also used the risk premium model. In its simplest form, the risk premium model takes a specific long-term debt interest rate and adds an associated risk premium to estimate the ROE.

Both parties used the CAPM, either as part of the analysis or as a check on the DCF results. Historically, the Board has not given much weight to any CAPM analysis, because there were concerns about its reliability. However, the Board has considered the results from the CAPM method as another tool in its ROE determination, al beit not the most important one, and will do so here, as well.

All the models used by the various parties produced results worth considering, although the Board has traditionally given more weight to some models than others. In this proceeding, none of the models appeared to produce results that were contrived or so unreasonable as to be not worthy of consideration.

The final ROE recommendations (without adjustments) are Iowa-American at 10.1 percent and Consumer Advocate at 9.3 percent. In this proceeding, the various DCF results range from about 8.5 to 10.53 percent (Tr. 881, 887), the various CAPM ranges are from about 8.2 to 10.1 percent (Tr. 107, 886), and the various risk premium ranges are from about 10.1 to 10.7 percent. (Tr. 108, 112)

The Board in recent years has used the risk premium method as a check on reasonableness when determining ROE. The risk premium model often used by the Board adds 250 to 450 basis points to either the most current A-rated utility bond yield, or the 12-month average of that yield. The most recent bond yield available (October 2013) is 4.7 percent, which produces a ROE range of 7.2 to 9.2 percent, below the ROE recommendation of either party. This reflects the fact that bond yields are historically low and therefore should not be relied upon as predictors of the future with as much confidence as in prior cases, when bond yields were significantly higher and there appeared to be a more normal relationship between bond yields and ROE.

In reviewing current market data and the ranges produced by the various models, the Board concludes an ROE between 9.5 and 10.1 percent is reasonable, particularly given the relative closeness of the DCF and CAPM ranges. The Board will set the ROE at 9.9 percent, which appropriately balances the interests of the shareholders and ratepayers and is consistent with recent ROE decisions.

2. Size Adjustment

Iowa-American argued that because it is small in size compared to the size of other water companies used by its ROE witness in his proxy group, there should be a 40 basis point upward adjustment to the ROE to reflect this risk. (Tr. 122-124) In addition, Iowa-American said it was facing increasing amounts of business risks compared to its peer companies due to the approximately $50 million of capital investment that Iowa-American plans in the next five years. (Tr. 125)

Consumer Advocate opposed Iowa-American's size adjustment, noting that Iowa-American is a subsidiary of a large national company. Consumer Advocate pointed out that throughout the record, there are references to the synergies that exist with American Water as the parent such as control of Iowa-American's board of directors, amounts spent for services from related companies, and American Water acquiring debt on behalf of Iowa-American. (Tr. 199-202)

The Board will reject Iowa-American's proposed size adjustment. As the Board has noted in the past, because the various ROE models consider so many factors, it is difficult to isolate any one item, such as size, and make that the basis for an additional adjustment to the allowed return on equity. Interstate Power and Light Company, "Final Decision and Order," Docket Nos. RPU-02-3, RPU-02-8, ARU-02-1 (4/15/2003), p. 63.

Proxy groups generally contain both large and small companies and should capture any risk associated with size, if it is significant. There is no persuasive evidence to persuade the Board to isolate individual factors to adjust ROE because the models take into account such factors as business and financial risk. See, Interstate Power and Light Company, "Final Decision and Order," Docket No. RPU-08-1 (2/13/2009), p. 62. Also, the proxy group used in this case was selected because the companies have risk criteria similar to Iowa-American's, making separate adjustments for isolated factors unnecessary.

3. Flotation Costs

Iowa-American argued that a flotation cost adjustment was necessary because issuing common equity is not cost-free. Iowa-American said that direct costs associated with common equity include compensation for marketing and consulting services and that indirect costs associated with common equity deal with what is called market pressure where there is downward pressure on the stock price due to the new issuance increasing the supply of stock. (Tr. 113-114) Iowa-American noted that because flotation costs are not expensed when common stock is issued, they need to be recovered another way, such as through an upward adjustment to the ROE. Iowa-American asked for a 30-basis point adjustment. (Tr. 115)

Consumer Advocate opposed the adjustment, stating that Iowa-American does not have flotation costs because no common stock was issued in the test year and no issuance is planned in the near term, no Iowa-specific data were provided by Iowa-American (so any adjustment would be speculative), and no market pressure adjustment is needed because utility stocks trade far above book value in the market, meaning that market pressure is already accounted for. (Tr. 895) Consumer Advocate pointed out that Iowa-American's witness agreed that Iowa-American does not have flotation costs and that American Water's flotation costs were reflected in its market stock price. (Tr. 195-199)

The Board will deny the proposed flotation adjustment. No common equity has been issued recently and Iowa-American expects to issue none in the near future. See, Iowa Southern Utilities Company, "Final Decision and Order," Docket No. RPU-85-11 (02/25/1986), p. 58.

B. Capital Structure

The primary difference between Iowa-American's and Consumer Advocate's proposed capital structure is whether to include Iowa-American's November 2013 debt that was issued outside the test year and more than nine months after the conclusion of the 2012 test year. Iowa Code § 476.33(4). Iowa-American said the expected interest rate for the 30-year issuance is 4.95 percent and the estimate issuance expense is $40,800. (Tr. 290, 302) Iowa-American argued that the issuance should be included in the capital structure because it was sufficiently known and measureable and reflects the actual capital invested in its assets to provide service to Iowa-American's customers.

Consumer Advocate excluded the November 2013 debt issuance because it was outside the test year and occurred more than nine months after the test year. Consumer Advocate said that such adjustments are not known and measureable.

The Board will exclude the November 2013 debt issuance from Iowa-American's capital structure and use the capital structure proposed by Consumer Advocate. The issuance occurred more than nine months after the conclusion of the test year and § 476.33(4) only requires the Board to consider verifiable data within this nine-month period. The Board has consistently denied such adjustments to capital structure outside that nine-month period, which in this case ended on September 30, 2013. (Tr. 867)

C. Double Leverage

In looking at a rate-regulated utility's capital structure, the Board traditionally considers the capital structure of the utility company, which includes debt, as the first layer of leverage. The Board also considers any debt at the parent holding company level that could be used for a capital infusion into the utility, which is the second layer of leverage. Without the double leverage adjustment, there is concern that a parent company could manipulate its debt and equity at the parent and subsidiary levels to earn an equity return on long-term debt that is actually invested in its utility subsidiary.

The Board has rejected utility efforts to avoid double leverage adjustments in several cases, including Docket Nos. RPU-02-3, RPU-02-8, and ARU-02-1 and Iowa-American's prior rate case, Docket No. RPU-2011-0001. However, the Board in those cases said it would not apply double leverage mechanically in each case, but rather would examine the particular facts and circumstances in each case where the adjustment is proposed.

The Iowa Supreme Court has affirmed the Board's use of double leverage on two occasions, in General Telephone Co, of the Midwest v. Iowa State Commerce Comm'n, 275 N.W.2d 364, 369 (Iowa 1979), and United Telephone Co. v Iowa State Commerce Comm'n 257 N.W.2d 466, 479-480, 482 (Iowa 1977). It is important to note that the Court did not mandate that double leverage be applied in all (or any) situations. Examples of application of the double leverage adjustment, and an exception to when the adjustment is made, are detailed in Iowa-American's last rate case decision. Iowa-American Water Company, "Final Order and Order Approving Settlement," Docket No. RPU-2011-0001 (2/23/2012), pp. 15-19.

Since 1977, double leverage has been applied to Iowa-American. Iowa-American in this case argues that it qualifies for an exception because there were no cash proceeds from debt issues available to invest in Iowa-American's common equity. Iowa-American's arguments regarding an exception to the application of double leverage in this case are substantially the same as those posed by Iowa-American in its last rate case, and for the same reasons the Board will not apply an exception to the application of double leverage in this case. Id., pp. 14-20.

Iowa-American also argued in this proceeding that double leverage should not be applied under any circumstances. Iowa-American said that there were various conceptual and practical limitations to double leverage.

First, Iowa-American said that double leverage violates the cost of capital concept and principles of finance, economics, and fairness. Iowa-American argued that how the capital is used is what determines the true cost of capital, not the source of the funding for the investment. (Tr. 71, 77)

Second, Iowa-American maintained that double leverage is illogical because the equity contributed by the parent has one cost rate while the equity contributed by individual investors has a different cost rate and double leverage implies that an investor would earn zero percent return if the investor inherited the stock or received it as a gift. (Tr. 175-176) Also, Iowa-American said that under double leverage, the subsidiary's cost of equity could be higher simply because it was sold to a different owner. (Tr. 176)

Third, Iowa-American argued that double leverage is discriminatory to a corporate investor because if a utility is a standalone company it would earn one equity return while a utility that is part of a holding company would likely earn a lower return even though they are identical in all other respects. (Tr. 177-178) Based on

Consumer Advocate's position, Iowa-American said that the standalone utility's individual investor would earn a 9.3 percent return while the corporate investor would earn 8.885 percent. (Tr. 937-938; Munoz Reply Exh. MM-2, Sch. A, p. 1)

Iowa-American noted that it found double leverage was used only by one other state regulatory body, Tennessee. (Tr. 171) Iowa-American also said that FERC rejected the application of double leverage within the past year.

Iowa-American pointed out that an argument that has always been used to support double leverage is that capital is fungible as funds pass between the parent and subsidiary. However, Iowa-American argued that the fungibility argument fails with respect to the subsidiary's retained earnings because those are never passed through to the parent company; therefore, Iowa-American said it was not possible to mix its retained earnings with funds held by American Water, Iowa-American's parent. (Tr. 255-256)

Consumer Advocate urged the Board to apply the double leverage adjustment. Consumer Advocate said that determining the capital structure for an independent utility is straightforward; however, this task is more difficult when a utility is part of a holding company. Consumer Advocate argued that it is important to incorporate the parent/subsidiary relationship when determining the subsidiary's capital structure to prevent the earnings from being above a fair and reasonable level because the parent's investment is leveraged twice, once at the parent level and once at the subsidiary level. (Tr. 887)

Consumer Advocate noted that a well-run company uses debt in combination with equity to produce the lowest overall cost of capital. The combination of the parent's capital is used to invest in the equity of a subsidiary, and Consumer Advocate maintained that the parent should not earn an equity return on capital funds that are cheaper because the parent then would earn a return above a fair and reasonable level. Consumer Advocate concluded that considering the parent's cost of capital reflects the true capital costs of a wholly-owned subsidiary of a holding company. (Tr. 887-888)

Historically, double leverage was used to prevent financing abuse by the parent corporation. Application of the double leverage adjustment discourages a parent from artificially inflating the common equity return by increasing the amount of debt at the parent level and decreasing the amount of debt at the subsidiary level. (Tr. 889)

One Board member believes that the evidence presented by Iowa-American in this docket was basically the same as the company presented in Docket No. RPU-2011-0001 and found that Iowa-American had not presented persuasive evidence for the Board to depart from its long-standing precedent applying double leverage. This Board member is not persuaded that an exception for retained earnings is warranted because those earnings could also be manipulated at the subsidiary level so that the utility could earn a higher return. For these reasons, and the reasons set forth in the final order in Docket No. RPU-2011-0001 cited previously, this Board member would apply the double leverage adjustment.

Another Board member finds the arguments against the application of double leverage persuasive and would no longer apply the adjustment to Iowa-American. Iowa is one of perhaps only two states that still apply the adjustment and application of the adjustment could place Iowa-American at a competitive disadvantage with respect to capital investment by its parent, American Water Works, when higher earnings may be earned by utility subsidiaries in states where there is no double leverage adjustment. This would also be true for other Iowa rate-regulated utilities with a parent company that has more than one subsidiary. In particular, this Board member believes the evidence and argument regarding retained earnings demonstrates the conceptual problems with the double leverage adjustment cited by Iowa-American.

This does not mean this Board member is not concerned with the abuses that double leverage was designed to prevent, such as artificially inflating the common equity return by increasing the amount of debt at the parent and by decreasing the amount of debt at the subsidiary. However, this Board member would have the Board deal with these issues as other jurisdictions have, by imposing a hypothetical capital structure on the utility, if necessary. Consumer Advocate acknowledged that other states use this instead of double leverage. (Tr. 959-960) Continuing to use a regulatory tool that has fallen out of fashion puts Iowa at a disadvantage because of the decreased return that results from application of double leverage; by using a different tool to prevent the same ills, parent companies with subsidiaries in more than one state may look more favorable than the Iowa utility as an appropriate place to invest additional capital.

Two Board members heard the evidence at hearing and are participating in this decision; the other Board member recused herself from this proceeding. Because the two Board members do not agree on the application of double leverage, Iowa-American has not met its burden of persuasion to change the Board's previously-established regulatory principle and double leverage will therefore be applied to Iowa-American, consistent with past Board precedent.

V. PROPOSED ADJUSTMENT CLAUSES

A. Qualified Infrastructure Plant Adjustment Surcharge

Iowa-American proposed a Qualified Infrastructure Plant Automatic Adjustment Clause (QIP), a cost recovery mechanism for use between rate cases that it said would provide Iowa-American an incentive to accelerate investment in its infrastructure replacement program. Iowa-American said its QIP proposal is designed to recover a return on and return of capital investments to replace or rehabilitate qualified non-revenue producing plant. Iowa-American stated that the QIP is necessary because of Iowa-American’s aging infrastructure, a substantial portion of which is between 50 and 100 years old and a significant portion of which is nearing the end of its expected life. Iowa-American argued that an accelerated infrastructure improvement program will improve water quality, increase water pressure, have fewer main breaks and service interruptions, and lower levels of lost water. Currently, Iowa-American replaces about 0.3 percent of its buried system each year (a 300-year replacement cycle); Iowa-American contends a QIP would allow it at some point to increase the replacement rate to 1.0 percent (100-year replacement cycle) for distribution system pipe and 2.0 percent (50-year replacement cycle) for valves and hydrants.

The QIP proposed by Iowa-American would only apply to qualified non-revenue producing plant investment that had not been included in rate base in a prior rate proceeding. Iowa-American said that the QIP rate would be established semi-annually using actual historical plant replacement that has been placed in service and is used and useful. Iowa-American said it would file for recovery and the Board and Consumer Advocate would have 90 days to request additional information, review, and verify the information. Iowa-American noted that the proposed QIP also includes an annual reconciliation between authorized collections and actual collections; the reconciliation would be filed within 60 days of the end of the QIP rate adjustment year. Iowa-American said that any over or under collection would then be included in the calculation of the QIP rate adjustment. Iowa-American proposed to cap the recovery through the QIP at 15 percent of the total authorized revenue level as established by the Board in the most recent general rate proceeding.

Consumer Advocate opposed the proposed QIP, noting that it is virtually identical to the QIP rejected by the Board in Iowa-American's last rate case. Consumer Advocate said that the QIP does not meet the traditional criteria used by the Board for approving automatic adjustment mechanisms, which are: (1) whether the costs proposed to be recovered are beyond the control of management; (2) whether the costs are subject to significant variations; and (3) whether the costs are a significant part of the utility's cost of providing service. Consumer Advocate pointed out that Iowa-American acknowledges that the QIP fails to satisfy any of the traditional factors.

Consumer Advocate also argued that Iowa-American does not need the clause to make necessary infrastructure investments, noting that fewer than half of American Water Works' water utility subsidiaries have such a clause and that Iowa-American witness Kaiser testified that approval of the QIP would not change how Iowa-American approached its infrastructure investment and that Iowa-American had not had any problems obtaining the necessary capital from its parent corporation, American Water Works. Consumer Advocate noted regulatory lag was not a factor because of Iowa's temporary rate statutes and the statute allowing consideration of investment that is in place within nine months after the end of the test year.

Consumer Advocate pointed out that Iowa-American has no actual, specific plan to increase infrastructure investment from the current 0.3 percent level. While Iowa-American indicated such a clause could extend the time between rate cases, Consumer Advocate said that there was no specific commitment and Iowa-American refused to give a date for its next rate filing, if QIP were approved. Consumer Advocate noted that Iowa-American did not want to share any of the benefits of QIP with its ratepayers, either in the form of a lower rate of return for QIP-eligible costs to reflect reduced risk or a commitment to file rate cases less frequently.

Use of adjustment mechanisms to address certain costs is authorized by Iowa Code § 476.8 and the Board has approved such mechanisms when they meet certain criteria. Traditionally, an adjustment mechanism permits utility rates to be adjusted up or down automatically in relation to fluctuations in certain defined operating expenses, allowing increases or decreases in costs to be passed on to customers with no profit or loss to the utility. Adjustment clauses are common for electric utilities for fuel costs and gas utilities for gas costs; clauses have also been approved by various states for other expenses.

The Board has recognized, however, the occasional need for adjustment mechanisms that do not necessarily meet the traditional standards. The Board adopted for natural gas utilities an automatic adjustment mechanism that allowed for a recovery of and return on investments that were required because of government action or federal and state pipeline safety regulations. Rule 199 IAC 19.18 provides for such a clause, provided that certain conditions are met.

Iowa-American is proposing that the Board approve an automatic adjustment mechanism that allows the company to recover from ratepayers a return on and a return of certain capital investments between general rate case filings. The eligible capital investment would be for replacement of utility plant in the following accounts: (1) Account 331 (343), Transmission and Distribution Mains, including main rehabilitation and valves; (2) Account 333 (345), Services; (3) Account 334 (346 & 347), Meters and Meter Installations; and (4) Account 335 (348), Hydrants. The eligible plant would be non-revenue producing plant that was not included in Iowa-American's rate base in this rate case. Iowa-American said that the QIP proposed in this case is essentially the same as the QIP proposed in Iowa-American's prior general rate case, with one exception. The cap for the QIP has been raised in this proposal from 5 percent to 15 percent. (Tr. 611)

In Docket No. RPU-2011-0001, the Board found that the proposed QIP did not satisfy the three traditional factors that the Board normally considers when deciding whether to approve a proposed automatic adjustment mechanism. Iowa-American Water Company, "Final Order and Order Approving Settlement (Final Order)", Docket No. RPU-2011-0001 (2/23/2012), p. 11. The three primary traditional factors considered by the Board when considering whether to approve an automatic adjustment mechanism are: (1) whether the costs are beyond the direct control of the management; (2) whether the costs are subject to significant variations; and (3) whether the proposed costs are a significant part of the costs of providing service. (see 199 IAC 19.18(1)"a" and 20.9(1)). As in the prior case, Iowa-American has not argued that the capital investments are beyond the control of management.

The proposed QIP does not meet the traditional adjustment clause three-part test. The investment projected by Iowa-American shows that Iowa-American management has control over the rate of replacement and that Iowa-American can, if management chooses, increase the replacement rate without a QIP. Iowa-American management has budgeted a fairly even investment in QIP-type plant over the period 2008-2012 and is projecting fairly even investment in QIP-type plant over the period from 2013-2017. Based upon the projections, there does not appear to be significant fluctuations in those investments. In addition, Iowa-American's overall rate base is approximately $101 million and Iowa-American's investment in QIP-eligible plant in 2013 as shown on Exhibit 9 is approximately $5,127,000. QIP-type plant, if all plant is included, is approximately 6 percent of the total rate base and this is not a significant part of the cost of providing service.

As evidenced by the natural gas rule, there can be circumstances where adjustment clauses can be justified that do not meet the traditional regulatory scheme for adjustment clauses. However, the justifications put forth by Iowa-American do not justify establishment of the proposed QIP in this case.

Regulatory lag is not a sufficient justification for the proposed QIP. In Docket No. RPU-2011-0001, the Board stated that regulatory lag was not a sufficient justification for implementing the QIP proposed in that case. (Final Order, p. 11) The Board pointed out under current law Iowa-American can recover capital infrastructure investment placed in service within nine months after the close of the test year in a general rate case and can implement temporary rates within ten days of filing an application for a general rate increase. These two provisions limit regulatory lag and, coupled with Iowa-American's continued filing of general rate increase cases every two years maximum, regulatory lag is reduced to 12-18 months. Id. This short period of regulatory lag does not justify a QIP, and Iowa-American made no firm commitments in this proceeding to increase the time between its general rate cases.

As noted by Consumer Advocate, any mechanism designed to reduce regulatory lag should provide some benefit to ratepayers. In this case, Iowa-American presented a proposal that would not benefit ratepayers. Under the QIP proposal, customers could be charged up to an additional 15 percent of the customer's normal bill every six months. Iowa-American has not offered to extend the time between rate cases or reduce the carrying charge for QIP investment, either of which would provide a benefit to ratepayers and partially offset the significant rate increases that could result from the QIP.

The Board offered similar criticisms in Docket No. RPU-2011-0001, yet Iowa-American presented an almost identical proposal in this case that did not respond to the Board’s criticisms that Iowa-American’s plans are indefinite and there are no tangible benefits to ratepayers. There is still no concrete, plan to replace aging infrastructure and no tangible benefits to ratepayers from the proposed clause. Iowa-American appeared to simply ignore the Board’s order in Docket No. RPU-

2011-0001 in fashioning its current proposal. As acknowledged by Iowa-American, nothing really changed with the current proposal, other than to increase the QIP cap from 5 to 15 percent of the total authorized revenue.

While Iowa-American's planned expenditures for 2013 through 2017 are an increase over the expenditures for the previous five years, the evidence in this case is similar to the evidence in Docket No. RPU-2011-0001 in that Iowa-American's replacement program consists of replacing plant where leaks and breaks occur and when facilities are required to be relocated due to state or local government action. Since leaks and breaks are projected to increase, Iowa-American responded by increasing the amount budgeted for replacement. Iowa-American states that it wants to increase its replacement rates to 1 and 2 percent (as it said in the last rate case, also), but presented no specific plan to do so. A statement by Iowa-American that replacing small mains in Clinton is a priority without additional information about a program to replace the mains is insufficient to justify QIP rate increases between rate cases.

It appears from responses to Board questions that Iowa-American made a management decision to maintain the current replacement rate of 0.3 percent in the past and has made a management decision to increase investment for QIP-type plant for the next five years, but the evidence shows that this amount will be spent whether or not QIP is approved. There is no proactive, specific, concrete plan to increase the level of replacement to the levels that Iowa-American claimed were necessary. General assertions about the need for replacement have now been made in two cases, with no apparent plan to tackle the problem. Iowa-American did not address the concerns raised by the Board in the last rate proceeding.

The testimony at the hearing demonstrates that Iowa-American has chosen to maintain the current 0.3 percent replacement rate over the past years even as Iowa-American has argued in rate cases that the rate is not sufficient to replace aging water mains. According to Mr. Verdouw, Iowa-American will receive enough investment from its parent company for projects that "absolutely" have to be done, but if Iowa-American is going to move its replacement program from 0.3 percent to 1 percent Iowa-American will have to spend more. (Tr. 740) Mr. Verdouw testified if the Board approved the Iowa-American proposals for a QIP, declining usage, weather normalization, and the adjustment clause for purchase power and chemical costs, Iowa-American might be willing to commit to extending the period between rate cases, but no firm commitment was given and it appeared the extension would be at most for only 6 to 9 months.

Mr. Kaiser testified that Iowa-American has no plans to replace water mains beyond normal leak and break and relocation replacements and approval of the QIP would not change the replacement program. (Tr. 412, 413) According to Mr. Kaiser, a QIP would make more funds available but would not change replacement plans. (Tr. 414) Capital investment for main replacement must be put into the investment budget that is approved by the parent corporation and priorities on replacing pipe would not change if a QIP is approved. (Tr. 416) Mr. Kaiser testified that approval of a QIP-like mechanism in other states had extended the time between rate cases from two to two and one half years on average.

In this case, Iowa-American has provided similar justification for an automatic adjustment mechanism as it did in its last rate proceeding. There are Iowa-American facilities that are required to be relocated because of state and local government action; however, Iowa-American has not proposed to limit the QIP to just those investments. While increasing the rate of replacement of aging infrastructure might justify an adjustment clause, no specific plan to do this was presented and no ratepayer benefits from the proposed clause were presented. The QIP as proposed by Iowa-American would recover investment for facilities that will be replaced under current replacement programs and has been accounted for in future budgets, with no apparent acceleration to tackle the aging infrastructure problem and to increase replacement levels to 1 percent for distribution system pipe and 2 percent for valves and hydrants.

It is particularly important that Iowa-American has not shown that ratepayers will benefit from the surcharge. If approved, the QIP would mean rate increases for Iowa-American customers between general rate cases (which are currently filed every two years), resulting in a continuous increase in customer rates with no offsetting benefit. Iowa-American has also proposed to recover the rate of return approved by the Board in this case on the QIP investment even though QIP recovery reduces the risk to Iowa-American for recovery of these investments. In the natural gas utility infrastructure automatic adjustment rule, the Board set the return on eligible investment at the utility's cost of debt to recognize this reduced risk. Iowa-American does not agree with a reduced return for determining QIP recovery.

Without a commitment to extend the time between rate cases and some recognition that a QIP reduces the recovery risk of QIP eligible investments (and without a proactive QIP plan), there appears to be little or no benefit to ratepayers of the QIP. Under the QIP, customers would face rate increases of up to 15 percent every six months and then general rate increases every two years, at least under Iowa-American’s current rate case timing. However, each case costs about $1 million in rate case expenses; these costs are generally recovered from ratepayers. If the QIP is adopted, ratepayers would not only be subject to the approximately $1 million rate case expense every two years, but would have to pay the additional QIP surcharges between rate cases.

Finally, the Board has concerns about the mechanics of the QIP proposal. The QIP proposal submitted by Iowa-American is too broad and should cover distribution infrastructure only, not those items for which Iowa-American has a current replacement plan. In addition, potential increases every 6 months, and the process to implement those increases, appears unworkable and untenable for ratepayers, the Board, and Consumer Advocate. For all of these reasons, Iowa-American's QIP proposal will be rejected.

B. Purchased Power and Chemical Charge

Iowa-American proposed an automatic adjustment mechanism for the pass-through of incremental changes in purchased power and purchased chemical costs that differ from the level of costs authorized by the Board in base rates. Iowa-American said that its chemical costs are beyond the utility's control and subject to market forces. Iowa-American noted that its purchased power costs are subject to automatic adjustment mechanisms, such as an energy adjustment clause, that are utilized by Iowa-American's electric service providers.

Consumer Advocate opposed the clause, noting that the proposed mechanism would severely reduce or eliminate Iowa-American's economic incentive to control relevant expenditures. Consumer Advocate argued that the proposed clause did not meet the three traditional criteria for an adjustment mechanism, primarily because the costs are not significant or volatile enough. Consumer Advocate also argued an adjustment mechanism was inappropriate since the proposed clause seeks to recover two unrelated costs.

While these costs together may be Iowa-American's largest non-labor operations and maintenance expense, together they represent only 7.9 percent of Iowa-American's total expense and only 20 percent of Iowa-American's total operation and maintenance expenses, excluding labor and benefits. More importantly, the adjustment mechanism proposed by Iowa-American seeks to combine two unrelated costs in an attempt to meet the traditional adjustment clause criteria.

Examined separately, neither purchased power nor chemical costs is a significant portion of Iowa-American's overall cost of providing service to customers. These costs are part of the normal operating expenses of doing business as a water utility and are not the type of costs traditionally eligible for an automatic adjustment mechanism.

A pass-through mechanism for these costs would reduce Iowa-American's incentive to take steps to use electricity more efficiently. It would also reduce Iowa-American's incentive to monitor the contracting practices of its affiliate that negotiates chemical purchases. Chemical costs in particular are not entirely beyond the direct control of management. These types of operating costs are appropriate to examine in a general rate proceeding where all of the utility's expenses and revenues can be matched in determining just and reasonable rates.

Attempting to combine two disparate costs in an adjustment clause is not reasonable and the Board will not approve the proposed adjustment. Examined separately, Iowa-American has not shown that the three traditional criteria have been satisfied. These costs, particularly chemical costs, are normal operations and maintenance expenses that are appropriate to consider in rate proceedings and are not so extraordinary or significant as to warrant an adjustment mechanism.

VI. COST-OF-SERVICE ISSUES

A. Introduction

Prior to 2009, Iowa-American had two separate rate structures for General Metered Service and Private Fire Service, one for the Quad Cities district and one for the Clinton District. General Metered Service rates (customer charges and volumetric consumption charges) were equalized between the two districts with the Board's final decision in Docket No. RPU-2009-0004. Private Fire rates were equalized with the final decision in Docket No. RPU-2011-0001 so that now both districts pay the same rates for all services.

In Docket No. RPU-2011-0001, the Board ordered Iowa-American to file a new class cost-of-service study in its next rate proceeding. Iowa-American provided such a study in this docket, which uses the Base-Extra Capacity method described in the 2012, 6th edition, Principles of Water Rates, Fees and Charges (as well as prior manuals) published by the American Water Works Association. Iowa-American said that the four basic cost functions allocated to each customer class are base costs (average daily class usage), extra capacity costs (class usage in excess of average usage), customer costs (facilities costs and accounting costs), and fire protection costs.

Consumer Advocate did not perform a separate cost-of-service study but disagreed with two aspects of the study, the peak day ratio and allocation of customer costs. Each will be discussed separately.

B. Peak Day Ratio

Iowa-American proposed a peak day ratio of 1.65, which is rounded up from the actual number Iowa-American determined, 1.632. Consumer Advocate used a peak day ratio of 1.45.

Iowa-American said its peak day ratio means that peak day usage on its system is 65 percent higher than average day usage and is calculated based on actual data in its cost-of-service study. Consumer Advocate's proposed peak day ratio of 1.45 (peak day usage is 45 percent higher than average day usage) is based on a 15-year average of annual peak day ratios from 1998 through 2012.

Iowa-American argued that Consumer Advocate's peak day ratio underestimates the costs associated with the extra capacity on its system and therefore does not properly allocate costs associated with peak demand. In examining peak day ratios from 1998 through 2012, the Board agrees. The ratios for 2011 and 2012 were both 1.63 and were higher than past ratios, indicating that use of such a long-term average is not representative of Iowa-American's current level of excess capacity. (Herbert Exh. 1, Sch. 4)

However, the Board does not believe it is appropriate to round up the actual peak day ratio calculated by Iowa-American, 1.632, to 1.65. The Board will adopt 1.63 as the peak day ratio.

C. Customer Costs

Customer costs are those costs associated with serving customers regardless of their usage or demand characteristics. There are direct customer costs related to customer facilities (meters and service lines) and customer accounting (billing and meter reading). There are also indirect or common costs; Iowa-American allocates some of these costs to the customer charge while Consumer Advocate does not.

Iowa-American said that the AWWA Water Rates Manual supports the use of fully allocated customer costs, including indirect or common costs, to develop customer charges. Iowa-American argued that administrative and general costs are fixed and support the entire operation of the company, not just the water-related costs. Iowa-American maintained that if none of the administrative and general costs are allocated to customer related functions, then 100 percent of these costs would be allocated to consumption charges, resulting in understated customer charges and overstated consumption charges. Because these common costs are fixed, Iowa-American said that a portion should be allocated to the fixed customer charge.

Consumer Advocate said that Iowa-American's current customer charge is too high and any rate increase should only be applied to the volumetric or consumption charges. Consumer Advocate excluded from the customer charge several costs, including employee pensions, health care, payroll taxes and other benefits that it argued were not costs associated with the delivery of water service to the individual customer. (Tr. 792-796)

Iowa-American's cost allocation method is consistent with the AWWA Water Rates Manual. Consumer Advocate did not identify any recognized authority which would exclude all customer costs from the customer cost allocation. Because the common costs do not change and some of those costs are related directly to the salaries and wages of meter and service line repairmen and others that perform functions directly related to providing service to the customer, it is appropriate to allocate some common costs to the customer charge and Iowa-American's allocation will be used in this proceeding.

VII. RATE DESIGN ISSUES

A. Billing Units—Declining Usage and Weather Normalization

Iowa-American proposed three adjustments to test year billing units and revenues by customer class. One was a proposed customer growth adjustment, which increased billing units and revenues. This adjustment was accepted by Consumer Advocate and is not contested.

The other two proposed adjustments are contested. The adjustments are for declining usage and weather normalization; both proposed adjustments reduce billing units and projected revenue, requiring an offsetting increase to the revenue requirements.

Iowa-American said that because Iowa-American's customers continue to use less water due to conservation and installation of efficient appliances, there should be an adjustment for declining usage. Iowa-American calculated base usage by using consumption during the winter months of January through March over a ten-year period (2003 through 2012); usage during these months is generally not influenced by outdoor use such as lawn watering. Iowa-American's linear regression analysis showed that residential usage is declining at an annual rate of 1,224 gallons per customer.

Consumer Advocate opposed the adjustment, noting that declining usage and declining sales are not the same. Consumer Advocate pointed out that Iowa-American's sales have increased in the years 2010, 2011, and 2012, so it would be inappropriate to project reduced revenue when revenue is increasing. Also, Consumer Advocate said that the number of customers has steadily increased since 2003, resulting in increased water sales.

Iowa-American also proposed a weather normalization adjustment because the test year was one of the warmest on record, resulting in an increase in non-base usage such as lawn watering. Iowa-American said its adjustment normalizes test year revenues to reflect normal weather.

Consumer Advocate said that Iowa-American's test year sales and revenues were reasonable and representative of normal operation conditions such that no adjustment was necessary. Consumer Advocate said the methodology to support Iowa-American's adjustment is based on usage from three winter months and assumes weather in the summer months is the only variation, ignoring the other six months of the year. Consumer Advocate said a similar adjustment proposed by another American Water Works subsidiary in Kentucky was rejected.

In recent years (beginning in 2006), Iowa-American has filed a rate proceeding every two years. Iowa-American's annual report filings with the Board show the following data for the residential class: [2]

Gallons Per Residential Customer
2006 through 2012 and Compared to 7-Year Average

	Gallons Sold (000)	Number of Customers	Gallons (000) Per Customer	Compared to 7-Yr Avg.
2006	3,442,444	53,406	64.46	15.92%
2007	3,102,494	53,842	57.62	3.63%
2008	2,944,154	54,196	54.32	(2.30%)
2009	2,847,755	54,410	52.34	(5.87%)
2010	2,849,789	54,599	52.19	(6.13%)
2011	2,908,482	54,847	53.03	(4.63%)
2012	3,061,810	55,395	55.27	(0.60%)
	7-Year Average		**55.61**	

The last column of the table compares annual gallons per customer to the seven-year average of 55.61. Although 2012 residential gallons per customer are slightly lower than the average, it is the smallest deviation in the seven-year period. Iowa-American's sales, as pointed out by Consumer Advocate, have generally increased in recent years and, in fact, both sales and per customer usage increased in 2010, 2011, and 2012. There is no substantial evidence in the record supporting

[2] Rate case billing units are in hundred cubic feet (CCF) and annual report usage is based on gallons. Beginning in 2013, the annual report form for water utilities requires usage to be provided in both CCF and gallons.

either proposed adjustment and both the declining usage and weather normalization adjustments will be rejected.

B. Proposed Rates and Public Fire

Iowa-American urged that any increase in rates resulting from this case should be based on Iowa-American's rate design recommendations, that customer charges should be increased to recover their associated costs, and commodity rates should be increased for each rate block in order to generate revenues from those rates that match their indicated costs. Iowa-American said its proposed customer charge would recover both the direct costs associated with providing service to customers, plus a portion of the indirect or common costs associated with providing service to customers.

Consumer Advocate argued that Iowa-American's customer costs were currently too high and not supported by the class cost-of-service study. Consumer Advocate said that there should be no change to Iowa-American's customer costs and that Iowa-American should not be allowed to move towards a straight fixed-variable rate design.

As noted in the earlier discussion regarding customer costs under the class cost-of-service study, Iowa-American's class cost-of-service study was performed in a manner consistent with the AWWA Rate Manual, the only reference material provided in this proceeding to support a study. Consistent with the manual, some indirect or common costs are appropriately included in the customer charge, and the Board will generally adopt Iowa-American's approach, with some exceptions.

Herbert Exhibits 2 and 7 show how costs are used to calculate the customer charge for the 5/8 inch meter. These exhibits show that all costs associated with public fire protection, such as fire hydrants, are currently recovered by Iowa-American solely through the customer charge.

Recovery of public fire costs in Iowa-American's service territory has changed since 1990. Prior to 1990, Iowa-American recovered public fire costs directly from the cities it served. In 1989, the legislature adopted Iowa Code § 476.6(15) which allowed cities that were furnished water by a public utility subject to rate regulation (like Iowa-American) to request that the Board allow recovery of public fire costs through the rates assessed to customers covered by the applicant's fire protection service. The cities served by Iowa-American filed these requests, and since 1990 public fire service costs have been recovered through Iowa-American's General Metered Service rates. In Docket No. RPU-90-10, the Board addressed the recovery of public fire costs. The final order in that docket states Iowa-American proposed recovering public fire costs through a uniform adjustment to all volumetric block rates, which the Board accepted. Subsequent Iowa-American rate cases, until this proceeding, resulted in a settlement of the issue.

It is appropriate for the Board to determine in this proceeding how public fire costs are to be recovered. Any public fire costs not recovered through the monthly customer charge would be recovered through the volumetric charge. The manner of recovery is revenue-neutral for Iowa-American. Options include recovery of all public fire costs through the customer charge (as proposed by Iowa-American), recovery of all public fire costs through volumetric rates, maintaining the existing customer charge and recovering the remaining public fire costs through volumetric rates (as implicitly proposed by Consumer Advocate), or allocation of public fire costs on another basis, such as 50 percent recovery through the customer charge and 50 percent through the volumetric charge.

Iowa-American’s class cost-of-service study presents no clear rationale for allocating all public fire costs to the customer charge. Apparently, Iowa-American preferred volumetric recovery in 1990, but prefers to recover public fire costs in the customer charge today, without any explanation for the change of approach. Because of the lack of rationale in the cost-of-service study and the different methods of recovery used in the past, it appears any of the options described above would be reasonable. The Board will allocate 50 percent of the public fire charges to the customer charge and 50 percent to the volumetric charge in order to obtain some of the benefits of each approach. However, taking into consideration other revenue and allocation decisions contained in this order, Iowa-American will be required to set the customer charge for the 5/8 inch meter at a rate that is no higher than the rate calculated based on the allocated costs determined by the class cost-of-service study; the $16.37 charge calculated by Iowa-American was based on acceptance of its proposals and will change with the revised class cost-of-service study the Board will require. However, Iowa-American will not be permitted to round this charge up, like it rounded the $16.37 up to $16.40 in its proposal. The customer charge can be no higher than what the revised class cost-of-service study shows.

VIII. PRIVATE FIRE

Iowa-American provides three separate and distinct services to its customers. Iowa-American's primary business is supplying general metered service, or potable water, to its customers. The costs of providing general service are recovered from all customers. Iowa-American also provides public fire service, which consists of the delivery of water to public fire hydrants for the purpose of fighting fires. The costs of that service are spread among all of Iowa-American's customers because all customers benefit. Going forward, half of the cost of public fire service will be paid by ratepayers through their customer charge and half of the cost through the volumetric charge, but all customers will still contribute to the cost of public fire service.

The third type of service, private fire service, is provided to customers with fire protection facilities specifically dedicated to their property (i.e., sprinkler systems) to protect the property from fires. Iowa-American’s costs associated with private fire service are largely capacity costs, which means there is additional standby system capacity to deliver water in sufficient quantities during fire emergencies, while maintaining general metered service for all other customers. Currently, private fire service is paid for by the customer requesting the service.

In Iowa-American's last rate proceeding, Docket No. RPU-2011-0001, there was substantial public interest in the level of Iowa-American's private fire service rates so the Board directed Iowa-American to include in its next rate filing a new class cost-of-service study that includes private fire service and also information on how other water companies recover the costs of private fire service. In this proceeding, Iowa-American recommended that private fire rates be increased to recover the costs of the service as shown by the class cost-of-service study and that those costs be paid by those requesting the service.

Some Iowa cities with populations over 25,000 have separate private fire service rates while others recover the costs from all water customers. With most costs incurred by a utility, the Board believes the cost causers should be the cost payers. This is a difficult principle to apply with private fire costs because those that install a sprinkler system not only benefit directly but there is also a broader public benefit because sprinkler systems help contain fires and often prevent them from spreading to other properties. Iowa-American's witness also noted that private fire service likely reduces the demand for public fire protection in those buildings protected by private fire service and also reduces the demand for public fire service in the immediate vicinity of protected buildings, another public benefit. (Tr. 340) Finally, even if private fire costs were spread to all customers, those private fire customers make a significant investment to obtain the service by paying for the sprinkler system and distribution main tap.

Because of the public benefits that result from private fire service, it is appropriate to spread some of the associated costs to all of Iowa-American's customers. In this proceeding, the Board will allocate 75 percent of the costs of private fire service to those that would traditionally be deemed the cost causers (private fire customers) and 25 percent to all of Iowa-American's customers, who share in the public benefit. The 25 percent allocated to all customers will be divided evenly (50/50) between the customer charge and volumetric charge. This allocation could change in the next rate proceeding as the Board continues examining and considering the policy issues surrounding private fire service and who should pay for the benefits that such service provides.

IX. COMPLIANCE FILING

Because the Board has made changes to the revenue requirement and rate design initially proposed by Iowa-American, Iowa-American will be directed to file an updated class cost-of-service study (including the functionalized costs by cost category) that reflects the Board's decisions on the issues in this proceeding and corresponds with Iowa-American's approved revenue requirement. Iowa-American will also be required to file schedules showing how its proposed compliance rates are calculated and an updated bill analysis (proof of revenue) demonstrating that its proposed compliance rates will produce no more than the approved revenue requirement.

All documentation supporting Iowa-American's post-decision filing is to be provided in Excel format, including formulas for each calculation. In addition, for future rate cases in which Iowa-American files a class cost-of-service study, Iowa-American will be required to file schedules showing the functionalized costs by cost category and schedules showing how all rates are calculated. These schedules are to be provided in Excel format, including formulas for each calculation.

X. OBJECTION TO RATE CASE EXPENSE

On December 27, 2013, Iowa-American filed a report of actual rate case expense in Docket No RPU-2013-0002. On January 2, 2014, Consumer Advocate filed an objection to the rate case expense report. In the objection, Consumer Advocate said that the rate case report filed December 27, 2013, by Iowa-American does not provide the detail required by Board rules.

On January 10, 2014, Iowa-American filed an amended rate case expense report that included additional details of the expenses incurred by Iowa-American in this rate case proceeding. The summary shows actual rate case expenses for outside counsel, outside expert witnesses, and utility personnel. Under utility personnel, the amended report shows "Service Company" with total hours of 1,314 and a rate-per-hour of $85. The total expense shown is $111,662.30. (The amended report refers to "Filing Requirements Rule 7.3," but the rate case expense filing requirements are now found in 199 IAC 26.4.)

On January 16, 2014, Consumer Advocate filed a "Motion for Reduction of Recoverable Rate Case Expense" requesting the Board (a) reduce Iowa-American's rate case recovery in two categories and (b) order Iowa-American to file details of rate case expenses related to service performed by American Water Works or Iowa-American affiliates sufficient to allow the Board and Consumer Advocate to assess the propriety of those expenses. Consumer Advocate said that it would be unjust and unreasonable to allow Iowa-American to charge ratepayers for the costs of re-litigating the double leverage issue and requests the Board disallow those costs as part of rate case expense. Consumer Advocate also objected to Iowa-American's Amended Rate Case Report, arguing the report fails to include information necessary for the Board and Consumer Advocate to assess the reasonableness of the fees paid to an expert witness hired by Iowa-American, Roger A. Morin.

On January 24, 2014, Iowa-American filed a resistance to the Consumer Advocate's motion. On January 29, 2014, Consumer Advocate filed a reply to Iowa-American's resistance.

A. Consumer Advocate's Motion

Consumer Advocate stated that Iowa Code § 476.6(5) provides that as part of the findings of the Board regarding a requested increase in rates, the Board "shall allow recovery of costs of the litigation expenses over a reasonable period of time to the extent the board deems the expenses reasonable and just." Consumer Advocate noted that this section also requires that at the conclusion of the proceeding the utility "shall submit to the board a listing of the utility's actual litigation expenses in the proceeding."

Consumer Advocate pointed out that the Board, in an order issued July 19, 2013, in this docket, expressed concern about the level of Iowa-American's rate case expense. Consumer Advocate also pointed out that the Board, in the July 19, 2013, order, stated "[r]elitigating issues every two years when the facts being litigated have not changed significantly and the testimony is substantially the same may at some point be unreasonable, at least with respect to recovery from ratepayers of litigation expense associated with repetitive issues." In re: Iowa-American Water Company, "Order Denying Motion for Issue Preclusion," Docket No. RPU-2013-0002, (5/19/13), pp. 5-6.

Consumer Advocate argued that Iowa-American has chosen to relitigate the double leverage issue even though the issue was fully litigated less than two years ago in Docket No. RPU-2011-0001. Consumer Advocate maintained that the evidence and arguments presented by Iowa-American in this case are virtually identical to the evidence and arguments addressed by the Board in the previous docket. Consumer Advocate then listed the similarities between the evidence and arguments in the two dockets and pointed out that the Board has expressed concerns about the relitigation of issues where the evidence is without significant difference from a recent case.

Consumer Advocate also argued that Iowa-American failed to provide the hours worked and the hourly rate for outside expert witness Dr. Morin, who testified on cost of capital issues, including double leverage. Consumer Advocate maintained that Board rules require this information so the Board can assess the reasonableness of the fees paid to Dr. Morin.

Consumer Advocate noted that some of the rate case expenses objected to in its motion filed on January 16, 2014, are expenses associated with American Water Works Service Company (Service Company) and employees of American Water Works. Consumer Advocate said that Iowa-American failed to disclose the hours worked by each employee of the Service Company and American Water Works and this failure prevents the Board and Consumer Advocate from determining the reasonableness of those expenses and whether the services in the rate case were already paid for under Iowa-American's service agreement with the Service Company.

Consumer Advocate argued that Iowa-American has not complied with the filing requirements of 199 IAC 26.4 because it has not provided the hours worked by each Service Company employee and each employee's hourly rate. Instead, Consumer Advocate noted that Iowa-American has filed total hours worked and total cost. Consumer Advocate argued that the language in the rule is clear that Iowa-American is to file the hours and hourly rate of each outside consultant or witness.

B. Iowa-American Resistance

Iowa-American said that the fact that rate case expenses must be filed for Board approval and the estimated expenses are often subject to cross-examination at the hearing provides the utility with the incentive to ensure that these costs are reasonable. Iowa-American stated that the Board has approved rate case expenses in earlier dockets and that the rate case expenses sought to be recovered in this docket should be reviewed based upon the facts, circumstances, and conduct of the parties in this docket.

Iowa-American argued that double leverage is a viable and reasonable issue for the Board to consider in this rate case. Iowa-American pointed out that although the double leverage issue was argued in Docket No. RPU-2011-0001, the issue had not been fully litigated for more than 20 years in an Iowa-American rate case. In addition, Iowa-American noted that the Board signaled a continuing interest in the issue by conducting an information gathering meeting addressing double leverage on November 27, 2013. Finally, Iowa-American argued that the evidence in this case is not the same evidence presented in Docket No. RPU-2011-0001 since the evidence in this docket specifically addresses previous Board questions and more fully develops the impact of double leverage on Iowa-American.

Iowa-American maintained that there is sufficient information in this case to assess the reasonableness of the fees paid Iowa-American witness Dr. Morin. The fee arrangement with Dr. Morin is clearly set out in the engagement letter, Attachment A to Iowa-American's resistance, and received into the record at hearing as Consumer Advocate Exhibit 103. Iowa-American explained that the letter of engagement sets out the flat-fee arrangement with Dr. Morin, which is a common practice for utility consultants.

Iowa-American pointed out that Dr. Morin presented testimony and underwent significant cross-examination on two major issues in this case, double leverage and rate of return. The length of Dr. Morin's prefiled testimony, the necessity of Dr. Morin reviewing the testimony of the Consumer Advocate's witness, Dr. Morin's response to discovery, and Dr. Morin's preparation and appearance at the hearing show that the flat-fee arrangement was reasonable. Iowa-American argued that reference to hours worked and hourly rate are not the only way to consider the reasonableness of rate case expense items such as outside consultant fees.

With respect to work performed by Service Company employees, Iowa-American said that the practice of engaging Service Company personnel for the Iowa rate case provides Iowa-American with access to individuals with significant industry expertise at a cost that is much less than if Iowa-American were to engage them individually. Iowa-American stated that the detail presented in the initial rate case report is consistent with the detail provided by Iowa-American in the previous rate case, Docket No. RPU-2011-0001, and that the rate case expense was approved as filed in that docket. Iowa-American stated that there is significant information in the record that explains the value of the services provided by the Service Company, including the services for this rate case. Iowa-American cited to transcript pages 54-56 and 765-766, and Verdouw prefiled direct testimony on pages 4-13. Iowa-American filed Attachment B to the resistance with specific hourly information for Service Company personnel associated with the rate case.

Attachment B submitted by Iowa-American shows the travel, hotel, and meals for each individual associated with this rate case, including outside counsel, outside witnesses, and internal employees: Rogers, Moore, Verdouw, Riechart, Tinsley, Thakadiyil, Kaiser, Jones, Rungren, and Bates. Iowa-American also provided in Attachment B the hours worked and hourly rate for 19 other Service Company employees associated with this rate case; for the 10 other Service Company employees identified above, the hours worked and hourly rates are shown only for Mr. Riechart and Mr. Thakadiyil.

C. Consumer Advocate Reply

Consumer Advocate argued that Iowa-American has not identified any evidence in this case that is significantly different than the evidence presented in Docket No. RPU-2011-0001 on the issue of double leverage. In addition, Consumer Advocate argued that a change in the members of the Board cannot justify the costs of re-litigating the double leverage issue because this would encourage relitigation of issues in the future, despite the existence of years of agency precedent. Consumer Advocate maintained that shareholders should be required to pay for relitigation of issues previously decided by the Board when there is no significant change in the evidence presented.

Consumer Advocate argued that Iowa-American is required by 199 IAC 26.4 to demonstrate that expenses incurred are just and reasonable and Iowa-American has not fulfilled this obligation with regard to Dr. Morin's expenses. Consumer Advocate pointed out that the engagement letter provides certainty with respect to the fees paid Dr. Morin; however, the requirement is that the fees be just and reasonable and not just certain. Without the number of hours worked and the hourly rate charged by each outside witness, Consumer Advocate said that the Board is unable to determine the reasonableness of these expenses.

Consumer Advocate also asserted that the rate case expense report, as supplemented, still lacks the necessary detail for the Board to properly determine whether the costs of the Service Company employees were reasonable and just and not duplicative as an expense item. Consumer Advocate argued that Iowa-American has not provided the detail as required by 199 IAC 26.4 so the Board can ensure that rate case expense does not include expenses covered by test year expenses and, therefore, are not being double recovered.

Even though Iowa-American has provided the hours worked and hourly rate for Service Company employees, Consumer Advocate argued Iowa-American has not described the work performed by the Service Company employees or explained why the work was not included in "Test Year Service Expense" of $4,479,976. Consumer Advocate pointed out that Iowa-American paid $4,479,976 during the test year for work performed by Iowa-American affiliates under a service agreement, which represents approximately 15 percent of test year expenses.

Consumer Advocate noted that Attachment B provided by Iowa-American only lists one of six Service Company employees who appeared as a witness in the rate case proceeding and the assumption by Consumer Advocate is that the other five witnesses' expenses were included in test year expense. Consumer Advocate argued that Iowa-American needs to explain how it calculated and accounted for these costs and how it determined which rate case expenses were included in the test year and which rate case expenses were not included in the test year. Consumer Advocate maintained that the Board needs this information to ensure there is no double recovery of these expense items. Consumer Advocate said the Board should disallow the Service Company rate case expense since Iowa-American had the burden of proof on this issue.

D. Board Discussion

Rule 199 IAC 26.4 provides, in relevant part, as follows:

> **199—26.4(476) Rate case expense.**
> **26.4(1)** A utility making an application pursuant to Iowa Code section 476.6 shall file, within one week of docketing of the rate case, the estimated or, if available, actual expenses incurred or to be incurred by the utility in litigating the rate case. Except for expenses incurred in

preparation of the rate filing and notification of customers, the expenses shall be limited to expenses incurred in the time period from the date the initial application is filed through the utility's reply brief. Each expense shall be designated as either estimated or actual.

26.4(2) Estimated or, if available, actual expenses shall identify specifically:
a. Printing costs for the following:
(3) Testimony
(4) Briefs
d. Outside expert witness/consultant
(1) Number of outside consultants employed
(2) Hours per consultant employed
(3) Cost/hour per consultant employed
e. Expenses stated by individual for both outside consultants and utility personnel
(1) Travel
(2) Hotel
(3) Meals
(4) Other (specify)
f. Other (specify)

26.4(3) Rate case expense shall not include recovery for expenses that are otherwise included in test year expenses, including salaries for staff preparing filing, staff attorneys, and staff witnesses. Rate case expense shall include only expenses not covered by test year expenses for the period stated in subrule 26.4(1).

26.4(6) Actual utility expenses shall be filed in the same format and detail as estimated expenses and shall be filed within two weeks after filing the final brief. All material variances shall be fully supported and justified.

26.4(7) The board may schedule any additional hearings to litigate the reasonableness of the final expenses.

Three issues were raised by Consumer Advocate with respect to Iowa-American's rate case expense: double leverage, Dr. Morin's fee, and Service

Company fees. There is a fourth issue the Board will address: rate case expense associated with the proposed QIP clause.

The first issue raised by Consumer Advocate is double leverage. Although the Board agrees that the evidence in this rate case is similar to the evidence concerning double leverage presented in Docket No. RPU-2011-0001, the Board will not disallow any rate case expense associated with this issue. While double leverage has been applied to Iowa-American for at least 20 years, the issue had not been fully litigated during that time period until Docket No. RPU-2011-0001, Iowa-American's most recent rate proceeding. Subsequent to the Board's decision to apply double leverage to Iowa-American, the Board held a meeting to allow interested participants to provide information about double leverage outside the confines of a rate case proceeding. There were numerous participants and the meeting could have been viewed by Iowa-American as an indication of the Board's continued interest in the subject. Further, the Board has now split on this issue, so double leverage will likely be relitigated until there is a definitive Board statement on the issue.

The second issue is Dr. Morin's fee. The Board understands Consumer Advocate's concern about the lack of detail to support the fee paid Morin in this case but there is no question that the issues addressed by Dr. Morin (double leverage and return on equity) are important and large-dollar issues that required significant time in preparing testimony, responding to discovery requests, reviewing Consumer Advocate testimony, preparing for hearing, and appearing at the hearing. There is no dispute as to Dr. Morin's expert qualifications in these subject areas and there is not sufficient information to disallow any of the fees paid to Dr. Morin in this case, particularly given that many experts in utility proceedings charge a flat fee like Dr. Morin. However, in future rate proceedings Iowa-American will be required to provide justification for any fee where the issues addressed by an outside consultant are settled. This information would consist of an hourly rate or similar amount associated with the time the consultant spent working on issues in the case. Even though the engagement may be by flat fee, the Board expects that in the future the time will be tracked on an hourly basis to help to establish whether the flat fee was reasonable.

The third issue raised by Consumer Advocate is Service Company expenses. Consumer Advocate argues that the Board should disallow rate case expense for Service Company employees because Iowa-American has not provided the detail to support the expenses associated with these employees as required by 199 IAC 26.4. Consumer Advocate maintained that Iowa-American is required to provide a description of the work performed by the Service Company employees and explain why that work was not part of the test year service contract expenses.

Board rule 199 IAC 26.4, in pertinent part, requires a utility to file within one week of the docketing of a general rate increase filing estimated or actual expenses in preparation of the rate filing, notification of customers, and litigation expenses between the date of filing and the utility's reply brief. Iowa-American estimated the cost of Service Company Labor and Benefits for this rate case as $153,000.

Iowa-American filed Tinsley Workpaper 5 showing the expenses paid to the Service Company during the test year. Tinsley Workpaper 5 does not include a breakout of hours worked or an hourly rate for specific employees from the Service Company that performed the various functions that Iowa-American includes in the workpaper. In addition to other categories, the workpaper shows expense items for "Regulatory Operations," "Regulatory Services," and "Legal."

Attachment B to Iowa-American's January 24, 2014, resistance includes the hours worked and hourly rate for Service Company employees included in the actual expenses claimed by Iowa-American for this rate case. As noted by Consumer Advocate, Attachment B does not show any hours worked or an hourly rate for Iowa-American witnesses Verdouw and Kaiser. Attachment B does show hours worked and an hourly rate for Iowa-American attorney Reichart and Iowa-American employee Thakadiyil.

Without more detail describing what services are provided in the test year by Service Company employees and more detail describing the work performed by the Service Company employees shown on Attachment B, the Board is unable to determine whether the actual rate case expense submitted by Iowa-American involves double counting of work performed by Service Company employees during the test year. It seems unusual that two Service Company witnesses, Mr. Verdouw and Mr. Kaiser, have no hours shown on Attachment B while other employees that presumably helped in preparation of the two witnesses' testimony are included for recovery in rate case expense. There is simply inadequate support and documentation for the Service Company expenses.

The total actual rate case expense for Service Company employees as shown on Attachment B is $111,662. This total includes actual rate case expense for Mr. Reichart and Mr. Thakadiyil. While it is evident that Mr. Reichart as Iowa-American counsel had actual rate case expense incurred outside the test year, there is not sufficient support to identify these expenses because there is a “Legal” category of expenses included in the test year without any detail.

In reviewing the record, Iowa-American has not provided sufficient support to establish the reasonableness of the Service Company expenditures, and those expenses ($111,662) will be disallowed. In its next rate proceeding, Iowa-American will be required to provide descriptions of work performed by Service Company employees during both the test year and during the rate case proceedings to establish that there is no double-counting, or risk disallowance of Service Company expenses.

Another category of rate case expense needs to be examined, and that is the cost associated with litigating Iowa-American’s proposed QIP clause. The Board in its May 19, 2013, order denying Consumer Advocate's motion for issue preclusion raised the issue that Iowa-American was relitigating issues every two years where an issue and the supporting testimony and exhibits did not change significantly from case to case. The Board stated that at some point the expenses of relitigation could be considered unreasonable from ratepayers' view and it would be more appropriate for the utility to recover the litigation expense associated with these issues from shareholders rather than ratepayers. In this case, the issue of Iowa-American's proposed QIP automatic adjustment mechanism is an issue that was litigated in the last rate case, Docket No. RPU-2011-0001. The proposed QIP mechanism and the testimony and exhibits supporting the QIP in this case are essentially the same as the QIP proposed in the earlier rate case, as acknowledged by Iowa-American's witness. (Verdouw Direct, p. 48) The only significant difference from the last rate case to the current rate case is that the cap on the amount to be recovered from ratepayers through the QIP has been raised from 5 percent to 15 percent.

Two Iowa-American witnesses (Mr. Kaiser and Mr. Verdouw) provide the majority of the testimony and evidence on QIP, although QIP is mentioned by some other Iowa-American witnesses. Mr. Kaiser presents essentially the same testimony he presented in Docket No. RPU-2011-0001, with updates for the passage of time and some additional detail about the age of the water system infrastructure. Mr. Verdouw presents the underlying rationale in support of the QIP in this case and his testimony is similar to the testimony by Iowa-American witness Foran in Docket No. RPU-2011-0001. Mr. Verdouw testified at the hearing that the increase in the cap and the additional states that had adopted a similar recovery mechanism were the only changes from Docket No. RPU-2011-0001. (Tr. 761)

As discussed earlier in this order in its decision on QIP, the Board noted that In Docket No. RPU-2011-0001, the Board found that the QIP as proposed (1) did not meet the traditional three criteria for approving an automatic adjustment mechanism; (2) that regulatory lag was not sufficient justification for implementing the QIP in that case; (3) there appeared to be no benefit to rate payers from the QIP; and (4) Iowa-American had not presented a specific replacement plan to replace parts of the aging infrastructure. In this docket, the Board previously discussed that (1) Iowa-American admits the QIP does not meet the three traditional criteria; (2) regulatory lag is not a significant issue since Iowa-American files a rate case every two years and Iowa statutes contain provisions minimizing the lag; (3) there appears to be no benefit to ratepayers from the QIP such as extending the time between rate cases or a reduced rate or return; and (4) Iowa-American did not present a specific plan for replacing aging infrastructure. The only plan presented by Mr. Kaiser is to replace leaks and breaks as they occur, which is the same plan Mr. Kaiser presented in Docket No. RPU-2011-0001.

Based upon the repetition of the testimony and the lack of new evidence to support the QIP in this case, the Board will deny rate case expense associated with Mr. Verdouw's and Mr. Kaiser's testimony in support of the QIP. However, as the Board noted when discussing Service Company rate case expenses, there appears to be no expense associated with Mr. Verdouw's and Mr. Kaiser's testimony in this case. Since there appears to be no expense associated with the Iowa-American witness testimony in support of QIP, there is not a specific amount that can be disallowed.

While there is no specific amount that can be disallowed based on Iowa-American’s expenses, there was Board and Consumer Advocate time associated with reviewing the clause, although the Board cannot determine exactly how much Board and Consumer Advocate time was spent on the issue. However, the Board can readily determine the amount of time the Board staff person primarily responsible for the QIP issue spent on the case. This amount is $5,830, and it will be disallowed. The Board notes that other expenses of the Board and Consumer Advocate associated with relitigating QIP offer further support for the disallowance of the amount of costs associated with the Service Company.

Iowa-American’s rate case expense constitutes a large percentage of the overall revenue increase, particularly because Iowa-American has a historic pattern of filing rate cases every two years. While there can be extenuating circumstances where rate cases must be filed close together, here it appears to be a pattern and not the result of extenuating circumstances. This is supported by Iowa-American’s evidence as to the time between rate cases in other jurisdictions. The Board encourages Iowa-American to extend the time between rate cases and to put more effort into resolving issues early with Consumer Advocate and any other intervenors, or risk the burden of rate case expense being placed on the shareholders, not the ratepayers, of Iowa-American. Of particular note is the rate case expense in Docket No. RPU-2011-0001, where rate case expense represented about 40 percent of the rate increase. Management should seek ways to manage the utility such that more money is put into replacing pipe and less spent on rate case expense.

XI. FINDINGS OF FACT

Based on a thorough review of the entire record in these proceedings, the Board makes the following findings of fact:

1. The business transformation adjustment of $4,939,942 agreed to by Iowa-American and Consumer Advocate is reasonable.

2. It is reasonable to use total revenue lag days of 72.05 days (including 26.58 bill collection days), federal income tax lead days of 37.0 days, state income taxes lead days of 52.25 days, property tax lead days of 332.86 days, and Iowa-American's miscellaneous expense lead days.

3. Based on the evidence in this proceeding, the unbilled revenue adjustment proposed by Iowa-American is unreasonable.

4. It is reasonable to use a three-year simple average to calculate an uncollectible expense adjustment of (72,696).

5. It is unreasonable to make an adjustment to uncollectible expense to account for any increase in uncollectible revenue based on the rates approved in this proceeding.

6. It is reasonable to recalculate interest synchronization to reflect the Board's decisions in this proceeding.

7. It is reasonable to adjust test year property tax expense by $263,006.

8. Based on the evidence in this proceeding, it is reasonable to adopt a two-year amortization period for current and unamortized rate case expense.

9. It is reasonable to adopt a return on common equity for Iowa-American of 9.9 percent.

10. It is unreasonable to adjust Iowa-American's return on equity based on the utility's size.

11. It is unreasonable to adopt a flotation cost adjustment to Iowa-American's return on equity.

12. Based on the evidence in this proceeding, it is reasonable to use the capital structure for Iowa-American proposed by Consumer Advocate.

13. Iowa-American did not meet its burden regarding elimination of the double leverage adjustment and, therefore, double leverage will be applied.

14. Based on the evidence in this proceeding, it is unreasonable to adopt a qualified infrastructure plant adjustment surcharge as proposed by Iowa-American.

15. It is unreasonable to adopt an automatic adjustment mechanism for purchased power and chemical charges.

16. 1.63 is a reasonable peak day ratio.

17. It is reasonable to allocate some common costs to the customer charge and Iowa-American's allocation is appropriate in this proceeding.

18. It is unreasonable to adopt an adjustment to test year billing units and revenues for either declining usage or weather.

19. It is reasonable to allocate 50 percent of the public fire costs to the customer charge and 50 percent to the volumetric charge, and it is reasonable to set the customer charge for the 5/8 inch meter at a rate no higher than the rate calculated based on the allocated costs determined by Iowa-American's class cost-of-service study.

20. It is reasonable to allocate 75 percent of the costs of private fire service to private fire customers and 25 percent to all of Iowa-American's customers, with that 25 percent allocation divided evenly (50/50) between the customer charge and volumetric charge.

21. It is reasonable to reduce rate case expense recoverable from ratepayers by $117,492.00. .

XII. CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to Iowa Code chapter 476 (2013).

XIII. ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposed tariffs filed by Iowa-American Water Company on April 30, 2011, identified as TF-2013-0069 and TF-2013-0070, and made subject to investigation as part of this proceeding, are declared to be unjust, unreasonable, and unlawful.

2. Iowa-American Water Company shall file tariffs in compliance with this order within 20 days from the date of this order, reflecting rates that produce additional annual revenues (above test year revenues) of no more than $40,573,126, consistent with this order and attached schedules A through D. Iowa-American shall file at the time it files proposed compliance tariffs an updated class cost-of-service study (including the functionalized costs by cost category) that reflects the Board's decisions on the issues in this proceeding and corresponds with Iowa-American's approved revenue requirement. Iowa-American shall also file within 20 days of the date of this order schedules showing how its proposed compliance rates are calculated and an updated bill analysis (proof of revenue) demonstrating that its proposed compliance rates will produce the approved revenue requirement. All documentation supporting Iowa-American's post-decision filing (except the tariffs themselves) is to be provided in Excel format, including formulas for each calculation. The compliance tariffs shall become effective upon approval by the Board.

3. In future rate case proceedings, Iowa-American is to provide additional support for rate case expense as identified in the body of this order.

4. For future rate cases in which Iowa-American files a class cost-of-service study, Iowa-American shall file schedules showing the functionalized costs by cost category and schedules showing how all rates are calculated. These schedules shall be provided in Excel format, including formulas for each calculation.

5. This order constitutes the final decision of the Utilities Board in Docket No. RPU-2013-0002.

UTILITIES BOARD

/s/ Elizabeth S. Jacobs

ATTEST:

/s/ Joan Conrad
Executive Secretary

/s/ Nick Wagner

Dated at Des Moines, Iowa, this 28th day of February 2014.

Iowa American Water Company
Revenue Requirement
Schedule A
Docket Number RPU-2013-0002
Final Rates

		Amount
1	Rate Base	$100,823,968
2	Rate of Return	8.467%
3	Required Net Operating Income	$8,536,765
4	Adjusted Net Operating Income	$6,288,884
5	Net Operating Income Deficiency (Excess)	$2,247,882
6	Revenue Conversion Factor	1.71145
7	Revenue Deficiency (Excess)	$3,847,137
8	Adjusted Operating Revenue	$36,725,989
9	Revenue Requirement	$40,573,126

Iowa American Water Company
Rate Case
Schedule B
Docket Number RPU-2013-0002
Final Rates

		Rate Base
1	Plant in Service	$178,835,713
2	Accumulated Amort. & Deprec.	$51,940,450
3	Net Utility Plant	$126,895,263
	Additions to Rate Base	
4	Materials and Supplies	$528,016
5	Fuel Stocks	$0
6	Prepayments	$94,175
7	Cash Working Capital	$416,636
8	Total Additions	$1,038,827
	Deductions to Rate Base	
9	Accum. Deferred Income Tax	$17,722,644
10	Contributions in Aid of Constr.	$3,605,683
11	Customer Advances	$5,608,480
12	Accum. Prov. For Uncollectibles	$173,315
13	Total Deductions	$27,110,122
14	Total Rate Base	$100,823,968

Iowa American Water Company
Weighted Average Cost of Capital
Schedule C
Docket Number RPU-2013-0002
Final Rates

American Water Works Corporation

	Amount	Ratio	Cost Rate	Weighted Cost
1 Long-term Debt	$939,159,337	12.785%	6.055%	0.774%
2 Preferred Stock	$0	0.000%	0.000%	0.000%
3 Common Equity	$6,406,399,179	87.215%	9.900%	8.634%
4 Total	$7,345,558,516	100.00%		9.408%

Iowa American Water Company

	Amount	Ratio	Cost Rate	Weighted Cost
5 Long-term Debt	$44,454,114	47.429%	7.424%	3.521%
6 Preferred Stock	$0	0.000%	0.000%	0.000%
7 Common Equity	$49,273,491	52.571%	9.408%	4.946%
8 Total	$93,727,605	100.00%		8.467%

Iowa American Water Company
Income Statement
Schedule D
Docket Number RPU-2013-0002
Final Rates

		Amount
1	Operating Revenues	$40,573,125
	Operating Expenses	
2	Oper. And Maint. Expense	$17,820,665
3	Depreciation and Amortization	$6,832,445
4	General Taxes	$3,720,985
5	Federal Income Tax	$954,739
6	State Income Tax	$553,804
7	Federal Deferred Income Tax	$1,787,061
8	State Deferred Income Tax	$403,859
9	Investment Tax Credit	($37,198)
10	Total Operating Expense	$32,036,360
11	Operating Income	$8,536,765

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's	)	
Request for Authority to Implement a General Rate Increase	)	**File No. WR-2015-0301**
for Water and Sewer Service Provided in Missouri Service	)	
Areas	)	

REPORT AND ORDER

Issue Date: May 26, 2016

Effective Date: June 25, 2016

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's)
Request for Authority to Implement a General Rate) **File No. WR-2015-0301**
Increase for Water and Sewer Service Provided in)
Missouri Service Areas)

REPORT AND ORDER

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Appearances

William R. England, Paul A Boudreau, and Dean Cooper, Attorneys at Law, Brydon, Swearengen & England, PC, P.O. Box 456 Jefferson City, Missouri 65102

For Missouri-American Water Company.

Mark D. Poston, Deputy Public Counsel, and **Timothy Opitz**, Senior Counsel, P.O. Box 2230, Jefferson City, Missouri 65102

For the Office of the Public Counsel.

Kevin A. Thompson, Chief Staff Counsel, **Marcella Mueth**, Assistant Staff Counsel, and **Jamie Myers**, Assistant Staff Counsel, 200 Madison Street, Suite 800, P.O. Box 360, Jefferson City, Missouri 65102

For the Staff of the Missouri Public Service Commission.

Alexander Antal, Associate General Counsel, 301 West High Street, Jefferson City, MO 65102

For Missouri Department of Economic Development-Division of Energy.

Gary Drag, Attorney at Law, 3917A McDonald Ave, St. Louis Missouri 63116-3816

For the City of Brunswick, Missouri.

Marc H. Ellinger and Stephanie S. Bell, Attorneys at Law, Blitz, Bardgett, Deutsch, 308 East High Street, Suite 301, Jefferson City, Missouri 65101

For the City of Joplin, Missouri.

Joe Bednar and Keith Wenzel, Attorneys at Law, Spencer Fane LLP, 304 East High Street, Jefferson City, Missouri 65101

For the City of Riverside, Missouri.

Leland B. Curtis, Attorney at Law, Curtis, Heinz, Garret & O'Keefe, 130 S. Bemiston, Suite 200, St. Louis Missouri 63105

For the City of Warrensburg, Missouri.

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Diana M. Vuylsteke, Attorney at Law, Bryan Cave LLP, 211 N. Broadway, Suite 3600, St. Louis, Missouri 63102

For the Missouri Industrial Energy Consumers.

Larry W. Dority, Attorney at Law, Fischer & Dority, PC, 101 Madison, Suite 400, Jefferson City, Missouri 65101

For Public Water Supply District No. 1 of Andrew County, and
Public Water Supply District No. 2 of Andrew County

Joshua K.T. Harden and Karl Zobrist, Attorneys at Law, Dentons, 4520 Main Street, Suite 1100, Kansas City, Missouri 64111

For Triumph Foods, LLC.

Jeffrey R. Lawyer and Lee C. Tieman, Attorneys at Law, Tieman, Spencer & Hicks, LLC, 702 Felix Street, St. Joseph, Missouri 64501

For the City of St. Joseph.

Greg A. Campbell and Emily R. Perez, Attorneys at Law, Hammond and Shinners, P.C., 7730 Carondelet Ave, Suite 200, St. Louis, Missouri 63015

For Utility Workers Union of American Local 335, AFL-CIO.

Chief Regulatory Law Judge: **Morris L. Woodruff**

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REPORT AND ORDER

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Procedural History

On July 31, 2015, Missouri-American Water Company (Missouri-American or Company) submitted revised tariff sheets to implement a general rate increase for water and sewer service throughout its service territory to increase its annual revenues by $51 million. The proposed tariff sheets bore an effective date of August 30, 2015. In order to allow time to study the tariff sheets and to determine if the rates resulting therefrom are just, reasonable and in the public interest, the Commission suspended the proposed tariff sheets until June 28, 2016.

In its order suspending the tariff sheets, the Commission directed that notice of the filing be given and invited applications to intervene. The following entities requested intervention: the Missouri Industrial Energy Consumers (MIEC); the Missouri Department Economic Development – Division of Energy; Triumph Foods, LLC; the City of Warrensburg, Missouri; the City of St. Joseph, Missouri, the City of Joplin, Missouri; Public Water Supply District Nos. 1 and 2 of Andrew County, Missouri; the City of Riverside, Missouri; the City of Brunswick, Missouri; Stonebridge Village Property Owners Association; and Utility Workers Union of America Local 335, AFL-CIO. The Commission granted all requests to intervene.

In January 2016, the Commission held local public hearings across the state. Those hearings were held in Jefferson City, Branson, Joplin, Warsaw, Warrensburg, Riverside, St. Joseph, Brunswick, Mexico, Arnold, and St. Louis County.

An evidentiary hearing was scheduled to begin on March 14, 2016. Before the start of the hearing, the parties requested and were granted time to formalize an agreement. As a result, the first week of the hearing was cancelled. On March 16, several parties filed a non-unanimous stipulation and agreement that indicated the parties' agreement to increase Missouri-American's annual revenues by $30.6 million.[1] No one objected to that stipulation and agreement, and the Commission approved it and a second stipulation and agreement in an order issued on April 6.

The approved stipulations and agreements did not resolve all the issues. An evidentiary hearing was held regarding the remaining issues on March 21, 22 and 23. The parties filed initial post-hearing briefs on April 8, with reply briefs following on April 22.

The Issues

District Consolidation/Consolidated Pricing

Background:

This issue concerns the means of allocating Missouri-American's revenue requirement to its various groups of customers. The amount of the increase in the company's revenue requirement that will result from this case has already been determined through the approved stipulation and agreement of the parties.

Findings of Fact:

Water District Consolidation

1. Missouri-American currently provides water service to 19 distinct water systems in Missouri. Those water systems vary in size from the St. Louis Metro system, which counts 366,815 customers, to the Redfield system, which counts 23 customers. In all, Missouri-American serves 459,429 water customers. Of those 19 water systems, only four – St. Louis Metro, St. Joseph, Joplin, and Jefferson City – serve more than 8,000 customers.[2]

2. Missouri-American also provides wastewater (sewer) service to 11,790 Missouri customers through 13 sewer systems. Those 13 sewer systems range in size from Arnold with 6,877 customers, to Ozark Meadows with 26 customers.[3]

3. The described water and sewer systems are themselves consolidations of still smaller water and sewer systems. For example, the Maplewood/Riverside/Stonebridge water system with 1,385 customers is comprised of separate systems located in Pettis, Stone, and Taney Counties.[4] Furthermore, the St. Louis Metro system includes systems in St. Louis County, Warren County, and St. Charles County.[5]

4. Missouri-American's costs of providing service must be allocated to these various water and sewer systems for purposes of developing the rates that the customers served by those systems must pay.[6]

5. Some costs can be directly assigned to a particular system, such as the cost of a treatment facility or the mains and pipes that serve that system. Other costs, such as a customer call center, billing services, or

other corporate services are allocated to the various water and sewer systems in a less definite manner, based on allocation factors determined by whomever is examining the company's books and records, in this case by the company and by Staff's auditors.[7] As a result, the company's cost to serve a particular system is not a definite or unquestionable number.

6. The allocation of costs and resulting rates to the water and sewer systems can be accomplished using two methods. The first is district-specific pricing wherein the auditor attempts to collect all the costs of providing service to each individual district and develops rates based on that district's cost of service. Thus, in theory, the ratepayers in any district pay rates designed to recover the cost of providing service to that district.[8] Under district-specific pricing residential customers in St. Joseph, Brunswick, and Joplin would all pay their own, distinct rate.

7. The second method is single-tariff pricing. In single-tariff pricing all costs of the utility are combined and rates are developed on a system-wide basis. Thus, all customers in a given rate class, for example, residential customers, will pay the same customer charge and commodity rate for the water they consume, no matter where within the company's service territory they live.[9] So, for example, residential customers in St. Joseph will pay the same rates as residential customers in Brunswick and in Joplin.

8. District-specific pricing and single-tariff pricing are the two extremes on the spectrum of possible methods of allocating costs and designing rates. Allocating costs and designing rates can also be done by consolidating the system into larger districts for purposes of allocating costs and determining rates. Under this consolidated pricing method, residential customers in St. Joseph and Brunswick might pay one rate, while a residential customer in Joplin might pay a different rate.[10]

9. In a 2000 rate case, the Commission decided that Missouri-American should move away from its then existing single-tariff pricing toward district-specific pricing.[11] As a practical matter, Missouri-American has never actually reached pure district-specific pricing. Currently, Missouri-American's rates are calculated using eight water districts established by stipulation and agreement of the parties in the company's last rate case. The seven largest districts – St. Louis Metro, Mexico, Jefferson City, Warrensburg, Joplin, Platte County, and St. Joseph - have rates designed based on their estimated cost of service. The eighth district is a consolidation of the remaining service territories, broken into additional sub-districts.[12]

10. In this case, Missouri-American initially proposed to consolidate the existing water districts into 3 new districts based on their current level of rates:[13]

Zone 1	Zone 2	Zone 3

St. Louis Metro	Mexico	Brunswick
Joplin	Platte County	Spring – Valley – - Lake Manor
St. Joseph	Jefferson City	Ozark Mountain-LTA
Warrensburg		Rankin Acres-Whitebranch
Maplewood/Riverside/Stonebridge – Saddlebrooke - Emerald Pointe Water		
Tri-States		

11. Staff also proposed consolidation into three new water districts:[14]

District 1	District 2	District 3
St. Louis Metro (St. Louis County, Warren County, and St. Charles	St. Joseph	Joplin
Mexico	Platte County	Stonebridge
Jefferson City	Brunswick	Warrensburg
Anna Meadows		Whitebranch
Redfield		Lake Taneycomo
Lake Carmel		Lakewood Manor
		Rankin Acres
		Spring Valley
		Tri-States
		Emerald Pointe
		Maplewood
		Riverside Estates

12. Staff's proposed consolidation is based on geographical location and operating characteristics. District 1 includes existing water districts in east-central Missouri, District 2 contains districts located in the northwest portion of the state, and District 3 contains the districts in the southwest part of the state.[15] Each of Staff's proposed Districts includes at least one larger district as an anchor for the District. That allows costs within each District to be spread to a larger customer base.[16] Further, the water systems in the various districts share many of the same labor and management personnel and operating characteristics, and thus share similar corporate costs. The systems within the proposed Districts also share similar sources for their water.[17] Finally, labor costs will tend to be similar in each of the three Districts proposed by Staff.[18]

13. Missouri-American does not oppose Staff's plan for water district consolidation.[19]

14. On March 22, 2016, during the course of the evidentiary hearing, Public Counsel, MIEC, Brunswick, St. Joseph, and Joplin filed a non-unanimous stipulation and agreement regarding rate design, district consolidation and sewer revenue. Staff objected to the stipulation and agreement, so, by Commission rule, the

stipulation and agreement became merely a joint position of the parties to which they are not bound.[20] Nevertheless, the signatory parties continue to support that joint position.

15. The joint position proposes to maintain the current 8 water districts with slight modifications. The current 8 water districts are as follows:[21]

Joplin
Jefferson City
Mexico
Platte County
St. Joseph
St. Louis Metro
Warrensburg
District 8 (This district includes all the other smaller water systems served by Missouri-American. Brunswick is currently in District 8

16. The joint position would consolidate Anna Meadows and Hickory Hills, which are recently acquired systems, into the St. Louis Metro district for water only. It would consolidate Brunswick into the St. Joseph district. Redfield, another recently acquired system, would be consolidated into the Jefferson City district. Finally the remaining districts currently in District 8 would become a new consolidated Branson district. All other water systems would remain in their current districts. In addition, the Platte County district would receive a five percent reduction in its residential rates, with ten percent of the reduction reallocated to Joplin and ninety percent reallocated to the St. Louis Metro district.[22]

17. At the hearing, the City of Riverside proposed yet another three-district consolidation. Under that option, Joplin and St. Joseph would each remain in their own district, with all other water systems being consolidated into a single district.[23]

18. The fifth and final consolidation option would be to consolidate all the existing districts into one, and return to single-tariff pricing.[24]

19. Missouri-American intends to retire the aged water treatment facility in the Platte County district by 2018.[25] The anticipated capital expense associated with replacing that water treatment facility makes Platte County an unattractive consolidation partner for the other existing districts.

20. The various water systems operated by Missouri-American are spread across the state and, because of the distance separating them are not physically interconnected.[26] Thus, for example, a customer in Joplin will never receive water from a treatment plant in Warrensburg.[27]

21. Despite the inherent differences in the various water systems, Missouri-American's annual cost to serve a residential customer is fairly consistent across the existing districts. For most districts, the annual cost to serve a customer is in the $400 to $500 range. The annual cost to serve a residential customer in the St. Louis Metro district, which serves 366,815 customers, is $481.86 per year. The most significant outliers are Brunswick, which serves 330 residential customers at an annual customer cost of $702.92, and Platte County, which serves 6,216 customers at an annual customer cost of $1,031.48.[28]

22. The consistency in costs to serve customers between districts is attributable to the fact that most of the costs of providing service to Missouri-American's customers are very similar, if not the same, from district to district because a portion of Missouri-American's statewide costs are allocated to the various districts. So, for example, Missouri-American's costs of capital will be the same for each of the districts. When Missouri-American buys pipe, meters, and other supplies, the cost of those supplies will be the same in all districts. Similarly, management salaries for Missouri-American's executives will be allocated equally to customers in each of the districts.[29]

23. Consolidation of water rates will help address some structural problems within the water industry. Currently, water service in the United States and in Missouri tends to be very fragmented. As of 2010 there were over 52,000 Community Water Systems operating in the United States. Most of those systems are classified as small or very small.[30]

24. The same fragmentation problem can be seen in Missouri-American's service territory, where the St. Louis Metro water system serves 366,815 customers, while the remaining 18 systems serve a total of 92,624 customers. And more than half of those non-St. Louis metro customers are in either Joplin or St. Joseph.[31]

25. The fragmentation of the industry with many small systems serving very few customers creates affordability problems. The Federal and state governments have recently imposed many new regulations designed to protect public and environmental health. Those regulations are needed, but they impose a heavy burden on small systems with few customers. For example, the Environmental Protection Agency estimates that compliance with the Safe Drinking Water Act costs an average of $4 per household per year for systems serving

more than 500,000 people. But for systems serving no more than 100 customers, that annual cost rises to $300 per household.[32]

26. An easy demonstration is that a $1 million water or sewer system capital project will cost each customer in a consolidated system with 460,000 customers a total of $2.17. But if that $1 million project is required in a system like Brunswick that serves 400 customers, the cost per customer is $2,500. The same project in a system like Redfield would cost each of the system's 23 customers $43,478.

27. Given those economies of scale problems, Missouri has many struggling small water and sewer companies. James Busch, the Regulatory Manager of the Commission's Water and Sewer Department,[33] explained that seven small water or sewer systems in Missouri are currently operating under the control of a receiver, and that the situation for small water and sewer companies is not improving.[34] He offered the opinion that: "[i]f consolidated pricing allows for MAWC or other entities to acquire troubled systems to keep them out of receivership, then consolidated pricing is a favorable change that could provide benefit to Missouri citizens without any undue burden or cost."[35]

28. Mr. Busch also explained that the Commission's Staff spends a significant portion of its time speaking with owners and managers of many water and sewer utilities. That includes companies that are interested in possibly purchasing small water and sewer utilities that may not yet be in receivership. Through those interactions, Staff has become aware that "consolidated pricing is a major consideration in the decision to own and operate systems in Missouri and on whether or not to expand. It is Staff's opinion, based on its years of experience, that a move toward further consolidation will send a positive signal to those companies."[36]

29. Mr. Busch has been the manager of the Commission's water and sewer department since 2008,[37] and the Commission is aware of his work with struggling water and sewer companies. His testimony in this regard is very credible.

30. In contrast to the fragmented rates common in the water and sewer industry, public electric and natural gas utilities generally charge their customers uniform rates no matter where within their system they happen to live. For example, a customer of a large electric utility, such as Ameren Missouri, will pay the same rate for electricity whether they live in the middle of St. Louis or in a rural area of the Ozarks.[38] Obviously, an electric system is different than a water or sewer system in that the entire electric system is interconnected by a transmission grid. However, there can be no doubt that it costs more to serve an individual customer at the end

of a miles-long line through the woods than it does to serve a customer in an apartment building in a densely populated urban area.[39]

31. By spreading out the cost of mandated environmental upgrades over a larger number of customers, consolidated-tariff pricing will better promote improved and uniform water and environmental quality throughout Missouri-American's water and sewer service territory.[40] However, that ability to spread costs also carries with it the risk that Missouri-American will have an incentive to overbuild its water and sewer system to maximize shareholder profits if the constraints of customer affordability are reduced.[41]

32. To address that concern, Staff proposes that Missouri-American be required to file a five-year capital expenditure plan with the Commission for review by January 31 of each year after the effective date of rates in this case. Staff, and every party to this case, would then have the ability to review Missouri-American's plans and could make recommendations regarding investment and the need to make investments in any service area. All expenditures would be subject to full review in Missouri-American's future rate cases.[42]

33. A concern was raised that consolidated pricing would reduce Missouri-American's incentive to perform due diligence before acquiring new water systems and could impact the price Missouri-American is willing to pay to acquire new systems.[43] However, Missouri-American and other potential purchasers understand that this Commission has generally not recognized acquisition premiums for purchased systems. As a result, such systems are usually purchased based on the selling utility's rate base valuation, which keeps purchase prices in line with the system that is in place and avoids undue costs being passed to ratepayers.[44]

34. Consolidated pricing will also tend to reduce administrative and regulatory costs by lowering the costs of billing and collections and by reducing the regulatory costs of having to calculate and file multiple rates within a rate case.[45] Staff agrees that consolidated pricing can significantly reduce the cost of preparing a future rate case.[46]

35. All water systems will eventually require large capital investments.[47] If the cost of making those investments is spread among consolidated districts, in the long term any perceived short-term unfairness will be balanced out.

36. Since 2000, the Commission has set rates for Missouri-American based on a district-specific pricing theory. During that time Joplin and St. Joseph have incurred costs for major infrastructure projects that have not been spread among other districts.[48] However, rate payers do not pay all the expenses for a major capital

project immediately. Instead, those costs are amortized over many years and recovered by the company through rates over that extended period of time. Thus, capital projects completed in recent years have not been fully paid for through rates and, because of consolidation, the remaining balance of those costs will be spread to other districts.[49]

Sewer District Consolidation

The facts found regarding water district consolidation also apply to the question of sewer district consolidation and are incorporated herein. Additional facts regarding sewer district consolidation follow.

37. Staff proposed to consolidate Missouri-American's 12 existing sewer districts into five districts:[50]

Sewer District 1	Sewer District 2	Sewer District 3	Sewer District 4	Sewer District 5
Arnold	Platte County	Cedar Hills	Jefferson City	Stonebridge
		Warren County	Maplewood	Saddlebrooke
		Anna Meadows	Ozark Meadows	Emerald Pointe
		Meramec		

Staff based its sewer district recommendations on geographic location, reasoning that the workers responsible for any given district will also have responsibility for nearby systems.[51]

38. Missouri-American proposed to consolidate its existing sewer districts into just two districts, with Arnold in one district and every other system in the second.[52]

39. Arnold is by far Missouri-American's largest sewer system with 6,877 customers, far outpacing the second largest sewer district, Jefferson City, with 1,374 customers.[53] As such, it is reasonable for Arnold to be separated into its own district.

40. Arnold is also the source of a disagreement in this case. On April 27, 2015, Missouri-American's then-President Frank L. Kartmann sent a letter on behalf of Missouri-American to the City of Arnold, which was in the process of approving the sale of the Arnold system to Missouri-American. In that letter, Kartmann assured the City of Arnold that, absent any extraordinary circumstances, "the Arnold sewer bill for a 5,000 gallon monthly residential customer, currently at $24.33 per month (based on $73.00 per quarter), will not increase beyond $33.58 per month during the first 4 years of Missouri-American's ownership."[54]

41. At the time Staff filed its direct testimony, based on Staff's calculation of Missouri-American's revenue requirement, it estimated that the total increase in the cost of service for Missouri-American's sewer operations would be only $39,345. Based on that estimate, Staff recommended leaving sewer rates at their

current levels. Staff would have accounted for the resulting $39,345 shortfall by taking it from its proposed District 2 for water service. Staff reasoned that taking the sewer shortfall from the water service side of the equation was reasonable because Missouri-American's overall corporate costs must be allocated in some manner between the company's water and sewer operations. Staff believed the reallocation of $39,345 was within the zone of reasonableness for those corporate allocations.[55]

42. Despite its proposal to consolidate the sewer districts, Staff recommended that all existing sewer rates be left at their current levels.[56]

43. In its cost allocation study, Missouri-American limited its allocation of corporate and joint and common costs to $20 per year, per customer in small districts with less than 3,000 customers. In doing so, it reasoned that smaller districts do not require the same level of service as larger districts. It looked at the level of overhead costs the small districts typically incur and used that as the basis for the $20 per customer allocation. The remaining corporate and joint and common costs were then allocated to the larger districts.[57] If the limited allocations to the small district are not used, the traditional allocation methods would allocate between $50 and $300 in costs per customer to the small districts, while the allocations would be less than $20 per customer in the larger districts.[58]

44. Staff did not accept Missouri-American's limited allocation of costs to the smaller districts and instead allocated those costs to the districts using what it believes to be an appropriate allocation factor.[59]

45. The increase in Missouri-American's annual revenue requirement agreed to by the parties and established in this case is significantly larger than the amount Staff had recommended at the time it filed its direct testimony. Based on the then agreed upon $30.6 million increase to the company's revenue requirement, the sewer shortfall was estimated to be $2,055,059. $1,489,263 of that shortfall was attributed to Arnold.[60]

46. At the hearing, Staff Indicated the non-Arnold sewer shortfall was $565,000 and proposed to assign and collect those additional costs from the three water districts proposed by Staff, with 80 percent of the $565,000 to be collected from District 1, and 10 percent from each of District 2 and 3.[61] Under Staff's proposal, existing sewer rates would not be changed as a result of this case.[62]

47. Staff's proposal did not account for the $1,489,263 sewer revenue shortfall attributable to Arnold. Staff took the position that unless Missouri-American was willing to increase Arnold's rates above the cap promised in Kartmann's letter to the City of Arnold, it believed that no additional allocations to the water district

should be made and Missouri-American's shareholders could absorb those extra costs. The Staff's cost study showed that Arnold's rates would have to be increased by 44 percent to cover its full costs.[63]

48. Mr. Busch testified for Staff that Mr. Kartmann told him in a phone conversation that Missouri-American shareholders would be responsible for any revenue shortfall resulting from the commitment to Arnold. Mr. Busch indicated that Staff did not believe it would be fair for other ratepayers to pick-up that shortfall on behalf of Missouri-American's shareholders. He also testified that he became concerned about Kartmann's commitment to Arnold only after it became apparent that there would be a significant shortfall.[64]

Conclusions of Law:

A. Section 393.130, RSMo (Cum. Supp. 2013), establishes the requirements for the provision of service by regulated utilities. In general, it requires that all charges for utility service must be "just and reasonable" and not more than allowed by law or order of this Commission. Subsection 2 of that statute further states:

> No … water corporation or sewer corporation … shall directly or indirectly by any special rate, rebate, drawback or other device or method, charge, demand collect or receive from any person or corporation a greater or less compensation for … water, sewer [service] …, except as authorized in this chapter, than it charges, demands, collects or receives from any other person or corporation for doing a like and contemporaneous service with respect thereto under the same or substantially similar circumstances or conditions.

Subsection 3 adds:

> No … water corporation or sewer corporation shall make or grant any undue or unreasonable preference or advantage to any person, corporation or locality, or to any particular description of service in any respect whatsoever, or subject any particular person, corporation or locality or any particular description of service to any undue or unreasonable prejudice or disadvantage in any respect whatsoever.

In sum, the statute says that utilities cannot give any "undue or unreasonable" preference or disadvantage to any particular customer, or class of customers, or locality.

B. Some parties argue that Section 393.130 requires the use of district-specific pricing and forbids the use of single-tariff pricing or even consolidated-tariff pricing. They are wrong.

C. The most cited case interpreting the meaning of "undue or unreasonable" preference is *State ex rel. Laundry v. Public Service Commission*,[65] a 1931 decision by the Missouri Supreme Court. The *Laundry* decision arose from a complaint brought before the Commission by two laundry companies contending that they should be allowed to receive water service at the same reduced rate made available to ten manufacturing customers. In its decision, the Missouri Supreme Court found that the laundries were similarly situated to the manufacturing customers and should have been allowed to take water at the reduced manufacturer's rate. Specifically, the Court held that principles of equality "forbid any difference in charge which is not based upon difference in service" and found "there is no dissimilarity or difference in the service of furnishing and supplying water [to the manufacturing customers] and the service of furnishing and supplying water to the complainants herein".[66] *Laundry* does not say that only cost differences can be considered when the Commission decides whether there is any undue or unreasonable preference.

D. While a difference in charge must be based upon a difference in service, differences in services are not based solely on differences in cost to provide that service. In a 1978 case, *State ex rel. City of Cape Girardeau v. Public Service Commission*,[67] the City of Cape Girardeau challenged the design of the electric rates imposed on the city by the Missouri Utilities Company. The city contended that the rates charged to its citizens should be lower than the rates charged to surrounding rural areas because it was less expensive for the company to serve its customers within the more concentrated areas of the city. In denying the city's challenge, the Missouri Court of Appeals held that section 393.130(3)

> forbids discrimination against persons as well as locations. The Commission's order and report made it clear that it was aware of this dual obligation and in this case chose to emphasize equity to the individual user by maintaining a rate system designed on the basis of cost to a class of customer rather than to an area. … We cannot hold as a matter of law that the city was entitled to the relief it sought merely by showing a lower cost of service to the city area as a whole[68]

The Missouri Court of Appeals further found that the record supported the Commission's decision to charge a single rate in both rural and urban areas even if it was assumed that it cost the company less to serve the Cape Girardeau urban area.[69]

E. Similarly, in *State ex rel. City of West Plains v. Public Service Commission*,[70] the Missouri Supreme Court addressed the question of whether a telephone company could lawfully charge rates that included a surcharge to recover the license and occupation city taxes from the residents of the cities that imposed those taxes on the phone company. For purposes of this discussion, the most important portion of the Missouri Supreme Court's opinion is as follows:

> We are able to discern no legitimate reason or basis for the view that a utility must operate exclusively either under a systemwide rate structure or a local unit rate structure, or the view that an expense item under a systemwide rate structure must of necessity be spread over the entire system regardless of the nature of the item involved. Experts in utility rates may well conclude that a 'hybrid system' or 'modified system' of rate making, wherein certain expense items are passed on to certain consumers and certain items are thereby treated on a local unit basis and others on a systemwide basis, is the system which will produce the most equitable rates. And it would appear to be the province and the duty of the commission, in determining the questions of reasonable rates, to allocate and treat costs (including taxes) in the way in which, in the commission's judgment, the most just and sound result is reached. … And, in any event, the fact that an order may ignore 'the theory and practice of rate making and utility operation upon a systemwide basis' does not, standing alone, tend to demonstrate the unlawfulness or unreasonableness of that order. [71]

Thus, the Missouri Supreme Court recognized that the Commission is not bound by statute to implement any particular theory of ratemaking. In this case, it is not bound to a theory of either district-specific or single-tariff pricing. Rather, the Commission must weigh the evidence presented and arrive at a decision that implements just and reasonable rates.[72]

F. There is one more court decision that needs to be addressed. The Commission's 2000 Missouri-American rate case, in which the Commission announced its intention to move toward district-specific tariff pricing, was appealed by the City of Joplin. The Commission's decision had moved all other then-existing districts to district-specific pricing, but kept Joplin at the rates it had been paying under single-tariff pricing. If Joplin had also been moved to district-specific pricing along with the other districts, it would have seen a rate decrease amounting to $880,000 per year. The Circuit Court of Cole County reversed the Commission's order for failing to offer sufficient findings of fact and conclusions of law to support its decision to reallocate Joplin's rate decrease to other districts. Because of procedural disputes the matter did not reach the court of appeals for decision until Missouri-American had filed its next rate case and new rates had been established. The Circuit Court of Cole County dismissed the appeal as moot, and that dismissal was appealed.

G. In *State ex rel. City of Joplin v. Public Service Commission*,[73] the Court of Appeals held that the City of Joplin's appeal was not moot because the legal principle upon which the City of Joplin appealed was recurring and could evade appellate review. The Court expressed concern that the Commission's decision was unjustly discriminatory towards Joplin, but found that the Commission's inadequate findings of fact and conclusions of law precluded meaningful judicial review and remanded the matter to the Commission to prepare new, sufficient findings and conclusions. The decision did not mandate the use of district-specific pricing.

H. Section 393.320, RSMo (Cum. Supp. 2013), passed in 2010, establishes a procedure whereby a large water or sewer utility (more than 8,000 customers) attempting to acquire a small water or sewer system (8,000 or fewer customers) may establish a ratemaking rate base for the small system to be acquired. The purpose of the statute is to make it easier for a large water or sewer utility to acquire small systems. For purposes of this decision, the most relevant provision in the statute is subsection 6, which states:

> Upon the date of the acquisition of a small water utility by a large water public utility, whether or not the procedures for establishing ratemaking rate base provided by this section have been utilized, the small water utility shall, for ratemaking purposes, become part of an existing service area, as defined by the public service commission, of the acquiring large water public utility that is either contiguous to the small water utility, the closest geographically to the small water utility, or best suited due to operational or other factors. This consolidation shall be approved by the public service commission in its order approving the acquisition.

I. This statute is important for two reasons. First, it shows that the legislature is aware of the affordability problems faced by small water systems and allows those problems to be ameliorated by consolidation with a larger service area for ratemaking purposes. That shows that the legislature is not hostile to the concept of consolidated-tariff pricing. It would be unreasonable to conclude that the legislature approved of consolidated tariff pricing for small water systems acquired after the statute passed in 2010, but forbade it, and required district-specific pricing, for the small water systems acquired before the passage of the statute.

J. Second, the statute tends to undercut one argument presented in favor of consolidated tariff pricing; the argument that consolidated-tariff pricing is needed to reassure potential buyers of struggling water systems. If the statute already allows for consolidation of newly acquired water systems into larger districts, then it appears that no further reassurance of potential buyers is required. However, the application of the statute is limited in that it defines a "large water public utility" as a public utility that provides water to more than 8,000 customer connections.[74] In effect, Missouri-American is the only "large water public utility" currently operating in this state. Some other entity that wanted to buy multiple water or sewer systems in Missouri and consolidate them for ratemaking purposes would not be able to take advantage of this statute and might still need the reassurance that consolidated-tariff pricing may be available.

K. Commission Rule 4 CSR 240-2.115(2)(D) provides that a non-unanimous stipulation and agreement to which an objection is made, becomes merely a joint position of the parties signing the agreement. The signatory parties are not bound by their agreement and the Commission can adopt their joint position only if it is supported by competent and substantial evidence.

L. This rule is important because the parties that adhere to the Joint Position seem to assume that the Commission can adopt their position that some consolidation and reallocation of costs is appropriate because it is in their stipulation and agreement, while also adopting their other position that district-specific pricing is required by the controlling statute. The two positions cannot be reconciled.

Decision:

The Commission's task in this case is to devise a rate structure that is just and reasonable for all Missouri-American's customers, no matter where they live within the company's service area. The Commission must also ensure that the rates it authorizes do not unduly or unreasonably grant a preference or impose a prejudice on any person, corporation, or locality. That is a difficult task that requires a great deal of balancing differing interests. Missouri-American's cost to serve its customers is one factor to be balanced, but it is not the only factor.

The needs of the customers must be met no matter where they happen to live, or how recently the company's infrastructure in their area was installed or replaced.

Consolidated pricing will help to meet the needs of all customers by sharing the cost of providing needed services among a larger group of customers, making the cost of service more affordable for all. Consolidation will limit rate shock when new infrastructure must be installed in a district with a small population, and all districts will eventually face that prospect.

Consolidation is not without risk. It averages rates and inevitably some customers will pay more than they pay now, and some will pay less. At least in the short term that will be seen by some as unfair, but, over the long term, the effects of consolidation will even out across the state. It is not reasonable to keep patching the current group of rate districts to deal with the needed, but unaffordable, infrastructure repairs and improvements as they occur.

There is also a concern that consolidation will give Missouri-American an incentive to build more infrastructure than is needed so as to increase its rate base and increase profits for its shareholders. To avoid that problem, the Commission will adopt Staff’s five-year capital planning report proposal.

The Commission will adopt Staff’s consolidation plan as the best option at this time. Missouri-American has essentially abandoned its initial consolidation plan, and anyway, it did little to accomplish the purposes of a consolidation plan since it did little to spread costs. Similarly, the plan put forward in the Joint Position did not capture the benefits to be gained from consolidation and seemed to be little more than a plan to give a little something to various parties to obtain their signature on the compromise document.

Full single-tariff pricing is an attractive option, but since none of the parties proposed that option during the case it was not fully considered by the parties. Because of that lack of scrutiny, the option has many unknowns, and the Commission is not willing to take that leap at this time.

The Commission may need to make take that leap in Missouri-American’s next rate case as it will likely be facing the prospect of a major new capital construction project in the Platte County district, a district that will have difficulty affording a major capital expense. For that reason, the Commission will expect the parties to fully examine single-tariff pricing in the next rate case.

Consolidation is also needed on the wastewater side of Missouri-American’s business. The existing sewer districts are even more fragmented than the water districts. A separate problem has arisen regarding sewer service because of a promise made by Missouri-American’s President to the City of Arnold. That promise to limit any sewer rate increases to Arnold’s customers for four years after Missouri-American purchased the system was made without consultation with Staff, or approval from the Commission. As a result, it will be the responsibility of Missouri-American’s shareholders to support that promise if it has any effect.

The Commission will adopt Missouri-American’s limitation on the allocation of corporate expense to small water and sewer companies. That may eliminate the so-called sewer shortfall that Staff had proposed to collect from Missouri-American’s water customers.

The Commission will direct that the existing sewer districts be consolidated into two districts as proposed by Missouri-American. That will leave Arnold in its own sewer district, responsible for its own share of costs. If Arnold's rates need to rise above $33.58 per month, the promised rate, to cover its share of costs, Missouri-American's shareholders shall be responsible for those extra costs.

For the other district, assuming there will be no shortfall in sewer revenue after the allocation of corporate expense to small companies is implemented, the rates currently paid by the individual sewer systems shall remain unchanged, as originally proposed by Staff. If there is a revenue shortfall for sewer, it shall be recovered pro rata among all the consolidated sewer systems and their individual rates shall be adjusted as necessary.

This treatment of sewer rates is necessary because no party actually addressed the rebalancing of sewer rates during the hearing, and the Commission does not wish to adjust those rates without more information. In the next rate case, the Commission intends to move the consolidated sewer systems toward a single, balanced rate.

Rate Design & Customer Charge

Background:

After a utility's revenue requirement is determined – in this case by agreement of the parties, approved by the Commission – a determination must be made as to how, and from whom, the utility will be allowed to recover the required revenue. That is the issue of rate design.

Findings of Fact:

1. Only Missouri-American and Staff performed cost of service allocation studies in this case, although experts engaged by other parties examined those studies and suggested revisions to them. Missouri-American's study was presented in the direct testimony of Paul Herbert.[75] Staff's study was presented in its Report on Class Cost of Service and Rate Design.[76]

2. Missouri-American's study allocated costs to serve fourteen different water districts and summed those costs to arrive at a state-wide cost of service.[77] It separately performed a state-wide class cost of service study to allocate costs to four classes of customers. Those classes are:

> Rate A, consisting of residential, commercial, small industrial, and other public authorities customers, Rate B, consisting of sales for resale customers, Rate J, consisting of large users, and Rate F, private fire protection customers. The cost of service associated with public fire protection was identified and reallocated back to the Rate A and Rate J classifications.[78]

Staff used the same four customer classifications in its cost of service study.[79]

3. Both Missouri-American and Staff used the Base-Extra Capacity Method in preparing their studies. That method is outlined in the American Water Works Association manual of water supply practices and is the method generally accepted by the industry. It has been used in past Missouri-American rate cases by both Staff and Missouri-American.[80]

4. In the Base Extra Capacity Method, costs of service are generally classified into the following four primary cost components as described in Staff's testimony:

> Base costs are the costs that vary with the amount of water used and operation under average load conditions. Base costs are allocated to customer classifications according to the amount of water consumed.
>
> Extra capacity costs are the costs associated with meeting the requirements that are in excess of the average load conditions. The extra capacity costs include operation and maintenance expenses and capital costs for system capacity above what is required for the average rate of use.
>
> Customer costs are those costs associated with serving customers, regardless of the amount of water consumed. Those costs include customer accounting and collection expenses, meter-reading, billing, and capital costs related to meters and services.
>
> Fire protection costs are those costs directly assigned to fire protection functions.[81]

5. Staff's study used nineteen factors to allocate the various costs to the customer classes. A description of each of those factors can be found in Staff's Report on Class Cost of Service and Rate Design.[82] Missouri-American used a similar set of factors to allocate those costs.[83]

6. Since Missouri-American and Staff use the same cost allocation method and cost allocation factors, their studies reach the same general results.

Purchased Power Allocation

7. MIEC's witness, Brian Collins, generally agreed with Missouri-American's cost of service study, but he challenged the allocation factor used to allocate Purchased Fuel / Power for Pumping costs for the St. Louis Metro district. The Missouri-American study allocated those costs under Factor 1, which allocates costs based on class annual water volume. Collins argued that such pumping costs vary in part on customer peak demands and should be allocated on that basis,[84] using Factor 3, which is tied to average flow and maximum day demand requirements.[85]

8. Collins' proposed modification would have the primary effect of shifting some costs from Rate J, which is the large user class, to Rate A, which is the residential and commercial class.[86]

9. Collins cites the American Water Works Association's Manual M-1, Principles of Water Rates, Fees and Charges, Sixth Edition, as support for his modification of Missouri-American's cost study.[87] In his reply to Collins, Missouri-American's witness, Paul Herbert, quoted that manual as saying "the demand portion of power costs should be allocated to extra capacity **to the degree that it varies with the demand pumping requirements**." (emphasis added in Herbert's testimony).[88] Herbert analyzed Missouri-American's power bills and concluded that only approximately 4.5 percent of the total purchased power expense can be attributed to extra demand. A reallocation of 4.5 percent of the total purchased power costs would reduce the amount of costs allocated to Rate J by only $24,160, or about 0.35 percent of the total costs allocated to Rate J. That is an insignificant amount.[89]

Declining Block Rates

10. Missouri-American proposes to implement a one-block uniform volumetric rate throughout its water districts for all rate classes.[90] Currently, Missouri-American uses a one-block uniform volumetric rate in its St. Louis Metro district, but uses a declining block volumetric rate structure for non-residential customer rate classifications for other districts, most notably the St. Joseph district. Staff proposes to continue that structure for its proposed districts that do not include the St. Louis Metro area.[91]

11. The Public Water Supply Districts of Andrew County, Nos. 1 and 2 are parties to this case. They appeared and participated at the hearing, but did not present any testimony. Legal Counsel for the Water Supply Districts offered an opening statement at the hearing and filed post-hearing briefs addressing the continuation of declining block rates under which they take service through the St. Joseph district. The Water Supply Districts purchase their entire water supply from Missouri-American and then resell that water to their customers. They currently benefit from declining block rates and ask that they be continued.[92]

12. In a single block rate structure the commodity rate a customer pays remains constant regardless of the amount of water the customer uses. A declining block rate establishes one or more additional rate blocks by which the customer pays less per gallon of water as usage increases. In other words, the additional gallons consumed in the higher usage rate block are cheaper than the first gallons consumed in the lower usage rate block.[93]

13. It is also possible to design volumetric rates using inclining blocks. Under such a structure, customers would pay more for water as they increase their usage. Such a structure would be designed to

encourage water conservation by discouraging discretionary water usage, such as outdoor watering or other summer use.[94]

14. Conservation of water is important for more than just a need to conserve the supply of water. Water and wastewater supply processes are energy intensive. Large amounts of electricity are required to pump water through the pumping stations, treatment facilities and distribution system.[95] Thus, the promotion of water efficiency leads to the promotion of energy efficiency.[96]

15. The establishment of inclining block rates would further promote efficiency, but none of the parties advocated for the establishment of inclining block rates in this case, although the Division of Energy's witness suggested they should be implemented in a future rate case.[97]

16. Inclining block rates are difficult to design in a way that will ensure Missouri-American recovers its approved revenue requirement.[98] The data required to properly design inclining block rates is not available in this case.[99]

Customer Charge

17. A customer charge is the fixed amount a customer is charged on each bill without regard to the amount of water they consume. In contrast, volumetric charges on the customer's bill vary with the amount of water consumed.[100] Missouri-American's revenue requirement has already been determined, and the company will be allowed an opportunity to recover that revenue requirement through a combination of a customer charge and volumetric rates. That means a decrease in the allowed customer charge will necessarily increase the volumetric charge. Of course, that also means an increase in the customer charge will decrease the volumetric charge.[101]

18. Customer charges should be established at a level that will allow the utility to recover "customer-related costs" based on the number of customers served by a utility, not based on the amount of water they consume. In general, customer-related costs would include things like meter-reading, billing, and meter and service line-related costs.[102]

19. In general, utilities prefer to recover as many of their fixed costs as possible through the customer charge, recognizing that not all fixed costs can be described as customer costs.[103] Utilities prefer to recover their fixed costs through fixed customer charges because that rate structure removes the risk that the company will not sell enough volumes of water to cover its fixed costs. The other side of the coin is that consumer groups

and environmental groups prefer to require the utility to recover its costs through volumetric rates. That allows customers more control of their total bill if they can reduce their use of water.[104]

20. If Missouri-American were to attempt to recover all its fixed costs through a customer charge, in other words, through a straight-fixed variable rate structure, its monthly customer charge for a customer with a 5/8 inch meter, which would be a typical residential customer, would need to be approximately $56.[105]

21. Missouri-American did not request a straight-fixed variable rate structure in this case. Instead, it performed a cost study that supported a fixed monthly customer charge of $16.90 for a customer with a 5/8 inch meter.[106] Missouri-American would collect that same customer charge from all customers statewide.[107] Missouri-American currently collects 21.5 percent of its total revenues from its existing customer charge. If its proposed increased customer charge were adopted, it would collect approximately 25 percent of its total revenues from its customer charge.[108]

22. Staff also performed a cost study. However, rather than propose a single-statewide customer charge, Staff recommends that a different customer charge be established in each of the three consolidated district recommended by Staff. Staff would set the customer charge at $16.46 for District 1[109], $14.83 for District 2, and $14.56 for District 3.[110]

23. Both Missouri-American and Staff altered their proposed customer charges during the course of the rate case proceeding. Missouri-American initially proposed a customer charge of $17.40, but reduced that amount to $16.90 when it re-ran its model using the lower revenue requirement agreed to by the parties.[111] Staff initially proposed monthly customer charges of $11.06 for District 1, $10.57 for District 2, and $9.32 for District 3.[112] Staff increased its recommended customer charge for various reasons, including a recognition that the agreed-upon revenue requirement increase was significantly greater than originally modeled by Staff.[113]

24. The most significant cause for the difference between the customer charge recommendations of Staff and Missouri-American results from their differing treatment of public fire protection costs in their cost studies. Staff would have Missouri-American recover those costs through its volumetric rates, while Missouri-American would recover them through the customer charge.[114]

25. Missouri-American contends public fire protection costs are fixed costs that do not vary with water usage, so they must be recovered through customer charges.[115] But the mere fact that such costs are fixed

does not make them customer-related costs that should be recovered through the customer charge. Missouri-American points to nothing about fire protection costs that would make them customer-related. The Commission finds that such costs are not customer-related and, therefore, should be recovered through volumetric rates rather than through the customer charge. As a result, Staff's cost study relating to the customer charge is more reliable, and the customer charge amount advocated by Staff is more appropriate.

26. The other difference between the customer charge recommendations of Missouri-American and Staff is that Missouri-American advocates a single, state-wide customer charge, while Staff would vary that charge between its three proposed districts. The Commission finds that there is little difference between districts in the costs attributed to customer costs. As Mr. Herbert testified for Missouri-American;

> All customers have a similar service line and meter, all have their meter read for billing either monthly or quarterly, all are billed from a centralized billing facility, and all receive customer service from a shared call center."[116]

The Commission agrees that there is no compelling reason to create the additional complication and confusion that would result from having slightly different customer charges in the three districts.

27. Staff did not offer testimony at the hearing about what its recommended customer charge would be if a single charge were calculated to be applied to all districts. However, Staff's witness agreed to make that calculation and to provide that information to the Commission after the hearing.[117] Staff did so in a pleading filed on April 7, reporting that Staff's system-wide customer charge would be $15.33 for a customer with a 5/8 meter.

28. No other party performed a cost study to support a proposed customer charge. However, the Division of Energy offered criticisms of the Missouri-American and Staff studies to advocate for a lower customer charge.[118] Martin Hyman, witness for the Division of Energy, challenged the inclusion of uncollectable account expense for recovery through the customer charge in the cost studies of both Missouri-American and the Staff. He argued that "each customer within a class is not equally responsible for costs associated with uncollectable expenses. Therefore, uncollectable expenses should not be collected on a uniform basis through the customer charge." He further argued that "uncollectable accounts expense generally varies with the level of revenue and should be recovered through variable charges which change with the amount of use." Hyman offered no facts in support of either of those statements.[119]

29. In its initial brief, Public Counsel removed both the public fire protection costs and the uncollectable costs from Missouri-American's calculation of the customer cost and arrived at a customer charge of $13.76, which Public Counsel contends is appropriate.[120]

30. Paul Herbert, witness for Missouri-American, contends that uncollectable accounts do not vary with usage, rather they vary with the number of customers. He also demonstrated that uncollectables are overwhelmingly attributable to the residential class.[121] The Commission finds Mr. Herbert's testimony in this regard to be credible. There is no reason to believe that customers who do not pay their bills use more water than others, or that they fail to pay their bill when they use more water. Rather, a percentage of customers will not pay their bills regardless of how much water they use. Thus, as the total number of customers rises, uncollectables will also rise. That makes it a customer-related cost that is appropriately recovered through the customer charge on an equal basis from all customers, rather than through volumetric charges that would collect more from those customers who consume larger volumes of water.[122]

31. The Joint Position held by the signatories to the objected-to rate design stipulation and agreement advocates for a single statewide customer charge of $14.42 per month for a 5/8 inch meter customer. That is the current St. Louis Metro customer charge.[123]

32. Generally, regulated prices are not set at a utility's marginal cost of providing service, because to do so would deny the utility its ability to recover its prudently incurred sunk costs.[124] No marginal cost study has been performed in this case, and Public Counsel's witness, Dr. Marke, acknowledged that performing a reliable marginal cost study in this case would represent a "herculean" task.[125]

Conclusions of Law:

A. Section 393.130.1, RSMo (Cum. Supp. 2013) requires that all charges made by a water corporation must be "just and reasonable".

Decision:

Purchased Power Allocation

MIEC proposed to modify Missouri-American's class cost of service study to change the allocation factor used to allocate Purchased Fuel / Power for Pumping Costs. If adopted, that proposal would tend to shift some costs from the large user class, Rate J, to the residential and commercial class, Rate A. That shift of costs would have a direct effect only on Missouri-American's class cost of service study. It would not have a direct effect on the rates charged by the company. Missouri-American's witness demonstrated that when properly understood, the proposed change to the allocation factor would have only an insignificant effect on the allocation of costs within the study. The proposed modification is neither necessary nor appropriate and shall not be made.

Declining Block Rates

Missouri-American proposes to use a one-block uniform volumetric rate in all its water districts for all rate classes, thereby eliminating some existing declining block rates for non-residential rate classifications for some of its districts. The Commission believes it is important to encourage the conservation of water, and as a result, conservation of the energy needed to pump and treat that water. Declining block rates discourage conservation of water and are therefore inappropriate. The Commission will adopt Missouri-American's proposal to use a one-block uniform volumetric rate in all its water districts for all rate classes. In the next rate case, the Commission asks the parties to file information on inclining block rates so the Commission can consider the information in setting just and reasonable rates in that case.

Customer Charge

In determining the amount of the customer charge that Missouri-American may recover from its customers, the Commission has attempted to set a charge that will be fair to both the company and its customers. The best way to do that is to look to a cost of service study to determine which of the company's costs can best be identified as customer costs for which the company should be allowed to recover through the customer charge. For the reasons described in the Commission's findings of fact, the cost study prepared by Staff best establishes the cost basis for a reasonable and appropriate customer charge. Although Staff proposed to use that study to establish distinct customer charge amounts for each of its three water districts, the Commission believes that it is more appropriate to establish a single state-wide customer charge for Missouri-American. Therefore, the Commission will order Missouri-American to implement a customer charge in the amount recommended by Staff, modified to establish a single state-wide customer charge.[126]

The Division of Energy and Public Counsel urge the Commission to exercise its discretion to order as low a customer charge as possible. Division of Energy desires a low customer charge with a correspondingly high commodity charge because it believes that will provide customers with more incentive to conserve water. Public Counsel desires a low customer charge because it believes a low charge will benefit lower income customers whom it believes tend to use less water.

The Commission has an obligation to establish just and reasonable rates that are fair to all concerned. It is fair for Missouri-American to be able to recover customer-related costs through a customer charge. Anything else is unfair to not only the company, but also to customers who use higher amounts of water and thus are disadvantaged by the higher volumetric rates that must accompany a lower customer charge. There is no absolute definition of what is, or is not, a customer cost,[127] but Staff's customer cost study has done a good job of identifying those costs and is the appropriate basis for establishing a just and reasonable customer charge.

Low-Income Tariffs

Findings of Fact:

1. Missouri-American proposes to implement a special low-income water rate that would offer eligible low-income customers an 80 percent discount on the customer charge for a residential 5/8 inch meter. Discounting the customer charge would help keep water service affordable to qualified customers, while sending appropriate pricing and demand-side efficiency signals to the customers through the undiscounted volumetric charge.[128] Since the Commission has established a customer charge of $15.33 in this report and order, the program would discount the customer charge for eligible customers by $12.26, leaving a customer charge of $3.07 for eligible customers.

2. Eligibility for the discount would be based on a determination of eligibility for participation in the Missouri Low Income Home Energy Assistance Program (LIHEAP). Eligibility requirements for LIHEAP assistance are based on income, household size, available resources, and responsibility for payment of home heating costs.[129] A customer's eligibility for LIHEAP would be determined by their local Community Action Agency.[130]

3. Missouri-American proposed that the low-income discount program be implemented throughout all its Missouri service area. Based on 2014 poverty figures, it estimated that 57,900 customers would be eligible statewide.[131] The company further estimated that 30 percent of eligible customers would actually participate in the discount program, at an annual cost to the company of $960,000.[132]

4. Because the exact cost of the program cannot be known at this time, Missouri-American proposed that it be allowed to defer the cost of the program as a regulatory asset for possible recovery in its next rate case.[133]

5. Because of the uncertainties associated with the low-income discount program, several parties suggested the program be implemented as an experimental pilot program. Missouri-American's witness suggested that the St. Joseph district be chosen as the site for the pilot program based on the fact that many witnesses at the local public hearing in St. Joseph expressed concerns about the affordability of their water bills.[134]

6. One of the purposes of the pilot program would be to study the impact of the low-income discount on the amount of uncollectable charges (bad debt) experienced by Missouri-American.[135]

7. Implementation of the low-income pilot program in a limited portion of Missouri-American's service territory would better allow for study and comparison of the effects of the program on a range of communities.[136]

8. The exact cost of the low-income pilot program cannot be known in advance. But limiting the program to a smaller population will significantly reduce the cost from that estimated by Missouri-American for a program applicable to all its customers. **Conclusions of Law:**

A. Section 393.130, RSMo (Cum. Supp. 2013), establishes the requirements for the provision of service by regulated utilities. In general, it requires that all charges for utility service must be "just and reasonable" and not more than allowed by law or order of this Commission. Subsection 2 of that statute further states:

> No … water corporation or sewer corporation … shall directly or indirectly by any special rate, rebate, drawback or other device or method, charge, demand collect or receive from any person or corporation a greater or less compensation for … water, sewer [service] …, except as authorized in this chapter, than it charges, demands, collects or receives from any other person or corporation for doing a like and contemporaneous service with respect thereto under the same or substantially similar circumstances or conditions.

Subsection 3 adds:

> No … water corporation or sewer corporation shall make or grant any undue or unreasonable preference or advantage to any person, corporation or locality, or to any particular description of service in any respect whatsoever, or subject any particular person, corporation or locality or any particular description of service to any undue or unreasonable prejudice or disadvantage in any respect whatsoever.

In sum, the statute says that utilities cannot give any "undue or unreasonable" preference to any particular customer, or class of customers.

B. Note that the statute does not prohibit any such preference, only preferences that are "undue or unreasonable". The parties have not identified, and the Commission has not found, any court decisions that have directly addressed the question of whether a low-income rate would be an "undue or unreasonable" preference.

C. The parties suggest the Commission adopt the low-income rate proposed by Missouri-American as a limited, experimental rate. The Missouri Supreme Court has long held that the Commission has the authority to grant interim test or experimental rates as a matter of necessary implication from practical necessity.[137] By experimenting with this low-income rate, the Commission will be better able to evaluate the reasonableness of the rate and any preference in Missouri-American's next rate case.

Decision:

The Commission will authorize Missouri-American to implement a residential low-income program providing eligible low-income customers with an 80 per cent discount on the customer charge for a residential 5/8-inch meter. This will be an experimental pilot program that shall end on the effective date of new rates to be established in Missouri-American's next general rate proceeding. An experimental pilot program will allow the parties and the Commission to evaluate the effectiveness of such a program as well as the administrative requirements, delivery systems, marketing and participation rates involved in such a program. The program will be reviewed in Missouri-American's next rate case.

The Commission will not identify a specific city or area in which the low-income pilot program should be implemented. Instead, the Commission will direct Missouri-American to work with Staff, Public Counsel, and any other interested stakeholders to identify a city, district, or other portion of its water service territory that will be most suitable for implementation of the pilot program. In making that choice, Missouri-American and the other stakeholders should consider the relative poverty of the customers and the existing level of bad debt within the chosen area. While the Commission is establishing the broad parameters of the program in this order, Missouri-American and the interested stakeholders may craft the details of the program as they see fit.

Missouri-American customers in the chosen area may establish eligibility by contacting their local community action agency and establishing that they would qualify for the Missouri Low Income Home Energy Assistance Program (LIHEAP), whether or not they actually participate in LIHEAP. Customers shall reestablish eligibility on an annual basis.

Missouri-American is authorized to record on its books a regulatory asset that represents the actual discounts provided to those customers participating in the Low-Income Program, along with any third-party administrative costs. Missouri-American shall maintain this regulatory asset on its books until the effective date of rates resulting from Missouri-American's next general rate proceeding. The amortization period for the deferred regulatory asset associated with the Low Income Program shall be determined in the next Missouri-American general rate proceeding.

Missouri-American shall file a tariff consistent with this order no later than 120 days after the effective date of this order.

Union Issues

Background

The parties identified three issues raised by Missouri-American's union. The parties agreed among themselves that the Union issues would be presented to the Commission based on prefiled testimony and written briefs. Those issues follow

1. Should the Commission condition any rate increase upon Missouri-American filling unfilled bargaining unit positions?

2. Should the Commission order semi-annual reporting of various items as urged by the Unions? and

3. Should the Commission order Missouri-American to comply with and implement American Water Works' valve maintenance program?

The Commission will take up all three issues together.[138]

Findings of Fact

1. Utility Workers Union of America, Local 335 is the union representing approximately 355 members who work for Missouri-American.[139]

2. The vice-president of the union local, Alan Ratermann, offered pre-filed testimony on behalf of the union. He expressed concern that Missouri-American is not hiring enough bargaining-unit employees to fill vacant positions with the company. As of October 31, 2015, Missouri-American employs 68 fewer bargaining-unit employees than it did on December 31, 2010.[140] Ratermann is concerned that the reduced employment levels could affect Missouri-American's ability to offer safe and adequate service, but he offered no specific facts to support a conclusion that the company has failed to offer safe and adequate service.[141]

3. Missouri-American fills positions as business needs dictate. It may reduce its workforce when it finds a more efficient way to perform operations, such as by replacing obsolete equipment and automating processes.[142] The Commission finds that Missouri-American employs a suitable workforce sufficient to provide safe and adequate service.

4. The union also expressed concern that Missouri-American is failing to properly maintain the many valves present in its water distribution system. It believes Missouri-American should undertake a valve exercising program, through which valves are opened and closed periodically to ensure they are capable of operating properly.[143]

5. The union points out that Missouri-American's corporate parent, American Water Company, has developed a valve inspection and maintenance practice for its subsidiaries, and contends Missouri-American

should be ordered to comply with those practices,[144] including a requirement to hire additional employees to engage in the valve maintenance program.[145]

6. Finally, the union contends the Commission should require Missouri-American to file detailed semi-annual reports about its valve inspection and maintenance practices.[146]

7. American Water Company does not require Missouri-American to follow its recommended valve exercising practice. Rather, Missouri-American is free to adopt all or part of that practice to meet its needs.[147]

8. Missouri-American exercises its valves and performs required repair and maintenance as it operates, maintains, and repairs the rest of its water distribution system. It assigns valve maintenance work as fill-in work for crews when main breaks are at a low level.[148]

9. Establishment of a required valve maintenance program and the imposition of reporting requirements about such a program would increase costs for Missouri-American.[149] Such costs would ultimately be recovered from ratepayers.

Conclusions of Law

A. Section 393.130.1, RSMo (Cum. Supp. 2013), requires every water and sewer corporation, including Missouri-American, to "furnish and provide such service instrumentalities and facilities as shall be safe and adequate and in all respects just and reasonable."

B. Section 393.140(1), RSMo 2000 gives this Commission general supervisory authority over all water and sewer corporations, again including Missouri-American. Subsection (2) of that statute authorizes the Commission to examine or investigate the operations of such utilities and to:

> order such reasonable improvements as will promote the public interest, preserve the public health and protect those using such … water or sewer system …., and those employed in the manufacture and distribution thereof, and have power to order reasonable improvements and extensions of the works, wires, poles, pipes, lines, conduits, ducts and other reasonable devices, apparatus and property of … water corporations and sewer corporations.

Based on the authority given by that statute, the Commission may exercise a great deal of control over Missouri-American's operations.

C. But, while the Commission has authority to regulate Missouri-American to ensure it provides safe and adequate service, the Commission does not have authority to manage the company. The Missouri Court of Appeals has explained:

> The utility's ownership of its business and property includes the right of control and management, subject, necessarily to state regulation through the Public Service Commission. The powers of regulation delegated to the Commission are comprehensive and extend to every conceivable source of corporate malfeasance. Those powers do not, however, clothe the Commission with the

general power of management incident to ownership. The utility retains the lawful right to manage its own affairs and conduct its business as it may chose, as long as it performs its legal duty, complies with lawful regulation and does no harm to public welfare.[150]

Therefore, except as necessary to ensure the provision of safe and adequate service, the Commission does not have the authority to dictate to the company how many employees it must hire to perform the work of the company.

D. Section 393.140, RSMo 2000, gives the Commission authority to inspect and investigate water and sewer systems and to examine the records and books of water and sewer corporations, including Missouri-American.

Decision:

The evidence presented by the Union does not demonstrate that Missouri-American has failed to provide safe and adequate service. Therefore, the Commission will not dictate to the company how many new employees it must hire. Furthermore, there is no demonstrated need for the Commission to direct Missouri-American to undertake any particular valve maintenance program at this time. To do so would be an unwarranted intrusion on the management of the company.

The Commission further concludes there is no need to impose a new reporting requirement on Missouri-American as Staff can already obtain whatever information it needs from the company. Further, additional reporting requirements would ultimately increase costs for Missouri-American's ratepayers.

Quality of Water in Platte County

Findings of Fact:

1. Customers in some subdivisions in Platte County have experienced problems with the quality of their water. At the Local Public Hearing held in Riverside on February 1, 2016, several customers testified about excessive amounts of scale buildup in their pipes and appliances resulting from the water delivered to their homes by Missouri-American.[151]

2. During cross-examination, Missouri-American's President, Cheryl Norton, explained that Missouri-American must soften the water that comes from its treatment facility in Platte County so that calcium introduced in the softening process will inhibit corrosion in pipes and prevent lead from leaching into drinking water. Unfortunately, in certain homes, calcium intermittently settles out in large amounts.[152] The large amounts of calcium damage the customers' pipes and appliances.[153] The calcium issue does not affect the safety of the drinking water.[154]

3. The problem has been going on for several years. Missouri-American has not yet been able identify its cause,[155] but believes the introduction of carbon dioxide into the system will reduce the amount of scale that is forming in the customers' houses.[156]

4. Missouri-American indicates it is working with customers to assess the damages that have resulted from the water quality problems.[157]

Conclusions of Law:

A. Section 393.130.1, RSMo (Cum. Supp. 2013) requires Missouri-American to provide safe and adequate water to its customers.

B. Section 393.140(2), RSMo 2000 gives the Commission authority to investigate the quality of the water supplied by Missouri-American.

C. Section 386.230, RSMo 2000 gives the Commission authority to act as an arbitrator in any controversy between a public utility and another party. However, such arbitration is voluntary and all parties to the controversy must agree in writing to the arbitration.

D. The Missouri Supreme Court has held:

> [t]he Public Service Commission is an administrative body only, and not a court, and hence the commission has no power to exercise or perform a judicial function, or to promulgate an order requiring a pecuniary reparation or refund. The commission has no power to declare or enforce any principle of law or equity and as a result it cannot determine damages or award pecuniary relief.[158]

Decision:

The Commission is concerned about the quality of the water Missouri-American delivers to some of its customers in Platte County. In its reply brief, the City of Riverside asks the Commission to order Missouri-American to agree to:

1) Enter into arbitration proceedings pursuant to Section 386.230, RSMo;

2) Establish a new case for each and every customer who has suffered damages as a result of this problem so that the customers can bring evidence of their damages before the Commission and the Commission can award adequate compensation to the customers; or

3) Reduce rates to the level established in the tariff of 2008, when this problem was first reported to Missouri-American, until all customers who have suffered damages are compensated and the quality of water is restored.

The Commission has no authority to force Missouri-American into an arbitration proceeding and it has no authority to determine or award damages to Missouri-American's customers. As a result, it cannot take the steps requested by the City of Riverside. However, the Commission will direct Missouri-American to prepare a report describing the resolution of the problems experienced by its customers in Platte County. Missouri-American shall file that report in this case no later than 90 days after the effective date of this Report and Order.

THE COMMISSION ORDERS THAT:

1. The tariff sheets filed by Missouri-American Water Company on July 31, 2015, and assigned tariff numbers YW-2016-0026, YW-2016-0027, YW-2016-0028, YW-2016-0029, YW-2016-0030, YW-2016-0033, YS-2016-0031, YS-2016-0032, YS-2016-0034, YS-2016-0035, YS-2016-0036, YS-2016-0037, YS-2016-0038, YS-2016-0039, and YS-2016-0040, are rejected.

2. Missouri-American Water Company is authorized to file tariffs sufficient to recover revenues as determined by the Commission and to otherwise comply with this order.

3. Missouri-American Water Company shall file a five-year capital expenditure plan with the Commission for review by January 31 of each year after the effective date of rates in this case. The required annual plans shall be filed in this case file until Missouri-American files its next general rate case, at which time they shall be filed in that new case file.

4. Missouri-American Water Company shall file the information required by Section 393.275.1, RSMo 2000, and Commission Rule 4 CSR 240-10.060 no later than July 6, 2016.

5. This report and order shall become effective on June 25, 2016.

BY THE COMMISSION

Morris L. Woodruff
Secretary

Hall, Chm., Stoll, Kenney, Rupp, and Coleman, CC., concur;
and certify compliance with the provisions of Section 536.080, RSMo.

Dated at Jefferson City, Missouri,
on this 26th day of May, 2016.

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[1] Missouri-American's annual revenue increase was subsequently reduced to $30.413 million by agreement of the parties as ordered by the Commission on May 11, 2016.

[2] Cassidy Surrebuttal, Ex. Staff-16, Page 2, Lines 16-37.

[3] Cassidy Surrebuttal, Ex. Staff-16, Page 3, Lines 1-16.

[4] Marke Direct, Ex. OPC-9, Page 9, Lines 1-8.

[5] Busch Direct, Ex. Staff-9, Page 9, Lines 9-10.

[6] Busch Direct, Ex. Staff-9, Page 4, Lines 2-4.

[7] Busch Direct, Ex. Staff-9, Page 4, Lines 8-12.

[8] Busch Direct, Ex. Staff-9, Page 4, Lines 16-22.

[9] Busch Direct, Ex. Staff-9, Page 5, Lines 15-21.

[10] Busch Direct, Ex. Staff-9, Page 6, Lines 5-7.

[11] *In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increases*, File No. WR-2000-281 Report and Order, 9 Mo. P.S.C. 3d 254, 291 (2000).

[12] Busch Direct, Ex. Staff-9, Page 6, Lines 8-18.

[13] Herbert Rebuttal, Ex. MAWC-9, Pages 2-3, Lines 26, 1-3, and Schedule PRH-6.

[14] Busch Direct, Ex. Staff-9, Page 9, Lines 7-14.

[15] Busch Rebuttal, Ex. Staff-11, Pages 3-4, Lines 20-23, 1-3.

[16] Busch Rebuttal, Ex. Staff-11, Pages 4-5, Lines 22-23, 1-3.

[17] Busch Direct, Ex. Staff-9, Page 10, Lines 1-19.

[18] Busch Surrebuttal, Ex. Staff-12, Pages 9-10, Lines 20-23, 1-3.

[19] Herbert Rebuttal, Ex. MAWC-9, Page 3, Lines 11-15.

[20] Commission Rule 4 CSR 240-2.115(2)(D).

[21] Smith Direct, Ex. OPC-15, Page 14, Line 1.

[22] Non-Unanimous Stipulation and Agreement on Rate Design, District Consolidation and Sewer Revenue.

[23] This consolidation plan was proposed by the City of Riverside. *See,* Transcript, Pages 110-111, Lines 21-25, 1-4. Missouri-American subsequently presented calculations about the effect such consolidation would have on customer rates at Transcript, Page 356, Lines 14-23 and Ex. MAWC-51.

[24] Missouri-American calculated the rate impact of that option in Ex. MAWC-53.

[25] Dunn Direct, Ex. MAWC-4, Pages 23-26.

[26] Marke Direct, Ex. OPC-9, Page 6, Lines 1-7.

[27] Transcript, Page 676, Lines 3-14.

[28] Herbert Rebuttal, Ex. MAWC-9, Schedule PRH-6.

[29] Busch Surrebuttal, Ex. Staff-12, Page 9, Lines 8-19.

[30] McDermott Direct, Ex. MAWC-12, Pages 6-7, Lines 16-19, 1-9.

[31] Cassidy Surrebuttal, Ex. Staff-16, Page 2, Lines 17-37.

[32] McDermott Direct, Ex MAWC-12, Pages 7-8, Lines 17, 1-3.

[33] Busch Surrebuttal, Ex. Staff-12, Page 1, Lines 16-18.

[34] Busch Surrebuttal, Ex. Staff-12, Page 13, Lines 1-17.

[35] Busch Surrebuttal, Ex. Staff-12, Page 13, Lines 20-23.

[36] Busch Surrebuttal, Ex. Staff-12, Page 14, Lines 4-11.

[37] Transcript, Page 418, Lines 23-25.

[38] McDermott Direct, Ex. MAWC-12, Pages 12-13, Lines 23, 1-5.

[39] Busch Surrebuttal, Ex. Staff-12, Pages 10-11, Lines 19-23, 1-6.

[40] Busch Rebuttal, Ex. Staff-11, Page 8, Lines 5-14.

[41] Marke Direct, Ex. OPC-9, Page 22, Lines 1-15. See also, Busch Rebuttal, Ex. Staff-11, Pages 8-9, Lines 18-23, 1-4.

[42] Busch Rebuttal, Ex. Staff-11, Page 11, Lines 3-10.

[43] Collins Direct, Ex. MIEC-5, Page 6, Lines 15-21.

[44] Busch Rebuttal, Ex. Staff-11, Page 11, Lines 11-23.

[45] McDermott Direct, Ex. MAWC-12, Page16, Lines 10-17.

[46] Busch Direct, Ex. Staff-9, Page 8, Lines 1-9. *See also*, Busch Surrebuttal, Ex. Staff-12, Page 15. Lines 5-15.

[47] Transcript, Pages 672-673, Lines 20-25, 1-20.

[48] Haase Rebuttal, Ex. Jop-1, Page 2, Lines 15-18.

[49] Transcript, Page 425, Lines 2-14.

[50] Busch Direct, Ex. Staff-9, Page 9, Lines 15-20.

[51] Busch Direct, Ex. Staff-9, Pages 10-11, Lines 22-23, 1-2.

[52] Herbert Direct, Ex. MAWC-7, Page 21, Lines 7-9.

[53] Cassidy Surrebuttal, Ex. Staff-16, Page 3, Lines 1-17.

[54] Ex. Staff-32.

[55] Busch Direct, Ex. Staff-9, Pages 11-12, Lines 20-23, 1-5.

[56] Busch Direct, Ex. Staff-9, Page 11, Lines 15-16.

[57] Tinsley Direct, Ex. MAWC-35, Page 14, Lines 16-24.

[58] Tinsley Rebuttal, Ex. MAWC-36, Page 27, Lines 16-19.

[59] Bolin Rebuttal, Ex. Staff-7, Page 3, Lines 13-20.

[60] Ex. MAWC-52. The amount of the shortfall will be changed to some extent by the revised stipulated revenue requirement increase of $30.413 million. *See* footnote 1.

[61] Transcript, Page 453, Lines 17-20.

[62] Transcript, Pages 454-455, Lines 10-25, 1-13.

[63] Transcript, Page 457, Lines 6-20.

[64] Transcript, Pages 457-458, Lines 24-25, 1-19.

[65] 34 S.W.2d 37 (Mo. 1931)

[66] *Laundry*, at 46.

[67] 567 S.W.2d 450 (Mo. App. St. L. 1978).

[68] *Cape Girardeau,* at 453.

[69] *Cape Girardeau*, at 453.

[70] 310 S.W.2d 925 (Mo. banc 1958).

[71] *West Plains*, at 933.

[72] Section 393.130.1, RSMo (Cum. Supp. 2013).

[73] 186 S.W.3d 290 (Mo. App. W.D. 2005)

[74] Section 393.320.1(1), RSMo (Cum. Supp. 2013).

[75] Ex. MAWC-7.

[76] Ex. Staff-3.

[77] Herbert Direct, Ex. MAWC-7, Page 4, Lines 6-16.

[78] Herbert Direct, Ex. MAWC-7, Page 4, Lines 17-22.

[79] Staff Report on Class Cost of Service and Rate Design, Ex. Staff-3, Page 2.

[80] Staff Report on Class Cost of Service and Rate Design, Ex. Staff-3, Page 2.

[81] Staff Report on Class Cost of Service and Rate Design, Ex. Staff-3, Page 2.

[82] Ex. Staff-3, Pages 3-5.

[83] Herbert Direct, Ex. MAWC-7, Schedule C.

[84] Collins Direct, Ex. MIEC-5, Pages 9-10, Lines 14-22,1-2.

[85] Collins Direct, Ex. MIEC-5, Page 10, Lines 10-17.

[86] Collins Direct, Ex. MIEC-5, Page 11, Lines 8-18. *See also*, Smith Rebuttal, Ex. OPC-16, Pages 5-6, Lines 17-21, 1-6.

[87] Collins Direct, Ex. MIEC-5, Page 10, Lines 3-9. The manual cited by Collins is not in the record.

[88] Herbert Rebuttal, Ex. MAWC-9, Page 8, Lines 4-6.

[89] Herbert Rebuttal, Ex. MAWC-9, Pages 7-8, Lines 4-27, 1-15.

[90] Herbert Direct, Ex. MAWC-7, Page 14, Lines 12-17.

[91] Report on Class Cost of Service and Rate Design, Ex. Staff-3, Page 6.

[92] The Public Water Districts' opening statements on this issue can be found at Transcript Pages 312-320 and Page 564. The statements of counsel and briefs are not evidence and are cited only to provide background information on this issue.

[93] Report on Class Cost of Service and Rate Design, Ex. Staff-3, Page 6.

[94] Herbert Supplemental, Ex. MAWC-8, Page 5, Lines 9-16.

[95] Epperson Direct, Ex. DE-1, Pages 3-4, Lines 14-21, 1-18.

[96] Hyman Direct, Ex. DE-4, Page 3, Lines 2-3.

[97] Hyman Direct, Ex. DE-4, Page 6, Lines 13-19.

[98] Transcript, Pages 788-789, Lines 13-25, 1-5.

[99] Transcript, Page 819, Lines 13-25.

[100] Herbert Supplemental, Ex. MAWC-8, Page 2, Lines 10-13.

[101] Herbert Supplemental, Ex. MAWC-8, Page 4, Lines 19-21.

[102] Hyman Direct Ex. DE-4, Page 4, Lines 1-14.

[103] Transcript, Page 613, Lines 3-19.

[104] Transcript, Page 782, Lines 12-18.

[105] Herbert Direct, Ex. MAWC-7, Page 20, Lines 14-19.

[106] The amount of the customer charge would increase proportionately as customer meter sizes increase.

[107] Transcript, Page 625, Lines 1-4.

[108] Transcript, Page 395, Lines 13-23.

[109] Staff's proposed District 1 includes the current St. Louis Metropolitan district.

[110] Transcript, Page 796, Lines 1-4.

[111] Transcript, Pages 624-625, Lines 25, 1-11.

[112] Report on Class Cost of Service and Rate Design, Ex. Staff-3, Schedules 2-1, 2-2 and 2-3.

[113] Transcript, Page 795, Lines 4-25.

[114] Transcript, Page 796, Lines 10-25.

[115] Herbert Rebuttal, Ex. MAWC-9, Page 4, Lines 30-39.

[116] Herbert Rebuttal, Ex. MAWC-9, Page 5, Lines 16-19.

[117] Transcript, Pages 815-817, Lines 20-25, 1-25, and 1-8.

[118] Transcript, Pages 770-771, Lines 22-25, 1-12.

[119] Hyman Direct, Ex. DE-4, Page 13, Lines 7-13.

[120] Public Counsel's Initial Brief, Page 11.

[121] Herbert Rebuttal, Ex. MAWC-9, Page 9, Lines 4-25.

[122] Transcript, Page 579, Lines 1-11.

[123] Non-Unanimous Stipulation and Agreement on Rate Design, District Consolidation and Sewer Review, Page 1.

[124] McDermott Rebuttal, Ex. MAWC-13, Page 11, Lines 22-26.

[125] Marke Surrebuttal, Ex. OPC-12, Page 4, Lines 19-20.

[126] As previously indicated, Staff represented that amount to be $15.33 per month for customers with a 5/8 meter. Customer charges for customers with larger sized meters shall be established in the same manner based on Staff's customer cost study.

[127] Public Counsel and Division of Energy have edged toward defining customer costs as the incremental cost of adding one more customer to the company's system. Incremental or marginal cost is not an appropriate definition of customer cost because a calculation of incremental or marginal costs, even if possible, would not allow the company to recover its sunk costs for things like meters and service lines, which all parties seemingly agree are a part of customer costs.

[128] Tinsley Surrebuttal, Ex. MAWC-37, Page 5, Lines 5-13.

[129] Tinsley Surrebuttal, Ex. MAWC-37, Page 5, Lines 15-23.

[130] Transcript, Page 841, Lines 4-12.

[131] Transcript, Page 841, Lines 16-21.

[132] Transcript, Page 842, Lines 18-25.

[133] Transcript, Page 846, Lines 1-5.

[134] Transcript, Page 851, Lines 2-4.

[135] Transcript, Pages 849-850, Lines 21-25, 1-16.

[136] Transcript, Page 865, Lines 15-18.

[137] *State ex rel. Laclede Gas Co. v. Pub. Serv. Comm'n*, 535 S.W.2d 561, 567, n 1 (Mo. App. 1976).

[138] No testimony regarding the Union issues was presented at the hearing and the parties are deemed to have waived cross-examination of the witnesses who offered that pre-filed testimony.

[139] Ratermann Direct, Ex. Union-1, Page 2, Lines 3-4.

[140] Ratermann Direct, Ex. Union-1, Page 2, Lines 14-16.

[141] Ratermann Direct, Ex. Union-1, Page 3, Lines 9-20.

[142] Wood Rebuttal, Ex. MAWC-41, Page 10, Lines 12-19.

[143] Ratermann, Direct, Ex. Union-1, Page 5, Lines 16-22.

[144] Ratermann, Direct, Ex. Union-1, Pages 6-7, Lines 7-23, 1-4.

[145] Ratermann Direct, Ex. Union-1, Page 8, Lines 17-19.

[146] Ratermann Direct, Ex. Union-1, Page 8, Lines 9-17.

[147] Wood Rebuttal, Ex. MAWC-41, Page 11, Lines 18-24.

[148] Wood Rebuttal, Ex. MAWC-41, Page 12, Lines 2-14.

[149] Wood Rebuttal, Ex. MAWC-41, Pages 12-13, Lines 18-24, 1-5.

[150] *State ex rel. Harline v. Pub. Serv. Comm'n*, 343 S.W.2d 177, 181-182 (Mo.App. W.D. 1960), citing *State ex rel. City of St. Joseph v. Pub. Serv. Comm'n,* 30 S.W.2d 8, (Mo. banc 1930).

[151] Transcript, Public Hearing, February 1, 2016, Riverside, Missouri.

[152] Transcript, Page 121, Lines 3-22.

[153] Transcript, Page 122, Lines 16-23.

[154] Dunn Surrebuttal, Ex. MAWC-6, Page 14, Lines 1-5.

[155] Transcript, Page 122, Lines 6-15.

[156] Dunn Surrebuttal, Ex. MAWC-6, Page 13, Lines 6-22.

[157] Transcript, Page 125, Lines 8-17.

[158] *Straube v. Bowling Green Gas Co.*, 227 S.W.2d 666, 668-669 (Mo. 1950) (citations omitted).

May 26, 2015

In the matter of the application of Maryland-American Water Company for authority to adjust its existing schedule of tariffs and rates	* * *	Case No. 9372

To All Parties of Record:

The Proposed Order of Public Utility Law Judge filed in the above-entitled matter on May 7, 2015, was not appealed by any party, nor has the Commission modified or reversed the Proposed Order or initiated further proceedings into this matter. Therefore, on May 22, 2015 the Proposed Order became a final order of the Commission, and today it was assigned Order No. 86997.

Very truly yours,

Kathleen Berends
Administrator

lw

ORDER NO. 86997

IN THE MATTER OF THE APPLICATION OF MARYLAND-AMERICAN WATER COMPANY FOR AUTHORITY TO ADJUST ITS EXISTING SCHEDULE OF TARIFFS AND RATES	* * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND
		CASE NO. 9372

Issued: May 7, 2015

PROPOSED ORDER OF PUBLIC UTILITY LAW JUDGE

Appearances:

H. Russell Frisby, Jr., for Maryland-American Water Company.

Annette B. Garofalo and Lloyd J. Spivak, for the Staff of the Public Service Commission of Maryland.

Theresa V. Czarski, for the Office of People's Counsel.

I. PROCEDURAL HISTORY

On December 19, 2014, Maryland-American Water Company ("MAW" or "the Company") filed an application for an increase in rates and tariffs for water service in Bel Air and its environs in Harford County, Maryland ("Application"). MAW's Application and its accompanying testimony and exhibits requested authority to increase rates and charges to produce an increase of $812,665, or 19.8%, in its operating revenues. The Company's request was based upon the erosion of revenues due to declining consumption, increased operating expenses, tank painting costs, purchased water, waste disposal expenses, and the continuing need to invest in infrastructure.

MAW based its request on a 12-month test period ending September 30, 2014. As of that date, the Company served approximately 4,971 customers in the Town of Bel Air ("the Town") and Harford County. The Company asserted that its earned return on pro forma rate base was 4.78%.[1] The proposed effective date for the increase was January 18, 2015. The Company's Application included the direct testimonies of William R. Walsh, MAW's President;[2] Rod P. Nevirauskas, Director of Rates and Regulation;[3] Gary L. Akmentins, Manager of Rates and Regulation;[4] and Paul R. Moul, Managing Consultant with P. Moul & Associates,[5] as well as several exhibits supporting MAW's filing.[6]

On December 22, 2014, the Public Service Commission of Maryland ("the Commission") suspended the proposed rates for 150 days from the effective date of January 18, 2015, or until June 17, 2015, and delegated this matter to the Public Utility Law Judge Division. On January 28, 2015, a pre-hearing conference was held and a procedural schedule was agreed upon and subsequently issued.[7]

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[1] MAW's last rate case was Case No. 9187, filed on April 30, 2009, and resulted in a settlement that authorized the Company to increase its annual revenues by $615,000 and set a 10.75% return on equity. *Re Maryland-American Water Co.*, 100 Md. P.S.C. 291, 294-295 (2009).

[2] MAW Ex. 2 – Direct Testimony of William R. Walsh.

[3] MAW Ex. 3 – Direct Testimony of Rod P. Nevirauskas.

[4] MAW Ex. 4 – Direct Testimony of Gary L. Akmentins.

[5] MAW Ex. 5 – Direct Testimony of Paul R. Moul.

[6] MAW Ex. 6 – Rate Study Based on Twelve Months Ended September 30, 2014, which consisted of six exhibits with numerous schedules.

[7] A revised procedural schedule was issued to correct the filing date for Staff's and Intervenors' direct/reply testimony.

On March 6, 2015, the Commission's Technical Staff ("Staff") filed the testimony of Zenon Sushko,[8] Yulia Poberesky,[9] Tanu Jeffrey Pongsiri,[10] and, Jason A. Cross;[11] and the Office of People's Counsel ("OPC") filed the testimony of Michael J. Majoros,[12] James S. Garren, Jr.,[13] and Mitchell A. Semanik.[14]

On March 20, 2015, the Company filed the rebuttal testimony of Messrs. Nevirauskas,[15] Akmentins,[16] and Moul.[17] OPC filed the reply testimony of Mr. Majoros.[18]

On March 23, 2015, an evening hearing for public comment was held in Bel Air, Maryland.

On April 1, 2015, Staff filed the surrebuttal testimony of Ms. Poberesky[19] and Mr. Pongsiri.[20]

On April 3, 2015, pursuant to the parties' request, the procedural schedule was suspended to provide the additional time to formalize a settlement agreement and file testimony in support of

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[8] Staff Ex. 1 – Direct Testimony and Exhibits of Zenon Sushko.

[9] Staff Ex. 2 – Direct Testimony and Exhibits of Yulia Poberesky.

[10] Staff Ex. 3 – Direct Testimony of Tanu Jeffrey Pongsiri.

[11] Staff Ex. 4 – Direct Testimony and Exhibits of Jason A. Cross.

[12] OPC Ex. 1 – Public Direct Testimony of Michael J. Majoros, Jr. Mr. Majoros' Confidential Direct Testimony was admitted as OPC Ex. 1C.

[13] OPC Ex. 2 – Direct Testimony of James S. Garren.

[14] OPC Ex. 3 – Direct Testimony of Mitchell A. Semanik.

[15] MAW Ex. 7 – Rebuttal Testimony of Rod P. Nevirauskas.

[16] MAW Ex. 8 – Rebuttal Testimony of Gary L. Akmentins.

[17] MAW Ex. 9 – Rebuttal Testimony of Paul R. Moul. An errata to Mr. Moul's Rebuttal Testimony, consisting of an omitted exhibit, was admitted as MAW Ex. 10.

[18] OPC Ex. 4 – Reply Testimony of Michael J. Majoros, Jr.

[19] Staff Ex. 5 – Surrebuttal Testimony and Exhibits of Yulia Poberesky.

[20] Staff Ex. 6 – Surrebuttal Testimony and Exhibits of Tanu Jeffrey Pongsiri.

the settlement. An evidentiary hearing was scheduled for April 22, 2015.

On April 17, 2015, on behalf of the parties, Staff filed an Agreement of Stipulation and Settlement ("the Settlement").[21] Additionally, Staff filed the Settlement Testimony of Yulia Poberesky regarding the reasonableness of the Settlement.[22]

On April 22, 2015, an evidentiary hearing was held to enter the parties' pre-filed testimony and the Settlement into the administrative record. Staff witness Cross appeared at the hearing and responded to my questions regarding the proposed tariff and rates resulting from the Settlement.

On April 30, 2015, Staff filed an exhibit that contained the revised bill impacts of the proposed Settlement.[23]

II. SUMMARY OF PUBLIC COMMENTS

Only one member from the public spoke at the evening hearing. The individual was the Director of Public Works for Harford County and requested that Harford County ("the County") be charged the same rates with respect to fire hydrants as the Company charges the Town. He noted that the Town has 302 fire hydrants on

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[21] Joint Ex. 1 – Agreement of Stipulation and Settlement. This document is attached as Appendix A and incorporated herein by reference.

[22] Staff Ex. 7 – Settlement Testimony of Yulia Poberesky.

[23] Staff Ex. 8 – revised bill impacts for the Settlement. (The document is labeled as Staff Ex. 11 on the cover page and in the header.) Given that this is a unanimous settlement and no party expressed concern about the document, I determined that there would be no objection to its entry into the record. Therefore, Staff Ex. 8 was admitted post-hearing.

MAW's system and it is charged $208.00 per hydrant for the first 53 hydrants and $109.00 for the remaining hydrants. However, the County has 162 hydrants on the Company's system and is charged $219.00 per hydrant for all 162.

III. PROPOSED BASE RATES AND TERMS OF THE SETTLEMENT

The Settlement authorized an increase of $490,000 (11.91%) in MAW's annual revenues effective for service on and after June 19, 2015.[24] The Settlement also contained the schedules and proposed rates based on the increased revenues, and the parties agreed that the rates are based upon the Company's present rate usage level.[25]

Additionally, the parties agreed that in the Company's next base rate case, MAW is required to submit both a depreciation study and a cost of service study ("COSS").[26] The Settlement also reduced the fire hydrant rates for Harford County, Maryland to the rates paid by the Town, and set the Company's return on equity ("ROE") at 10.00%.[27]

Revised tariff pages were also included in the Settlement consisting of both the proposed rates and several tariff changes. Specifically, the proposed tariff included a reconnection

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[24] Joint Ex. 1, para. 8.

[25] *Id.* at para. 12.

[26] *Id.* at paras. 9-10.

[27] *Id.* at paras. 11 and 13.

charge that would increase from $15.00 to $25.00, the New Service Activation Fee would be $25.00, a returned check charge of $15.00 for each occurrence, and new rules for cross-connections.[28]

Finally, the Settlement included the standard language contained in many settlements, such as the agreement being conditioned upon the Commission's acceptance without making any changes, that it represents a full settlement and compromise of the Company's Application, that the parties are not precluded from taking different positions in future proceedings, that the parties can withdraw from the Settlement in the event it is altered by the Commission, and that the parties have waived their rights to both rehearing and appeal.[29]

IV. TESTIMONY IN SUPPORT OF THE SETTLEMENT

Ms. Poberesky provided testimony in support of the reasonableness of the Settlement. She gave a summary of the parties' positions based upon the pre-filed testimony as to the appropriate revenue requirement and ROE for MAW.[30]

[28] *Id.* at Revised Tariff Page No. 2.

[29] *Id.* at paras. 1-7.

[30] Staff Ex. 7, at 1-2.

Parties' Positions

Party	**Proposed Revenue Increase**	**Percentage Increase In Rates**	**Proposed ROE**	**Proposed Overall Rate Of Return**
MAW	$780,627[31]	18.98%	11.00%	8.77%
OPC	$0.00[32]	0.0%	8.50%	7.56%
Staff	$603,584	14.50%[33]	10.25%	8.41%
Proposed Settlement[34]	$490,000	11.91%	10.00%	8.29%[35]

Ms. Poberesky noted that the Settlement contained no discussion of specific accounting adjustments.[36] She testified regarding the requirements the Company must comply with in its next rate case, which include submitting new cost of service and depreciation studies.[37] Finally, Ms. Poberesky stated that present water usage levels were used to set the proposed rates and that the fire hydrant rates for Harford County were reduced to the same rates paid by Bel Air, Maryland.[38]

She testified that Staff believed that the Settlement was both reasonable and in the public interest.[39] Ms. Poberesky set forth the Commission's practice regarding stipulations and

[31] The Company initially sought an increase of $812,665. MAW Ex. 2, at 4.

[32] OPC witness Majoros testified that his recommendations resulted in $11,423 excess revenues for the Company, but due to the small amount, he recommended no change in rates. OPC Ex. 1, p. 6; *see also*, Staff Ex. 7, at 3, fn. 2.

[33] Staff Ex. 4, at 5, Table 4.

[34] Joint Ex. 1, at 2.

[35] Tr. 17.

[36] Staff Ex. 7, at 2.

[37] *Id.*

[38] *Id.*

[39] *Id.*

settlements and the factors the Commission has previously considered to determine whether settlements are in the public interest. Some of the factors previously considered by the Commission include whether the parties' positions were adverse and whether the agreement resolved serious differences and resolved issues without lengthy and expensive litigation.[40]

Ms. Poberesky stated that the Settlement avoids additional rate case costs by eliminating the need for evidentiary hearings, briefs, and potential appeals.[41] She also noted that the agreed upon revenue increase of $490,000 is approximately $113,000 less than Staff's litigated position.[42]

During the evidentiary hearing, pursuant to my request, Mr. Cross answered several questions regarding the new tariff and proposed rates. He stated that under the Settlement, the average customer's bill would increase by 12.95%.[43] Mr. Cross also indicated that while base charge increases were greater than those agreed upon in the Company's previous rate case, Staff was still comfortable with the increases.[44]

I also requested that Staff provide a table similar to the one contained in Mr. Cross' direct testimony[45] to verify the bill impact of the agreed upon rates on average customers. On

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[40] *Id.* at 2-3.

[41] *Id.* at 3.

[42] *Id.*

[43] Tr. 20.

[44] Tr. 22-23.

[45] See Staff Ex. 5, p. 5, Table 4.

April 30, 2015, Staff provided a breakdown of the bill impacts on an average customer:[46]

		MAW[47]		Staff		Settlement	
	Current Bill	**Proposed Bill**	**Increase**	**Proposed Bill**	**Increase**	**Proposed Bill**	**Increase**
Res	$ 37.53	$ 44.99	19.88%	$ 43.07	14.77%	$ 42.39	12.95%
Comm	$245.40	$298.64	21.70%	$248.83	16.00%	$278.49	13.48%
OPA[48]	$479.52	$578.32	20.60%	$552.79	15.27%	$537.38	12.07%

Staff explained that the increases for the Commercial and OPA set forth in Mr. Cross' initial testimony were based upon the fixed charge for a 5/8" meter.[49] However, after the Settlement hearing, the Company informed Staff that most, if not all, Commercial and OPA customers have 2" meters, which have a higher fixed monthly charge; therefore, the bill impacts for these two classes were recalculated and resulted in a slight increase, but the rates were still below both the Company's and Staff's proposed increases.[50]

Finally, in regards to the Private Fire Service rates, Mr. Akmentins clarified that the rates in the tariff were annual rates, whereas the rates contained in Attachment 1 to the Settlement were quarterly rates.[51]

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[46] Staff Ex. 8 at 1.

[47] Based upon the Company's initial Application.

[48] "OPA" is an acronym for Other Public Authority.

[49] Staff Ex. 8 at 1.

[50] *Id.* at 1-2.

[51] Tr. 25-26.

V. ANALYSIS AND FINDINGS

In order to approve a settlement, the Commission typically applies a standard requiring the settlement to result in just and reasonable rates for customers and be in the public interest. For example, in approving a settlement in a Delmarva Power & Light Company rate case, the Commission stated, "We approve the Settlement because we find that, under the circumstances and on the record before us, the unanimous agreement of the parties will result in just and reasonable rates for Delmarva Power & Light Company ... and its customers and is consistent with the public interest."[52] The Commission further stated:

> The Commission has in the past considered and approved settlements proposed by adverse parties representing divergent interests in a proceeding. We acknowledge that delicate compromises are often required in order for parties to achieve an uncontested settlement. Historically, a settlement that is submitted by parties who normally have adverse interests is an indication that the overall agreement reached is a reasonable one. However, the mere fact of a settlement does not end our inquiry - we must review any settlement carefully to ensure that the outcome, and the resulting rates, is indeed just and reasonable.[53]

Even with a finding that the terms of a settlement are reasonable, the resulting rates must be found to be "just and

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[52] *Re Delmarva Power and Light Co.*, 102 Md. P.S.C. 236, 237 (2011)(footnote omitted).

[53] *Id.* at 239-240 (footnote omitted).

reasonable" and not an undue burden to one customer class more than another.[54] Public Utilities Article ("PUA") § 4-101 defines a "just and reasonable rate" as:

> a rate that (1) does not violate any provision of this article; (2) fully considers and is consistent with the public good; and (3) except for rates of a common carrier, will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair-value of the public service company's property used and useful in providing service to the public.

In this case, the Company indicated that due to increases in investments, labor, purchased water and waste disposal costs, and other expenses, MAW would not be able to obtain a reasonable return on its investment as authorized in its previous rate case. Therefore, the Company initially asserted that an increase in rates in the amount of $812,665 would produce and equate to an approximate 19.8% increase. That figure was subsequently reduced to $780,627 which would result in an approximate 18.98% increase.

Both OPC and Staff reviewed the Company's Application and supporting documentation, conducted discovery and its own analysis, and filed testimony that identified numerous issues,

[54] *In the Matter of the Application of Baltimore Gas and Elec. Co. for Adjustments to Its Electric and Gas Base Rates*, Case No. 9355, Order No. 86757, at 18 (dated December 4, 2014)(slip op.), citing *Re Potomac Elec. Power Co.*, 80 Md. P.S.C. 61, 64 (1986).

i.e., accounting adjustments, cost of capital, taxes, proposed tariff revisions, etc. ... Both Staff's position and, to a much greater extent, OPC's position regarding the appropriate amount of revenue increase and ROE were lower than MAW's position. Despite the differences in the parties' pre-filed positions, the parties reached an agreement, memorialized in the Settlement, which they all submit is reasonable and in the public's interest.

There are obvious concessions in the Settlement compared to the parties' litigated positions. Some of the most evident compromises include OPC's agreement to increase the revenue requirement by $478,577 (from ($11,423)), as well as the Company's agreement to a revenue reduction of $290,627 (from $780,627), and the parties' agreement on a 10.00% ROE, which was 150 basis points higher than OPC's position, 100 basis points lower than the Company's recommendation, and 25 basis points lower than Staff's position. Additionally, the Company agreed to provide two studies (COSS and depreciation) in its next rate case, both of which were concerns raised by Staff and/or OPC. The Company also agreed to lower the rates for fire hydrants paid by Harford County to the same rate paid by the Town.

It is unknown whether the revenue increase ultimately agreed upon in the Settlement, approximately $290,000 less than MAW's final position, will permit the Company to earn its authorized rate of return. However, the Settlement clearly indicated that an increase was necessary. Furthermore, there can be no doubt that the parties' positions in this case were significantly adverse.

In terms of the resulting rates, the proposed rates included increases in the capacity charge (11.18%), usage charge (6.33%), base charges (between 21.70% to 32.55%), private fire fees (11.88% to 12.01%), and public fire service fees (15.92% for hydrants in excess of 53).[55] Additionally, the overall impact on average customers is reasonable, and I do not believe that the increase will create an undue burden on a particular class compared to another class. As noted by Staff, an average residential customer[56] will see a $4.86 bill increase (12.95%), and commercial and OPA customers will have increases of $33.09 (13.48%) and $57.86 (12.07%), respectively.[57] These increases are well below the Company's proposed increase, as well as Staff's.[58]

After reviewing the Application and supporting documents, all of the pre-filed testimony, the Settlement and testimony supporting settlement, and public comments, I find that the terms of the Settlement are reasonable. Furthermore, I find that the agreed upon revenue requirement is well within the range of reasonableness, especially considering the wide gap in the parties' original positions and the number of issues raised that,

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[55] Joint Ex. 1, Attachment #1 at 1. The public fire rates where also decreased by 39.22% for the first 53 fire hydrants, and 42.39% for fire hydrants outside the town limits of Bel Air. *Id.*

[56] An average residential customer uses 3,800 gallons a month. Staff Ex. 8, at 1.

[57] Staff Ex. 8 at 1.

[58] *Id.*

but for the Settlement, would have been fully litigated. Additionally, I find that approval of the Settlement is in the public interest as it will avoid additional costs that would be incurred as a result of a litigated hearing, briefs, and possibly appeals. Finally, I find that the resulting rates are just and reasonable without undue burden to any one class of customers.

Therefore, I find that the parties' Agreement of Stipulation and Settlement, as submitted, is reasonable, that the resulting rates are just and reasonable, and in the public interest, and should be accepted without change.

IT IS, THEREFORE, this 7th day of May, in the year Two Thousand Fifteen,

ORDERED: (1) That the Application filed by Maryland-American Water Company, Inc. on December 19, 2014, as amended, is hereby denied.

(2) That the Agreement of Stipulation and Settlement, attached hereto and incorporated herein by reference, entered into by the parties on April 17, 2015, is hereby approved without modification.

(3) That Maryland-American Water Company, Inc. is authorized to revise its rates for water services so as to produce a projected overall increase in gross operating revenues of $490,000.

(4) That Maryland-American Water Company, Inc. shall file clean tariff pages consistent with this Proposed Order

of Public Utility Law Judge subject to the acceptance by the Commission and with an effective date of June 19, 2015.

(5) That this Proposed Order will become a final order of the Commission on May 22, 2015, unless before that date an appeal is noted with the Commission by any party to this proceeding as provided in Section 3-113(d)(2) of the Public Utilities Article, or the Commission modifies or reverses the Proposed Order or initiates further proceedings in this matter as provided in Section 3-114(c)(2) of the Public Utilities Article.

Ryan C. McLean
Public Utility Law Judge
Public Service Commission of Maryland

ALJ/WAC/ek4 **Date of Issuance 4/10/2015**

Decision 15-04-007 April 9, 2015

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for Water Service by $18,473,900 or 9.55% in the year 2015, by $8,264,700 or 3.90% in the year 2016, and by $6,654,700 or 3.02% in the year 2017.	Application 13-07-002 (Filed July 1, 2013)

DECISION ADOPTING THE 2015, 2016, AND 2017 REVENUE REQUIREMENT FOR CALIFORNIA-AMERICAN WATER COMPANY

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DECISION ADOPTING THE 2015, 2016, AND 2017 REVENUE REQUIREMENT FOR CALIFORNIA-AMERICAN WATER COMPANY

Summary

This decision resolves California-American Water Company's (Cal-Am) 2015 general rate case (GRC). This decision grants in part and denies in part the Joint Motion for the Adoption of Partial Settlement Agreement between California-American Water Company, City of Pacific Grove, Las Palmas Wastewater Committee, Monterey Peninsula Water Management District, and the Office of Ratepayer Advocates on Revenue Issues in the GRC. This decision also grants the Settling Parties' Joint Motion to Amend the Partial Settlement Agreement. This decision reflects the changes made to the Partial Settlement Agreement and waives the comment period related to the Amended Partial Settlement Agreement. This decision authorizes a $206,507,269 revenue requirement for Cal-Am in Test Year 2015, as proposed in the Amended Partial Settlement Agreement. This authorized revenue requirement represents a $2,487,909 increase, or 1.64 percent, over present rates. This decision also resolves four contested issues not included in the Amended Partial Settlement Agreement. The table below illustrates the average residential bill impacts for each district for the 2015 year.

District	Percentage Change in Overall Revenues	Percentage Change in Avg. Monthly Residential Bill
Sacramento	0.7%	-6.4%
Larkfield	-0.8%	3.3%
Monterey	-0.3%	0.3%
Toro	12.0%	-28.4%
San Diego	5.2%	2.6%
Ventura	4.6%	8.9%
Los Angeles – Baldwin Hills	1.2%	2.8%

Los Angeles-San Marino	-2.1%	4.0%
Los Angeles-Duarte	-3.7%	-7.0%
Garrrapta	9.4%	9.4%
Monterey Wastewater	-5.4%	-5.4%

1. Procedural Background

On July 1, 2013, California-American Water Company (Cal-Am) filed Application (A.) 13-07-002 seeking increased revenue for its water service in the years 2015 through 2017. The California Public Utilities Commission's (Commission) Office of Ratepayer Advocates (ORA) [1], the Mark West Area Community Services Committee (Mark West) and the Central Coast Coalition of Communities for Wastewater Equity (Central Coast Coalition) all filed timely protests and are parties to the proceeding. In addition, the City of Pacific Grove (Pacific Grove), the Monterey Peninsula Water Management District (MPWMD), the Coalition of Peninsula Businesses, the National Association of Minority Companies, Inc., California Water Association, and the Small Business Utility Advocates have all requested and been granted party status in the instant proceeding. The California Water Rights Association requested party status on June 12, 2014, and was denied status on June 19, 2014.

A Prehearing Conference (PHC) was noticed and held on September 17, 2013. The assigned Commissioner and assigned Administrative Law Judge (ALJ) jointly conducted the PHC. During the PHC the parties discussed the scope of the proceeding, the schedule, and times and locations for public participation hearings (PPHs).

[1] ORA was formerly the Division of Ratepayer Advocates.

On October 9, 2013, Cal-Am filed an update to its 2015 general rate case (GRC) application. On October 1, 2013, Cal-Am filed Supplemental Testimony with the rate design proposal for all districts except Monterey.

On November 12, 2013, ORA filed a motion for a Companion Order Instituting an Investigation (OII) regarding Cal-Am's responses to Minimum Data Requirements (MDRs) required by Decision (D.) 07-05-065 and whether Cal-Am violated Rule 1.1 of the Commission's Rules of Practice and Procedure.[2] As part of requirement MDR II.D.5, Cal-Am listed five projects that were authorized in prior GRCs but not built.[3] However, in response to a data request sent by ORA, Cal-Am identified 62 projects that were not actually built.[4] An additional PHC was held on January 21, 2014, in which the parties and the ALJ discussed the possibilities of an Order to Show Cause (OSC) in this proceeding as opposed to a separate OII proceeding. On February 21, 2014, the assigned ALJ denied ORA's motion for a Companion OII and directed Cal-Am to show cause why it should not be sanctioned for violation of Rule 1.1.

On March 6, 2014, the assigned ALJ convened an OSC hearing to show cause why Cal-Am should not be sanctioned for violating Rule 1.1. Parties submitted post-hearing briefs on March 17, 2014, and reply briefs on March 28, 2014. This matter is addressed in a separate decision.

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[2] Unless otherwise indicated, all references to Rules are to the Commission's Rules of Practice and Procedure.

[3] Administrative Law Judge's Ruling Denying the Motion of the Office of Ratepayer Advocates for an Order Instituting an Investigation and Directing California-American Water Company to Show Cause Why It Should Not Be Sanctioned By the Commission For Violation of Rule 1.1 of the Commission's Rules of Practice and Procedure, February 21, 2014, at 2.

[4] *Id*.

On March 28, 2014, Cal-Am noticed an all-party settlement conference for April 4, 2014.

Several PPHs were held between April 24, 2014, and May 19, 2014. Evidentiary hearings were held from June 16, 2014, through June 19, 2014. Also on June 19, 2014, the assigned ALJ directed the parties to submit any settlement agreements to the Commission no later than July 25, 2014. On July 21, 2014, parties filed opening briefs. In accordance with the assigned ALJ's ruling, on July 25, 2014, Cal-Am, Pacific Grove, Las Palmas Wastewater Committee (LPWC), MPWMD, and ORA (collectively, the Settling Parties) filed the Joint Motion for the Adoption of Partial Settlement Agreement between California-American Water Company, City of Pacific Grove, Las Palmas Wastewater Committee, Monterey Peninsula Water Management District, and the Office of Ratepayer Advocates on Revenue Issues in the General Rate Case.

On July 21, 2014, Cal-Am filed a motion for interim rate relief, which was granted on September 16, 2014. Central Coast Coalition filed Comments to the Joint Motion on August 25, 2014. Cal-Am filed Reply Comments on September 9, 2014.

On February 19, 2015, the Settling Parties filed a joint motion to amend the Partial Settlement Agreement. The amendments reduce Cal-Am's revenue requirement by removing Access Service Request Well #3 and the associated $4.1 million of capital expenditures in the Monterey Wastewater District from present and proposed operating revenues. The amendments also include a corrected formula, which reduces California Corporate General Office costs by $98,834 for Monterey. The overall impact of those two changes is to lower the increase to the monthly average Monterey residential bill by $1.94. The remainder of the amendments clarify and address minor issues but do not otherwise affect Cal-Am's revenue requirement for this GRC period. For instance, changes include adding missing titles to charts, corrects typographical errors, and corrections to align sections within the Partial Settlement Agreement.

Relying on the Rules 1.12 and 11.1, the Settling Parties also requested the Commission to waive the comment period in connection with the joint motion to amend and the Amended Partial Settlement Agreement Between California-American Water Company, City of Pacific Grove, Las Palmas Wastewater Committee, Monterey Peninsula Water Management District, and the Office of Ratepayer Advocates on Revenue Issues in the General Rate Case (Amended Partial Settlement Agreement). The adopted Amended Partial Settlement Agreement is attached as Attachment A to this decision.

Submission of this proceeding was set aside to receive the joint motion to amend the Partial Settlement Agreement. This proceeding was submitted on March 4, 2015.

2. Terms of the Amended Partial Settlement Agreement

The Settling Parties agreed on a resolution of the issues set forth in the Amended Partial Settlement Agreement. The Amended Partial Settlement Agreement addresses the new rates to be established for Cal-Am's service areas in the Larkfield, Los Angeles County, Monterey County Water, Monterey Wastewater, Sacramento, San Diego County, and Ventura County Districts for calendar year 2015, and sets parameters to file for escalation and attrition allowances in 2016 and 2017.[5]

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[5] Joint Motion For the Adoption of Partial Settlement Agreement Between California-American Water Company, City of Pacific Grove, Las Palmas Wastewater Committee, Monterey Peninsula Water Management District, and the Office of Ratepayer Advocates on Revenue Issues in the General Rate Case (Joint Motion), July 25, 2014, at 3.

As part of the Amended Partial Settlement Agreement, Cal-Am and ORA have agreed to most of the significant elements of Cal-Am's 2015 GRC revenue requirement and rate design, including the number of customers, usage per customer, rate base, operating expenses, utility plant additions, depreciation expense, income taxes, and most special requests.[6] Additionally, Cal-Am and ORA have reached an agreement on forward-looking interpretation of MDR II.D.5.[7]

The Amended Partial Settlement Agreement also addresses 1) Cal-Am's agreement with MPWMD on issues related to conservation, utility plant additions in Monterey,[8] 2) Cal-Am's agreement with MPWMD and Pacific Grove on certain special requests, and 3) Cal-Am's agreement with LPWC regarding Monterey wastewater issues.[9]

3. Request to Waive the Comment Period for the Amended Partial Settlement Agreement

In the joint motion to amend the Partial Settlement Agreement, the Settling Parties also request the Commission to waive further comments, replies, or responses in connection with the amendments or the motion to amend because the amendments only slightly reduce Cal-Am's revenue requirement and make minor corrections. The Commission grants this request.

Rule 1.12(b) states that if the time for filing a reply, response, protest, or answer to the original document has passed, the ALJ may limit or prohibit any

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[6] Joint Motion at 3.

[7] Joint Motion at 3.

[8] Amended Partial Settlement Agreement Between California-American Water Company, City of Pacific Grove, Las Palmas Wastewater Committee, Monterey Peninsula Water Management District, and the Office of Ratepayer Advocates on Revenue Issues in the General Rate Case, (Amended Partial Settlement Agreement) at 2.

[9] Amended Partial Settlement Agreement at 2.

further reply, response, protest, or answer to the amended document. Rule 12.2 provides parties 30 days to contest all or part of a settlement from the date the motion for adoption of settlement was served. Here, the Settling Parties filed the joint motion to adopt the Partial Settlement Agreement on July 25, 2014. Furthermore, pursuant to Rule 11.1(g), the Commission or the ALJ may rule on a motion before responses or replies are filed. Therefore, the ALJ may use his discretion and waive the comment period as permitted by Rule 1.12(b).

The amendments made to the Partial Settlement Agreement are minor in nature and were made to clarify issues and correct typographical errors. In addition, the amendments reduce Cal-Am's revenue requirement by: 1) removing the ASR Well #3; 2) removing the capital expenditures associated with ASR Well #3; and 3) reduces the California Corporate General Office costs by $98,834 for Monterey. Considering the nature of the changes and the resulting decrease in Cal-Am's revenue requirement for this GRC period, the comment period related to the Amended Partial Settlement Agreement shall be waived.

4. Settled Issued Approved by the Decision

The majority of the issues in this proceeding were settled among various parties and the product of that settlement is contained in the Amended Partial Settlement Agreement attached as Appendix A to the Settling Parties' Joint motion to Amend Partial Settlement Agreement. The following is a summary of the settled issues adopted by this decision. Settled issues denied and modified are discussed in Sections 6 and 7, respectively.

4.1. Water Customer, Consumption and Revenues

4.1.1. Customer Growth

Based on its review of actual customer growth from 2008 through the end of 2012 and its District managers review of actual growth trends, Cal-Am projected annual customer growth in customers to be 77 water customers and

23 fire service customers.[10] ORA recommended using a five-year average customer growth for forecasting active service connections and consumption per customer in all districts, except for the Monterey County District. ORA projected annual customer growth in customers to be 264 water customers and 47 fire service customers.

The Settling Parties agreed with Cal-Am's decision not to forecast customer growth for the Monterey County District.[11] ORA and Cal-Am agree: (1) to the level of customers proposed by Cal-Am for Sacramento, Larkfield, Toro, Garrapata, and the Los Angeles County Districts; (2) to the level of customers proposed by ORA for the San Diego County and Monterey Districts; and (3) that the customer growth for Ventura County District is based on adjusting the five-year average for the reclassification between residential and commercial customer classes and starting from a base of actual 2013 residential and commercial customers. The Amended Partial Settlement Agreement reflects a projected annual customer growth in customers to be 132 water customers and 38 fire service customers.

4.1.2. Consumption

Cal-Am used a three-year (2010 - 2012) average of the historical information for all customer classes, with the exception of the Sacramento District's residential customers, to forecast consumption. In the case of the Sacramento District's residential customers, Cal-Am used a three-year average and adjusted 2014, 2015, and 2016 numbers by reducing them by two percent each year to reflect the completion in 2013 of the conversion of unmetered residential customers to meters

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[10] Amended Partial Settlement Agreement at 3.

[11] This is due to the State Water Resources Control Board Moratorium on "new and expanded" service. Amended Partial Settlement Agreement at 3.

and implementing conservation rates in the Sacramento District.[12] ORA recommended the use of the five-year average of annual consumption. In the proposed Amended Partial Settlement Agreement, the settling parties agreed to use a four-year average of 2010 - 2013 for all customer classes. In addition, Sacramento residential consumption was further reduced by two percent per year as discussed above. In the proposed Amended Partial Settlement Agreement, both the Ventura County and San Marino residential four-year averages were increased 200 cubic feet annually to reflect a recent trend of increasing customer use.

4.1.3. Revenues

Cal-Am forecasted water revenues for the 2015 test year based on a projection of the number of customers by class, consumption per customer by class, and the use of standard tariff rate design reflecting the 2014 Step Rate Increase and the revenues associated with capital expenditure Advice Letters, which is based on the Commission's Standard Practice U-7-W, entitled *Rate Design for Water and Sewer System Utilities Including Master Metered Facilities* (dated July 2006).

In regard to Cal-Am's escalation year filings, Cal-Am proposes that it continue to use its interpretation of the Pro-Forma test[13] and customer growth[14]

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12 Amended Partial Settlement Agreement at 8.

13 Cal-Am 's interpretation of the Pro Form Test is to multiply the actual number of customers by the authorized consumption per customers for residential and commercial classifications and to then multiply the product by the appropriate rates to determine the Pro Forma revenues for these two classifications, and then adds to that the recorded revenues for all other classifications. *See* Amended Partial Settlement Agreement at 73.

14 Cal-Am's interpretation of the customer growth requirements are to use the actual number of customers in the pro forma calculations and to use the latest Commission authorized number of customers for the escalation year and the difference between the escalation year and test year number of customers added to the escalation year to set the number of customers in the attrition year. *See* Amended Partial Settlement Agreement at 74.

requirements. ORA withdrew its recommendations to require Cal-Am to use recorded revenues and customers in the escalation and attrition year revenue requirement determinations and to adjust the five-year average growth for all customer classes.

The table below illustrates the settled revenue requirement for 2015 for each of the California-American Water Company's districts.

County	2015 Settled Revenue Requirement	Percentage Increase Over Present Rates
Larkfield	$ 3,332,448	-0.77%
Los Angeles	29,259,820	-1.85%
Monterey	53,205,444	-0.28%
Sacramento	52,799,113	0.70%
San Diego	27,288,723	5.23%
Ventura	36,433,402	4.57%
Garrapata	80,965	9.44%
Toro	773,900	11.97%
Monterey Wastewater	3,343,454	-5.39%
Total	206,507,269	1.22%

In regard to non-revenue water, Cal-Am and ORA agreed with the five-year average in each district as a reasonable quantity as it aligns with use of averages for average water use per customer. ORA and Cal-Am also agreed to retain the calculation methodology of the Monterey non-revenue water penalty/reward program adopted in D.12-06-016. ORA and Cal-Am agree that Cal-Am shall monitor, record, and report specific volumetric amounts for non-revenue water, instead of by percentage, for ratemaking purposes. ORA and Cal-Am agree that it is appropriate for Cal-Am to use the results of the American Water Works Association Water Loss Audit Report for each of its sub-systems in its Monterey County District, including trends in water loss efficiency metrics, volumetric quantities, and the known feasible cost-effective methods available to reduce non-revenue water.

For fire service revenues, Cal-Am determined revenues based on projected customers and standard tariff rate design at present rates. Cal-Am forecasted the Other Revenues generally based upon historical information. ORA did not oppose Cal-Am's forecast, but recommended that the Commission direct Cal-Am to use its *actual* rates for all revenue calculations in all future GRCs rather than projections. The Settling Parties agreed on the proposed rate revenues for projected test year 2015.

4.2. Rate Base

The table below illustrates the settled rate base for 2015 and 2016 for each of the California-American Water Company's districts. The rate base for 2015 and 2016 as proposed in the Amended Partial Settlement Agreement are adopted.

District	2015 Settlement	2016 Settlement
Larkfield	$ 7,132,407	$ 7,028,542
Los Angeles	75,869,974	85,232,754
Monterey	136,896,895	139,817,064
Sacramento	146,930,723	152,934,802
San Diego	23,676,120	23,828,409
Ventura	45,666,311	51,673,215
Garrapata	126,763	135,002
Toro	1,559,623	1,631,536
Monterey Wastewater	1,589,591	1,545,412

4.2.1. Construction Work in Progress

Cal-Am has historically included all spending on construction in rate base including spending on projects that are in the development/construction phase.