ORA recommends removing construction work in progress (CWIP) amounts from the two test years for all projects Cal-Am anticipates being in service after 2016. ORA argues that removing CWIP amounts from rate base for projects that will not be used or useful in the test years is reasonable.

Cal-Am and ORA agree that for the purposes of determining rate base for 2015, 2016 and 2017, in this proceeding and for this rate case cycle only, for projects not completed and in service prior to December 31, 2016, the spending on those projects will not be included in the rate base (or in the revenue requirements). In lieu of including the proposed accumulated spend in rate base, Cal-Am and ORA agree that Cal-Am will be able to capitalize the carrying costs Allowance of Funds Used During Construction of the project's reasonable and prudent costs into the project's overall cost up until the time the project is completed and in service and then capture separately in an off-book regulatory account the carrying cost of the project from the time it is completed until it goes into rates and rate base.

4.3. Rate Design

Other than adjustments to block widths and rate percentage differences between blocks, Cal-Am did not propose any specific rate design changes for any district. ORA did not oppose the rate design proposed by Cal-Am for Larkfield, Ventura, San Diego, Los Angeles, Garrapata, and Toro service areas; therefore, ORA agreed to Cal-Am's proposed design.

Cal-Am proposed that residential customers in the Sacramento District be placed under a two-tier inclining block rate design with a modest price differential of 10 percent between the tier rates and 25 percent of fixed costs recovered in the monthly fixed charges, and that all other customers continue on a single block rate with 25 percent of the fixed costs recovered in the monthly fixed charges. In addition, Cal-Am proposes a Water Revenue Adjustment Mechanism/Modified Cost Balancing Account (WRAM/MCBA) mechanism. The requested WRAM would track all under or over recoveries of authorized fixed costs collected as part of the quantity rates, and the requested MCBA would track the under or over recovery of actual purchased water and power costs from customers. ORA does not oppose the rate design proposed by Cal-Am or the WRAM/MBCA for the Sacramento District.

Excluding mixed-use customers, Cal-Am proposes to continue the parameters agreed to by all the parties in the Settlement Agreement approved in Cal-Am's last GRC for Monterey. ORA did not oppose this rate design. For Monterey mixed-use customers, the Settling Parties agreed to bill these customers under the residential rate design, but in a manner that provides allotments for both the residential and non-residential use that are then combined together to develop a specific allotment for each of the five residential tiers.

4.4. Conservation

Cal-Am and ORA agree to Cal-Am's three-year combined budget for conservation programs of $3,551,802 for its Larkfield ($90,524), Los Angeles County ($642,929), Sacramento ($1,463,998), San Diego County ($493,053), and Ventura County ($861,298) Districts for years 2015, 2016 and 2017. Cal-Am and ORA also agree to Cal-Am and MPWMD's joint conservation program for the Monterey County District, which proposed a three-year budget of $2,398,500 for Cal-Am and a three-year surcharge amount of $899,000 for MPWMD. In addition, Cal-Am and ORA agree that the three-year conservation funding monies may be moved between the three rate case years as long as the total year funding levels are not exceeded. Cal-Am may not move monies between different districts.

Cal-Am and ORA further agree that Cal-Am will continue to track conservation expenses in a capped, one-way balancing account with any unspent funds refunded to ratepayers after the end of the rate case period.

4.5. Monterey Wastewater

The settling parties agree to ORA's proposals and recommendations for the number of customers, purchase power costs, chemical costs, other administrative and general expenses, annual depreciation accrual, and costs of materials and supplies. ORA did not oppose Cal-Am's methodology for calculating uncollectible expenses, rent estimates, contribution depreciation, retirement expenses, net negative salvage factors, depreciation weighting factor, depreciation expenses, and average plant weighting factors. As for estimating Monterey Wastewater's rate base, ORA and Cal-Am agree with the following total recurring project capital amounts: 2015 - $171,459; and 2016 - $171,816. ORA also agrees to allow Cal-Am to manage the overall bottom-line Recurring Projects budget by district, with flexibility to allocate different spending levels to specific Recurring Project line items, consistent with the 2010 GRC settlement between ORA and Cal-Am.

Cal-Am also reached a settlement with LPWC on Irrigation System Odor Issues. The current Las Palmas Recycle/Reclamation System consists of a wastewater collection system with two parallel treatment trains rated at 90,000 gallons per day (gpd) and 145,000 gpd, and an average daily flow rate of 200,000 gpd. The System discharges to two holding ponds described as the "lower pond" and the "upper pond." Odors have been reported as occurring for more than 20 years. In response to LPWC's concerns, Cal-Am took water quality samples from: (1) the Las Palmas Drinking Water System, (2) treatment plant influent, (3) treatment plant effluent to lower pond, (4) upper pond, and (5) irrigation system at discharge point.

Based on its investigation, Cal-Am believes that a primary contributor of the odors is hydrogen sulfide, which is generated by a layer of solids at the bottom of the upper pond. The removal of this layer prevents the formation of hydrogen sulfide, which ameliorates the odor. Cal-Am agrees to drain the upper pond and remove the layer of solids at the bottom of the pond. As required by the Settlement, LPWC shall make reasonable efforts to secure the cooperation of Las Palmas residents while the pond is drained. While the pond is drained for cleaning, Cal-Am shall not be responsible for providing alternative sources of irrigation water.

In addition, the settlement obligates Cal-Am to make good faith efforts to implement a chemical treatment process at the plant to oxidize hydrogen sulfide compounds believed to be forming in the upper pond and causing the unpleasant odors. In order to do so, Cal-Am must obtain regulatory authorization prior to implementing this process change. Cal-Am will make reasonable efforts to obtain such authorization. Moreover, Cal-Am agrees to not raise or attempt to raise rates in connection with any of the expenses associated with the water quality sampling, pond cleaning, or chemical treatment processes identified in the Amended Partial Settlement Agreement.

Furthermore, Cal-Am agrees to meet with LPWC representatives on a semi-annual basis to discuss residents' concerns about the operation of the Wastewater System. On an annual basis, Cal-Am will provide LPWC with a summary of annual operating expenses, operating revenue, depreciation, and general and income taxes which are allocated to the active wastewater systems and passive wastewater systems in Cal-Am's Monterey Wastewater Division.

4.6. Minimum Data Requirement II.D.5

During this proceeding, ORA alleged that Cal-Am provided inaccurate information in response to its MDRs.[15] The testimony requirement of MDR II.D.5 requires a "list of the plant improvements authorized in the test years but not

[15] Brief of the Office of Ratepayer Advocates Regarding the Administrative Law Judges Order to Show Cause Regarding California-American water Company's Violation of Rule 1.1 at 2.

built."[16] Cal-Am responded that the information provided was accurate at the time the MDRs responses were prepared, based on its interpretation of the MDR.[17] Cal-Am and ORA differed as to which were the "test years" for reporting purposes, whether "not built" included projects that were temporarily on hold, projects that Cal-Am expected to complete by the end of 2013, projects that were still in progress at the time the MDRs response was prepared, and whether the MDRs applied to advice letter projects and multi-year projects.

As a result of the settlement, Cal-Am and ORA agree that future MDR II.D.5 reports will include the information set forth below, which Cal-Am will use in subsequent GRC filings, unless and until the reporting requirements of MDR II.D.5 are modified by Commission decision. Cal-Am will further ensure that all MDRs responses are complete and accurate in future GRC filings in compliance with this interpretation of the MDR II.D.5 requirement.

In providing information subject to MDR II.D.5, Cal-Am will include the status of all projects authorized by the Commission in the last GRC, including:

1. Advice letter projects;
2. Multi-year projects;
3. Projects authorized in the test years but not built for whatever reason, even if the project is temporarily on hold and Cal-Am expects to the complete the project;
4. Projects authorized in all test years, even if the reporting occurs during a particular test year;
5. Projects authorized in all test years, even if the project is currently in progress; and

[16] D.07-05-062 at A-27.

[17] California-American Water Company Post-Hearing Reply Brief on Order to Show Cause at 3.

6. Projects authorized in all test years, even if Cal-Am expects the project to be complete during the years in which the GRC is filed and decided.

The MDR shall include the status on both a recorded and forecast basis through the end of the prior GRC cycle. Cal-Am will update the status as close to the application date as reasonably possible, and any further updates will be provided in response to data requests issued in the GRC. This compromise interpretation applies going forward, but not retroactively.

4.7. Special Requests

The settlement resolves 63 of Cal-Am's 65 Special Requests (including the 33 subparts of Special Request No. 29). Fifty-two Special Requests were settled. Four Special Requests are no longer in dispute as the Commission determined that the requests were outside the scope of this proceeding. Seven Special Requests were withdrawn and two were left unsettled.[18] The unsettled Special Requests are discussed in Section 8 below.

5. Compliance with Rule 12.1 of the Commission's Rules of Practice and Procedure

In order for the Commission to approve any proposed settlement, the Commission must be convinced that the parties have a sound and thorough understanding of the application, the underlying assumptions, and the data included in the record. Pursuant to Rule 12.1(d), the Commission will only approve settlements if the settlement is reasonable in light of the whole record, consistent with the law, and is in the public interest. As discussed below, we find

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[18] In Cal-Am's 2015 GRC Application, Cal-Am proposed the same Special Request twice as Special Request Nos. 23 and 31. In the Amended Partial Settlement Agreement, the Settling Parties withdrew Special Request No. 31 because of this error.

the Amended Partial Settlement Agreement consistent with Rule 12.1 and adopt it with modification.

5.1. Reasonableness in Light of the Record as a Whole

The Amended Partial Settlement Agreement, excluding the below exceptions, is reasonable in light of the record as a whole based on the Settling Parties' discussions and thorough review and understanding of the record. The Settling Parties submitted extensive testimony and the Commission held evidentiary hearings and PPHs in which witnesses offered additional testimony and the public was heard. Moreover, settlement conferences took place as scheduled, with multiple parties participating and engaging in settlement discussions and negotiations.

5.2. Consistent with Law and Prior Commission Decisions

The Amended Partial Settlement Agreement is also consistent with law and prior Commission decisions. The issues resolved in the Amended Partial Settlement Agreement are within the scope of the proceeding.

5.3. The Public Interest

After weeks of discussions and good faith negotiations, the Settling Parties came to a reasonable compromise that furthers the public interest. The Amended Partial Settlement Agreement promotes a favorable outcome for ratepayers and public safety. Specifically, the Amended Partial Settlement Agreement establishes policies and targets for cost-effectively reducing water losses.[19] It also enables Cal-Am to: (1) track conservation expenses in a capped, one-way balancing account with any unspent funds refunded to ratepayer; (2) to maintain a

[19] Joint Motion at 6.

non-revenue water loss penalty/reward program for Monterey; and (3), continue using multi-tiered block rate designs in several districts.[20] Lastly, by coming to a compromise, the Settling Parties avoided excess litigation over the matter and made an efficient use of time and resources.

5.4. Conclusion

Based upon the record of this proceeding, we find that the Settling Parties complied with Rule 12.1 by making the appropriate filings and noticing settlement conferences. We find that the Amended Partial Settlement Agreement contains factual and legal considerations sufficient to advise the Commission of the scope of the settlement and of the grounds for its adoption; that the settlement was limited to the issues in this proceeding; and, that the settlement included comparisons indicating the impact of the settlement in relation to the utility's application and issues the other parties contested in their prepared testimony, or would have contested in a hearing. We conclude, pursuant to Rule 12.1(d) that the Amended Partial Settlement Agreement, with the exceptions outlined below, is reasonable in light of the whole record, consistent with the law and in the public interest.

6. Settled Issues Denied or Modified by the Decision

6.1. Special Request No. 16

The Commission denies Special Request No. 16. Cal-Am's request sought Commission approval of a Consumption Adjustment Mechanism (CAM) modeled after the Sales Reconciliation Mechanism (SRM) authorized for the California Water Service Company (Cal Water) in Cal Water's 2012 GRC (A.12-07-007).

While the Commission authorized Cal Water to implement a SRM in

[20] Joint Motion at 6.

D.14-08-011 at Ordering Paragraph 43, it did so as a trial program for the second and third years of Cal Water's rate case cycle. The Commission weighed the costs and benefits and the policy implications of implementing such a program and found that Cal Water's SRM is in the public interest. However, the Commission authorized the SRM on a trial basis. This allows the Commission to revisit the efficacy and benefits of the SRM.

Given the complexity and experimental nature of Cal Water's SRM, authorizing further pilot programs based on Cal Water's mechanism before a review is completed could lead to flawed designs and unintended consequences being replicated in other pilot programs. However Cal-Am may seek authorization to implement a CAM in either its next GRC or through another application filed prior to its next GRC.

6.2. Special Request No. 18

Special Request No. 18 seeks to authorize Cal-Am to establish a memorandum account to track all penalties and fines that could be assessed as a result of a violation of the State Water Resources Control Board's (State Water Board) Cease and Desist Order. Due to the position Cal-Am is in, the Commission grants Cal-Am's request with modifications. Specifically, in order to recover these costs, Cal-Am must file a formal application for the Commission to determine whether or not such costs are necessary and reasonable. A formal application process will allow the Commission and intervenors appropriate scrutiny on the costs associated with the Cease and Desist Order.

Knowing that this is a contentious issue with Monterey ratepayers, the Commission sought to reach an appropriate balance between competing interests. On one hand, Cal-Am is voluntarily and intentionally diverting water from the Carmel River in violation of the State Water Board's Cease and Desist Order; therefore, Cal-Am should be held responsible for the penalties and fines it incurs.

However, Cal-Am's actions were and are undertaken for the purpose of supplying the residential, municipal, and commercial needs of the Monterey Peninsula area communities. In other words, if Cal-Am was not obligated to provide services to Monterey County, then it would not violate the terms of the State Water Board's Cease and Desist Order.

To ensure that ratepayer funds are used properly and for their benefit, it is necessary for the Commission to ensure that procedural safeguards will be in place prior to any attempt to recover these costs. Therefore, it is reasonable to allow Cal-Am to establish a memorandum account with the requirement that Cal-Am file a formal application to recover costs rather than seek recovery through an advice letter. This will allow Cal-Am to track its expected penalties and fines while also granting the public an opportunity to be heard and for a reasonableness review of the costs incurred.

6.3. Special Request No. 32

In Special Request No. 32, Cal-Am requests authorization to track in the Monterey County District's WRAM/MCBA all lost revenues associated with the loss of sales to certain Pacific Grove properties as Pacific Grove plans to build, own, operate, and distribute water to those properties from a yet to be constructed water reclamation facility.[21] Special Request No. 32 should be granted and Cal-Am allowed to track lost revenue associated with loss of sales due to the Pacific Grove Projects in its existing Monterey District WRAM/MCBA. Cal-Am should seek any recovery for lost revenue associated with the loss of sales to certain Pacific Grove properties in its next GRC.

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[21] Application of California-American Water Company to Increase Revenues in Each of Its Districts Statewide (Cal-American Application) at 18.

7. Resolution of the Remaining Contested Issues

While the Amended Partial Settlement Agreement resolved most issues presented in Cal-Am's GRC application, four issues remain unresolved. The issues are: (1) ORA's recommendation that Cal-Am should be required to file 2016 and 2017 escalation year filings for each and every district; (2) ORA's proposal to require Cal-Am to use recorded rate base up to, but not exceeding, its authorized rate base in order to calculate Cal-Am's 2017 rate base; (3) Special Request No. 23, which seeks authorization for Cal-Am to establish a memorandum account associated with Placer County purchased water supply contract and track costs associated with ongoing peaking charges imposed by Placer County for later recovery if such charges are found reasonable and prudent; and (4), Special Request No. 30, which seeks authorization to include the Placer County Water Agency's peaking charges in its Purchased Water Balancing Account for Cal-Am's Sacramento District.[22] This decision approves ORA's escalation year filing proposal but does not approve ORA's proposed attrition year filing methodology and Cal-Am's Special Requests Nos. 23 and 30. We address each of these unresolved items in turn below.

7.1. ORA's Recommendation to Require Cal-Am to File 2016 and 2017 Escalation Year Filings For Every District

ORA proposes that Cal-Am be required to file 2016 and 2017 escalation year filings (step rate filings) for each and every district, regardless whether the filing will result in an increase or decrease in rates. The Commission grants ORA's request for this GRC cycle.

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[22] Joint Motion at 4.

ORA presented three persuasive arguments. First, requiring Cal-Am to file 2016 and 2017 escalation year filings for each and every district is not unprecedented and is, in fact, consistent with the Commission's directives in Cal-Am's 2012 GRC (A.10-07-007).[23] During Cal-Am's last GRC, the Commission ordered Cal-Am to "file Tier 2 advice letters in conformance with General Order 96-B proposing new revenue requirements and corresponding revised tariff schedules for *each* district for escalation years 2013 and 2014."[24]

Second, requiring such a filing for this GRC would be in the ratepayers' best interest. By allowing water utilities to pick and choose the districts for which it files escalation year filings, a utility may conceal over-earning by choosing not to file an escalation filing for a district that would be entitled to a rate decrease.[25] While Cal-Am's assertion that water utilities previously had discretion in this arena is true,[26] we are persuaded that modifying this practice for this GRC cycle will allow the most transparency and fairness to ratepayers.

Third, such a requirement does not change the Rate Case Plan.[27] D.07-05-062 states that each GRC decision shall include standard ordering paragraphs providing for escalation year increases subject to an earnings test, unless deviation is otherwise expressly justified in the decision.[28] The standard ordering paragraph provided in D.07-05-062 states, "[a]n escalation advice letter,

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23 Opening Brief of the Office of Ratepayer Advocates at 11.

24 D.12-06-016, *Decision Adopting The 2011, 2012, 2013, And 2014 Revenue Requirement For California-American Water Company*, Ordering Paragraph 7 at 90 (emphasis added).

25 Opening Brief of the Office of Ratepayer Advocates at 12.

26 D.04-06-018 at 12 states, "[t]o implement the escalation increase . . . the utility may file an advice letter setting out its calculations and supporting analysis for the escalation year rates."

27 Opening Brief of the Office of Ratepayer Advocates at 12.

28 D.07-05-062 at A-13 of Appendix A.

including workpapers, may be filed in accordance with General Order (GO) 96-B no later than 45 days prior to the first day of the escalation year."[29] Deviating from optional escalation filings to requiring escalation filings for every district is justified because it serves the public interest by protecting ratepayers and ensures the provision of safe, reliable utility service and infrastructure at reasonable rates from utilities. Furthermore, this requirement is for the current rate case cycle and does not pre-determine any consideration of this issue in Cal-Am's next GRC.

7.2. ORA's Proposal Regarding Attrition Year Filings

The Commission rejects ORA's proposal that Cal-Am be required to use its recorded rate base up to, but not to exceed, the authorized rate base to calculate its 2017 attrition year rate base filing. The Commission rejects this modification because it is impractical as applied, is contrary to the Rate Case Plan, and Cal-AM's methodology for using a forecasted test year to determine its attrition year rate base is reasonable.

ORA's proposal is impractical for achieving ORA's goal of improving transparency. ORA's underlying motivation for Cal-Am to use a recorded rate base for its attrition year rate base is to address Cal-Am's "historical failure to complete its authorized capital projects."[30] However, adopting a different formula for calculating an attrition year rate base in this regard is an inappropriate reactionary measure. Due to Cal-Am's filing schedule, ORA's proposal requires Cal-Am to continue to forecast the last three months of its attrition year. Thus, this attempt to make Cal-Am's filings more reflective of actual recorded data falls short.

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[29] *Id.*

[30] Reply Brief of the Office of Ratepayer Advocates at 10.

In addition, ORA's proposal to modify Cal-Am's attrition year rate base formula for this particular GRC is contrary to the Rate Case Plan. D.04-06-018 identified the methodologies for calculating escalation and attrition year filings. It adopted ORA's recommendation at the time to retain the existing system of two test years and one attrition year.[31] The existing system provided for two consecutive test years, followed by one attrition year for January filers and two attrition years for July filers.[32]

In differentiating the methodology between evaluating a test year and an attrition year, the decision stated that "a "test year" is a 12-month period over which projected costs and revenue are evaluated . . . [t]his evaluation includes specific review of all projected costs and forecasts of consumer use."[33]

In contrast, an "attrition year" provides for rate increases based on an adopted formula.[34] In articulating the attrition year formula, D.04-06-018 stated that the attrition allowance methodology provides for rate base additions in Year Three by adding the difference between test Year One and test Year Two rate base to test Year Two rate base.[35] Neither D.04-06-018 nor D.07-05-062 identified whether forecasted or recorded rate bases are to be used for the attrition year. However, D.04-06-018 determined that:

> Standard ratemaking practice uses "test year" to refer to the period over which the cost of service and proposed rates will be evaluated. Two types of test years are used: historical and

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[31] D.04-06-018, *Interim Order Adopting Rate Case Plan*, June 09, 2004 at 15.

[32] *Id.* at 5.

[33] *Id.*

[34] *Id.*

[35] *Id.* at footnote 6 at 15.

> forecasted (or future) test years. The Commission's current practice for water utilities is to use two forecasted test years.[36]

Moreover, while D.07-05-062 provides for modifications to escalation year filings, the language of the decision does not afford such flexibility for formulating an attrition year rate base.

Lastly, while D.04-06-018 and D.07-05-062 do not specify which type of test year to use in calculating an attrition year rate base, it is reasonable to use a forecasted test year. As stated in D.04-06-018, the Commission's current practice for water utilities is to use two forecasted test years rather than historic test years. The Commission reasoned that "using a forecast allows the utility to project expected costs and determine the revenue required to recover those costs, and the Commission to tailor the rate changes to match anticipated cost changes."[37] As such, attrition allowance methodology provides for rate base additions in Year Three by adding the difference between the two forecast test years to the test Year Two rate base. Since the Rate Case Plan decisions have not strayed from "current practice"[38] in using two test years and one attrition year, it is reasonable for Cal-Am to use forecasted test years as an attrition year rate base.

7.3. Special Request No. 23

In Special Request No. 23, Cal-Am requests authorization to establish a memorandum account to tracks costs associated with the Sacramento/Placer County purchased water supply, including capacity charges assessed in a new purchased water agreement to cover the costs of capital investment. These costs include amounts attributed to negotiation, development, and implementation of a

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[36] *Id*. at 6.

[37] D.04-06-018 at 6.

[38] *Id*. at 15.

new water supply agreement. The Commission rejects Special Request No. 23 because it does not meet the requirements set out in Standard Practice U-27-W for establishing a Memorandum Account.

In order to establish a Memorandum Account, Cal-Am must satisfy a four part test. Memorandum accounts are appropriate when the following conditions are met:

> (1) Expense is caused by an event of an exceptional nature that is not under the utility's control;
>
> (2) The expense cannot have been reasonably foreseen in the utility's last GRC and will occur before the utility's next scheduled rate case;
>
> (3) The expense is of a substantial nature in the amount of money involved; and
>
> (4) The ratepayers will benefit by the memorandum account.[39]

Cal-Am asserts that because its agreement with Placer County Water Agency provides for Cal-Am's sole source of water in Placer County, "the agreement between the two bodies is exceptional in nature and of significant importance."[40] Cal-Am further asserts that the agreement is not within Cal-Am's control because Cal-Am must obtain that water to service the area.[41] However, this agreement is undoubtedly under Cal-Am's control- albeit, incomplete control. Cal-Am is one of the largest water utilities in the business of providing water to its ratepayers. As such, it is able to bring a plethora of resources and industry experience to the bargaining table. To suggest that Cal-Am is at the mercy of Placer County Water

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[39] Standard Practice U-27-W; *See* also D.02-08-054 *Interim Decision Authorizing Creation of Memorandum Account*, August 22, 2002 at 3.

[40] California-American Water Company's Opening Brief at 12.

[41] California-American Water Company's Opening Brief at 12.

Agency is to starkly misconstrue Cal-Am's bargaining position as an experienced and needed service provider for Placer County residents.

In regard to the second prong of this four part test, Cal-Am asserts that because negotiations had not yet begun at the start of this GRC, the level of increased requirements and costs is unknown.[42] Although the exact costs are unknown, these negotiations are neither a first-time event for Cal-Am, nor are they on par with Cal-Am's cited example of the Commission's authorization of a memorandum account for Great Oaks Water Company for the cost of Chromium-6 compliance.

Cal-Am has already negotiated with Placer County Water Agency for this exact purpose in the past. Based on Cal-Am's past negotiating experiences, current agreement with Placer County Water Agency, and experience in the industry, Cal-Am can reasonably foresee the future costs the agreement presents. Therefore, the costs associated with the agreement are not entirely unforeseeable now. Moreover, the costs were not unforeseeable in Cal-Am's last GRC considering that Cal-Am was well aware of the expiration date of its current agreement with Placer County Water Agency and that it needs to procure such an agreement in order to continue providing services to Placer County.

Furthermore, in Resolution W-4965, Great Oaks Water Company was required to comply with future federal and state regulations that had yet to be established. Great Oaks Water Company was authorized track expenditures (capital and operating costs) due to compliance related to the final Chromium-6 Maximum Contaminant Level drinking water standard adopted by the California

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[42] California-American Water Company's Opening Brief at 12.

Department of Public Health.[43] In that case, Great Oaks Water Company was not in a position to negotiate or bargain. Rather, it had to react to new, unilateral requirements established by a state agency. Although every negotiation is different, here it is only a matter of degree. In this instance, Cal-Am is able to negotiate and bargain for a beneficial position and has done so before.

Cal-Am asserts that it satisfies the third prong because the expenses associated with negotiations are of a substantial nature in the amount of money involved based on its 2010 GRC. In its 2010 GRC, Cal-Am had a budget of $1.5 million to pay an initial capacity charge for a purchased water agreement with the City of Sacramento.[44] Here, Cal-Am argues that it *may* incur costs of increased capacity, new capital investment or one-time payments and that they are always substantial in nature.[45] However, Cal-Am has not identified any particular costs or projected capital expenditures that it is likely to incur or at least a degree of certainty that such costs will in fact occur because of these negotiations.

Lastly, in regard to the fourth prong, Cal-Am argues that ratepayers will benefit from the memorandum account treatment because it allows for the continued delivery of water to customers in Placer County. While this is true in the general sense, Cal-Am has not proposed that it will in fact stop negotiations with Placer County Water Agency and stop delivering water to Placer County ratepayers in the event that a memorandum account is not authorized. Thus, Cal-Am has failed to meet Standard Practice U-27-W's four part test and therefore, is not authorized to establish a memorandum account to track costs associated

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43 Resolution W-4965, Great Oaks Water Company. *Order Authorizing Establishment Of A Memorandum Account For Chromium-6 Compliance Costs*, December 5, 2013 at 2.

44 California-Water Company Closing Brief at 13.

45 California-Water Company Opening Brief at 13 (emphasis added).

with the Sacramento/Placer County purchased water supply and changes in the Placer County Water Agency agreement.

7.4. Special Request No. 30

The Commission rejects Cal-Am's Special Request No. 30 that seeks authorization to include the Placer County Water Agency's peaking charges in its Purchased Water Balancing Account for Cal-Am's Sacramento District for the following four reasons. First, D.13-10-003 explicitly states that Cal-Am will not recover peaking charges incurred after January 1, 2012, because of the construction of new facilities including the Walerga storage tank and the Special Facilities Fees (SFF) approved in the decision.[46] Second, granting Special Request No. 30 presents perverse incentives in regard to Cal-Am's negotiations with Placer County Water Agency. Third, Cal-Am's arguments that Cal-Am is only requesting authority to track charges at the moment does not adequately justify tracking peaking charges. Fourth, that the Walerga Tank Project has not been completed due to the delay in Phase 2 of Cal-Am's 2012 GRC is irrelevant to the need for tracking peaking charges.

First, Ordering Paragraph 4 of D.13-10-003 explicitly restricts Cal-Am's ability to recover peaking charges incurred after January 1, 2012.[47] The Commission disallowed the recovery of peaking charges incurred after January 2012, because the Commission authorized Cal-Am to recover SFF applicable to all new customers in the West Placer Service Area and because of the

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[46] D.13-10-003, *Decision Resolving the Dry Creek Special Facilities Fees Issues*, October 03, 2013 at 12.

[47] Cal-Am is authorized to file a Tier 1 Advice Letter to recover peaking charges of $797,912 from its purchased water account for the Sacramento District for 2005 to 2010. Cal-Am may not recover peaking charges incurred after January 1, 2012." (D.13-10-003 at 19.)

Walerga Tank's ability to eliminate peaking charges.[48] While it is true that peaking charges are not incurred solely because of Cal-Am's actions,[49] the plain meaning of "Cal-Am may not recover peaking charges incurred after January 1, 2012" is clear. There could be no other logical interpretation of D.13-10-003, Ordering Paragraph 4 other than that the Commission restricted Cal-Am from recovering peaking charges incurred after January 1, 2012.

Cal-Am is correct in its submissions that D.13-10-003 relies on portions of the Settlement Agreement between Cal-Am, ORA, and The Utility Reform Network. However, pursuant to Rule 12.5, unless the Commission expressly provides otherwise, adoption of a settlement agreement does not constitute approval of or precedent regarding any principle or issue in any future proceeding. Therefore, even though the Commission relied on portions of the prior settlement agreement to reach a decision, that settlement agreement is not binding here because the Commission did not expressly provide otherwise.

Second, Cal-Am's argument concerning its renegotiations with Placer County Water Agency does not justify granting Special Request No. 30. By authorizing Cal-Am to recover peaking charges, the Commission would institute perverse incentives for Cal-Am to bargain for positions contrary to the best interest of its ratepayers.

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[48] " . . . [E]xisting customers currently pay annual peaking charges ranging from $200,000 to $400,000 that will be eliminated by the Walerga Tank Project, and that the tank will provide equalized pressure to the whole system throughout the day and meet fire flow requirements benefitting all customers within the system." D.13-10-003 at 10; "Due to the construction of new facilities including the Walerga storage tank and the SFF approved in this decision, we find Cal-Am's recovery of $797,913 in peaking charges for 2005–2010 reasonable. Cal-Am will not recover peaking charges incurred after January 1, 2012." (D.13-10-003 at 12.)

[49] Cal-Am argues that peaking charges result from customer need, possible rapid growth, emergency maintenance, natural occurrences, and the actions of third parties. California-American Water Company's Opening Brief at 15-16.

Third, while Cal-Am is requesting authority to track charges and not to recover charges at the moment,[50] the purpose of a memorandum account is to ultimately recover what costs are tracked. Considering that the Commission decided not to allow Cal-Am to recover peaking chargers for rate payers in the Sacramento District pursuant to D.13-10-003, tracking such charges in a memorandum account is unreasonable and serves no purpose.

Finally, Cal-Am asserts that peaking charges could occur in 2015 because the Walerga tank might not be completed by 2015 due to a delay in Phase 2 of Cal-Am's 2012 GRC.[51] However, regardless of the timing of Phase 2 of Cal-Am's last GRC, the construction of the Walerga Tank Project could have been completed irrespective of Commission action. Therefore, that the tank has not been completed does not adequately justify tracking peaking charges.

8. Conclusion

After reviewing the Application, parties' briefs and testimony, the Commission adopts the Amended Partial Settlement Agreement as is, except for Special Requests Nos. 16, 18, and 32. Special Requests Nos. 16 is denied and Special Request No. 18 and 32 are modified.

In regard to the remaining disputed issues unsettled by the Amended Partial Settlement Agreement, the Commission: (1) approves ORA's proposal to require Cal-Am to file 2016 and 2017 escalation year filings for each and every district; (2) rejects ORA's proposal to require Cal-Am to use recorded rate base, up to but not exceeding authorized rate base, in order to calculate Cal-Am's rate base for 2017; (3) denies Cal-Am's Special Request No. 23, which seek authorization for Cal-

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[50] California-American Water Company's Opening Brief at 15-16.

[51] California-American Water Company's Opening Brief at 15-16.

Am to establish a memorandum account to track costs associated with Placer County purchased water supply contract; and (4) denies Cal-Am's Special Request No. 30, which seeks authorization to include the Placer County Water Agency's peaking charges in Cal-Am's Purchased Water Balancing Account for the Sacramento District.

This decision adopts the Amended Partial Settlement Agreement and reflects the changes made to the Partial Settlement Agreement. Considering the nature of the changes made and the resulting decrease in Cal-Am's revenue requirement for this GRC period, this decision grants the Setting Parties' request to waive the comment period related to the Amended Partial Settlement Agreement.

9. Categorization and Need for Hearing

In Resolution ALJ 176-3326, dated November 14, 2013, the Commission preliminarily categorized this application as ratesetting, and preliminarily determined that hearings were necessary. On December 6, 2013, both TURN and ORA filed protests to the application. Evidentiary hearings have been held and with the filing of the Amended Partial Settlement Agreement and supporting Joint Motion, no further hearings are necessary. We confirm the categorization and need for hearings.

10. Comments on Proposed Decision

Proposed decision of ALJ Colbert in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on March 26, 2015 by Cal-Am and the California Water Association (CWA). ORA late filed its comments on March 27, 2015. ORA filed reply comments on were filed on April 1, 2015.

After reviewing the Comments and Reply Comments to the PD submitted by the Cal-Am, CWA and ORA, we have determined that Cal-Am and CWA have failed to demonstrate any material legal error in the PD. As a result, we decline to make any substantive changes to the PD based on alleged legal error.

We specifically note Cal-Am's request, in §VIII of their comments to the PD[52], for modification of footnote #8 to the Settlement Agreement. ORA has not affirmatively agreed to the modification of footnote #8 and we did not raise the issue in the PD and thus decline to modify the footnote. We have modified the PD based on the Comments of Cal-Am, ORA and on our own initiative, in the following manner:

- The revenue requirement and rate increase on page 2 of the PD have been revised;
- The tables on pages 2 and 11 have been revised;
- Section 6 of the PD has been revised;
- Finding of Facts #8 has been revised;
- Conclusions of Law #11, #12 and #13 have been revised;
- Ordering Paragraph #3 has been revised; and
- Ordering Paragraph #14 has been added.

There are no other changes to the PD.

11. Assignment of Proceeding

Carla J. Peterman is the assigned Commissioner and W. Anthony Colbert is the assigned ALJ in this proceeding.

Findings of Fact

1. On July 25, 2014, the Settling Parties filed and served the Joint Motion for the Adoption of Partial Settlement Agreement between Cal-AM, City of Pacific Grove, Las Palmas Wastewater Committee, MPWMD, and the ORA on Revenue Issues in the GRC.

[52] Cal-Am Comments to PD at 15, §VIII.

2. Central Coast Coalition of Communities for Wastewater Equity filed Comments to the Joint Motion on August 25, 2014.

3. Cal-Am filed Reply Comments on September 9, 2014.

4. On February 19, 2015, the Settling Parties filed the Settling Parties' Joint Motion to Amend Partial Settlement Agreement.

5. In addition to requesting to amend the Partial Settlement Agreement, the Settling Parties request the Commission to waive the comment period pertaining to the amendments and the joint motion to amend.

6. The Amended Partial Settlement Agreement enables Cal-Am to: (1) track conservation expenses in a capped, one-way balancing account with any unspent funds refunded to ratepayer; (2) to maintain a non-revenue water loss penalty/reward program for Monterey; and (3), continue using multi-tiered block rate designs in several districts.

7. By coming to a compromise, the Settling Parties avoided excess litigation over the matter and made an efficient use of time and resources.

8. In Special Request No. 32, Cal-Am requests authorization to track in the Monterey County District's WRAM/MCBA lost revenues associated with the loss of sales to certain Pacific Grove properties as Pacific Grove plans to build, own, operate, and distribute water to those properties from a yet-to-be-constructed water reclamation facility.

9. Cal-Am's Special Request No. 16 requested the Commission to approve a CAM modeled after the SRM requested by Cal Water in its 2012 GRC.

10. D.14-08-011, Ordering Paragraph 43 authorized Cal Water to establish a SRM for a trial period during the second and third year of its rate case period.

11. The complexity and experimental nature of Cal Water's SRM, could lead to flawed designs and unintended consequences for Cal-Am's CAM.

12. In Special Request No. 18, Cal-Am seeks to establish a memorandum account to track all penalties and fines that could be assessed as a result of a violation of the State Water Board's Cease and Desist Order.

13. Cal-Am is voluntarily and intentionally diverting water from the Carmel River in violation of the State Water Board's Cease and Desist Order.

14. During Cal-Am's last GRC, the Commission ordered Cal-Am to "file Tier 2 advice letters in conformance with General Order 96-B proposing new revenue requirements and corresponding revised tariff schedules for *each* district for escalation years 2013 and 2014."

15. It is in the ratepayers' best interest to require Cal-Am to file escalation year filings for each district, regardless of an increase or a decrease in rates.

16. By allowing water utilities to pick and choose what districts it files escalation year filings for, a utility may conceal over-earning by choosing not to file an escalation filing for a district that would be entitled to a rate decrease.

17. D.07-05-062 states that each GRC decision shall include standard ordering paragraphs providing for escalation year increases subject to an earnings test, unless deviation is otherwise expressly justified in the decision.

18. ORA's underlying motivation for Cal-Am to use a recorded rate base for its attrition year rate base is to address Cal-Am's "historical failure to complete its authorized capital projects."

19. D.04-06-018 identified the methodologies for calculating escalation and attrition year filings and adopted ORA's recommendation to retain the existing system of two test years and one attrition year.

20. In differentiating the methodology between evaluating a test year and an attrition year, D.04-06-018 stated that "a 'test year' is a 12-month period over which projected costs and revenue are evaluated . . . [t]his evaluation includes specific

review of all projected costs and forecasts of consumer use" while an "attrition year" provides for rate increases based on an adopted formula.

21. D.04-06-018 stated that the attrition allowance methodology provides for rate base additions in Year Three by adding the difference between test Year One and test Year Two rate base to test Year Two rate base.

22. Neither D.04-06-018 nor D.07-05-062 identified whether forecasted or recorded rate bases are to be used for the attrition year.

23. D.04-06-018 determined that "test year" refers to the period over which the cost of service and proposed rates will be evaluated and that the Commission's current practice for water utilities is to use two forecasted test years.

24. The Commission's current practice for water utilities is to use two forecasted test years rather than historic test years.

25. Memorandum accounts are appropriate when the following conditions are met: (1) expense is caused by an event of an exceptional nature that is not under the utility's control; (2) the expense cannot have been reasonably foreseen in the utility's last GRC and will occur before the utility's next scheduled rate case; (3) The expense is of a substantial nature in the amount of money involved; and (4) the ratepayers will benefit by the memorandum account.

26. Cal-Am is one of the largest water utilities in the business of providing water to its ratepayers and is able to bring a plethora of resources and industry experience to negotiations between Cal-Am and Placer County Water Agency.

27. Although the exact costs are unknown, the negotiations are neither a first-time event for Cal-Am, nor are they on par with Cal-Am's cited example of the Commission's authorization of a memorandum account for Great Oaks Water Company for the cost of Chromium-6 compliance.

28. Cal-Am has already negotiated with Placer County Water Agency for this exact purpose in the past.

29. Based on Cal-Am's past negotiating experiences, current agreement with Placer County Water Agency, and experience in the industry, Cal-Am can reasonably foresee the future costs the agreement presents.

30. The costs were also foreseeable in Cal-Am's last GRC considering that Cal-Am was well aware of the expiration date of its current agreement with Placer County Water Agency and that it needs to procure such an agreement in order to continue providing services to Placer County.

31. Cal-Am has not identified any particular costs or projected capital expenditures that it is likely to incur or at least a degree of certainty that such costs will in fact occur because of these negotiations considering the state and capacity of existing facilities.

32. Cal-Am has not proposed that it will stop negotiations with Placer County Water Agency and stop delivering water to Placer County ratepayers in the event that a memorandum account is not authorized.

33. D.13-10-003 explicitly states that Cal-Am will not recover peaking charges incurred after January 1, 2012, because of the Walerga Storage Tank's ability to eliminate peaking charges and the Special Facilities Fees approved in the decision.

34. Regardless of the timing of Phase 2 of Cal-Am's last GRC, the construction of the Walerga Tank Project could have been completed irrespective of Commission action.

Conclusions of Law

1. 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 further reply, response, protest, or answer to the amended document.

2. 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.

3. Pursuant to Rule 11.1(g), the Commission or the ALJ may rule on a motion before responses or replies are filed.

4. Since the Partial Settlement Agreement and the joint motion to approve the Partial Settlement Agreement were filed on July 25, 2014, the ALJ may use his discretion and waive the comment period as permitted by Rule 1.12(b).

5. Considering the minor nature of the changes made to the Partial Settlement Agreement and the resulting decrease of Cal-Am's revenue requirement for this GRC period, the comment period related to the Amended Partial Settlement Agreement should be waived.

6. Rule 12.1(d) provides that the Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

7. The Amended Partial Settlement Agreement, with the exceptions noted in this decision, is reasonable in light of the whole record, consistent with law, and is in the public interest.

8. The Amended Partial Settlement Agreement, with the exceptions noted in this decision, should be adopted.

9. The issues resolved in the Amended Partial Settlement Agreement are within the scope of the proceeding.

10. The Amended Partial Settlement Agreement, with the exceptions noted in this decision, promotes a favorable outcome for ratepayers and public safety by establishing policies and targets for cost-effectively reducing water losses.

11. Special Request No. 32 should be granted and Cal-Am allowed to track lost revenue associated with loss of sales due to the Pacific Grove Projects in its existing Monterey District WRAM/MCBA..

12. Cal-Am should seek any recovery for lost revenue associated with the loss of sales to certain Pacific Grove properties in its next GRC.

13. Special Request No. 16 should be denied, but this does not preclude Cal-Am from requesting authorization for a CAM in Cal-Am's next GRC or through a separate application.

14. The Commission should grant Cal-Am's Special Request No. 18 with modification because it is reasonable to allow Cal-Am to establish a memorandum account with the requirement that Cal-Am file a formal application to recover costs rather than an advice letter.

15. Cal-Am's diversion of water from the Carmel River were and are undertaken for the purpose of supplying the residential, municipal, and commercial needs of the Monterey Peninsula area communities.

16. In order to recover the costs associated with the Cease and Desist Order, Cal-Am should be held responsible for the penalties and fines it incurs and required to file a formal application for the Commission to determine whether or not such costs are necessary and reasonable.

17. Allowing Cal-Am to track expected penalties and fines and to require Cal-Am to file a formal filing to recover costs will grant the public an opportunity to be heard and for a reasonableness review of the costs incurred.

18. It is in the ratepayers' best interest to require Cal-Am to file escalation year filings for each district, regardless of an increase or a decrease in rates.

19. By allowing water utilities to pick and choose what districts it files escalation year filings for, a utility may conceal over-earning by choosing not to file an escalation filing for a district that would be entitled to a rate decrease.

20. The Commission should grant ORA's proposal that Cal-Am be required to file 2016 and 2017 escalation year filings for each district.

21. Requiring Cal-Am to file 2016 and 2017 escalation year filings for each and every district is consistent with the Commission's requirements in Cal-Am's 2012 GRC and is within the public interest.

22. Requiring Cal-Am to file 2016 and 2017 escalation year filings does not change the Rate Case Plan because deviation from the standard ordering paragraphs in D.07-05-062 is justified because it serves the public interest by protecting ratepayers and ensures the provision of safe, reliable utility service and infrastructure at reasonable rates from utilities.

23. The Commission should not grant ORA's proposal to require Cal-Am to use its recorded rate base up to but not to exceed the authorized rate base to calculate its 2017 attrition year rate base filing.

24. ORA's proposed modification to the attrition year rate base methodology is in an inappropriate reactionary measure because, due to Cal-Am's filing schedule, ORA's proposal would require Cal-Am to continue to forecast the last three months of its attrition year.

25. ORA's attrition year rate base methodology proposal is impractical for achieving ORA's goal of improving transparency and is contrary to the Rate Case Plan.

26. It is reasonable for Cal-Am to use a forecasted test year to determine its attrition year rate base for this GRC cycle because using a forecast allows the utility to project expected costs and determine the revenue required to recover those costs, and the Commission to tailor the rate changes to match anticipated cost changes.

27. The Commission should deny Special Requests No. 23 because Cal-Am's request does not meet the requirements set out in Standard Practice U-27-W for establishing a Memorandum Account.

28. Cal-Am's comparison to Great Oaks Water Company is not warranted because Great Oaks Water Company was required to comply with future federal and state regulations that had yet to be established and was not in a position to negotiate or bargain.

29. The Commission should deny Cal-Am's Special Request No. 30 that seeks authorization to include the Placer County Water Agency's peaking charges in its Purchased Water Balancing Account for Cal-Am's Sacramento District.

30. Cal-Am's arguments that Cal-Am is only requesting authority to track charges at the moment does not adequately justify tracking peaking charges.

31. The Commission restricted Cal-Am from recovering peaking charges incurred after January 1, 2012; therefore, tracking such charges in a memorandum account is unreasonable and serves no purpose.

32. The fact that the Walerga Tank Project has not been completed due to the delay in Phase 2 of Cal-Am's 2012 GRC is irrelevant to the need for tracking peaking charges.

O R D E R

IT IS ORDERED that:

1. 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 is granted.

2. The Settling Parties' Joint Motion to Amend Partial Settlement Agreement is granted.

3. The Amended Partial Settlement Agreement is adopted in part and denied in part. Specifically, Special Requests Nos. 16 is denied and Special Request No.18 and 32 are adopted with the additional requirement that California-American Water Company be required to file a formal application to recover costs associated with penalties and fines levied by the State Water Resource Control Board.

4. California-American Water Company is authorized to file a Tier 1 advice letter to recover the difference between the 2015 interim and final rates from its customers. This calculation must be based on the 2015 rate tariff schedules that would have been implemented under the present rate design.

5. California-American Water Company must also recalculate the 2015 Water Revenue Adjustment Mechanism/Modified Cost Balancing Account balance for these districts to include the final revenue requirement adopted today and the recorded revenue California-American Water Company would have received if final rates had been effective on January 1, 2015.

6. California-American Water Company must update its 2015 Water Revenue Adjustment Mechanism/Modified Cost Balancing Account annual report to the Commission for changes resulting from today's order.

7. California-American Water Company is authorized to file a Tier 1 advice letter for the revised 2015 Water Revenue Adjustment Mechanism/Modified Cost Balancing Account balance.

8. For escalation years 2016 and 2017, California-American Water Company shall file Tier 2 advice letters proposing new revenue requirements and corresponding revised tariff schedules for each district. The filing shall include rate procedures set forth in the Commission's Rate Case Plan (Decision 07-05-062) for Class A Water Utilities and shall include appropriate supporting workpapers. The revised tariff schedules shall take effect no earlier than January 1, 2016, and January 1, 2017, respectively and shall apply to service rendered on and after their effective dates.

9. The proposed revisions to revenue requirements and rates shall be reviewed by the Commission's Division of Water and Audits. The Division of Water and Audits shall inform the Commission if it finds that the revised rates do not

conform to the Rate Case Plan, this order, or other Commission decisions, and if so, reject the filing.

10. Going forward, California-American Water Company shall include in its Minimum Data Requirements the status of all projects authorized by the Commission in the last general rate case including: including:

1. Advice letter projects;
2. Multi-year projects;
3. Projects authorized in the test years but not built for whatever reason, even if the project is temporarily on hold and California-American Water Company expects to the complete the project;
4. Projects authorized in all test years, even if the reporting occurs during a particular test year;
5. Projects authorized in all test years, even if the project is currently in progress; and
6. Projects authorized in all test years, even California-American Water Company expects the project to be complete during the years in which the GRC is filed and decided.

11. The Minimum Data Requirements shall also include the status of projects authorized by the Commission in the last general rate case on both a recorded and forecast basis through the end of the prior general rate case cycle. California-American Water Company must update the status as close to the application date as reasonably possible, and any further updates must be provided in response to data requests issued in the general rate case.

12. California-American Water Company shall establish a memorandum account to track all penalties and fines that are assessed as a result of a violation of the State Water Resources Control Board's Cease and Desist Order. In order to recover these costs, California-American Water Company must file a formal application for the Commission to determine whether or not such costs are necessary and reasonable.

13. California-American Water Company is required to file 2016 and 2017 escalation year filings for each and every district.

14. Within 30 days of the effective date of this decision, California-American Water Company is authorized to file Tier 1 Advice Letters with revised tariff schedules in compliance with this decision for each district and rate area in the proceeding. The adopted rates for test year 2015 are included as Attachment A to this decision and shall be retroactively effective to January 1, 2015 in conformance with the Commission's interim rate process. The filing shall be subject to approval by the Commission's Division of Water Audits.

15. Application 13-07-002 is closed.

This order is effective today.

Dated April 9, 2015, at San Francisco, California.

MICHAEL PICKER
President
MICHEL PETER FLORIO
CATHERINE J.K. SANDOVAL
CARLA J. PETERMAN
LIANE M. RANDOLPH
Commissioners

ATTACHMENT A

(Amended Partial Settlement Agreement)

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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

In the Matter of the Application of)
)
HAWAII-AMERICAN WATER COMPANY)
)
For Approval of Rate Increases)
and Revised Rate Schedules and)
Rules.)
)

DOCKET NO. 2010-0313

DECISION AND ORDER

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(Docket No. 2010-0313, Hawaii-American Water Company)

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

In the Matter of the Application of)) HAWAII-AMERICAN WATER COMPANY)) For Approval of Rate Increases) and Revised Rate Schedules and) Rules.))	Docket No. 2010-0313

DECISION AND ORDER

By this Decision and Order, the commission approves an increase of $1,246,630, or approximately 14.20% over revenues at present rates for HAWAII-AMERICAN WATER COMPANY ("Hawaii American," "HAWC," or "Applicant"), based on a total revenue requirement of $10,026,020 for the 2011 calendar test year ("Test Year").[1] In so doing, the commission, in response to HAWC's Application, filed on February 22, 2011,[2] approves the

[1]The Parties are HAWC and the DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS, DIVISION OF CONSUMER ADVOCACY ("Consumer Advocate"), an ex officio party to this proceeding, pursuant to Hawaii Revised Statutes ("HRS") § 269-51 and Hawaii Administrative Rules § 6-61-62(a).

[2]Application; Exhibits 1 - 14; Attachments; Verification; and Certificate of Service, filed on February 22, 2011 (collectively, "Application"). See Order Regarding Completed Application and Other Initial Matters, filed on March 20, 2011 (the filing date of HAWC's complete application is February 22, 2011).

Parties' Stipulation of Settlement Agreement in Lieu of [HAWC's] Rebuttal Testimonies, Evidentiary Hearing and Briefs, filed on October 21, 2011.[3] The commission, in approving the Stipulation, authorizes an across-the-board, 14% increase in HAWC's monthly wastewater service charges.

The commission timely issues this Decision and Order, in accordance with HRS § 269-16(d).

I.

Background

A.

HAWC

HAWC, a Nevada corporation, is a public utility authorized to "provide wastewater collection, treatment, and disposal service to the residences, condominiums, and commercial establishments in the Hawaii Kai community on the island of Oahu."[4] HAWC's sole shareholder is American Water Works

[3]Stipulation of Settlement Agreement in Lieu of Rebuttal Testimonies, Evidentiary Hearing and Briefs; Exhibit A; and Certificate of Service, filed on October 21, 2011 (collectively, "Stipulation"). The Parties, throughout their Stipulation, round each amount to the nearest zero dollar. Thus, for example, $13 is rounded down to $10, while $18 is rounded up to $20.

[4]Application, at 2.

Company, Inc. ("American Water"), a Delaware corporation.[5] HAWC operates as part of American Water's Western Region.

As described by HAWC in its Application:

> [HAWC's] facility consists of a collection system of more than sixty-five (65) miles of sewer lines, seven (7) pump stations as well as a treatment plant. The system serves the entire area from the eastern ridge of Kuliouou Valley to the Mauka side of Kalanianaole Highway at Sandy Beach. [HAWC's] plant provides tertiary treatment to the wastewater collected before discharging it into the ocean approximately one-quarter (1/4) of a mile offshore at a depth of approximately 55 feet[.]

Application, Exhibit 2, at 1; see also Exhibit 14-T-300, at 4-12 (description of HAWC's collection system).

HAWC's existing rate design consists of monthly service charges for: (1) Single-Family Residential Units and Multi-Family Residential Units, at a flat rate; (2) Commercial Food Service (i.e., the restaurant class) and Commercial Non-Food Service (i.e., the non-restaurant class), based on the amount of water usage; and (3) the Public Utility-Other class and the Public Authority-Dwelling class, based on the amount of wastewater treated.[6]

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[5]On January 27, 1998, the commission approved American Water's acquisition of all the issued and outstanding shares of East Honolulu Community Services, Inc., which is now known as HAWC. See In re Maunalua Assoc., Inc., East Honolulu Comm. Serv., Inc., and Am. Water Works Co., Inc., Docket No. 97-0339, Decision and Order No. 16175, filed on January 27, 1998.

[6]As described in HAWC's existing rate schedule:

In addition to its Hawaii Kai wastewater operations, HAWC provides wastewater utility service within its Mauna Lani service area on the island of Hawaii.[7] HAWC's Mauna Lani operations are not affected by HAWC's request to increase its wastewater service charges for its Hawaii Kai operations.

B.

Application

On January 4, 2011, the commission granted HAWC's motion to utilize the 2011 calendar year as the test year, in lieu of a 2011-2012 mid-test year period, subject to the proviso

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> The Public Authority-Other class refers to the sewerage services provided by Hawaii American to the City and County of Honolulu ("City"), the State of Hawaii and other facilities (including parks, schools, fire station, and Lunalilo Home) . . . .
>
> The Public Utility-Dwelling class refers to the services provided by Hawaii American to the City for the City's residential customers in Hawaii Kai, including Kuliouou Valley, Portlock, Paiko, and other areas, which fall outside of Hawaii American's service territory, but which are served directly by the City's sewerage system and then connected to Hawaii American's wastewater collection, treatment, and disposal system for distribution and processing.

See Application, at 5 n.8 and n.9.

[7]In re Mauna Lani STP, Inc. and Hawaii-American Water Co., Docket No. 05-0229, Decision and Order No. 22299, filed on February 28, 2006 (approving the sale and transfer of Mauna Lani STP, Inc.'s utility assets, operations, and operating certificate to HAWC, subject to certain conditions).

that HAWC file its application for a general rate increase by February 28, 2011.

On February 22, 2011, HAWC timely filed its Application, seeking an increase in revenues of $1,764,860 (approximately twenty-one percent) over its present total revenues of $8,779,390.[8] The requested increase in revenues is based on an estimated total revenue requirement of approximately $10,544,250 for the Test Year, and a rate of return of 8.79%.

HAWC proposes to implement its requested increase in revenues by increasing its monthly service charge for: (1) the

[8]HAWC's two prior applications for general rate increases, based on the 2006 and 2008 calendar test years, respectively, were recently decided by the commission. See In re Hawaii-Am. Water Co., Docket No. 05-0103 (2006 test year rate case); and In re Hawaii-Am. Water Co., Docket No. 2007-0180 ("Docket No. 2007-0180")(2008 test year rate case). Hence, HAWC, in its Application, utilizes the most recent interim wastewater rate design approved by the commission in Docket No. 2007-0180 as the basis for calculating its revenues at present rates for the 2011 test year period. See Docket No. 2007-0180, Interim Decision and Order, filed on October 10, 2008; and HAWC's letter, dated October 15, 2008, transmitting the interim wastewater rate design approved by the commission in its Interim Decision and Order. The Parties, likewise, utilize the current effective interim rates approved by the commission in Docket No. 2007-0180 in calculating revenues at present rates in the Stipulation filed in this proceeding, Docket No. 2010-0313.

For ease of reference, the term "**present rates**" as used in this Decision and Order, unless clearly required otherwise by the context, refers to the interim wastewater rate design approved by the commission in Docket No. 2007-0180, HAWC's pending 2008 test year rate case. On November 11, 2011, the commission adopted the interim rate design as its final rate design. See Docket No. 2007-0180, Final Decision and Order, filed on November 10, 2011.

Single-Family Residential Unit and Multi-Family Residential Unit classes by approximately 21.12%; (2) the Commercial Non-Food Service class (i.e., the non-restaurant class) by approximately 20.81%; (3) the Public Utility-Other class by approximately 20.81%; and (4) the Public Authority-Dwelling class by approximately 21.17%. HAWC also proposes that its monthly service charge for the Commercial Food Service class (i.e., the restaurant class) remain unchanged.

HAWC states that the requested increases in its wastewater charges are necessary to: (1) cover the increases in its operating costs; and (2) allow it to continue to invest in its wastewater utility system.

C.

Public Hearing

On April 27, 2011, the commission held a public hearing on the requests set forth in HAWC's Application, at the Kamiloiki Elementary School cafeteria in Hawaii Kai, Oahu, pursuant to HRS §§ 269-12(c) and 269-16(b). At the public hearing, HAWC's representative, the Consumer Advocate, and ratepayers appeared and testified.[9] The commission also received

[9] See Transcript of the Public hearing held on April 27, 2011.

written comments from ratepayers.[10] In general, ratepayers object to or express their concerns with the proposed increases in HAWC's wastewater utility rates and charges. Ratepayers also complain about the odors from HAWC's wastewater treatment plant.

D.

Consumer Advocate's Written Testimonies and the Parties' Stipulation of Settlement Agreement in Lieu of Rebuttal Testimonies, Evidentiary Hearing and Briefs

On July 27, 2011, the Consumer Advocate filed its direct testimonies and exhibits. Thereafter, the Parties commenced settlement negotiations. On October 4, 2011, the commission approved the Parties' request to cancel as moot the evidentiary hearing and filing of post-hearing briefs, in light of the Parties' global settlement in principle of all the issues in this proceeding.[11] On October 21, 2011, the Parties filed their Stipulation in lieu of HAWC's rebuttal testimonies and exhibits. On October 28, 2011, the commission, following its review of the Stipulation, issued clarifying information requests, to which HAWC responded on November 4, 2011.

[10]See, e.g., enclosures to the Commission's transmittal letters, dated April 15, 28, and 29, 2011, May 11 and 16, 2011, September 14, 19, and 28, 2011, and October 12 and 28, 2011.

[11]Order Approving Revisions to the Procedural Schedule Proposed by Hawaii-American Water Company and the Division of Consumer Advocacy, and Filed on September 30, 2011, filed on October 4, 2011.

E.

Issues

As set forth in the commission's Prehearing Order, filed on May 10, 2011, the issues in this proceeding are:

1. Whether HAWC's proposed general rate increase is reasonable.

   A. Whether the proposed tariffs, rates, and charges are just and reasonable.

   B. Whether the revenue forecasts for the Test Year at present rates and proposed rates are reasonable.

   C. Whether the projected operating expenses for the Test Year are reasonable.

   D. Whether the projected rate base for the Test Year is reasonable, and are the properties included in the rate base used or useful for public utility purposes.

   E. Whether the requested rate of return is fair.

2. Whether any other relief (e.g., interim relief) as may be just and reasonable should be granted under the circumstances.

II.

Discussion

HRS § 269-16 states in relevant part:

> **Regulation of utility rates; ratemaking procedures.** (a) All rates, fares, charges, classifications, schedules, rules, and practices made, charged, or observed by any public utility

or by two or more public utilities jointly shall be just and reasonable and shall be filed with the public utilities commission. The rates, fares, classifications, charges, and rules of every public utility shall be published by the public utility in such manner as the public utilities commission may require, and copies shall be furnished to any person on request.

To the extent the contested case proceedings referred to in chapter 91 are required in any rate proceeding to ensure fairness and to provide due process to parties that may be affected by rates approved by the commission, the evidentiary hearings shall be conducted expeditiously and shall be conducted as a part of the ratemaking proceeding.

(b) No rate, fare, charge, classification, schedule, rule, or practice, other than *one established pursuant to an automatic rate* adjustment clause previously approved by the commission, shall be established, abandoned, modified, or departed from by any public utility, except after thirty days' notice to the commission as prescribed in section 269-12(b), and prior approval by the commission for any increases in rates, fares, or charges . . . . A contested case hearing shall be held in connection with any increase in rates, and the hearing shall be preceded by a public hearing as prescribed in section 269-12(c), at which the consumers or patrons of the public utility may present testimony to the commission concerning the increase. The commission, upon notice to the public utility, may:

(1) Suspend the operation of all or any part of the proposed rate, fare, charge, classification, schedule, rule, or practice or any proposed abandonment or modification thereof or departure therefrom;

(2) After a hearing, by order:

(A) Regulate, fix, and change all such rates, fares, charges, classifications, schedules, rules, and practices so that the same shall be just and reasonable;

(B) Prohibit rebates and unreasonable discrimination between localities or between users or consumers under substantially similar conditions;

(C) Regulate the manner in which the property of every public utility is operated with reference to the safety and accommodation of the public;

(D) Prescribe its form and method of keeping accounts, books, and records, and its accounting system;

(E) Regulate the return upon its public utility property;

(F) Regulate the incurring of indebtedness relating to its public utility business; and

(G) Regulate its financial transactions; and

(3) Do all things that are necessary and in the exercise of the commission's power and jurisdiction, all of which as so ordered, regulated, fixed, and changed are just and reasonable, and provide a fair return on the property of the utility actually used or useful for public utility purposes.

. . . .

(d) <u>The commission shall make every effort to complete its deliberations and issue its decision as expeditiously as possible and before</u>

nine months from the date the public utility filed its completed application; provided that in carrying out this mandate, the commission shall require all parties to a proceeding to comply strictly with procedural time schedules that it establishes. If a decision is rendered after the nine-month period, the commission shall report in writing the reasons therefor to the legislature within thirty days after rendering the decision.

Notwithstanding subsection (c), if the commission has not issued its final decision on a public utility's rate application within the nine-month period stated in this section, the commission, within one month after the expiration of the nine-month period, shall render an interim decision allowing the increase in rates, fares and charges, if any, to which the commission, based on the evidentiary record before it, believes the public utility is probably entitled. The commission may postpone its interim rate decision for thirty days if the commission considers the evidentiary hearings incomplete. In the event interim rates are made effective, the commission shall require by order the public utility to return, in the form of an adjustment to rates, fares, or charges to be billed in the future, any amounts with interest, at a rate equal to the rate of return on the public utility's rate base found to be reasonable by the commission, received under the interim rates that are in excess of the rates, fares, or charges finally determined to be just and reasonable by the commission. Interest on any excess shall commence as of the date that any rate, fare, or charge goes into effect that results in the excess and shall continue to accrue on the balance of the excess until returned.

. . . .

HRS § 269-16 (emphasis added).

The commission timely issues this Decision and Order.[12]

A.

Parties' Stipulation

1.

Terms and Conditions

The Stipulation represents the Parties' global settlement of all issues. In reaching their global settlement:

> The Parties agree that the following provisions of the Stipulation are binding between them with respect to the specific issues and matters to be resolved in the subject docket. In all respects, it is understood and agreed that the agreements evidenced in this Stipulation represent compromises by the Parties to fully and finally resolve all issues in the subject docket on which they had differences, for the purpose of

[12]The Parties did not strictly comply with the commission's procedural schedule, which is a condition precedent to the commission's issuance of its decision and order within nine months from the filing date of HAWC's complete Application. See HRS § 269-16(d). Instead, the commission approved multiple requests for extensions of time to comply with the procedural schedule. See Order Approving Hawaii-American Water Company's Request, Filed on June 21, 2011, for Extensions of Time, filed on June 22, 2011; Order Approving the Division of Consumer Advocacy's Request, Filed on July 18, 2011, for an Extension of Time, filed on July 28, 2011; Order Approving the Parties' Request for Extensions of Time, filed on August 24, 2011; Order Approving Hawaii-American Water Company's Request, Filed on September 23, 2011, for Extensions of Time, filed on September 27, 2011; and Order Approving Revisions to the Procedural Schedule Proposed by Hawaii-American Water Company and the Division of Consumer Advocacy, and Filed on September 30, 2011, filed on October 4, 2011. Nonetheless, the commission, in this specific instance, timely issues this Decision and Order by November 22, 2011, the nine-month deadline.

> simplifying and expediting this proceeding, and are not meant to be an admission by any of the Parties as to the acceptability or permissibility of matters stipulated to herein. The Parties reserve their respective rights to proffer, use and defend different positions, arguments, methodologies, or claims regarding the matters stipulated to herein in other dockets or proceedings. Furthermore, the Parties agree that nothing contained in this Stipulation shall be deemed to, nor be interpreted to, set any type of precedent, or be used as evidence of a Party's position in any future proceeding, except as necessary to enforce this Stipulation.

Stipulation, at 8-9.

Ultimately, the Parties acknowledge that the Stipulation is subject to the commission's review and approval, and that the commission is not bound by the Stipulation.

In this regard, it is well-settled that an agreement between the parties in a rate case cannot bind the commission, as the commission has an independent obligation to set fair and just rates and arrive at its own conclusion. In re Hawaiian Elec. Co., Inc., 5 Haw. App. 445, 447, 698 P.2d 304, 307 (1985). With this mandate, the commission proceeds in reviewing whether the Parties' Stipulation is just and reasonable, taken as a whole.

2.

Summary

The Parties first reached agreement on HAWC's Test Year revenues and expenses at present rates, average depreciated rate base, and rate of return. As a result, the Parties stipulated to an increase of $1,246,630, or approximately 14.20% over revenues at present rates for HAWC, based on a Test Year revenue requirement of $10,026,020.

Once the Parties reached agreement on HAWC's Test Year revenue requirement, they then agreed to implement the stipulated increase in revenues by an equal, across-the-board percentage increase in HAWC's monthly wastewater service charges.

B.

Revenues

The Parties stipulate to the following estimates of HAWC's revenues at present rates (Stipulation Exhibit A, at 2 and 4):

Revenues		Present Rates
Residential (Domestic)		$7,281,100
Commercial		$770,770
Public Authority-Dwelling		$518,360
Public Authority-Other		$169,710
Miscellaneous		$39,450
	Total:	$8,779,390

The Parties' stipulated amounts for revenues at present rates incorporate HAWC's estimates, which the Consumer Advocate accepts for settlement purposes.[13]

1.

Residential

For Single-Family Residential Units and Multi-Family Residential Units, HAWC assesses a monthly, flat rate charge for wastewater service. The Parties stipulate to $7,281,100 in Residential revenues at present rates, calculated as follows:[14]

Description	Customer Count	Monthly Charge	Residential Revenues at Present Rates
Single-family	6,892	$58.70	$4,854,725
Multi-family	4,048	$49.95	$2,426,371
			$7,281,100 (rounded)

See Stipulation, at 11-12, and Stipulation Exhibit A, at 2 and 4.

HAWC's customer counts for the single-family and multi-family residential units are based on the year-end number of residential customer units that received wastewater utility service in 2010. HAWC utilized these customer counts based on

[13]Application, Exhibit 14-T-100, at 14-18, and Exhibits 6, 7, and 7-1; and CA-T-1, at 20-41, and Exhibit CA-101.

[14]For the: (1) single-family units: $58.70 monthly service charge x 12 months x 6,892 single-family units = $4,854,725; and (2) multi-family units: $49.95 monthly service charge x 12 months x 4,048 multi-family units = $2,426,371.

its projections of no residential customer growth during the Test Year period due to the near or full build-out of residential units in the Hawaii Kai service area.[15]

The commission finds reasonable the Parties' stipulated amount of $7,281,100 in Residential revenues at present rates.

2.

Commercial

For Commercial Food Service (i.e., the restaurant class) and *Commercial Non-Food Service (i.e., the non-restaurant* class), HAWC assesses a monthly charge for wastewater service that is based on the customer's water volumetric rate per thousand gallons ("TG"). The Parties stipulate to $770,770 in Commercial revenues at present rates, calculated as follows:[16]

Description	Water Usage (gallons)	Water Volumetric Rate	Commercial Revenues at Present Rates
12 restaurants	26,869,050	$14.10 per TG	$378,854
29 non-restaurants	45,307,800	$8.65 per TG	$391,912
			$770,770 (rounded)

See Stipulation, at 12-13, and Stipulation Exhibit A, at 2 and 4.

[15]Application, Exhibit 14-T-100, at 17, and Exhibit 14-T-300, at 22-23; CA-T-1, at 24-28; and Stipulation, at 11-12.

HAWC's estimated water usage amounts for the Commercial classes (Food Service and Non-Food Service) are based on the actual, historical water usage data for 2010, as adjusted to normalize this data in order to "correct" for an inadvertent overbilling which affected commercial customers. HAWC utilized this normalized 2010 water usage data based on its projections of no significant commercial customer growth during the Test Year period.[17] In addition, the Consumer Advocate, following its review of HAWC's responses to CA-IR-59 and CA-IR-60, "noted that the 2011 Test Year commercial water use appeared consistent with historical consumption."[18]

The commission finds reasonable the Parties' stipulated amount of $770,770 (rounded) in Commercial revenues at present rates.

3.

Public Authority

For the Public Authority classification, HAWC assesses a monthly charge for wastewater service that is based on the

[16]For the: (1) restaurant class: 26,869,050 gallons x $14.10 per TG = $378,854; and (2) non-restaurant class: 45,307,800 gallons x $8.65 = $391,912.

[17]Application, Exhibit 14-T-100, at 17-18, and Exhibit 14-T-300, at 22-25; and Stipulation, at 12-13.

[18]Stipulation, at 13 (citing to CA-T-1, at 35-37).

amount of water that is processed and treated by HAWC. The Parties stipulate to $688,070 in Public Authority revenues at present rates, calculated as follows:[19]

Description	Treated Water (gallons)	Wastewater Treatment Rate	Commercial Revenues at Present Rates
1 Public Authority-Dwelling customer	159,007,000	$3.26 per TG	$518,360
8 Public Authority-Other customers	19,619,801	$8.65 per TG	$169,710 (rounded)
			$688,070

See Stipulation, at 13-17, and Stipulation Exhibit A, at 2 and 4.

A.

Public Authority-Dwelling

The Public Authority-Dwelling customer refers to the bulk wastewater treatment service HAWC provides to the City for the City's residential customers that reside in areas which are outside of HAWC's service territory (including Kuliouou Valley, Paiko, and Portlock), but which are served directly by the City's sewerage system and then connected to HAWC's wastewater

[19]For the: (1) Public Authority-Dwelling class: 159,007,000 gallons x $3.26 per TG = $518,360; and (2) Public Authority-Other class: 19,619,801 gallons x $8.65 per TG = $169,710 (rounded).

collection, treatment, and disposal system for processing and treatment.[20]

HAWC's estimated wastewater amount for the Public Authority-Dwelling customer is based on the actual, historical, water usage data for 2010, as adjusted to normalize this data in order to "correct" for an inadvertent overbilling which affected the City.[21] The Consumer Advocate, in its direct testimony, did not propose any adjustments to HAWC's projected revenues at present rates for the Public Authority-Dwelling customer, concluding that HAWC's "2011 Test Year wastewater flow was consistent with the 2010 and 2011 to-date flow information."[22]

The commission finds reasonable the Parties' stipulated amount of $518,360 in Public Authority-Dwelling revenues at present rates.

B.

Public Authority-Other

The Public Authority-Other customers refer to the wastewater utility service HAWC provides to certain City and

[20]Application, at 5 n.9.

[21]Application, Exhibit 14-T-100, at 17-18, and Exhibit 14-T-300, at 22-25; and Stipulation, at 13-15.

[22]Stipulation, at 15 (citing to CA-T-1, at 38-39).

State facilities, such as parks, schools, and a fire station, and to Lunalilo Home.

HAWC's estimated wastewater amount for the Public Authority-Other customers is based on: (1) the actual, historical, water usage data for 2010, as adjusted to normalize this data in order to "correct" for an inadvertent overbilling which affected this customer base; and (2) HAWC's projection that there will be no change in the number or type of Public Authority-Other customers during the Test Year period.[23] The Consumer Advocate, in its direct testimony, did not propose any adjustments to HAWC's projected revenues at present rates for the Public Authority-Other customers, noting that "the Test Year water usage [data] was consistent with historical information."[24]

The commission finds reasonable the Parties' stipulated amount of $169,710 (rounded) in Public Authority-Other revenues at present rates.

4.

Miscellaneous

"Miscellaneous revenues represent miscellaneous and late payment fees on delinquent account balances and the

[23]Application, Exhibit 14-T-100, at 17-18, and Exhibit 14-T-300, at 22-25; and Stipulation, at 16-17.

[24]Stipulation, at 16 (citing to CA-T-1, at 40).

revenues Applicant receives for its license agreement with Time Warner Entertainment Company, LP dba Oceanic Cable ('Oceanic Cable') as further discussed in Docket No. 2010-0158."[25] The Parties stipulate to $39,450 in miscellaneous revenues at present rates, comprised as follows:

Description	Miscellaneous Revenues at Present Rates
Oceanic Cable license agreement fee	$38,870
Returned check fees (non-sufficient funds)	$580
	$39,450

See Stipulation, at 17, and Stipulation Exhibit A, at 2 and 4.

On December 9, 2010, the commission, in In re Hawaii-American Water Co., Docket No. 2010-0158 ("Docket No. 2010-0158"), approved a license agreement between HAWC and Oceanic Cable, for the cable service provider's use of HAWC's ground space in Hawaii Kai, in exchange for a monthly license fee.[26]

The Parties' estimated amount of revenues at present rates generated from: (1) the license fee arises out of the license agreement between HAWC and Oceanic Cable that was approved by the commission in Docket No. 2010-0158; and (2) the

[25]Stipulation, at 17 (footnote and citation therein omitted).

[26]Docket No. 2010-0158, Decision and Order, filed on December 9, 2010.

returned check fees is based on the simple average of the actual, historical fees collected from 2008 - 2010.[27]

The commission finds reasonable the Parties' stipulated amounts of $38,870 and $580 in revenues at present rates generated from the miscellaneous fees.

5.

Total Revenues at Present Rates

The commission finds reasonable the Parties' stipulated amount of $8,779,390 in revenues at present rates.

C.

Expenses

HAWC's Test Year expenses consist of the following categories: (1) operations and maintenance; (2) depreciation; (3) amortization of costs for comprehensive planning studies; (4) taxes other than income taxes; and (5) income taxes.

1.

Operations and Maintenance

The Parties stipulate to the following operations and maintenance expense amounts at present rates (Stipulation Exhibit A, at 2):

[27]Stipulation, at 17, and Stipulation Exhibit A, at 4.

Description	Present Rates
Labor	$862,330
Fuel and power	$567,980
Chemicals	$273,910
Waste disposal	$323,440
Management fees	$905,710
Group insurance	$212,130
Pensions	$175,490
Insurance other than group	$124,610
Customer accounting	$100,370
Rents	$49,500
General office	$78,220
Miscellaneous	$368,840
Repairs and maintenance	$175,460
Regulatory	$133,020
	$4,351,010

In general, HAWC's operations and maintenance expense amounts (excluding regulatory expense) represent the normalized level of funds it will expend during the Test Year to operate and maintain its wastewater treatment system to provide: (1) wastewater utility service to its customers located within its service area; and (2) wastewater treatment service to its Public Authority customers. Regulatory expense, meanwhile, represents the reasonable amount of expenses incurred by HAWC to process this rate case, as agreed-upon by the Parties, amortized over a two-year period.

A.

Labor

For the Test Year period, HAWC has a total of sixteen employees: (1) fourteen employees for its Hawaii Kai operations;

and (2) two employees for its Mauna Lani operations.[28] Six of HAWC's employees are non-union members, while the other ten employees are union members. Two of HAWC's non-union employees are directly assigned to solely support Mauna Lani's operations, while the other four non-union employees support both the Hawaii Kai and Mauna Lani operations.[29]

HAWC's labor-related expenses are affected by two allocations which reduce the level of expenses incurred by HAWC for its Hawaii Kai operations: (1) an allocation to HAWC's Mauna Lani operations; and (2) an allocation to capitalized labor, i.e., the labor capitalization allocation factor.

Because four non-union employees support both HAWC's Hawaii Kai and Mauna Lani operations, an allocation is required to reflect the labor-related costs associated with the support these employees provide to HAWC's Hawaii Kai operations. The Parties stipulate to applying a labor allocation factor of 10.72% for HAWC's Mauna Lani operations, calculated as follows:[30]

[28]The labor and related costs attributable to the two Mauna Lani employees are not reflected in HAWC's Test Year revenue requirement. Stipulation, at 20.

[29]Stipulation, at 20 and 29.

[30]Stipulation, at 21, and Stipulation Exhibit A, at 5 and 6.

Actual annual hours spent on Mauna Lani's operations: (historical, three-year average from 2007 to 2010)	223
Total normalized annual work hours:	2,080

$$\frac{223}{2{,}080} = 10.72\%$$

The commission finds reasonable the Parties' calculation of the labor allocation factor for HAWC's Mauna Lani operations.

"Capitalized labor represents the compensation for the hours an employee works on projects whose costs are capitalized and recorded as utility plant in service. The capitalized labor percentage represents the ratio of capitalized labor for a given year to the total labor costs for that year. For the 2011 test year, the capitalized labor represents the test year capitalized labor percentage times the total test year labor costs."[31]

The Parties stipulate to a labor capitalization allocation factor of 14.91%, which is based on HAWC's "average capitalization ratio from 2007 to 2011 year-end to date in order to better normalize the ratio to be used for the 2011 Test Year."[32]

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[31]Application, Exhibit 14-T-100, at 24; see also, Stipulation, at 27 (the labor capitalization allocation factor represents the percentage of labor costs that are charged to HAWC's capital improvement projects for each year).

[32]Stipulation, at 28; see also Stipulation Exhibit A, at 5 and 6.

The commission finds reasonable the Parties' calculation of HAWC's labor capitalization allocation factor.

The Parties stipulate to $862,330 (rounded) in labor expense at present rates, comprised as follows:

Base compensation	$918,171	
Overtime pay	$92,497	
Standby pay	$18,784	
Gross labor expense	$1,029,452	
Allocation to Mauna Lani	($13,635)	
Capitalized labor	($153,491)	
Net labor expense	$862,330	(rounded)

HAWC's non-union employees received salary increases in January 2010 and January 2011, while HAWC's union employees, pursuant to the terms of the current collective bargaining agreement, received wage increases in July 2010 and July 2011.

For base compensation, HAWC, as reflected in its Application, initially sought to include the salary and wage increases in calculating its labor expense.[33] The Consumer Advocate, as part of its direct testimony, recommended the disallowance of the 2010 and 2011 salary and wage increases.[34] Now, the Parties stipulate to a base compensation expense amount of $918,171 at present rates, which represents: (1) the exclusion of the salary increases for HAWC's non-union

[33]Application, Exhibit 14-T-100, at 19-20.

[34]Stipulation, at 19-21 (citing to CA-T-2, at 3-4).

employees; and (2) the inclusion of the wage increases for HAWC's union employees.[35]

The Parties' estimate of $92,497 in overtime pay at present rates for HAWC's union employees is calculated based on: (1) the average number of overtime hours from 2009 to 2010 for the electrician and senior operator positions, multiplied by the applicable overtime pay rate; and (2) the average number of overtime hours from 2008 to 2010 for the other union employee positions, multiplied by the applicable overtime pay rate. The Parties utilize the two-year in lieu of three-year average for the electrician and senior operator due to both positions being filled during the end of 2008.[36] Likewise, the Parties' estimate of $18,784 in standby pay for HAWC's union employees is calculated based on the same methodology, utilizing the average number of standby hours from 2008 or 2009 to 2010, depending on the position, multiplied by the applicable standby rate.[37]

The Parties' estimate of gross labor expense of $1,029,452, minus the amounts allocated to HAWC's Mauna Lani

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[35]Stipulation, at 19-23, and Stipulation Exhibit A, at 5 and supporting worksheets attached thereto.

[36]Stipulation, at 23-24, and Stipulation Exhibit A, at 5 and supporting worksheets attached thereto.

[37]Stipulation, at 24-25, and Stipulation Exhibit A, at 5 and supporting worksheets attached thereto.

operations and capitalized labor, respectively, results in $862,330 (rounded) in net labor expense at present rates.

In In re Hawaiian Elec. Co, Inc., Docket No. 2010-0080 ("Docket No. 2010-0080"), Hawaiian Electric Company, Inc.'s ("HECO") pending 2011 test year rate case, the commission authorized HECO to recover for interim relief purposes the expenses incurred by the electric utility for wage and salary increases for its employees, subject to further review as to the ultimate reasonableness of such expenses as part of the commission's forthcoming final decision and order. The commission, in Docket No. 2010-0080, noted that it reviews the need for any labor cost adjustments on a case-by-case basis.[38]

The Parties' agreement to include wage increases for its union employees reflects an area of compromise that results from: (1) the commission's Interim Decision and Order issued in HECO's pending 2011 test year rate case, Docket No. 2010-0080; (2) the staff reduction/reorganization, operational efficiencies, and other cost containment measures implemented by HAWC to lower its labor costs;[39] and (3) HAWC's concurrence with the Consumer Advocate's position of no recovery for

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[38]Docket No. 2010-0080, Interim Decision and Order, filed on July 22, 2011, at 39-47.

[39]Stipulation, at 21-22 (citing to Application, Exhibit 14-T-300, at 12-15; and Stipulation Exhibit A, at 5, and

incentive-based compensation (i.e., at-risk compensation) for its non-union employees.[40]

Based on the overall settlement agreement, the commission, in this specific instance, finds reasonable the Parties' estimate of $862,330 (rounded) in net labor expense at present rates.

B.

Power and Fuel

For HAWC, "[p]ower and fuel is comprised of expenses for electricity and synthetic natural gas, respectively. Electricity expense is primarily incurred to operate the plant and pumps at the seven pump stations. The expense reflects the amount of kilowatt hours ('kwh') required for such operation, times the normalized price per kwh for the 2011 Test Year."[41]

The Parties' stipulate to the following expense amounts for electricity and fuel (i.e., synthetic natural gas) at present rates:

Electricity	$567,715 (rounded)
Fuel	$265
	$567,980

confidential supporting worksheet attached thereto, Analysis of Labor Cost Savings to Fund Pay Increases).

[40]Stipulation, at 25-26, and Stipulation Exhibit A, at 5.

[41]Stipulation, at 30.

For electricity expense, the Parties' stipulate to HAWC's projected electricity usage of 2,254,307 kwh during the Test Year period to operate the wastewater treatment plant and seven pumping stations. The projected amount of electric use, in turn, is based on HAWC's historical, actual kwh usage between the twelve-month period from August 2010 to July 2011.[42] In the Parties' view, this recent twelve-month period "take[s] into consideration the monthly fluctuation in kwh usage at the plant and pump stations and better reflect[s] a normalized usage for rate setting purposes."[43] In addition, for consistency purposes, the Parties stipulate to basing the average price per kwh on the electricity costs incurred by HAWC from August 2010 to July 2011 as a surrogate for the Test Year period. The stipulated average price per kwh, moreover, includes the 3.1% interim increase in rates approved by the commission for HECO in Docket No. 2010-0080, HECO's pending 2011 test year rate case.[44]

[42]Stipulation, at 30-33, and Stipulation Exhibit A, at 7, and supporting worksheet attached thereto.

[43]Stipulation, at 32.

[44]Stipulation, at 30-33, and Stipulation Exhibit A, at 7, and supporting worksheet attached thereto; and HAWC's response to PUC-IR-101.

The Parties' stipulated amount for fuel expense, meanwhile, is based on the historical, actual amount expended by HAWC in 2010 for synthetic natural gas.[45]

The commission finds reasonable the stipulated amount of $567,980 in electricity and fuel expenses at present rates.

C.

Chemicals

HAWC purchases and utilizes five types of chemicals as part of its wastewater treatment and processing operations.[46] HAWC's chemicals expense includes "an estimate for the cost of chemicals to process and treat the wastewater flows at the treatment plant and to control the odors emitting from the collection and treatment of the wastewater processed."[47]

The Parties stipulate to $273,910 (rounded) in chemicals expense at present rates, calculated based on the projected total quantity of chemicals that will be purchased during the Test Year, multiplied by the estimated costs for each type of chemical.[48]

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[45]Stipulation, Exhibit A, at 7.

[46]Stipulation Exhibit A, at 8.

[47]Stipulation, at 33.

[48]Stipulation Exhibit A, at 8.

For three of the chemicals, the Parties utilized the historical, three-year average from 2008 to 2010 to determine the quantity units of these chemicals HAWC will purchase during the Test Year. The Parties projected that the quantity units for the fourth chemical that HAWC intends to purchase during the Test Year will be approximately 66.67% less than the amounts purchased in 2010. Finally, the Parties projected the quantity units for the fifth chemical based on the historical, actual quantities purchased by HAWC in 2010, since HAWC's purchase of this chemical has consistently declined from 2008 to 2010.[49]

With respect to the price for each chemical, "[t]he 2011 price of each type of chemical purchased was . . . determined using the vendor quotation of the 2011 price increase, when available. If no increase was provided, the 2010 December unit price was used to determine the 2011 Test Year chemical expense."[50]

The commission finds reasonable the Parties' stipulated amount of $273,910 (rounded) in chemicals expense at present rates.

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[49]Stipulation Exhibit A, at 8.

D.

Waste Disposal

HAWC's "waste disposal expense represents the cost to haul and dispose of solid waste resulting from the wastewater treatment process."[51]

The Parties stipulate to $323,440 in waste disposal expense at present rates. Based on the historical, three-year average tons and loads of solid waste HAWC disposed of from 2008 to 2010, the Parties' calculated the waste disposal expense amount as follows:[52]

Projected Tons or Loads	Cost Per Ton or Load	Projected Cost	
2,420.7369 wet tons*	$91.07	$220,457	
393 loads*	$225.00	$88,425	
		$308,882	
	Taxes	$14,548	
		$323,440	(rounded)

*Based on the historical, three-year average tons and loads disposed of from 2008 to 2010.

The commission finds reasonable the Parties' stipulated estimate of $323,440 in waste disposal expense at present rates.

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50 Stipulation, at 33.

51 Stipulation, at 34.

52 Application, Exhibit 14-T-100, at 30-31, and Exhibit 7-5; CA-T-2, at 17, and Exhibits CA-101 and CA-201; and Stipulation, at 34-35, and Stipulation Exhibit A, at 9.

E.

Net Management Fees
(Shared Services)

American Water assesses HAWC management fees for certain support services the parent company's mainland employees provide to the affiliated utility entities, including HAWC for the utility's Hawaii Kai and Mauna Lani operations. The various support services, which American Water characterizes as "functional business units," include "audit, customer service call center, finance, human resources, information technology, and regulated operations management."[53]

The Parties stipulate to $905,710 (rounded) in net management fees expense at present rates, calculated as follows:

Gross management fees	$907,853
Allocation to Mauna Lani operations	($2,143)
Net management fees	$905,710

The gross management fees expense amount of $907,853 is based on the 2010 historical, actual amount of $1,039,341 in expenditures incurred by HAWC, reduced by ($131,488) to reflect a normalized, reasonable level of funds the Parties agree are necessary for the various support services, i.e., the functional business units.[54]

[53]Stipulation, at 36 (citing to the Application, Attachment TMB-401).

[54]Stipulation, at 35-38, and Stipulation Exhibit A, at 10, and confidential supporting worksheets attached thereto.

In addition, the Parties stipulate to reducing the gross management fees expense amount by ($2,143), which represents the amount that is allocated to HAWC's Mauna Lani operations based on an allocation factor of 0.24%. As noted by the Parties, "[t]he allocation [factor] is based on the ratio of customers at each utility operation over the total number of customers served by both utility operations applied to the total Test Year management fee."[55] Specifically:[56]

HAWC's customers	2011	Allocation
Hawaii Kai	10,990	99.76%
Mauna Lani	26	0.24%
	11,016	100%

The commission finds reasonable the Parties' estimate of $905,710 (rounded) in net management fees expense at present rates.

F.

Group Insurance

The Parties stipulate to a group insurance expense amount of $212,130 (rounded) at present rates, comprised as follows:

Medical, dental, prescription drug, disability and group life insurance	$145,203

[55]Stipulation, at 38-39 (citing to the Application, Exhibit 7-6, at 1).

[56]Stipulation, at 38-39, and Stipulation Exhibit A, at 10.

Post-retirement benefits coverage	$66,931
	$212,130 (rounded)

As explained by the Parties: (1) HAWC's estimated costs for medical, dental, and prescription drug insurance premiums are based on the employer's estimated 2011 contributions to Hawaii Medical Services Association for each covered employees' insurance plan (whether single or family), minus the covered employees' contributions; and (2) HAWC's estimated costs for disability and group life insurance premiums are based on the 2011 effective rates. The Parties then reduced the sum of these two cost estimates by respective allocations for HAWC's Mauna Lani operations and capitalized labor. The net result is $145,203 in expenses at present rates for medical, dental, prescription drug, disability and group life insurance coverage for HAWC's Hawaii Kai employees.[57]

HAWC's cost estimate of $66,931 for post-retirement benefits coverage is based on the employer's actuarial projected costs for each participating employee, minus respective allocations for HAWC's Mauna Lani operations and capitalized labor.[58]

[57]Stipulation, at 39-44, and Stipulation Exhibit A, at 11, and supporting worksheet attached thereto.

[58]Stipulation, at 44-45, and Stipulation Exhibit A, at 11.

The commission finds reasonable the Parties' estimate of $212,130 (rounded) in group insurance expense at present rates.

G.

Net Pension Cost

The Parties forecast $175,490 (rounded) in net pension costs at present rates, an amount that is based on the actuarial projected costs, minus the amounts allocated to HAWC's Mauna Lani operations and capitalized labor, respectively.[59] As noted by the Parties, the allocated reductions are "necessary to recognize the pension expense that is associated with the labor cost that are capitalized [to plant] and allocated to Applicant's affiliate (i.e., Mauna Lani) operations."[60]

The commission finds reasonable the Parties' estimate of $175,490 (rounded) in net pension costs at present rates.

H.

Insurance Other Than Group Insurance

Non-group insurance consists of HAWC's general liability, workers' compensation, and other insurance costs,

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[59]Stipulation, at 46, and Stipulation Exhibit A, at 12.

[60]Stipulation, at 46 (citing to Application, Exhibit 14-T-100, at 32-33).

including property. The Parties stipulate to $124,610 (rounded) in non-group insurance costs at present rates, an amount that is based on HAWC's current premium charges and budgeted amounts, minus: (1) the amount that is allocated to HAWC's Mauna Lani's operations; and (2) the amount of labor that is capitalized to plant for HAWC's workers' compensation premium.[61]

The commission finds reasonable the Parties' estimate of $124,610 (rounded) in non-group insurance costs at present rates.

I.

Customer Accounting

HAWC's expenses for customer accounting consist of the following accounts: (1) collection costs; (2) postage costs; (3) billing costs; and (4) uncollectible accounts. The Parties stipulate to $100,370 (rounded) in customer accounting expense at present rates, comprised as follows:

Description	Projected Costs
Collection	$13,043
Postage	$20,991
Billing	$6,900
Uncollectible accounts (bad debts)	$59,432
	$100,370 (rounded)

[61]Stipulation, at 50-51 (citing Application, Exhibit 14-T-100, at 33, and Exhibit 7-10), and Stipulation Exhibit A, at 14; see also Exhibits CA-101 and CA-201.

The Parties' estimates for the collection, postage, and billing accounts are based on HAWC's 2010 historical, actual amounts for each account, "escalated by 1.1% annually for 2011 based on the Honolulu [Consumer Price Index - Urban Consumers ('CPI-U')] listed by the Department of Business Economic Development & Tourism."[62]

Meanwhile, the Parties stipulate to a bad debt factor of 0.68%, which is based on a five-year historical average, from 2007 to 2011 to date, as adjusted to normalize "an abnormal situation where the bad debt recoveries exceeded the write-offs for 2010."[63] The Parties then calculated HAWC's bad debt amount as follows:[64]

Customer Class	Revenues at Present Rates From Customer Classes*
Residential	$7,281,100
Commercial	$770,770
Public Authority-Dwelling	$518,360
Public Authority-Other	$169,710
	$8,739,940

$8,739,940 x 0.68% = $59,432

*Excludes miscellaneous revenues at present rates.

[62]Stipulation, at 51 (citing to the Application, Exhibit 14-T-100, at 34, and Exhibit 7-11).

[63]Stipulation, at 52.

[64]Stipulation, at 51-52, and Stipulation Exhibit A, at 15.

The commission finds reasonable the Parties' stipulated amount of $100,370 in customer accounting expense at present rates.

Because HAWC's bad debt expense amount is calculated based on a percentage of revenues generated from the various customer classes, the Parties also stipulate to $8,480 in additional bad debt costs at proposed rates.[65] The commission, likewise, finds reasonable the $8,480 in bad debt estimate at proposed rates.

J.

Rents

The Parties stipulate to $49,500 (rounded) in rental expense at present rates. In support thereto, the Parties explain:

> Rent expenses include the leasing of a business office in the Hawaii Kai Shopping Center as well as rental of land where Applicant's ocean outfall is located. The 2011 Test Year office lease costs were based on the terms of the 2007 lease agreement, which includes a reduction in Applicant's original office space. Other rental expenses represent the cost to lease certain equipment used in the Company's operations. The cost of these lease agreements are based on the minimum lease obligation and are not expected to change from 2010 historical levels.

[65]$1,246,630 revenue increase x 0.68% = $8,480 (rounded).

Stipulation, at 53 (citing to Application, Exhibit 14-T-100, at 35, and Exhibit 7-12); see also Exhibits CA-101 and CA-201; and Stipulation Exhibit A, at 16.

Based on the Parties' supporting reasons, the commission finds reasonable the Parties' stipulated estimate of $49,500 (rounded) in rental expense at present rates.

K.

General Office

The Parties stipulate to $78,220 (rounded) in general office expense at present rates. In support thereto, the Parties explain that the respective amounts for each of the general office accounts are based on HAWC's 2010 historical, actual costs, as adjusted by the Honolulu CPI-U inflationary factor of 1.1%.[66]

The commission finds reasonable the Parties stipulated amount of $78,220 (rounded) in general office expense.

[66]Stipulation, at 53-54 (citing to the Application, Exhibit 14-T-100, at 36, and Exhibit 7-13), and Stipulation Exhibit A, at 17; see also Exhibits CA-101 and CA-201.

L.

Miscellaneous

HAWC's miscellaneous expense categories consist of miscellaneous costs associated with pumping, water treatment, storage facilities, transmission and distribution, and other operating expenses, including security, employee welfare, legal services, outside services, 401(k) contributions, and transportation services.[67]

The Parties stipulate to $368,840 (rounded) in miscellaneous expense at present rates. In support thereto, the Parties explain:

1. The respective amounts for the pumping, water treatment, storage facilities, transmission and distribution, security, employee welfare, legal services, and outside services accounts, with the exception of the tools and other supplies sub-account, are based on HAWC's 2010 historical, actual costs, as adjusted by the Honolulu CPI-U inflationary factor of 1.1%;[68]

2. The costs for tools and other supplies reflect the average cost incurred by HAWC from 2007 to 2010;[69]

3. For 401(k) contributions, the Parties agreed to include 401(k) expenses for employees hired after

[67]Stipulation, at 54, and Stipulation Exhibit A, at 18.

[68]Stipulation, at 54, and Stipulation Exhibit A, at 18.

January 1, 2006, and "exclude the 401(k) matching contribution costs related to those employees covered by both the defined benefit and the 401(k) contribution plans[;]"[70] and

4. For the various transportation service components: (A) the lease costs are based on the actual lease agreements; (B) the vehicular maintenance costs are based on the historical, three-year average costs incurred by HAWC from 2007 to 2009; and (C) the vehicular fuel costs are "derived by increasing the 2010 fuel expense by 8% due to the higher gasoline prices expected for the 2011 Test Year."[71]

The commission, based on the Parties' supporting rationale, finds reasonable the stipulated estimate of $368,840 (rounded) in miscellaneous expense at present rates.

M.

Repairs and Maintenance

HAWC's repairs and maintenance expense consists of two categories: (1) various repairs and maintenance accounts; and (2) the amortization of deferred maintenance account. The

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[69] Stipulation, at 55, and Stipulation Exhibit A, at 18.

[70] Stipulation, at 56; see also Stipulation Exhibit A, at 18.

[71] Stipulation, at 54.

Parties stipulate to $175,460 in repairs and maintenance expense at present rates, comprised as follows:[72]

Repairs and maintenance accounts	$104,692	
Amortization of deferred maintenance	$70,772	
	$175,460	(rounded)

HAWC's various repairs and maintenance accounts include "materials and supplies for maintaining various components of the wastewater treatment system such as generators, transformers and pump stations."[73] The Parties' stipulated estimate of $104,692 in expenses incurred for these various accounts are based on HAWC's 2010 historical, actual costs, as adjusted by the Honolulu CPI-U inflationary factor of 1.1%.[74]

The Parties' stipulated amount of $70,772 in amortized deferred maintenance expenses, meanwhile, incorporates the respective annual amortization costs agreed-upon by HAWC and the Consumer Advocate in Docket No. 2007-0180, HAWC's 2008 test year rate case, for two cost items. Specifically:[75]

[72]Stipulation, at 56-57, and Stipulation Exhibit A, at 19; see also Exhibits CA-101 and CA-201.

[73]Stipulation, at 56.

[74]Stipulation, at 56-57 (citing to the Application, Exhibit 14-T-100, at 39-40, and Exhibit 7-15), and Stipulation Exhibit A, at 19.

[75]Stipulation, 56-57, and Stipulation Exhibit A, at 19.

Amortization of the remaining Odor Control Study costs of $160,832 over a four-year period ($160,832/4 years = $40,208 per year)	$40,208
Amortization of the aerobic digester cleaning costs of $213,948 over a seven-year period ($213,948/7 years = $30,564)	$30,564
	$70,772

The commission finds reasonable the Parties' stipulated estimate of $175,460 (rounded) in repairs and maintenance expense at present rates.

N.

Regulatory
(Rate Case Expense)

The Parties stipulate to a regulatory expense amount of $133,020 at present rates for the Test Year period, which is based on a total regulatory expense amount of $266,040, amortized over a two-year period. The total sum consists of the legal fees and related costs incurred by HAWC's legal counsel to process this rate case, plus the costs incurred by HAWC to inform its ratepayers of the public hearing, comprised as follows:

Legal fees and costs	$250,000
Public notice costs	$16,040
	$266,040

The total sum of $266,040 was then divided by two, which represents the Parties' projected two-year interval period between HAWC's present and next rate cases.[76]

HAWC, in support of its legal fees and costs, states in part:

> [A]s of September 30, 2011, HAWC's total legal fees recorded in account no. 182000 are approximately $255,000 (i.e., approximately $5000 over the $250,000 projected for this rate case). These costs do not reflect the legal fees for time and expenses to be incurred subsequent to September 30, 2011 to, among other things, prepare the Stipulation of Settlement Agreement and supporting exhibits filed on October 21, 2011, and address the remaining steps set forth in the amended procedural schedule that the Commission deems necessary.

HAWC's response to PUC-IR-102; see also Stipulation, at 49 (in response to the Consumer Advocate's recommendation, HAWC agrees to remove the entire amount HAWC expended in travel expenses for the rate case, i.e., $10,000).

The public hearing costs, meanwhile, represents the actual costs incurred by HAWC to provide notice of the public hearing to its ratepayers. In this regard, the commission, on March 30, 2011, instructed HAWC to duly notify its customers and patrons of the public hearing, at a minimum, by first class mail and not standard mail.[77]

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[76] $\frac{\$266,040}{2} = \$133,020$

[77] Order Regarding Completed Application and Other Matters, filed on March 30, 2011.

The commission finds reasonable the Parties' stipulated amount of $133,020 in regulatory expense at present rates.

2.

Depreciation

"Test year depreciation expense represents the annual depreciation of utility plant-in-service less the annual amortization of the contributions in aid of construction ('CIAC') received to fund the cost of certain utility plant."[78] Simply stated, "[i]n general, depreciation expense represents the systematic write-off of the cost of a plant's asset over the asset's depreciable life."[79]

The Parties stipulate to a Test Year depreciation expense amount of $2,209,060 at present rates.[80] Based on the Parties' agreed-upon average net plant-in-service balance for the Test Year (see Section II.C.1, Net Plant-in-Service), the commission finds reasonable the Parties' estimate for depreciation expense.

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[78]Stipulation, at 57.

[79]In re Waikoloa Resort Util., Inc., dba West Hawaii Util. Co., Docket No. 2006-0409, Decision and Order No. 24085, filed on March 10, 2008, at 32.

[80]Stipulation, at 57-58, and Stipulation Exhibit A, at 2 and 20.

3.

Amortization of Costs for Comprehensive Planning Studies

On May 6, 2004, the commission, in In re Hawaii-American Water Co., Inc., Docket No. 03-0025 ("Docket No. 03-0225"), HAWC's 2004 test year rate case, approved the settlement agreement between HAWC and the Consumer Advocate, by which the parties stipulated to an increase of $245,813, or approximately 3.47% over revenues at present rates, for HAWC. As a result, the commission approved the parties' agreement to amortize over a nine-year period the $513,980 in costs incurred by HAWC to undertake comprehensive planning studies related to the development of future capital improvement projects.[81]

HAWC undertook the comprehensive planning studies in 2002, and the costs for the comprehensive planning studies will be fully amortized in 2011. Accordingly, the Parties stipulate to $33,310 in costs for the comprehensive planning studies, which reflects the remaining unamortized balance.[82]

Based on the commission's approval of the Parties' prior agreement in Docket No. 03-0025 to amortize the costs of the comprehensive planning studies over a nine-year period (2002

[81]Docket No. 03-0025, Decision and Order No. 20966, filed on May 6, 2004.

[82]Stipulation, at 58-59, and Stipulation Exhibit A, at 21 (citing to the Application, Exhibit 14-T-100, at 41, and Exhibit 7-17).

to 2011), the commission approves as reasonable the $33,310 in costs for such studies, i.e., the remaining unamortized balance.

4.

Taxes Other Than Income Taxes

HAWC's taxes other than income taxes consist of the: (1) State Public Service Company Tax ("PSCT"), 5.885%; (2) State Public Utility Fee ("PUC Fee"), 0.50%; and (3) payroll taxes.

The Parties' calculations of the PSCT and the PUC Fee are set forth in Stipulation Exhibit A, at page 22. The commission finds reasonable the Parties' stipulated amounts for the PSCT and the PUC Fee, calculated as follows:

Present Rates

PSCT:	5.885% x $8,779,390 =	$516,667
PUC Fee:	0.50% x $8,719,958* =	$43,600
		$560,267

*Excludes the allowance for bad debt, i.e., uncollectibles.

Proposed Rates

PSCT:	5.885% x 10,026,020 =	$590,031
PUC Fee:	0.50% x $9,958,111* =	$49,791
		$639,822

*Excludes the allowance for bad debt, i.e., uncollectibles.

Meanwhile, the Parties' calculation of payroll taxes is set forth in Stipulation Exhibit A, at page 5, confidential worksheet 1. In general: (1) payroll taxes were calculated based on the applicable payroll tax rates times the taxable portion of the salary and wage amounts for HAWC's employees; and (2) a portion of payroll taxes was excluded to account for capitalized labor and time spent on affiliated activities.[83]

The Parties stipulate to payroll taxes in the total amount of $77,714. The commission finds reasonable the Parties' estimate for payroll taxes.

In sum, the total amounts for taxes other than income taxes are as follows:

Present Rates

PSCT:	$516,667	
PUC Fee:	$43,600	
Payroll taxes:	$77,714	
	$637,980	(rounded)

Proposed Rates

PSCT:	$590,031	
PUC Fee:	$49,791	
Payroll taxes:	$77,714	
	$717,540	(rounded)

5.

Income Taxes

The Parties' stipulated amounts for income taxes at present and proposed rates are $211,910 (rounded) and $662,710 (rounded), respectively. The Parties' calculation of income taxes, as set forth in Stipulation Exhibit A, at pages 23

[83]Stipulation, at 59 (citing to the Application, Exhibit 14-T-100, at 42, and Exhibit 7-18).

and 32, is based on the federal and State composite income tax rate of 38.910%, minus the amortized amount of the Hawaii Capital Goods Excise Tax Credit ("HCGETC"). The commission finds reasonable the Parties' stipulated amounts for income taxes at present and proposed rates.

6.

Total Expenses

The commission finds reasonable the Parties' total estimates of $7,231,360 in expenses at present rates, and $7,319,400 in expenses at proposed rates.

D.

Rate Base

The Parties stipulate to the use of an average Test Year rate base, which is consistent with the commission's past practice.[84] Stipulation Exhibit A, at page 24, sets forth the Parties' agreed-upon calculations for HAWC's average depreciated rate base of $25,232,810, comprised as follows:

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[84]See, e.g., In re Waikoloa Resort Util., Inc., dba West Hawaii Util. Co., Docket No. 2006-0409, Decision and Order No. 24085, filed on March 10, 2008, at 34 (the use of an average test year rate base is consistent with the commission's past practice).

Description	Amount
Plant-in-service	$48,851,370
Accumulated depreciation	($22,616,160)
Net plant-in-service	$26,235,210
Net CIAC	($299,730)
Working capital	($215,570)
Accumulated deferred income taxes: federal	($638,570)
Accumulated deferred income taxes: State	$238,660
Unamortized Hawaii general excise tax credit	($132,190)
Average depreciated rate base	$25,232,810

1.

Net Plant-in-Service

In general, HAWC's net plant-in-service (i.e., its plant-in-service less accumulated depreciation) comprises its share of investments in its wastewater treatment, processing, and disposal operations.

The Parties' agreement on HAWC's average net plant-in-service balance of $26,235,210, in effect, reflects the net investment in utility property utilized by HAWC in providing wastewater utility service during the Test Year. In determining HAWC's average net plant-in-service balance, the Parties began with the amount of HAWC's plant-in-service balance as of December 31, 2006, as agreed-upon by them in Docket No. 2007-0180, HAWC's 2008 test year rate case.[85] Next, the

[85]Stipulation, at 63-67 (HAWC and the Consumer Advocate both began with HAWC's plant-in-service balance as of December 31, 2006; and the Parties' agreement to reclassify

Parties agreed to include the amounts for utility plant that were added by HAWC from 2007 to 2011 to date, i.e., plant additions, subject to certain downward adjustments recommended by the Consumer Advocate.[86] The Parties then agreed to reflect the amounts for utility plant that were retired by HAWC from 2007 to 2011 to date, i.e., plant retirements, as a reduction to HAWC's plant-in-service balance.[87] Lastly, the Parties agreed on an amount for HAWC's accumulated depreciation balance, and deducted this amount from HAWC's plant-in-service balance, to derive HAWC's average net plant-in-service balance of $26,235,210.[88]

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certain plant additions results in the same 2006 plant-in-service balance as reflected in Docket No. 2007-0180), and Stipulation Exhibit A, at 24, 25, and 26, Reconciliation of Stipulated Plan Additions From Docket No. 2007-0180 to Actual Plant Additions, and supporting worksheet attached thereto; see also CA-T-1, at 47.

[86]Stipulation, at 67-70 (description of plant additions between 2007 to 2011 to date, subject to certain downward adjustments recommended by the Consumer Advocate), and Stipulation Exhibit A, at 25 and 27, Annual Changes to Utility Plant in Service, and supporting worksheet attached thereto.

[87]Stipulation, at 70, and Stipulation Exhibit A, at 25 and 27, Annual Changes to Utility Plant in Service, and supporting worksheet attached thereto.

[88]Stipulation, at 70-72, and Stipulation Exhibit A, at 24, 25, and 28, Annual Changes to the Accumulated Depreciation Reserve Balance.

The Consumer Advocate, in its settlement discussions with HAWC, noted that the accumulated depreciation balance for certain accounts exceeded the asset's balance. HAWC acknowledged this situation, explaining that the "depreciation

The commission, based on its review of the Parties' methodology and corresponding calculations, finds reasonable HAWC's average net plant-in-service balance of $26,235,210, as agreed-upon by the Parties.

2.

Net CIAC

As explained by HAWC:

> CIAC represents the payments made by developers as a condition to receiving wastewater collection and treatment service, pursuant to Hawaii American's tariff. The monies are used to acquire or pay for utility plant that is needed to provide the requested service. Since the monies are not investor provided, the [unamortized] CIAC payments should be reflected as a reduction to the test year plant-in-service balances. In addition, the CIAC payments are amortized over a future time period in an attempt to "match" the CIAC amortization to the depreciation of the acquired utility plant. The accumulated amortization of CIAC is then offset against the CIAC payment for purposes of

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of its plant items is based on the group life methodology for computing depreciation expense. This methodology depreciates assets by functional plant account, rather than on an individual basis." Stipulation, at 71. The Consumer Advocate, in response, noted that "the accumulated depreciation balance for the functional plant accounts in which the accumulated depreciation balance exceeds the asset balance does not significantly impact ratepayers through the Test Year depreciation expense or accumulated depreciation balance in the Test Year rate base. Thus, for settlement purposes only, the Parties have agreed that no adjustments are required at this time to address the Consumer Advocate's observation. The Consumer Advocate reserves the right to take a different position in future proceedings." Stipulation, at 71-72.

> computing the test year rate base. For Hawaii American, the amortization period is twenty-five (25) years, as shown on Exhibit 8-2 [of the Application]. The process described above is intended to prevent ratepayers from having to pay . . . a return on and of the plant investment that is not funded by investor monies.

Application, Exhibit 14-T-100, at 46-47; see also Application, Exhibit 8-2, and Stipulation, at 72 (footnote and text therein omitted).

The Parties' calculations of their estimated average net CIAC balance of ($299,730) are set forth at page 29 of Stipulation Exhibit A (citing to the Application, Exhibit 8-2). In support thereto, HAWC explains:

> For the instant proceeding, the CIAC payments are the same as that reflected in the last rate case (i.e., Docket No. 2007-0180). The amounts are amortized over the same twenty-five (25) year period and the accumulated depreciation reflects the annual amortization that has been made subsequent to 2008 (the test year for Docket No. 2007-0180). Exhibit 8-2 provides the composition of the gross CIAC payments, the annual amortization of such payments, and the accumulated amortization at December 31, 2010 and December 31, 2011.

Application, Exhibit 14-T-100, at 47; see also CA-T-1, at 55-56, and Stipulation, at 72-73; and Stipulation Exhibit A, at 29.

The commission finds reasonable the Parties' estimate of ($299,730) in average net CIAC balance.

3.

Working Capital

As explained by the Parties:

> Working capital represents the net difference between the cash that is provided by the customers when they pay their bills and the cash that is provided by the shareholders to pay bills, etc. Depending on the timing of cash receipts from customer payments and cash payments by the utility company to pay various bills, etc. on time in order to ensure that utility service can continue uninterrupted, there will be a net positive balance, which increases rate base, or a net negative balance, which decreases rate base. Generally, working capital represents an addition to the rate base of a utility company when setting rates. In certain instances, however, it is possible (as in this case) for working cash to represent a deduction to rate base. These instances are generally found when a company collects payments in advance of the end of the service period. Because the Applicant charges its residential customers on a flat rate basis, it is able to bill in advance and may, in fact, collect payments months in advance of certain service periods, resulting in a negative working capital for rate setting purposes. CA-T-1 at 59-60.

Stipulation, at 74-75 (emphasis added).

The Parties stipulate to an average working capital balance of ($215,570)(rounded). The Parties' calculations of working capital are set forth in Stipulation Exhibit A, at page 30.[89] In effect, the Parties' stipulated balance for working capital consists of the sum of the following components:

[89] See also Stipulation, at 74-76.

HAWC's average daily operating costs for each expense account	x	Corresponding net lead or lag day for each account
HAWC's average daily amounts incurred for taxes	x	Corresponding net lead or lag day for each account

The Parties' calculation of working capital is based on the same methodology utilized by them in HAWC's 2006 and 2008 test year rate cases, Dockets No. 05-0103 and 2007-0180. The commission finds reasonable the stipulated average balance of ($215,570)(rounded) for working capital.

4.

Accumulated Deferred Income Taxes

In In re Young Bros., Ltd., Docket No. 2006-0396 ("Docket No. 2006-0396"), the commission noted:

> ADIT represents the difference between the amount of income tax expense reported for book (i.e., ratemaking) and for tax purposes. In general, a regulated entity calculates and reports book depreciation expenses on a straight-line basis (i.e., straight-line depreciation), but for tax purposes, the regulated entity may write-off the same asset on an accelerated basis, i.e., accelerated depreciation. The difference in tax liabilities calculated for book and tax purposes, respectively, generates deferred income taxes. Thus, the regulated entity must pass onto its ratepayers the tax benefits received as a result of the accelerated tax depreciation practices. For ratemaking purposes, the ADIT is reflected as a reduction to rate base.

Docket No. 2006-0396, Decision and Order No. 23714, filed on October 12, 2007, at 50; see also Stipulation, at 73 (ADIT is the difference in federal and State income tax liability computed for financial statement purposes versus income tax return purposes).

The Parties' calculations of federal and State ADIT are set forth in Stipulation Exhibit A, at page 31, inclusive of the supporting worksheets attached thereto. In general, the Parties calculated HAWC's federal and State ADIT balance by multiplying the appropriate federal and State income tax rates to the difference between the book and tax depreciation for the plant-in-service balances. The commission finds reasonable the stipulated average balances of ($638,570) and $283,660 for federal ADIT and State ADIT, respectively.

5.

Unamortized Hawaii Capital Goods Excise Tax Credit

As explained by the Parties:

> The HCGETC was enacted in 1987 as the Hawaii counterpart to the federal investment tax credit. It allows a business to reduce its income tax liability by a certain percentage of the amount spent on qualified capital investments. Generally, this credit is in the amount of four percent (4%) of the purchase price or construction cost of qualifying plant and equipment used in a trade or business. The Hawaii credit is amortized and commonly recognized in determining the revenue requirement for water and wastewater companies since these funds benefit a utility's operations by reducing the cost of certain utility assets and reducing a utility's income tax liability. *See* CA-T-1 at 56-57.

Stipulation, at 73-74.

The Parties' calculations of the HCGETC are set forth in Stipulation Exhibit A, at page 32, inclusive of the supporting worksheets attached thereto. In this regard, the credit reflects the balances that were considered in HAWC's 2008 test year rate case (Docket No. 2007-0180), adjusted for the actual credits that were taken in 2007 and 2008. The credit also recognizes the amounts that were taken in 2009, and the amounts that are expected to be taken in 2010 and 2011, based on the cost of the qualifying plant additions for 2010 and 2011. The amortization of the credits over a twenty-five year period and the accumulated amortization reflect the accumulated total of the amortization taken by HAWC.

The commission finds reasonable the stipulated average balance of ($132,190) for the HCGETC.

6.

Average Depreciated Rate Base

The commission finds reasonable the Parties' average depreciated rate base estimate of $25,232,810.

E.

Rate of Return

As discussed by the Hawaii Supreme Court ("Court") in In re Hawaii Elec. Light Co., Inc., 60 Haw. 625, 594 P.2d 612 (1979) ("In re HELCO"):

> A fair return is the percentage rate of earnings on the rate base allowed a utility after making provision for operating expenses, depreciation, taxes and other direct operating

> costs. Out of such allowance the utility must pay interest and other fixed dividends on preferred and common stock. In determining a rate of return, the Commission must protect the interests of a utility's investors so as to induce them to provide the funds needed to purchase plant and equipment, and protect the interests of the utility's consumers so that they pay no more than is reasonable.
>
> To calculate the rate of return, the costs of each component of capital - debt, preferred equity and common equity - are weighted according to the ratio each bears to the total capital structure of the company and the resultant figures are added together to yield a sum which is the rate of return.
>
> The proper return to be accorded common equity is the most difficult and least exact calculation in the whole rate of return procedure since there is no contractual cost as in the case of debt or preferred stock[:]
>
>> Equity capital does not always pay dividends; all profits after fixed charges accrue to it and it must withstand all losses. The cost of such capital cannot be read or computed directly from the company's books. Its determination involves a judgment of what return on equity is necessary to enable the utility to attract enough equity capital to satisfy its service obligations.
>
> . . . .
>
> Questions concerning a fair rate of return are particularly vexing as the reasonableness of rates is not determined by a fixed formula but is a fact question requiring the exercise of sound discretion by the Commission. <u>It is often recognized that the ratemaking function involves the making of "pragmatic" adjustments and there is no single correct rate of return but that there is a "zone of reasonableness" within which the commission may exercise its judgment</u>.

<u>In re HELCO</u>, 60 Haw. at 632-33 and 636, 594 P.2d at 618-20 (citations omitted)(emphasis added).

The Parties agree that a rate of return of 8.10% is fair and reasonable, based on the following capital structure and cost rates:

Capital Component	Amount	Ratio	Cost Rate	Weighted Cost
Long-Term Debt	$17,000,000	58.07%	6.58%	3.82%
Common Equity	$12,273,000	41.93%	10.20%	4.28%
	$29,273,000	100%		8.10%

Stipulation Exhibit A, at 33.

HAWC's capital structure of 58.07% debt and 41.93% equity is based on HAWC's capital structure for the year ending December 31, 2010.[90] HAWC's embedded cost of long-term debt of 6.58%, inclusive of debt issuance costs, is likewise based on HAWC's long-term debt rate for the year ending December 31, 2010.[91] HAWC's return on common equity of 10.20%, meanwhile, represents the Consumer Advocate's proposed compromise amount as a result of HAWC's updated cost of common equity estimates of 10.78% and 10.56%, which represent recent, updated estimates made by HAWC during the Parties' settlement discussions.[92]

[90]Application, Exhibit 14-T-500, at 18, and Attachment CDK-501.

[91]Application, Exhibit 14-T-500, at 21, and Attachment CDK-501.

[92]Stipulation, at 77-78 (based on HAWC's updated estimates of 10.78% and 10.56% for the cost of common equity, the Consumer Advocate proposed a cost of common equity of 10.20%, which HAWC agreed to for settlement purposes); and HAWC's response to PUC-IR-104 and Attachment PUC-IR-104 (information and data in

On balance, the commission finds that the stipulated rate of return is within the range of reasonableness described by the Court in In re HELCO. The stipulated rate of return, moreover, is seventy-five basis points less than HAWC's current authorized rate of return of 8.85%.[93] The commission approves as fair the Parties' stipulated rate of return of 8.10%.

F.

Rate Design

HAWC, by its Application, initially proposed: (1) an across-the-board, approximately twenty-one percent increase in its monthly service charges for the Residential classes (single-family and multi-family), Commercial Non-Food Service class (non-restaurant class), and Public Authority classes (Other and Dwelling); and (2) no increase in the monthly service charge for the Commercial Food Service class (restaurant class).[94] HAWC, in support of its initial proposal, stated its intent to "move each customer class towards cost of service

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support of HAWC's updated cost of common equity estimates of 10.78% and 10.56%, respectively).

[93]See Docket No. 2007-0180, Final Decision and Order, filed on November 10, 2011 (8.85% rate of return authorized for final relief purposes).

[94]Application, at 4-5, Exhibit 14-T-100, at 18, and Exhibits 4.

based rates gradually over time."[95] The Consumer Advocate, in its direct testimony, disagreed with HAWC's proposal, reasoning that until the docket record contained more evidence in support of HAWC's proposal, "all customer classes should receive the overall increase in revenue requirements."[96]

Now, based on their agreed-upon Test Year revenue requirement of $10,026,020 for HAWC, the Parties stipulate to the following rate design:

Monthly Service Charge

Customer Class	Present Rate	Stipulated Rate	Increase
Residential			
Single-family unit	$58.70	$67.08	14.28%
Multi-family unit	$49.95	$57.08	14.27%
Commercial			
Food Service (restaurant)	$14.10 per TG	$16.08 per TG	14.04%
Non-Food Service (non-restaurant)	$8.65 per TG	$9.87 per TG	14.10%
Public Authority			
Dwelling	$3.26 per TG	$3.73 per TG	14.42%
Other	$8.65 per TG	$9.87 per TG	14.10%

See Stipulation, at 79 and 83, and Stipulation Exhibit A, at 1.

The Parties, in essence, stipulate to an across-the-board, 14% increase in all of HAWC's monthly

[95]Application, Exhibit 14-T-100, at 18.

wastewater service charges. In support of the stipulated rate design, the Parties reason:

> The stipulated rates (i.e., across-the-board, fourteen percent increase in all of HAWC's monthly service charges) are just and reasonable because the rates are intended to generate sufficient revenues to recover a reasonable, normalized level of operating expenses, return of investment (i.e., depreciation) and taxes and provide HAWC with an opportunity to earn a reasonable rate of return on rate base. Furthermore, the rates resulting from the "across the board increase" to all customer classes maintains the existing rate structure that was determined to be just and reasonable, for interim purposes, in Docket No. 2007-0180.

HAWC's response to PUC-IR-105 (the Consumer Advocate concurs with HAWC's response); see also Stipulation, at 79 (rates rarely reflect the cost of service exactly, but rather as rate cases are completed, rates evolve in the direction of the cost of service).

Based on the Parties' supporting rationale, the commission, in this specific instance, approves as just and reasonable the Parties' stipulated, across-the-board rate design.

[96]CA-T-1, at 44; see also Stipulation, at 79.

G.

Commission's Approval

On balance, the stipulated increase in revenues of $1,246,630, or approximately 14.20% over revenues at present rates, provides HAWC with the opportunity to recover its normalized, reasonable utility expenses and to earn a fair return on its average depreciated rate base, consistent with the ratepayers' attendant benefits of continuing to receive wastewater utility service without interruption, at just and reasonable rates.[97] Furthermore, as explained by HAWC in its response to PUC-IR-106, the revenue requirement approved by the commission today includes the recovery of costs associated with addressing the odor complaints it receives from ratepayers.[98]

The commission finds that the Parties' Stipulation, taken as a whole, appears just and reasonable. Accordingly, the commission approves the Parties' Stipulation, consistent with the terms of this Decision and Order. Nonetheless, the commission's approval of the Parties' Stipulation, or any of the methodologies used by the Parties in reaching their global

[97] See Stipulation, at 9 (the results of the Stipulation provide HAWC with the opportunity to recover its projected normalized expenses and realize its projected net operating income for the Test Year).

[98] See also Application, Exhibit 14-T-200, Attachment TJN-201, Odor Management Plan for East Honolulu Wastewater

settlement, may not be cited as precedent by the parties in any future commission proceeding.

III.

Summary of Findings and Conclusions

The commission finds and concludes:

1. HAWC's Test Year revenues, expenses, and average depreciated rate base, as set forth in the attached schedules, are reasonable.

2. The stipulated rate of return of 8.10% is fair.

3. HAWC is entitled to an increase in revenues of $1,246,630, or approximately 14.20% over revenues at present rates, based on a total revenue requirement of $10,026,020, and a rate of return of 8.10%.

4. The stipulated rate design is just and reasonable.

5. The nine-month deadline for the commission to make every effort to issue its Decision and Order is November 22, 2011, pursuant to HRS § 269-16(d). The commission timely issues this Decision and Order.

Treatment Facility, dated January 2007, and Exhibit 14-T-300, at 11 (Odor Control).

IV.

Orders

THE COMMISSION ORDERS:

1. The Parties' Stipulation, filed on October 21, 2011, is approved, consistent with the terms of this Decision and Order.

2. HAWC may increase its wastewater service charges to produce an increase in revenues of $1,246,630, or approximately 14.20%, as reflected in the attached schedules, representing an increase in HAWC's total revenue requirement to $10,026,020.

3. HAWC shall promptly file its revised rate schedule for the commission's review and approval, consistent with the terms of this Decision and Order, with copies served on the Consumer Advocate. HAWC's revised rate schedule shall not take effect until it is affirmatively approved by the commission.

4. The failure to comply with the requirement set forth in Ordering Paragraph No. 3, above, may constitute cause to void this Decision and Order, and may result in further regulatory action as authorized by State law.

DONE at Honolulu, Hawaii NOV 2 1 2011.

PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

By Hermina Morita
Hermina Morita, Chair

By John E. Cole
John E. Cole, Commissioner

By Michael E. Champley
Michael E. Champley, Commissioner

APPROVED AS TO FORM:

Michael Azama
Michael Azama
Commission Counsel

2010-0313.cp

Hawaii American Water Company
Results of Operation Schedule
Test Year Ending Decmeber 31, 2011

	Present Rates	Additional Amount	Approved Rates
Revenues:			
Domestic	7,281,100	1,039,400	8,320,500
Commercial	770,770	108,470	879,240
Industrial	518,360	74,740	593,100
Public Authorities - Dwelling & Other	169,710	23,940	193,650
Miscellaneous	13,000	-	13,000
Other	26,450	-	26,450
Rounding	-	80	80
Total Operating Revenues	8,779,390	1,246,630	10,026,020
Operating Revenue Deductions:			
Labor	862,330		862,330
Fuel & Power	567,980		567,980
Chemicals	273,910		273,910
Waste Disposal	323,440		323,440
Management Fees	905,710		905,710
Group Insurance	212,130		212,130
Pensions	175,490		175,490
Regulatory Expenses	133,020		133,020
Insurance Other Than Group	124,610		124,610
Customer Accounting	100,370	8,480	108,850
Rents	49,500		49,500
General Office Expenses	78,220		78,220
Miscellaneous & Other Expenses	368,840		368,840
Other Maintenance	175,460		175,460
Total O&M Expenses	4,351,010	8,480	4,359,490
Depreciation	2,209,060	-	2,209,060
Amortization of CPS	33,310	-	33,310
Taxes, Other than Income	637,980	79,560	717,540
Total Operating Revenue Deduction	7,231,360	88,040	7,319,400
Operating Income Before Income Taxes	1,548,030	1,158,590	2,706,620
Income Taxes	211,910	450,800	662,710
Net Operating Income	1,336,120	707,790	2,043,880
Average Rate Base	25,232,810		25,232,810
Return on Rate Base	5.30%		8.10%

Hawaii American Water Company
Taxes Other Than Income Taxes
Test Year Ending December 31, 2011

	Revenues at Present Rates	Revenues at Approved Rates	Tax Rates	Taxes at Present Rates	Taxes at Approved Rates
Revenue Taxes					
Public Company Service Tax	8,779,390	10,026,020	5.885%	516,667	590,031
Public Utility Fee	8,719,958	9,958,111	0.500%	43,600	49,791
Total Revenue Taxes				560,267	639,822
Payroll Tax				77,714	77,714
Total Taxes Other Than Income Taxes				637,981	717,536
			Rounded	637,980	717,540

Hawaiian American Water Company
Income Taxes
Test Year Ended December 31, 2011

		Present Rates	Approved Rates
Operating Revenue		8,779,390	10,026,020
Expense Deductions		7,231,360	7,319,400
Ratemaking Interest		972,128	972,128
Total Revenue Deductions		8,203,488	8,291,528
Taxable Net Income		575,902	1,734,492
Income Taxes	38.910%	224,082	674,887
Less Amortization of HGCETC		(12,176)	(12,176)
Net Income Taxes		211,906	662,711
	Rounded	211,910	662,710

Hawaii American Water Company
Average Rate Base
Test Year Ending December 31, 2011

	Balance at December 31, 2010	Balance at December 31, 2011	Average 2011
Utility Plant in Service	48,430,449	49,272,284	48,851,367
Accumulated Depreciation	(21,624,849)	(23,607,480)	(22,616,165)
Net Utility Plant in Service	26,805,600	25,664,804	26,235,202
Deduct:			
Net Contributions in Aid of Construction	(311,320)	(288,140)	(299,730)
Working Captial	(215,570)	(215,570)	(215,570)
Accumulated Deferred Taxes: Federal	(757,323)	(519,809)	(638,566)
Accumulated Deferred Taxes: State	269,790	297,526	283,658
Unamortized Hawaii General Excise Tax Credit	(135,810)	(128,570)	(132,190)
Subtotal	(1,150,233)	(854,563)	(1,002,398)
Total Rate Base	25,655,367	24,810,241	25,232,804
Total Average Rate Base (Rounded)			25,232,810

Hawaii American Water Company
Working Capital
Test Year Ending December 31, 2011

	2011 Present Rates	Average Daily Amount	Expense (Lead)/Lag Days	Revenue Lag	Net (Lead)/Lag Days	Working Capital (Provided)/ Required
Operation and Maintenance						
Labor	862,330	2,363	(13.19)	8.50	(4.69)	(11,082)
Fuel & Power	567,980	1,556	(26.06)	8.50	(17.56)	(27,323)
Chemicals	273,910	750	(20.43)	8.50	(11.93)	(8,948)
Waste Disposal	323,440	886	(59.61)	8.50	(51.11)	(45,283)
Management Fees	905,710	2,481	(39.20)	8.50	(30.70)	(76,167)
Group Insurance	145,200	398	7.69	8.50	16.19	6,444
OPEB's	66,930	183	(34.11)	8.50	(25.61)	(4,687)
Pensions	175,490	481	(22.71)	8.50	(14.21)	(6,835)
Regulatory Expenses	133,020	364	-	8.50	8.50	3,094
Insurance Other Than Group	124,610	341	60.90	8.50	69.40	23,665
Customer Accounting	100,370	275	(25.98)	8.50	(17.48)	(4,807)
Rents	49,500	136	9.25	8.50	17.75	2,414
General Office Expenses	78,220	214	(20.00)	8.50	(11.50)	(2,461)
Miscellaneous & Other Expenses	368,840	1,011	(29.99)	8.50	(21.49)	(21,726)
Other Maintenance	175,460	481	(23.82)	8.50	(15.32)	(7,369)
General Taxes						
Payroll Taxes	77,710	213	(14.63)	8.50	(6.13)	(1,306)
PSC Taxes	516,670	1,416	(17.30)	8.50	(8.80)	(12,461)
PUC Fees	43,600	119	(76.50)	8.50	(68.00)	(8,092)
Income Taxes						
Current	211,910	581	(30.26)	8.50	(21.76)	(12,643)
				Total Working Capital		(215,573)
				Rounded		(215,570)

CERTIFICATE OF SERVICE

The foregoing order was served on the date of filing by mail, postage prepaid, and properly addressed to the following parties:

JEFFREY T. ONO
EXECUTIVE DIRECTOR
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
DIVISION OF CONSUMER ADVOCACY
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Honolulu, HI 96809

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Counsel for HAWAII-AMERICAN WATER COMPANY

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	:	
	:	
Proposed general increase in water and sewer rates. (Tariffs filed October 27, 2011)	:	**11-0767**
	:	
	:	

<u>ORDER</u>

DATED: September 19, 2012

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	:	
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Proposed general increase in water and sewer rates. (Tariffs filed October 27, 2011)	:	**11-0767**
	:	
	:	

ORDER

By the Commission:

I. PROCEDURAL BACKGROUND

On October 27, 2011, Illinois-American Water Company ("IAWC" or "Company") filed, with the Illinois Commerce Commission ("Commission"), revised tariff sheets ("Proposed Tariffs") in which it proposed a general increase in water and sewer rates pursuant to Section 9-201 of the Public Utilities Act (the "Act"), 220 ILCS 5/9-101 et seq.

Simultaneous with and in purported support of its filing of the Proposed Tariffs, IAWC filed testimony, exhibits and schedules intended to meet the requirements of 83 Ill. Adm. Code 285, 286 and 287 ("Parts 285, 286 and 287").

The Proposed Tariffs were identified in and suspended by a Commission Suspension Order entered December 7, 2011, and were subsequently resuspended to and including September 24, 2012.

Petitions for leave to intervene or appearances were filed by the following Parties: the People of the State of Illinois, by Lisa Madigan, Attorney General of the State of Illinois (the "People" or "AG"); United States Steel Corporation-Granite City Works, Air Products & Chemicals Company, and the University of Illinois collectively referred to as the Illinois Industrial Water Consumers ("IIWC"); the Cities of Champaign and Urbana, and the Villages of Savoy, St. Joseph, Sidney and Philo (collectively, the "Cities" or "Municipalities"); the Federal Executive Agencies ("FEA"); Bond-Madison Water Company ("Bond-Madison") and the Village of Bolingbrook ("Bolingbrook").

Pursuant to due notice, hearings were held in this matter before a duly authorized Administrative Law Judge of the Commission at its offices in Springfield, Illinois. Appearances were entered by respective counsel for IAWC, the Commission Staff ("Staff"), the AG, IIWC, FEA, the Municipalities and Bolingbrook. Testimony and exhibits filed by IAWC, Staff, IIWC/FEA and the AG were admitted into evidence. At the conclusion of the hearings, the record was marked "Heard and Taken."

Initial Briefs ("IBs") and Reply Briefs ("RBs") were filed by IAWC, Staff, IIWC/FEA, the AG, Staff, the Municipalities and Bolingbrook. On June 29, 2012, an entry of appearance was filed by the Embarras Area Water District. A Proposed Order ("Proposed Order") was issued by the Administrative Law Judge. Briefs on exceptions ("BOEs") and Reply Briefs on exceptions ("RBOEs") were filed by IAWC, Staff, IIWC/FEA, the AG, the Municipalities and Bolingbrook.

II. NATURE OF IAWC'S OPERATIONS

IAWC, a wholly owned subsidiary of American Water, provides residential, commercial, industrial, and sale-for-resale water service, as well as fire protection service, to numerous communities in various rate areas in Illinois.

The Zone 1 rate area currently includes the Southern (Alton, Cairo and Interurban including East St. Louis), Pontiac, Streator, Peoria, South Beloit, Sterling and Champaign districts. The other rate areas or districts are Lincoln, Pekin and Chicago Metro Water. IAWC also provides public utility wastewater service in the Chicago Metro Sewer district. In this proceeding, IAWC proposes to consolidate the Chicago Metro and Zone 1 districts with respect to non-production related costs.

III. TEST YEAR; PROPOSED REVENUE INCREASES

"Test year" options and filing requirements are set forth in 83 Ill. Adm. Code 285, 286 and 287. In this proceeding, the Company's proposed rate increase request is based on a future, or forecasted, test year consisting of the 12 months ended September 30, 2013. No party objected to the Company's use of the proposed test year, and it is found to be appropriate for the purposes of this proceeding.

The rates proposed in IAWC' filing were intended to increase revenues from water customers by 18.27% and revenues from sewer customers by 15.62%. Specific increases by water district would vary.

To date, 33 comments have been submitted in the Public Comments section of e-Docket. In these comments, IAWC's customers express strong opposition to the amount of the proposed rate increase and to the frequency of rate increases sought by IAWC.

IV. RATE BASE

The rate base represents the net level of investment that a utility company has dedicated to public service on which it is entitled to earn a return. The rate base consists principally of book investment in utility plant and working capital, less deductions to reflect other sources of funds, such as deferred taxes. Schedules showing IAWC's rate base at present and recommended rates for the future test year were presented by IAWC and Staff.

Contested rate base issues are discussed below. The Commission observes that the summaries of parties' positions on rate base issues, and all other issues, wherever they may be contained in this order, are not intended to reflect the opinions of or determinations by the Commission unless otherwise noted.

A. Pension Asset

IAWC seeks to include in rate base an amount of $9,575,288 related to its pension contributions sometimes described as a "pension asset." Staff opposes this proposal, as does the AG. The Parties' positions are summarized below. No exceptions were filed on this issue.

1. IAWC Position

Inclusion of this amount in rate base is appropriate, in IAWC's view, "because it properly reflects, for ratemaking purposes, the timing difference between the level of accrued pension expense IAWC collects in base rates (the Statement of Financial Account Standard No. 87 ('FAS 87') amount, as explained below) and the amount of the Company's actual pension contributions." (IAWC IB at 19)

When the FAS 87 expense amount collected from ratepayers exceeds the contribution amounts, the Commission consistently approves a reduction in rate base reflecting the difference. (*Id*., citing *Illinois-American Water Co.*, Order, Docket 09-0319 (Apr. 13, 2010), App. A at 2, and other orders)

Conversely, IAWC argues, when its pension contributions exceed what the Company may collect through rates, as is projected to occur in this case, the Commission should approve an increase to rate base. (IAWC IB at 20) Such complementary ratemaking treatment is appropriate considering, over time, the utility's pension contribution amounts and its pension expense accrual amounts will be the same. (IAWC Ex. 6.00R at 22) In other words, this treatment properly accounts for the timing difference between pension contribution and collection of expense in rates. Further, it encourages utilities to contribute to their plans. In light of this symmetrical approach to ratemaking, the Commission should approve IAWC's pension asset.

There are two ways that pension costs can be measured for ratemaking purposes. The first is the accrual method set forth in FAS 87. (*Id*., citing *Illinois-American Water Co.*, Order, Docket 92-0116 (Feb. 9, 1993), at 20, and another orders) FAS 87 was developed by the Financial Accounting Standards Board in 1987 to establish a standardized method, for financial reporting purposes, of determining pension cost associated with a particular period of employee service. *Illinois-American Water Co.*, Order, (Feb. 9, 1993) Docket 92-0116 at 20.

The other method is based on the funding requirements of the federal Employee Retirement Income Security Act, 29 USCS § 1002, et seq. ("ERISA"). The Commission has expressed a "strong preference" for the accrual method under FAS 87. (*Id*. at 20-21, citing Illinois-American Water Co., Order, Docket 02-0690 (Aug. 12, 2003) at 24)

Although the Commission uses the accrual method for ratemaking purposes, it is federal law (ERISA) that determines the actual cash funding, or contribution amount, that the utility is required each year to pay into a pension plan. This amount typically differs from the FAS 87 amount, although, over time, FAS 87 amounts and ERISA contribution amounts will be the same. (*Id*. at 21; IAWC Ex. 6.00R at 22) In a typical year, however, the amounts are usually different.

Consistent with "Commission precedent," IAWC presently records its accrued amount of pension expense in accordance with FAS 87. The Company's pension plan, however, is funded in accordance with the requirements of ERISA. (*Id.*; IAWC Ex. 6.00 (Rev.) at 5) In both 2010 and 2011, the Company's pension funding contribution amounts exceeded FAS 87 amounts. (IAWC Ex. 6.00R at 21) IAWC anticipates its contribution amounts will continue to exceed FAS 87 amounts in 2012 and 2013. (*Id*.)

Accordingly, in the test year (and in the years preceding it), the Company's shareholders and bondholders will fund that level of IAWC's pension contributions which the Company will not recover from ratepayers through rates -- IAWC's pension asset. As such, applying a ratemaking approach "symmetrical" to the Commission's practice outlined above, IAWC has included in its test year rate base $9,575,288, which reflects IAWC's current pension funding levels. (IAWC IB at 21)

As indicated below, Staff "proposed adjustments to disallow the pension asset proposed for rate base recovery by the Company since the Company has presented no evidence that the pension asset was created by anything other than ratepayer funds." (Staff IB at 5) In IAWC's view, Staff's contentions are misplaced, because the source of funds is not the relevant question when determining the appropriate treatment of IAWC's FAS 87 and pension contribution amount differences. (IAWC IB at 22)

Rather, the issue here is simply one of a timing difference, with the pension asset being the appropriate ratemaking treatment of the difference between amounts accrued as pension expense under FAS 87 and pension funding contributions. When the timing is such that FAS 87 amounts exceed contribution amounts, a rate base deduction has been approved. Fairness dictates, then, that the converse timing difference be treated symmetrically -- that when ERISA contribution amounts exceed FAS 87 amounts, a rate base increase is appropriate.

IAWC disputes Staff's reliance on orders such as *Peoples Gas Light and Coke Company*/*North Shore Gas Co*., et al., consolidated Docket 11-0280/0281 to support its position that "[t]he basic debate of the many Commission orders on this subject concerns where the utility acquired the funds that created the pension asset for which it is requiring rate base recovery." (IAWC IB at 22-23, citing ICC Staff Exhibit 2.0 at 4-5; IAWC RB at 16-18) However, none of those dockets concern the precise timing difference which created the pension asset at issue in this case. (IAWC IB at 23)

IAWC's pension asset results from the difference in plan funding and the amounts which IAWC is permitted to collect in base rates per FAS 87. Accordingly, it is neither the result of a wholly discretionary contribution on IAWC's part, nor prefunding of the plan with ratepayer funds, nor unexpected returns on the plan assets previously funded by ratepayers, which were the circumstances underlying the pension assets at issue in the referenced dockets. Staff's proposed disallowance fails to recognize that IAWC must actually pay these contributions amounts in the test year. (*Id*.)

Even accepting Staff's premise that a showing of shareholder funding is a condition precedent to recovery on IAWC's pension asset, Staff's contention that there has been no such showing in this case is incorrect in IAWC's view. If the amount contributed to the Company's pension plan exceeds the FAS 87 expense amount in the income statement that the calculation of the revenue requirement is based on, then, unless the Company is earning a return on common equity greater than that which it is allowed, the only source to fund the pension contribution amount above the FAS 87 expense amount is shareholders. (*Id*.)

Like Staff, the AG takes the position that IAWC should not recover a return on its pension asset. (IAWC IB at 23-24, citing AG Ex. 2.0 C (Rev.) at 54) However, the AG takes Staff's argument one step further and contends that AWW's pension plan was underfunded as of December 31, 2011 is evidence the pension asset was not investor-supplied. (AG Ex. 4.0 C (Rev.) at 23-24) In IAWC's view, AWW's pension funding status -- whether overfunded or underfunded – is simply is not relevant to the calculation of IAWC's pension asset. The pension plan is an external trust and is not included on IAWC's balance sheet. Thus, the funding level of the pension trust is not appropriate for consideration in determining rates. In other words, the AWW Pension Plan Actuarial Report's unfunded pension position and ERISA Funding Position Funding shortfall amounts are not determinative of whether, for ratemaking purposes, IAWC has a pension asset. Rather, the Company's pension asset is calculated based on IAWC's share of FAS 87 pension expense and its share of ERISA contributions.

In its Reply Brief, IAWC responds to the AG's reliance, in its Initial Brief as summarized below, on the definition the Commission accorded "pension asset" in *Commonwealth Edison Co.*, Docket 11-0721. IAWC states that the Commission has granted rehearing on the pension asset issue in that docket. See Commonwealth Edison Co., Notice of Comm'n Action, Docket 11-0721 (June 22, 2012). IAWC asserts that the AG's arguments in this regard should be accorded no weight. (IAWC RB at 19)

IAWC submits that the Commission has another alternative to the ratemaking treatment afforded IAWC's pension asset. (IAWC IB at 24) If the Commission does not approve recovery "on" the pension asset, it should permit recovery "of" it; it should authorize IAWC to use the pension funding contribution amount, rather than the FAS 87 amount, as the Company's test year level of pension expense. (IAWC Ex. 6.00R at 22) No party disputes the accuracy of IAWC's projected test year pension contribution amounts, or the prudency of the contributions. As such, this approach would at least provide IAWC with recovery of the actual test year amount that it expects to contribute to the pension plan. Use of this approach would increase pension expense by $4.447 million to $7.584 million.

According to IAWC, policy considerations also demand encouraging appropriate pension plan funding. (IAWC IB at 24-25) That is, the Commission should encourage pension contributions, not penalize utilities and their shareholders for making them, especially at a time when plans are underfunded. Nor should the Commission discourage utilities from complying with their pension funding obligations. (*Id*., citing *Commonwealth Edison Co*., Order on Rehearing, Docket 05-0597 (Dec. 20, 2006) at 20 (citing Final Order (July 26, 2006) at 39) (recognizing the utility's pension asset and approving partial recovery on the same, finding it did not want utilities to neglect their pension obligations in light of the seriousness of underfunding).

2. Staff Position

Staff witness Hathhorn proposed adjustments to disallow the pension asset proposed for rate base recovery by the Company since the Company has presented no evidence that the pension asset was created by anything other than ratepayer funds. (Staff IB at 5; Staff Ex. 2.0, Sch. 2.02)

In Staff's view, the Company's proposal is no different than those the Commission has considered, and rejected, in the past. (Staff IB at 6) The basic debate of the many Commission orders on this subject concerns where the utility acquired the funds that created the pension asset for which it is requesting rate base recovery. In the absence of evidence to the contrary, the Commission has repeatedly found that such funds, in this case the funding based on ERISA requirements over FAS 87, are provided by ratepayers and therefore there is no basis to provide shareholders a return on such funding through inclusion of the pension asset in rate base.

In this case, the Company provided no evidence of shareholder funding of the pension asset. Rather, the pension asset has been funded from normal operating revenues collected from utility ratepayers and represents funds supplied by ratepayers. The only source of funds provided in those responses is "reduced earnings available to its shareholders" and overhead charges paid to American Water Works Services Company ("Services Company") as Service Company fees. These are both normal operations of the Company rather than any special external contribution source to the pension plan. Since the pension asset was funded by normal operations, rather than provided by shareholders, shareholders should not earn a return on it. (Staff IB at 6; Staff Ex. 2.0 at. 5)

The Commission has repeatedly addressed the pension asset issue. In the *Peoples/North Shore* 2011 rate case, Docket Nos. 11-0280/11-0281 (Cons.), the Commission found that, consistent with its decisions in prior Peoples/North Shore's 2007 and 2009 rate cases, the accrued other post-employment benefits ("OPEB") liability should be deducted from rate base but that the pension balances should not be recognized in the determination of rate base (regardless of whether they are assets or liabilities). The Commission was clear when it concluded:

> Unlike the situation in Docket 05-0597, the Utilities have not shown that Peoples Gas' pension asset was created with shareholder funds. Without that evidence, there is no reason to believe that the pension asset is funded by any source other than ratepayers….The Commission finds no support in the record to allow for the inclusion of Peoples Gas' pension asset in rate base which in turn would allow shareholders to earn a return on ratepayer supplied funds. (Docket Nos. 09-0166/09-0167 (Cons.), Order, January 21, 2010, p. 36)

In Docket No. 04-0779 and Docket No. 95-0219, Northern Illinois Gas Company ("Nicor") sought to increase utility rate base for the amount of a prepaid pension asset. In both cases the Commission found that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds. The Commission concluded that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Accordingly, the Commission concluded that the pension asset should be eliminated from rate base. (Staff Ex. 2.0 at 7)

IAWC argues that since the Commission has authorized rate base deductions when the FAS 87 pension expense exceeded the ERISA contributions in the past, then there is no reason to treat the symmetrically converse situation differently. (Staff IB at 8) In Staff's view, the Company's argument fails in light of past Commission orders. As stated above, the Commission has concluded that, if FAS 87 amounts exceed pension funding amounts under ERISA, it is appropriate to apply the difference as a rate base deduction for ratemaking purposes since the excess funds are supplied by ratepayers, and not by shareholders; therefore, shareholders are not entitled to earn a return on these excess funds. This position was made clear in the Commission's order in Peoples/North Shore Docket Nos. 07-0241/07-0242 Cons., wherein the Commission found both that (a) the company's pension asset would not be allowed as an addition to rate base and (b) the company's accrued OPEB liabilities must be deducted from rate base. The Commission further found that this position was consistent with a number of previous decisions. (Staff IB at 8)

Rather than demonstrate external funding of the pension asset, the Company maintains that its pension funding has been supplied, in essence, by shareholders in the form of foregone earnings. (Staff IB at 10) According to Staff, this argument was not only rejected in the Peoples/North Shore orders discussed above, but also on appeal. (Staff IB at 10, citing *People ex rel. Madigan v. Illinois Commerce Commission*, 2011 Ill App (1st), 958 N.E.2d 405, 421, 426 (2011))

3. AG Position

AG witness Smith testified that the Company's contributions to its pension plan are an ordinary cost of operations and are not investments or shareholder-supplied funds entitled to a return. (AG IB at 6; AG Ex. 2.0 Rev. at 54-58) In the AG's view, IAWC's position is inconsistent with basic test year ratemaking principles.

In addition, IAWC's contributions to its pension plan do not qualify as a "pension asset." (AG IB at 7) On May 29, 2012, the Commission rejected Commonwealth Edison's argument that it was entitled to a return on a "pension asset" holding that a pension asset (as opposed to a pension contribution) is defined "as the amount by which ComEd's share of the pension plan is overfunded." *Commonwealth Edison*, ICC Docket 11-0721, Order at 113 (May 29, 2012). IAWC's pension has an unfunded liability of $421 million as of December 31, 2011. (AG Ex. 2.0 Rev. at 24) In the AG's view, IAWC's pension contributions do not qualify as a pension asset because IAWC is not making a greater pension contribution than it is required to make. (AG IB at 7)

4. Conclusion

IAWC proposes to include, in rate base, an amount of $9,575,288 sometimes characterized as a "pension asset." This is the amount by which IAWC's "actual pension contributions" exceed the FAS 87 expense amount collected from ratepayers. Staff and the AG oppose this proposal.

The Commission agrees with Staff and the AG that the pension asset should not be included in IAWC's rate base.

As Staff explained, the basic question is the source of the funds used to create the pension asset for which rate base recovery is sought. Here, IAWC has presented no evidence that the pension asset was created by anything other than ratepayer funds. That is, there is no indication that the pension asset was created with shareholder-supplied funds.

As such, the Company's proposal is not substantively different than those the Commission has considered, and rejected, in past rate case decisions such as the *Peoples/North Shore* Orders cited above. The Staff adjustment removing the amount from rate base is adopted.

B. Business Transformation Costs

IAWC's technology systems have become antiquated and need to be replaced. The Business Transformation ("BT") program is intended to address that need. It encompasses the development and system-wide deployment of new, integrated information technology ("IT") systems and the process of implementing the new systems in a manner that purportedly aligns business processes with the increased capabilities of the new systems. According to IAWC, replacement of the Company's antiquated IT systems will enhance IAWC's customer service and billing capabilities, and permit it to more efficiently comply with regulatory changes. (IAWC IB at 8)

There are three projects that comprise the core of the BT program: (1) an Enterprise Resource Planning System; (2) an Enterprise Asset Management System; and (3) a Customer Information System.

The BT program will impact various facets of the Company's operations, including human resources, finance and accounting, supply chain and procurement management, management of asset lifecycles (including the design, construction, commissioning, operations, maintenance and decommissioning or replacement of plant, equipment and facilities), work management for both customer service field work and transmission and distribution system work, billing and personal data about customers (including billing rates, water consumption, associated charges and meter information) and strategy for managing and nurturing interactions with customers. (IAWC IB at 9)

The total estimated cost of the Business Transformation program enterprise-wide is $300 million. (IAWC IB at 9; IAWC Exs. 9.00R at 2; 5.00SUPP at 15) That cost is being charged -- via the Service Company monthly bills -- to each of American Water's regulated subsidiaries, including IAWC, based on their respective customer counts in accordance with the approved Service Company Agreement. (IAWC Ex. 9.00 at 3) IAWC's resultant share of the cost is $28.9 million. (IAWC Ex. 5.00SUPP at 15) IAWC has made the determination to capitalize those amounts. (*Id*. at 16)

It is expected that the new Business Transformation IT systems will be deployed from 2012 to 2013. (IAWC IB at 9-10) IAWC has therefore included a level of investment in Business Transformation in its rate base that is purportedly consistent with the anticipated deployment dates of those systems and the Company's use of a test year ending September 30, 2013. (*Id*.; IAWC Ex. 4.00 at 2) IAWC also is requesting recovery of depreciation expense for the Business Transformation assets included in its rate base and recovery of associated test year operating expenses such as hardware maintenance and lease costs and software maintenance costs. (IAWC Ex. 5.02SUPP at 1-2)

1. AG Position

The AG recommends that the costs associated with the BT plan be removed from rate base. (AG IB at 8)

IAWC seeks to include $19.186 million in BT costs in test year rate base, consisting of $12.062 million for ERP, $3.021 million for EAM, and $4.103 million for CIS. (AG IB at 8; AG Ex. 2.0 Rev. at 21) The AG's adjustment would remove $17.821 million from plant in service, which is net of ADIT. The reasons for the AG's adjustment are summarized below.

First, the AG argues, in Section II.B. 1 of its Initial Brief, "The Commission should not allow IAWC to charge Illinois consumers for Business Transformation charges that are properly allocated to American Water's non-regulated businesses." (AG IB at 9; *See also* AG BOE at 7-8)

AWW allocated virtually all of the $300 million in BT system costs based on customer count. (AG IB at 9; AG 2.0 Rev. at 22) American Water's non-regulated operations account for 12.3% of American Water Works' consolidated revenue in 2011 and are part of the American Water Work's corporate enterprise. The audit of Service Company costs ordered by the Commission noted that: "AWWSC is organized into two levels: corporate and divisional: The corporate level of the organization performs services that can be universally provided to all companies, or functions that are necessary to support the corporate structure. The divisional level provides services specific to utilities within a region." (NorthStar Audit at III-5) The Commission should exclude corporate and other costs associated with BT properly attributable to American Water's non-regulated businesses from IAWC costs and protect Illinois ratepayers from paying these costs. (AG IB at 9)

In 2009, 2010 and 2011, the non-regulated businesses were allocated more AWWSC Information Technology Department charges than IAWC, and the total percentage of IT charges allocated to regulated utilities was 86.94%. By contrast, in 2012, 2013 and 2014, in addition to significantly higher IT costs overall, more than 90% of the costs are projected to be allocated to regulated utilities, with IAWC's charges increasing 39%. (AG IB at 9-10)

IAWC has acknowledged that non-regulated affiliates may use BT systems, but their use is optional and will be separately billed on an as-used basis. (AG Ex. 2.0 Rev. at 22) In addition to the lack of any apparent reason that functions such as human resources, finance and accounting, purchasing and inventory management, capital planning, cash management and customer services would not be needed by American Water's non-regulated services, the *ad hoc* allocation of charges to non-regulated operations allows them to escape primary responsibility for the BT costs while assigning virtually all of those costs to customers of American Water's monopoly utility operations. This raises the issue of "inappropriate subsidization of non-regulated operations by regulated utility customers who have no choice for essential water and wastewater service." (AG IB at 10) In the AG's view, "The Commission should reject IAWC's request that Illinois ratepayers pay for a program from which American Water's non-regulated operations are inexplicably excluded and revise the allocation of costs to Illinois ratepayers after allocation of 12.3% of total costs to American Water's non-regulated operations." (*Id*.)

According to the AG, a further indication that the allocation of BT costs to IAWC is overstated is the NorthStar audit's statement that in 2010 the allocation of AWWSC BT program costs to IAWC was only 8.9%. (AG IB at 10-11) IAWC did not explain why the allocation of BT costs to IAWC increased between 2010 and the test year. There is no suggestion that the number of customers served by IAWC has increased to justify an increase in allocation. Illinois consumers "should not be asked to shoulder both an increase in allocated costs as well as a portion of BT costs that should be allocated to American Water's non-regulated businesses." (*Id*.)

In Section II.B. 2 of its Initial Brief, the AG argues, "IAWC is asking ratepayers to pay a return and profit on Service Company expenses in violation of the SC Agreement that provides that services are provided at cost." (AG IB at 11; AG RB at 1-2; AG BOE at 5-7)

BT costs are American Water Works Service Company ("AWWSC") costs and therefore are subject to the affiliate Service Company Agreement ("the SC Agreement") approved by the Commission in ICC Docket No. 04-0595. The NorthStar Audit describes the BT project as an AWWSC program, and the vast majority of the contracts for BT are with AWWSC, while none are with IAWC. (AG IB at 11) The SC Agreement lists essentially the same functions that IAWC witness Twadelle identifies as BT functions.

The SC Agreement states: "All costs of service rendered by Service Company personnel shall be charged to Water Company based on actual time spent by those personnel as reflected in their daily time sheets or other mutually acceptable means of determination." (AG Cross Ex. 3 at 9) IAWC witnesses have repeatedly emphasized to the Commission that Service Company services are provided to IAWC "at cost" although the cost includes an extensive list of overhead expenses. (AG IB at 9)

Despite the provision that AWWSC costs and charges should be provided at cost with no mark-up for profit, IAWC is asking the Commission to allow it to include BT costs in rate base, which will result in Illinois consumers paying a profit on the cost of these BT systems. (AG IB at 11-12) However, the SC Agreement does not authorize AWWSC to shift its cost of service to the rate base of regulated utilities. Article II of the SC Agreement bases charges on "actual time spent," direct charges for services, allocated charges for services, and cost for support personnel, "as well as the cost of lease payments, depreciation, utilities and other costs associated with leasing office space and equipment." (*Id.*, citing AG Cross Ex. 3) Article II provides for the pass-through of office costs and depreciation, but does not provide that IAWC can move those costs into its rate base and earn a return, or "profit" from such a practice. (AG IB at 11-12)

The SC Agreement also specifically provides for an "Allowance for Overhead" in Article III. The Agreement specifies that "No general overhead of Service Company shall be added to costs incurred for services of non-affiliated consultants employed by the Service Company." General overhead is defined in paragraph 3.2 as pension and insurance premiums for SC employees, legal and other fees for services, taxes, other general office supplies and other similar expenses, and interest on working capital. In the AG's view, "The SC Agreement does not include the authority to include Service Company costs or an allocation of Service Company costs in IAWC's rate base." (AG IB at 12)

The AG argues, "In contravention of the SC Agreement and its representations to the Commission that there is no 'profit' associated with Service Company charges, IAWC is asking the Commission to allow it to earn a profit on Service Company BT costs by adding these costs to rate base." (AG IB at 12-13) In response to questions about why some BT costs were labeled as "O&M" in AG Cross Exhibit 18 (IAWC Response to AG DR 8.12) and whether IAWC is attempting to defer the O&M amounts that occurred prior to the start of the future test year in relation to the BT project, IAWC witness Kerckhove explained, in part, "Yes. Illinois has taken the position that we are requesting capital treatment of the amounts for business transformation in this case, and so while amounts were originally recorded as O&M, they were reclassified to construction work in progress." (AG IB at 13; Tr. at 429-430)

According to the AG, each of AG Cross Exhibits 18, 19, and 20 shows O&M in the BT costs IAWC seeks to recover in rate base. These costs would ordinarily be expensed, but IAWC is asking the Commission to include them in rate base. The fact that O&M are included in the total is not explicitly stated by IAWC. Nevertheless, "the Commission should not inadvertently include expenses in rate base, particularly when the SC Agreement allows neither rate base treatment of its overhead nor pass-through of O&M as anything except possibly as a component of overhead." (AG IB at 13-14)

On this point, the AG concludes, "The Commission should remove these [BT] costs from rate base because the SC Agreement approved by the Commission does not authorize rate base treatment of this type of cost. Further, the Commission should reject IAWC's implicit request to capitalize costs that American Water treats as O&M from pre-test year periods. … As IAWC concedes, the Commission is not obligated to treat these costs as capital costs, and ratepayers should not be obligated to pay a returning (including a return on equity or profit) on them." (AG IB at 14)

In Section II.B.3 of its Initial Brief, the AG argues, "The Commission should not allow IAWC to omit the value of cost savings associated with the BT project while charging consumers for BT costs." (AG IB at 14; *See also* AG BOE at 8-10)

The American Water Board of Directors correctly considered the cost savings expected in connection with the BT project. The NorthStar Audit, conducted at the direction of the Commission, similarly recognized that cost savings were expected. The NorthStar Audit identified the amount of American Water's "most recent estimate of potential BT savings" per year. (NorthStar Audit at IV-5) However, the auditors also noted that American Water and IAWC "are still unable to confirm the amount of potential savings that may be realized as a result of BT and are unable to specifically identify how potential savings will be attained." (*Id.*) The AG asserts, "Notwithstanding the fact that IAWC has not identified significant cost savings as a result of the BT project, it is asking consumers to pay it a profit on its BT costs." (AG IB at 14)

In Supplemental Testimony, IAWC witnesses identified staff reductions as a savings resulting from the BT project. Specifically, IAWC President Teasley testified that IAWC had a net decrease of 10 employee positions after the implementation of a BT related reorganization in April 2012. (AG IB at 15; Tr. 91) The test year savings for this staff reduction, however, are reduced by associated severance costs, resulting in a net savings of only $0.419 million. Further, no Business Support Services-Service

Company savings are apparent in the test year despite the fact that the BT systems are designed to update and improve the services regularly provided by the Service Company. It appears to the AG that the participation of AWWSC personnel in the multiple (i.e. up to 125) training sessions and meetings about BT has been included in the BT cost that IAWC wants to capitalize. (AG IB at 15)

IAWC seeks to include $20,069,826 in rates for Business Support Services - Service Company. (AG IB at 15, citing IAWC Ex. 5.01 SR at 1) This is a 10.8% increase from the last rate case, which allowed $18,114,000 in rates for Service Company costs, limiting the increase from two years earlier to 5%. Docket No. 09-0319, (April 13, 2010) Order at 47 & App. A. Significantly, the increase requested in this docket does not reflect savings from the implementation of the BT project, and in fact, when added to the BT expenditures allocated to IAWC, a further increase in Service Company costs becomes apparent. According to the AG, “The NorthStar Audit demonstrates that there are inefficiencies and inaccuracies embedded in the Service Company charges. The growth of this charge notwithstanding the implementation of some BT processes and in the wake of the NorthStar Audit is troubling.” (AG IB at 15)

The NorthStar Audit found that additional controls are necessary and that “remedial action should be focused in four areas” -- management controls over AWWSC service charges; outsourcing opportunities and their potential economic effect; overcharges and potential erroneous service charges; and AWWSC’s BT Program and its potential effect on future service charges. In the AG’s view, “The Commission should require IAWC to implement the controls NorthStar identified as a condition to any recovery of increased AWWSC charges and costs associated with the BT systems.” (AG IB at 15-16)

The Audit found that more information must be provided by AWWSC in order for IAWC to effectively review Service Company charges. The Audit found that AWWSC “does not consistently adhere” to its second and fourth cost assignment principles: direct charging whenever possible and accurate billing. (AG IB at 16) It also raised concerns about regulated entities subsidizing non-regulated businesses because the non-regulated businesses are not adequately charged for supply chain services. This “mirrors the People’s concern” that non-regulated businesses are allocated virtually no BT costs despite the fact that they are part of the American Water corporate structure and have a history of using AWWSC services, such as Information Technology. (AG IB at 16)

The auditors also found room for savings. They identified $3.3 to $3.5 million of potential annual savings from using competitively outsourced services, including accounting, human resources, executive assistant support, executive management services, and network services – all areas that will be affected by the BT system. (AG IB at 16-17) In addition, it identified $228,416 in errors or overcharges for 2010 alone, including charges for services provided to non-IAWC divisions.

According to the AG, The BT project was developed to make existing processes more efficient, and both the American Water Board and the Commission have the right to expect savings to result. However, in this case, IAWC seeks to increase costs to consumers for the BT project, while AWWSC costs continue to grow and identified savings are small (i.e., $419,000 due to IAWC Staff reorganization). The result is an "imbalance in both the costs and the risks borne by consumers." (AG IB at 16-17)

The California Public Utilities Commission decided the same issue of cost savings in regard to the same BT project in a rate case for IAWC's sister affiliate, California-American Water Company ("Cal-Am"). The California PUC adopted the estimated BT savings based on the projected savings provided to American Water's Board of Directors and reduced Cal-Am's revenue requirement accordingly. (AG IB at 17-18, AG RB at 3, citing *California-American Water Co*., Application No. 10-07-007 & 11-09-016, Order at 63-64 (June 14, 2012))

In conclusion, the AG argues, "The savings American Water internally identified should be allocated and applied to IAWC's operations in the test year, as shown on AG Exhibit 2.2, Schedule C-8, if any BT costs are to be charged to Illinois consumers." (AG IB at 19; see also AG RB at 2-3)

Language changes suggested by the AG, including for alternative proposals, are set forth in pages 10-18 of the AG's BOE.

2. Municipalities' and Bolingbrook's Positions

In their Initial Brief, the Municipalities argue, "The costs associated with IAWC's Business Transformation Project (BTP) should be removed from the Company's rate base because the costs have not been shown to convey any meaningful customer benefits." (Municipalities IB at 6; RB at 3) In support of this position, Municipalities cite rebuttal testimony from AG witness Mr. Smith. (*Id*. at 6-7) In their BOE, the Municipalities argue that the costs of the BT project should be offset by the amount of projected savings recommended by the AG. (Municipalities' BOE at 5)

In its Reply Brief, the Village of Bolingbrook also argues that the costs associated with IAWC's Business Transformation Project (BTP) should be removed from the Company's rate base. (Bolingbrook RB at 7)

3. IAWC Position

In its Initial Brief, IAWC argues, "Investment in Business Transformation Is Prudent." (IAWC IB at 11-12)

According to IAWC, there is ample record evidence Business Transformation is necessary. IAWC's IT systems, which were implemented in the early 1990s and 2000s, are used by the Company's various business departments, but are not integrated. In addition, they have limited automation and functionality. Accordingly, American Water undertook a comprehensive analysis of its current IT systems, the results of which indicated it has fully maximized the software and systems used by its operating companies by implementing significant customizations or workarounds, in part, to meet requirements and expectations the original software is not equipped to support. That comprehensive analysis further demonstrated the current IT systems have reached a point where additional customizations would be inefficient and increasingly costly to maintain. As such, wholesale replacement of those antiquated IT systems is warranted. (*Id*.)

IAWC argues, “No party to this proceeding disputes the need for the Business Transformation program or its merits. That is, not a single line of testimony has disputed—or even questioned—the need for IAWC to modernize its IT systems.” (*Id*. at 11-12; IAWC RBOE at 1-2)

IAWC next agues, “The Level of Business Transformation Costs is Reasonable.” (IAWC IB at 12-14) According to IAWC, American Water conducted extensive analyses of potential service providers, used competitive bidding processes to select key service providers and negotiated “not to exceed” fixed fee arrangements to ensure effective cost control. American Water has carefully managed the BT costs at every stage to provide customers and other stakeholders with the greatest value at a reasonable cost. Further, IAWC is an active participant in the Business Transformation program. IAWC employees are necessarily involved to ensure IAWC’s business needs are properly served at all stages of the program. (*Id*. at 12)

Consistent with the Service Company Agreement, BT costs are incurred by the Service Company and are charged to IAWC at the Service Company’s cost. That is, there is no additional cost component added by the Service Company. Those costs appear as a line item on the monthly invoice IAWC receives from the Service Company. IAWC then makes the determination whether to capitalize those allocated costs for accounting and ratemaking purposes based on the ratemaking and accounting considerations most appropriate for the Company as a regulated Illinois public utility. (*Id.*)

IAWC next argues, “The Business Transformation Systems Are Used and Useful in the Test Year.” (IAWC IB at 13) It is anticipated those systems will be deployed from 2012 to 2013 and have a useful life of 10 to 12 years. IAWC asserts, “The record shows that the components of the BT systems will be in service as follows: the Enterprise Resource Planning system is anticipated to be deployed enterprise-wide by August 2012; the Enterprise Asset Management system and Customer Information System will be deployed in three waves in 2013, and with those systems being deployed to IAWC in March 2013.” (*Id*.)

IAWC next argues, “The AG’s Recommended Wholesale Disallowance of the Investment in Business Transformation Should Be Rejected.” (IAWC IB at 14-16) AG witness Mr. Smith recommends disallowing in full IAWC’s investment in Business Transformation because “[r]atepayers should not be asked to fund these investments unless and until there is a reasonable assurance of savings, efficiencies, or improvements in service." (AG Ex. 2.0 C (Rev.) at 29) In IAWC's view, "that is not the standard by which plant investments are evaluated in Illinois." (IAWC IB at 14) IAWC states, "[T]he legal standard for determining whether Business Transformation costs should be borne by ratepayers is whether the Company's investment is reasonable and prudent and whether the assets will be used and useful during the applicable rate case period." (*Id.*)

In IAWC's Reply Brief, it responds to arguments in Section II.B.2 of the AG's Initial Brief, as summarized above, which is titled, "IAWC is asking ratepayers to pay a return and profit on Service Company expenses in violation of the SC Agreement that provides that services are provided at cost." IAWC responds, in part, "Including BT Costs in Rate Base Is Consistent with the Terms of the Agreement between IAWC and the Service Company Approved by the Commission." (IAWC RB at 4-5)

According to IAWC, the BT costs IAWC pays are capital investments that are properly included in utility rate base. BT costs are incurred by the Service Company and, consistent with the Service Company Agreement between IAWC and the Service Company, IAWC's share of those costs are charged to IAWC at the Service Company's cost. That is, there is no additional cost component (or "profit") added by the Service Company. Those costs appear as a line item on the monthly invoice IAWC receives from the Service Company. IAWC then pays the costs as shown on the invoice and records the amount as capital investment. (IAWC RB at 4)

The AG argues, in part, "The SC Agreement does not include the authority to include Service Company costs or an allocation of Service Company costs in IAWC's rate base. AG Cross Ex. 3 at ¶3.2. In contravention of the SC Agreement and its representations to the Commission that there is no "profit" associated with Service Company charges, IAWC is asking the Commission to allow it to earn a profit on Service Company BT costs by adding these costs to rate base." (AG IB at 5)

In IAWC's view, the AG's argument is wrong. The Service Company Agreement sets forth how the Service Company charges IAWC for services, but does not (and need not) determine how IAWC books its charges, or how IAWC recovers its costs in the ratemaking process. Rather, "IAWC makes the determination to capitalize the Service Company BT charges based on the ratemaking and accounting considerations most appropriate for the Company as a regulated Illinois public utility." (IAWC RB at 5; IAWC RBOE at 2) IAWC's determination to capitalize BT costs does not require express authorization in the Service Company Agreement and in no way violates the terms of that agreement, as the Commission has previously recognized. See, e.g., *Illinois-American Water Co.*, Order, Docket 09-0319 (Apr. 13, 2010) at 21-22 (including in rate base the unamortized balance of IAWC's portion of the cost of the Service Company's Comprehensive Planning Study). Moreover, to treat the BT costs as Service Company charges that are not capitalized, but expensed, would result in a significant increase to IAWC's test year revenue requirement.

IAWC next responds to arguments in Section II.B.1 of the AG's Initial Brief, titled, "The Commission should not allow IAWC to charge Illinois consumers for Business Transformation charges that are properly allocated to American Water's non-regulated businesses." In IAWC's view, "BT Costs Are Properly Allocated to IAWC and Its Affiliates." (IAWC RB at 5)

The AG recommends that the Commission allocate "12.3% of total [BT] costs to American Water's non-regulated operations." (*Id*., citing AG IB at 10) According to IAWC, the AG's recommendation is based on the incorrect premise the Service Company will use the new BT systems to support the core business activities of IAWC's market-based affiliates. IAWC contends that "there is no evidence in this case that even suggests that the new BT systems will be used to support the core business activities of IAWC's market-based affiliates." (IAWC RB at 5)

According to IAWC, IAWC's "unregulated" or market-based businesses own and operate separate finance, accounting, management of asset lifecycle, customer service, customer billing and strategic planning systems, which in large part satisfy the market-based operations' needs in these areas. Thus, the functionality associated with the BT systems was not designed for IAWC's market-based operations, and IAWC's market-based affiliates will continue to use different systems to support their core business activities the BT program and IT systems have been specifically designed to accommodate the needs of American Water's regulated utility companies. (IAWC RB at 6; IAWC RBOE at 5-6)

To the extent American Water's non-regulated business subsidiaries do use the BT systems, they will be charged accordingly. IAWC's market-based affiliates will access two limited aspects of the new BT systems: (1) Success Factors and (2) a portion of the SAP CRM (Customer Relationship Management) module. As a result, certain BT implementation costs have been and will be directly charged to the Company's market-based affiliates and, in other circumstances, will be credited to the Company and its regulated utility affiliates through a reduction in BT implementation (capital) costs. The record also shows certain ongoing subscription and maintenance costs will be charged to market-based affiliates, with a corresponding reduction in Service Company fees. (IAWC RB at 6-7)

Further, IAWC has agreed to reporting requirements, proposed by Staff, that will track any reductions in actual costs incurred and allocated to IAWC for current or future affiliates' use of the BT system. Updates to these reports will be included in the next rate case filing. (*Id*. at 7-8)

IAWC also has agreed "to file as part of its direct case in its next general rate case proceeding filed after Docket No. 11-0767, updates to the reports" identified above. Therefore, to the extent that an IAWC market-based affiliate is permitted to access any additional portions of the BT systems, IAWC will report on that amount, and customers will benefit through a reduction in BT development costs and/or a proportionate reduction in the ongoing BT operating and maintenance costs that will be reflected in IAWC's next rate case filing. (*Id*.)

IAWC also responds to what it refers to as a contention, made for the first time in AG's brief, that "a further indication that the allocation of BT costs to IAWC is overstated is the NorthStar audit's statement that in 2010 the allocation of AWWSC BT program costs to IAWC was only 8.9%." (IAWC RB at 8, citing AG IB at 10) The AG states that IAWC did not explain why the allocation of BT costs to IAWC increased between 2010 and the test year. In response, IAWC explains that its allocation percentage increased from 8.9% to 9.9% because the number of customers in the American Water system decreased with the sale of utilities in New Mexico and Arizona. That is, IAWC's percentage of the remaining customers is larger. (IAWC RB at 8)

In its Reply Brief, IAWC next responds to arguments and recommendations made in Section II.B.3 of the AG's Initial Brief, which is titled, "The Commission should not allow IAWC to omit the value of cost savings associated with the BT project while charging consumers for BT costs."

In IAWC's view, the Commission should reject the AG's recommendation to impute additional BT 'savings.'" (IAWC RB at 8)

According to IAWC, the AG's use of very preliminary board materials to determine a specific "savings" offset is premature and unwarranted. (*Id*. at 9) The AG misconstrues American Water's preliminary analysis, which speaks of costs and benefits -- not costs and savings. A statement that the Company will realize a certain value of benefits does not necessarily translate into dollar-for-dollar savings. IAWC asserts, "Even if the estimated benefits were anticipated in the Company's test year (they are not, beyond what IAWC has already reflected in its update), applying these estimated benefits as cost offsets to IAWC's revenue requirement overstates their value and fails to take into account costs and trade-offs necessary to achieve those benefits." (*Id*.)

It is anticipated that potential benefits from Business Transformation, in the form of mitigation of operations and maintenance expense increases, would begin once the new systems are fully deployed and employees are fully trained on those systems, beginning in 2014. (*Id*., citing IAWC Ex. 5.00R (2d Rev.) at 21; IAWC RBOE at 7-8) It should be self-evident that IAWC cannot begin to achieve cost savings from the new BT systems until they are implemented and the Company's employees have become acclimated to them. As such, they will be reflected in the revenue requirement of future cases.

IAWC adds, "Moreover, the projection of potential benefits, made several years ago to determine the feasibility of a project, is insufficient evidence to support the imputation the AG seeks." (IAWC RB at 9)

According to IAWC, the AG selectively used a single slide from a Board presentation in recommending the imputation of “BT-related savings.” The context provided by the other slides of the April 2011 presentation on which the AG relies underscores the insufficiency of the projections. For example, Page 10 demonstrates design of the BT systems had not yet begun. Page 35 shows that the initial “Blueprint Phase” of the BT program had only just been completed. Page 20 states: “Confidence in the level of forecasted costs & benefits will increase over the project lifecycle,” and indicates confidence levels of only 50% and 25% for costs and benefits, respectively, as of the time of that presentation. (IAWC RB at 10)

In addition, IAWC argues, the ability to realize benefits is a matter of timing and IAWC should not be reasonably expected to quantify all potential benefits of BT before it has even begun implementation of the program. (*Id*.)

Regarding the AG’s reliance in its Initial Brief to statements in the NorthStar audit report, IAWC argues that the AG’s references to the report should be given no weight because the report is “not part of the evidentiary record” due to the AG’s purported failure to comply with normal procedural rules applicable to exhibits. (IAWC RB at 10-12)

IAWC further states, “Also relying on the Audit Report, the AG recommends, for the first time in briefing, ‘[t]he Commission should require IAWC to implement the controls NorthStar identified as a condition to any recovery of increased AWWSC charges and costs associated with the BT systems.’” (IAWC RB at 12, citing AG IB at 16) IAWC asserts, “No witness made this recommendation. No witness defined or otherwise explained the ‘controls’ on which the AG (now) believes recovery of BT costs should be conditioned. No witness explained how such ‘controls’ should be implemented, or if they can be. The AG’s untimely and unsupported recommendation should be rejected.’’ (IAWC RB at 12)

In its Reply Brief, IAWC also argues that capitalization of BT costs is in the best interests of IAWC’s Customers. (IAWC RB at 14-15) According to IAWC, by accepting the AG and the Cities and Villages’ argument that BT costs should not be included in rate base, IAWC’s only choice would be to recognize all BT costs as expenses, which would increase the test year revenue requirement by millions of dollars. Capitalizing BT costs will significantly reduce the up-front rate increase for IAWC’s customers and will result in a significantly lower revenue requirement when compared to collecting the costs as expenses in rates. IAWC argues, “Because the BT assets will provide service to ratepayers over their useful life (10-12 years), the recovery of BT costs over their useful life is a more responsible ratemaking method than seeking to recover the costs over the shorter period when the costs are incurred.” (IAWC RB at 14-15; IAWC IB at 13; IAWC RBOE at 4)

4. Staff Position

In direct testimony, Staff witness Hathhorn proposed an adjustment to remove BT program costs for: (1) estimated cost savings that will occur due to implementation of the new computer systems, (2) hardware lease costs that will not be incurred until after the test year, and (3) reduced Service Company management fees due to non-regulated affiliates' use of the BT system. (Staff IB at 11; Staff Ex. 2.0, Sch. 2.03)

In response, the Company removed operating expenses due to organizational restructuring changes made in anticipation of BT solutions. Second, it concurred with Staff's adjustment for hardware lease costs inadvertently included in the test year.

Third, IAWC agreed in part to adjustments concerning non-regulated affiliates' use of BT. Staff had proposed to include 100%, rather than the 50%, of the Company's estimated amount of reduced Service Company fees to be charged to IAWC's rate zones for the non-regulated affiliates' use of the Customer Relationship and Billing ("CIS") system. However, the Company explained in rebuttal testimony that the 50% adjustment is appropriate since CIS will not be placed into service until April 2013. Therefore, Staff agreed that it is reasonable that the test year reflect only a half-year of reduced Service Company fees for the non-regulated affiliates' use of the CIS system. (Staff IB at 11-12; Staff Ex. 10.0 at 9-10)

Staff "does not believe that the evidence supports a finding that the Company should receive no cost recovery for the new computer systems required for customer information, customer service and customer billing necessary in order to provide utility service." (Staff IB at 12-13) The Company's rebuttal position reflects cost savings anticipated due to BT implementation, cost reductions for non-regulated affiliates' use of BT, and a correction of inadvertent errors. In Staff's view, "[T]he Company is correct that: 'The standards that should guide the Commission when considering whether BT costs should be borne by the customers are whether the Company's decision to incur the costs is reasonable and prudent, and whether the assets will be used and useful during the applicable rate case periods. IAWC should not be reasonably expected to quantify all potential benefits of BT before it has even begun implementation of the program.'" (Staff IB at 12-13, citing IAWC Ex. 5.00R at 19)

According to Staff, "The Company's test year reflects full retirement of the old computer systems that the BT program will replace. (Staff Ex. 10.0, pp. 11-12) Adopting the AG adjustments, then, would result in the unreasonable position that the Company should receive no cost recovery for computer systems necessary in providing utility service." (Staff IB at 13)

Due to the magnitude of the BT costs and nature of the future test year implementation, Staff recommends that the following BT reporting requirements, to which IAWC agrees, be imposed:

> To file a report on the ICC's e-Docket system under Docket No. 11-0767, with a copy provided to the Manager of the ICC's Accounting Department, every six months beginning with the date of the Order in Docket No. 11-0767 through and until new rates are effective from the rate proceeding filed after Docket No. 11-0767, of actual costs incurred and allocated to IAWC by ICC account number for its BT implementation costs;
>
> To file a report on the ICC's e-Docket system under Docket No. 11-0767, with a copy provided to the Manager of the ICC's Accounting Department, every six months beginning with the date of the Order in Docket No. 11-0767 through and until new rates are effective from the rate proceeding filed after Docket No. 11-0767, of reductions in actual costs incurred and allocated to IAWC for current or future affiliates' use of the BT system, by ICC account number; and
>
> To file as part of its direct case in its next general rate case proceeding filed after Docket No. 11-0767, updates to the reports discussed in the Company's responses to Staff Data Requests DLH-30.01 and DLH-30.02 (items #1 and #2 above).

In its Reply Brief, Staff states, "In its Initial Brief, the AG raises for the first time a new concern, arguing that the Company is not authorized by its Services Agreement to include the BT costs in rate base." (Staff RB at 4, citing AG IB at 11-14) Staff found that the Company has reflected retirement of its old computer systems that the BT program will replace. Further, the Company discusses the BT project as a replacement of its former systems. Therefore, the Company has included its information technology ("IT") costs, which also were provided by an affiliate, in rate base in the past.

Staff states that the Services Agreement is silent with respect to facilities and rate base. (Staff RB at 4-5) However, the historical presentation of the Company's prior IT systems is telling, in Staff's view. In this proceeding, Staff asserts, the Commission has the authority under Section 7-101 of the Act to approve the affiliated interest costs. Simply because the Company has yet to express its application of such statute in its case is not controlling. Further, Staff argues, the AG provides no workable solution, as its allegation that the BT charges should somehow have only been charged to IAWC as expense amounts through service company billings has not been quantified in the record. It is clear, though, that charging such costs to ratepayers in a large lump sum in the test year, rather that ratably through capitalized costs, would increase the cost of service substantially. Staff concludes, "For all these reasons, the BT costs, as appropriately updated by the Company and adjusted by Staff, should be approved by the Commission." (Staff RB at 4-5)

5. Conclusion

The American Water Business Transformation ("BT") program encompasses the development and system-wide deployment of new, integrated IT systems and the process of implementing the new systems in a manner that purportedly aligns business processes with the increased capabilities of the new systems. According to IAWC, the BT program is intended to replace existing technology systems which have become antiquated.

There are three projects that comprise the core of the program. They are identified as Enterprise Resource Planning, Enterprise Asset Management and Customer Information Systems.

The costs of the program are charged by the Service Company to IAWC, and other regulated subsidiaries of American Water, based on their respective customer counts. IAWC's share of the costs, using a customer allocation factor of 9.9%, will be $28.9 million.

Based on the anticipated deployment dates of the BT systems and the Company's use of a test year ending September 30, 2013, IAWC seeks to include $19.186 million in BT costs in test year rate base. Net of ADIT, the amount is $17.821 million. IAWC argues that the "investment in [BT] is prudent," and that the level of BT costs is reasonable.

The AG recommends that all such BT costs be removed from rate base. In support of its recommendation, the AG claims that the allocation of BT charges to IAWC is overstated because costs are not properly allocated to American Water's non-regulated businesses and because the customer allocation factor should be 8.9%, not 9.9%; that IAWC is asking ratepayers to pay a return and profit on Service Company expenses in violation of the SC Agreement which provides that services are provided at cost; and that IAWC has not properly reflected cost savings associated with the BT project.

Staff made adjustments to reflect estimated cost savings that will occur due to implementation of the new computer systems, to remove hardware lease costs that will not be incurred until after the test year, and to reduce Service Company fees due to non-regulated affiliates' use of the BT system. Staff notes that IAWC's test-year filing reflects full retirement of the old computer systems that the BT program will replace. Staff recommends that the BT costs, subject to the adjustments and reporting requirements proposed by Staff, be included in rate base.

Having reviewed the record, the Commission first finds that there is a need for the BT program. The current system is outdated and in need of replacement. The processes used to develop the BT program, and the projects that comprise the program, can reasonably be expected to satisfy that need.

The record also indicates that the projected timelines for deployment of the components of the BT systems are reasonable, and, subject to Staff adjustments, were accurately matched up with the test year.

Regarding costs, the record in this proceeding contains a description of the competitive bidding and other processes and analyses used to determine and control costs. There is no indication that either these processes and analyses, or the amounts of such costs, were unreasonable for the work involved. If evidence to the contrary is presented in future proceedings, adjustments could be proposed at that time.

With regard to cost savings, the AG argues that IAWC has not properly reflected, in test-year revenue requirement, the cost savings associated with the BT project. The AG complains that identified savings of $419,000 are small. The AG recommends that "the savings American Water internally identified should be allocated and applied to IAWC's operations in the test year … if any BT costs are to be charged to Illinois consumers." The AG estimates the amount to be $2.180 million for the test year.

Of the two proposals of record, the Commission believes the cost-savings estimate recommended by Staff and IAWC is the more accurate estimate of the amount of savings in the test year, and should be used for ratemaking purposes in this docket.

In making that determination, the Commission is not suggesting that additional savings are irrelevant. After all, it appears that estimates of additional cost savings were part of the AWW analysis of the BT program. So although the Commission believes it would premature to assign all such savings to the test year in this case, as noted above, the Commission does believe that the issue of whether and to what extent such additional savings were realized, or should be imputed, is a relevant one for consideration in future rate cases.

The Commission will next consider the AG's argument, raised in its Initial Brief, that by seeking to include BT costs in rate base, "IAWC is asking ratepayers to pay a return and profit on Service Company expenses in violation of the SC Agreement that provides that services are provided [to IAWC] at cost."

A basic problem with the AG's argument is that the "provision" of the Service Company Agreement, to which the AG refers, applies to charges assessed to IAWC by the Service Company. The Agreement does not purport to dictate how charges by IAWC, to its ratepayers, are to be assessed. As such, IAWC's efforts to include BT cost in rate base would not be a violation of the SC Agreement. Further, there is no indication that the charges assessed to IAWC by the Service Company contained any profit or mark-up on BT costs.

The AG asserts, in its brief, that the BT costs would ordinarily be expensed by IAWC, rather than capitalized. This position first appeared in AG's brief, as part of its argument, discussed above, that rate-basing BT costs would violate the SC Agreement. The AG's position is not supported by the evidentiary record. IAWC presented evidence that the BT systems will have a useful life of 10 to 12 years. There is no indication that recovering these costs through the income statement, rather than ratably through rate base, would result in a lower revenue requirement. Staff and IAWC contend that recovering such costs as an operating expense would result in higher rates in this proceeding that would rate base treatment.

Regarding allocation issues, the AG contends, in its brief, that the customer allocation factor applicable to IAWC should be 8.9%, not 9.9%. As explained by IAWC, however, the 9.9% factor used by IAWC is more current, and correct, because it reflects the sale of AWW systems in two other states.

The AG also claims that the allocation of BT charges to IAWC is overstated because costs are not properly allocated to American Water's non-regulated businesses. The AG asserts that 12.3% of BT costs should be allocated to non-regulated businesses based on pre-BT program usage.

Staff recommends a smaller adjustment to reflect use of the Customer Relationship and Billing system ("CIS") by non-regulated affiliates, but otherwise agrees with IAWC that the BT core system is not designed to support non-regulated affiliates, who will continue to use different systems to support their activities.

Based on the record, the Commission finds that the adjustment proposed by Staff properly reflects use of the BT systems by non-regulated affiliates. The adjustment proposed by the AG will not be adopted.

The Commission also finds that the reporting requirements and updates recommended by Staff are reasonable and are approved.

C. Cash Working Capital

In this case, IAWC has proposed to include approximately $3,503,000 of cash working capital ("CWC") in rate base. (IAWC IB at 25) According to IAWC, "the purpose of including cash working capital in a utility's rate base is to compensate the utility's investors for providing the funds required for those day-to-day business operations which require a cash outlay during the lag time between the provision of service and the receipt of revenues associated with that service." (*Id.*) Cash working capital is determined by an analysis of revenues received and expenses paid by the Company, i.e., the actual cash flows in and out. (*Id.*)

As defined by Staff, Cash Working Capital is the amount of funds required from investors to finance the day-to-day operations of a company.

A company's CWC requirement may be positive or negative, depending on whether it receives revenues, on average, slower or faster than it pays expenses. One way to determine the level of CWC to be included in rate base is through a lead-lag study that analyzes test year cash transactions and invoices. In general, lag times are associated with the collection of revenues owed to a Company (that is, the collection of cash from customers lags behind the Company's cash outlays for the provision of service), and lead times are associated with the payments for goods and services received by the Company (for example, vendors allow the Company to pay later for goods and services provided currently). (Staff Ex. 1.0 at 8)

In the current case, in response to direction in the Order in Docket No. 09-0319 that the lead-lag study presented in the next rate case should reflect the most recent data available at the time of filing, IAWC performed a lead-lag study "based on the most recent data available" to support the proposed cash working capital allowance. (*Id*.) Lead-lag studies are used to analyze the lag time between the date customers receive service and the date that customers' payments are available to a company, offset by a lead time during which the company receives goods and services, but pays for them at a later time. (IAWC Ex. 6.00R at 29-30)

According to IAWC, the "lead" and the "lag" were both measured in days; the annual test year cash expenses were then divided by 365 days to determine a daily cash working capital; the daily amount was then multiplied by the dollar-weighted lead and lag days to determine the amount of cash working capital required for operations. The resulting amount of cash working capital is then included as part of the Company's rate base. IAWC's lead-lag study was based on the most recent data available. (*Id*. at 31)

1. Prepayments to Service Company

The calculation of the payment lag in IAWC's lead-lag study reflects prepayments to the Service Company.

a. AG Position

The AG defines CWC as "the cash needed by the Company to cover its day-to-day operations and reflects the timing of both payments by the Company and receipts of revenue from customers." (AG BOE at 21; AG Ex. 2.0 Rev. at 47) In Section II.C.1 of its Initial Brief, the AG argues, "The Commission should adjust IAWC's cash working capital to remove the effect of purported prepayment to IAWC's affiliated Service Company." (AG IB at 19; AG BOE at 18-22)

IAWC claims that it prepays the AWWSC fee based on Paragraph 4.1 its agreement with the Service Company, which the Commission approved in ICC Docket 04-0595. That paragraph states that the Service Company shall render a bill "as soon as practicable after the last day of each month… for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." In the AG's view, this language does not require prepayment. (AG IB at 20)

In its cash working capital analysis, IAWC increased the cash working capital balance to reflect prepayment and did not specify which AWWSC costs are prepaid and which are post paid. The AG argues, "The cash working capital calculation should not include pre-payment to IAWC's affiliate Service Company when AWWSC submits its bill 'as soon as practicable,' IAWC is obligated to pay the charges 'within a reasonable time after receipt of the bill,' and in fact IAWC pays some charges after services are provided and some charges in advance based on estimates." (AG IB at 20-21)

Pennsylvania American Water, one of the largest American Water utilities, is not allowed by the Pennsylvania Public Service Commission to include the cost associated with prepaying Service Company fees in its cash working capital, and that has been the practice in Pennsylvania since the 1990s. (AG IB at 21-22) In 2009, the West Virginia Public Service Commission refused to allow the utility to include payment to AWWSC in its cash working capital calculation. (*Id*., citing Case No. 08-0900-W-42, Order at 35-36 (March 25, 2009))

In the AG's view, "The Commission should take with a generous grain of salt IAWC's argument that Service Company fees will increase if it disallows the effect of prepaying Service Company charges from the cash working capital balance. IAWC cannot demonstrate that one of American Water's largest utilities has increased its charges as a result of the prepayment adjustment, and there is no reason to believe that the charges to Illinois will be any different." (AG IB at 22)

The AG argues, "The same adjustment made in Pennsylvania should be made in this case." In order to protect consumers from an inflated rate base due to an overstated cash working capital balance, AG witness Smith recommended that the Commission apply the same labor lag it uses internally as a reasonable payment lag for payments to IAWC's affiliated Service Company. The Commission "should modify the Company's lead lag study to reflect this more reasonable and fair payment lag." (AG IB at 23)

b. IAWC Position

According to IAWC, the Commission-approved Service Company Agreement between IAWC and the Service Company requires prepayment of Service Company fees. (IAWC RB at 22; IB at 31-32; IAWC RBOE at 8-9)

The AG's assertion to the contrary "is contradicted by the express terms of the Service Company Agreement." (IAWC RB at 22) Under the Service Company Agreement, IAWC is contractually required to prepay the Service Company for services: "As soon as practicable after the last day of each month, Service Company shall render a bill to Water Company for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." (*Id*.)

Under IAWC's interpretation, the quoted language requires that the bill from the Service Company include two amounts: (i) amounts due; and (ii) an amount equal to the estimated cost of such services and expenses for the current month. (IAWC RB at 22) Further, "All amounts so billed shall reflect the credit for payments made on the estimated portion of the prior bill …." This "confirms that the Service Company

Agreement requires advance payment of an estimated amount. Thus, the Service Company Agreement clearly requires prepayment, and IAWC does in fact pay the current month's estimated Service Company fees in advance." (*Id*.)

The AG also argues, based on information from other jurisdictions, that adopting the AG's adjustment will not cause IAWC to be charged more by the Service Company. (IAWC IB at 22-23, citing AG IB at 21-22) The AG argues that because IAWC cannot demonstrate that its affiliate Pennsylvania-American Water Company has increased its charges as a result of the prepayment adjustment established by the Pennsylvania commission, there is no reason to believe that the charges to IAWC will be any different. In IAWC's view, "this misses the point." (IAWC RB at 23) IAWC "would still have to follow the terms of the agreement and prepay the Service Company, so the adjustment simply bars recovery of a prudently incurred cost by the utility." (*Id*.) IAWC adds, "Furthermore, [IAWC witness] Mr. Rungren's testimony at hearing was that while he does not believe the Pennsylvania ruling increased the fees the utility was paying to the Service Company, the utility was "taking a hit" -- i.e., the utility is no longer able to recover its prudently incurred costs." (*Id*., citing Tr. 356)

Of the jurisdictions in which American Water subsidiaries operate, "the AG can only point to two (Pennsylvania and West Virginia) that have adopted a similar adjustment." (*Id*. at 23) IAWC argues, "The AG simply ignores the Pennsylvania commission's rationale for its decision -- that the utility failed to quantify any benefit to its customers. The PAWC decision upon which the AG relies is thus distinguishable from IAWC's current case because the Commission has found Illinois ratepayers benefit as a result of an arrangement featuring prepayments to the Service Company by avoiding a Service Company overhead cost that IAWC would otherwise have been required to pay, and pass along to ratepayers, as part of the cost for services provided." (*Id*.)

The AG "also ignores the Tennessee commission recently rejected an adjustment similar to that proposed by Mr. Smith in this case in Tennessee American Water Company's most recent rate case." (*Id*., citing *Tennessee American Water Co.*, Order, No. 10-00189, Tenn. Reg. Auth. Apr. 27, 2012) Additionally, IAWC asserts, the AG ignores the Commission rejection, in IAWC's last rate case, of the very adjustment the AG proposes here. (*Id*. citing Order, Docket 09-0319 (Apr. 13, 2010) at 18)

c. Staff Position

Staff's position is that the Commission should not adopt Mr. Smith's proposal to adjust the payment lag to the Service Company. IAWC prepays its service company "as required in the service company agreement approved by the Commission." (Staff IB at 18; Staff Ex. 9.0-C at 9; Staff RBOE at 2)

d. Conclusion

The calculation of the payment lag in IAWC's lead-lag study reflects prepayments made by IAWC to the Service Company.

Whether the Service Company Agreement requires IAWC to make prepayments is in dispute. The AG argues that prepayments are not required, while IAWC and Staff contend that they are.

Having reviewed the record, the Commission agrees with IAWC and Staff that the Agreement provides for prepayments by IAWC. The amounts that are "due" from IAWC clearly include payments for upcoming services to be provided over the remainder of the "current" month.

The adjustment proposed by the AG is not adopted.

2. Collection Lag

The effect of late payments was included by IAWC as part of the cash working capital calculation through the collection lag component. The collection lag portion of the revenue lag was calculated using the Company's actual history of revenue collection from July 1, 2010 to June 30, 2011. (IAWC IB at 28-29) No exceptions were filed on this issue.

a. AG Position

Section II.C.2 of the AG's Initial Brief is titled, "The Commission should adjust IAWC's lead-lag study to remove the effect of uncollectibles from the payment lag." (AG IB at 23-24)

Twenty-one days is the bill payment time specified for residential customers in IAWC's tariffs. (*Id*.) According to the AG, "IAWC's revenue collection lag improperly assumes that the Company, on average, receives payment from consumers several days after the due date on the bill. This component of the lead-lag study is distorted because IAWC failed to remove the effect of uncollectibles, which by definition have an unusually long collection lag." (*Id*., citing AG Ex. 4.0 Rev. at 18)

IAWC's approach fails to remove the "distorting effect" of uncollectible accounts, thereby extending the payment lag. (AG IB at 23-24) Like other utilities, IAWC's rates include a factor for uncollectible accounts, so consumers are already compensating the Company on a regular basis for uncollectible accounts. The AG asserts, "It is unfair and a form of double counting to include a charge for uncollectibles in rates, and then include a payment lag for uncollectibles in rate base as if the Company were in fact not receiving payment for those same uncollectibles." (*Id*.)

In the AG's view, "the Commission should modify the Company's lead lag study to remove the effect of uncollectibles, which result in a collection lag of greater than 21 days." (*Id*. at 24; see also AG RB at 6-8)

b. IAWC Position

According to IAWC, its "detailed projection of its revenue requirement collection lag days … is based on actual lags identified in the Company's new lead-lag study," while the AG used an "arbitrary lag amount" based solely on the 21-day lag approved in IAWC's prior rate case. (IAWC RB at 21; IAWC IB at 29)

Commission Rules set a 21-day deadline in which a customer's bill should be paid but do not reflect the "actual collection lag." (*Id*.) Thus, late payment charges do not begin to accrue until 23 days after a bill is issued. The AG argues IAWC's lead-lag study is "distorted" because IAWC did not remove the effect of uncollectibles. IAWC responds, "That is wrong. As shown on line 4 of Schedule B-8, IAWC removed uncollectibles from its cash working capital calculation." (*Id*.)

In IAWC's view, the Commission should utilize IAWC's actual calculated collection lags based on the updated lead-lag study in this case.

c. Staff Position

Staff's position is that the evidence in the instant proceeding supports the collection lag days as proposed by the Company. (Staff IB at 17; Staff Ex. 9.0-C at 9) IAWC prepared a lead/lag study for the year ended June 30, 2011 using average receivables to determine collection lag. The method used by IAWC has been accepted by the Commission in many other proceedings. (Staff Ex. 9.0-C at 9)

d. Conclusion

Having reviewed the record, the Commission finds that the collection lag recommended by IAWC and Staff is appropriate.

IAWC presented an updated lead/lag study for the year ended June 30, 2011, and the collection lags are calculated based on actual customer payments. Further, the evidence shows IAWC did remove uncollectibles from its cash working capital calculation.

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3. Pension Expense

In its CWC calculation, IAWC included an amount for pension expense equal to the Company's projected qualified pension contribution. Staff maintains that pension expense should be used in the CWC calculation, rather than the contribution to the pension fund. No exceptions were filed on this issue.

a. Staff Position

According to Staff, CWC should be the amount of funds required from investors to finance the day-to-day operations of a company. The revenue requirement, which reflects a normal year of operation, represents the Company's annual operating funds required from investors. The CWC calculation removes non-cash items like uncollectibles, depreciation and amortization expenses from the revenue requirement leaving cash operating expenses. (Staff IB at 15-17; Staff Ex. 9.0-C at 6-8)

The recovery of pension expense, as reflected in the revenue requirement, is an expense of providing utility service, while a contribution to the pension trust fund is not. The Commission has adopted the practice of basing pension expenses on FAS 87 and has abandoned the practice of recognizing pay-as-you-go pension expense. Including the contribution to the pension fund in CWC would allow the Company to recover, in rates, an amount that is not a cost of providing utility service and would allow two different measures of pension costs to be considered in the ratemaking process.

IAWC attempts to equate pension contributions to purchased water and wastewater treatment expenses. Purchased water and wastewater treatment expenses are included in the CWC calculation, but since they are recovered through purchased water and purchased sewage treatment surcharges, they are not included in the revenue requirement. Purchased water and wastewater treatment expenses would be included in the revenue requirement if they were not recovered through a rider. The same is not true for the pension contribution. (*Id*.)

In Staff's view, considering contributions to pension funds in the CWC calculation is contrary to Commission practice. The Commission has consistently based CWC on the revenue requirement and has included expenses which would be in the revenue requirement if not collected through a rider. IAWC's proposal would have the Commission set rates for something which would not be in rate base or in the revenue requirement.

Staff regards IAWC's proposal as shortsighted. Commission practice includes many items in the CWC calculation that represent operating expenses from the revenue requirement but not the actual cash disbursements. In the revenue requirement and the CWC calculation, for example, federal income tax is calculated on a separate return basis; not on actual tax payments; return on equity is deducted from operating revenue at an amount equal to rate base multiplied by the weighted cost of capital, not actual dividends paid; and interest expense is an amount calculated on the interest synchronization schedule and included in rates, not interest actually paid. (Staff Ex. 9.0-C at 6-8)

b. IAWC Position

In IAWC's view, Staff's recommendation should be rejected because it ignores the amount of cash that IAWC actually expects to contribute to its pension trust in compliance with ERISA. In other words, IAWC's cash working capital amount should be based on available actual information. (IAWC IB at 27-28; IAWC RB at 19-20)

According to IAWC, its test year pension contribution amounts represent actual cash payments the Company projects to payout in the test year, and so it is the appropriate basis for determining cash working capital. Pension expense in the revenue requirement represents the income statement portion of FAS 87 expense. Pension contributions, on the other hand, are cash that is to be contributed to the pension trust in accordance with ERISA provisions, including the minimum amount required by law, and includes both the income statement and capital portions of pension funding. (IAWC IB at 27-28)

Items that are not reflected in the revenue requirement are still reflected in the cash working capital calculation. IAWC does not include in its revenue requirement amounts for purchased water or wastewater treatment revenues and expenses, yet they are included in the statement of cash working capital because they represent cash flow for the Company. IAWC is required to pay for purchased water and for wastewater treatment and collect from customers the associated revenues. Although purchased water and purchased wastewater treatment are removed from the revenue requirement, purchased water and purchased wastewater treatment are considered in the statement of cash working capital. (*Id*.)

c. Conclusion

Having reviewed the record, the Commission finds that the Staff recommendation should be adopted.

As explained by Staff, it is the pension expense -- not the actual contribution to the pension trust fund -- that is reflected in the revenue requirement as an expense of providing utility service. Including the contribution to the pension fund in CWC would allow the Company to recover, in rates, an amount that is not a cost of providing utility service. In addition, it would allow two different measures of pension costs to be considered in the ratemaking process.

IAWC's position that the pension contribution belongs in CWC because it is "cash" is not persuasive. In that regard, it is little different than other items in revenue requirement, noted by Staff, that are not adjusted to a cash disbursement amount for the CWC calculation.

4. Current and Deferred Income Taxes

In its rebuttal schedules, Staff combined, without notation, current and deferred income taxes in the cash working capital calculation. No testimony was presented in support of this adjustment, and no explanation for it was provided in the rebuttal schedule or Initial Brief.

IAWC argues that deferred and current taxes are calculated independently, and that it is not appropriate to combine them. (IAWC IB at 35-36)

No exceptions were filed with respect to this issue.

The Commission finds that the adjustment is not supported by the evidentiary record and should not be adopted. This issue may be revisited in future rate cases.

D. ADIT -- Repairs Deduction – FIN 48

IAWC states that in early 2008, it became apparent that the IRS had favorably changed its previous position on accounting for units of property relative to certain tax deductions for repairs. IAWC therefore applied for and received permission to change its method of accounting. The primary purpose of that change was to use larger units of property in the identification of repairs for tax purposes and, thereby, increase its tax deductions. (IAWC IB at 38; IAWC Ex. 13.00R at 12-14) According to the AG witness, the IRS approval allowed AWWC and its subsidiaries to take a tax deduction for costs that were previously capitalized for tax purposes. (AG Ex. 2.0 Rev. at 59)

The Company classified a portion of these increased deductions as "uncertain." IAWC states that these uncertain amounts were then classified as tax liabilities -- the Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") amounts at issue. (IAWC IB at 39, citing IAWC Cross Ex. 8 at 5)

1. AG Position

AG witness Mr. Smith stated that the decrease in taxable income reduced the Company's current taxes payable while increasing the accumulated deferred income tax ("ADIT") liability. (AG Ex. 2.0 Rev. at 59)

In the AG's view, the repairs deduction is a tax savings which represent an interest-free source of funds from the Federal and State government. (AG IB at 26; AG Ex. 2.0 Rev. at 61-62; AG RBOE at 5) The AG recommends that the Commission remove from rate base the non-investor funds, in the amount of $1,529,000, associated with the ADIT for the FIN 48 repairs deduction.

The AG also states that FIN 48 repairs deductions have been deducted from rate base by regulatory commissions in other states. (AG IB at 27-29, citing *Indiana American Water Co.*, Cause No. 44022 (Indiana PURC) Order at 40 (June 6, 2012); and *West Virginia American Water Co.*, Case No. 10-0920-W-42T, Order at 29 (April 18, 2011))

2. Staff Position

Staff recommends that the Commission adopt AG witness Mr. Smith's adjustment to ADIT related to the Company's change of method for accounting for repairs for tax purposes. The Company has realized tax savings which represent an interest free source of funds from the Federal and State government. (Staff IB at 18)

According to Staff witness Kahle, the FIN 48 amount represents a source of cost-free capital that should be reflected as a rate base deduction. (Staff RBOE at 2) Cost deductions on any tax return represent a level of uncertainty with regard to the final IRS determination of taxable income. Under the Company's proposal, if the IRS does not disallow the tax deduction associated with the FIN 48 reserve, customers would not receive the benefit of the deferred tax credits until the first rate case after tax returns are no longer subject to IRS review and adjustment. The Company has proposed no mechanism to protect customers for the increased rates while awaiting the IRS to complete its review of the issue if the FIN 48 reserve is proved to be unnecessary. (Staff Ex. 9.0-C at 11)

Staff states that the Federal Energy Regulatory Commission ("FERC") has provided guidance on this issue in FERC Docket No. AI 07-2-000. Certain classifications that are required or permitted under FIN 48 are not permitted under FERC reporting. The FERC guidance does not permit FIN 48 amounts to be combined with deferred tax accounts. The FERC guidance also requires that interest and penalties applicable to underpayment of income taxes be recorded as interest expense and penalties respectively. While FERC does not regulate water or wastewater utilities, an order from a federal regulatory agency that considers the appropriate accounting treatment of transactions to provide guidance on the regulatory treatment of an issue should be given consideration. (Staff IB at 18-19; Staff Ex. 9.0C at 12-13)

To mitigate the Company's risk in adopting uncertain tax positions, the Staff witness recommends that the Commission allow the Company to recover from ratepayers any interest accrued on FIN 48 funds in its cost of service as interest expense. He said the Company should still have an incentive to make uncertain tax positions. If the tax position prevails, the Company would retain the interest expense that the IRS would not collect. If the uncertain tax position fails, the Company would pay the interest expense collected in its cost of service to the Internal Revenue Service. (Staff Ex. 9.0C at 12-13)

On this point, Staff states, in its Initial Brief, "Since the Company does risk the payment of interest on the uncertain tax position if the IRS disallows the tax deduction, the Commission could allow the Company to recover from ratepayers any interest accrued on FIN 48 funds in its cost of service as interest expense." (Staff IB at 19)

3. IAWC Position

According to IAWC, the dispute over these FIN 48 amounts centers on the question of whether the utility should be subject to a disincentive to take uncertain tax positions that may ultimately benefit ratepayers. Consistent with the ratemaking treatment of FIN 48 liabilities by other regulatory commissions, and sound ratemaking policy, IAWC has removed from its test year balance of ADIT the balance of FIN 48 liabilities. The effect of this is to not deduct the FIN 48 amounts from rate base when the balance of ADIT is deducted from rate base. IAWC's treatment is appropriate for two reasons: (1) it provides the utility with incentive to pursue the uncertain tax position which, if successful, will result in a ratepayer benefit (through higher tax deductions, which produce lower current tax expense and an increased deferred tax amount, which would be deducted from rate base as ADIT); and (2) it recognizes that FIN 48 amounts are not ADIT as they are not "cost free" sources of capital. (IAWC IB at 36)

Ratepayers benefit when IAWC adopts uncertain tax positions because if the Company is able to prevail in the assertion of an uncertain tax position, at that point, the loan would be re-characterized as an ADIT loan and customers would enjoy an incremental rate base deduction in the next rate proceeding. (IAWC IB at 40-42; RB at 24-25) This point appears not to be in dispute.

The position taken by Staff and the AG eliminates the incentive for IAWC to take uncertain tax positions. Staff and the AG propose for ratemaking purposes to treat the amounts associated with uncertain tax positions ("FIN 48" amounts) as ADIT that is deducted from rate base. That treatment, however, would encourage IAWC to forego taking any uncertain tax position—in other words, under Staff or the AG's proposals, IAWC would be better off simply not taking the uncertain position, even though it could ultimately benefit ratepayers to do so. (IAWC RB at 25; IAWC Ex. 13.00R at 22-23) For this reason alone, their positions should be rejected. IAWC (and all utilities) should be encouraged to adopt uncertain tax positions to the benefit of ratepayers. The best way to do this is to treat the Company fairly in the regulatory process: it should not be required to recognize as deferred taxes FIN 48 amounts which it ultimately expects to pay with interest to the IRS. (IAWC RB at 25)

Staff and the AG's positions are based on the misperception that FIN 48 amounts are comparable to ADIT. In IAWC's view, they are not. (IAWC RB at 25-26) To begin with, the AG argues that FIN 48 amounts are not investor-supplied capital. But, IAWC argues, they are not ratepayer-supplied funds either. Rather, they represent a form of government loan, or government-supplied funds. (IAWC Ex. 13.00R at 6-7) But for that deduction, the utility would have paid more taxes. Further, FIN 48 amounts are not an interest-free loan from the government. (IAWC Exs. 13.00R at 8-9; 13.00SR at 3) Thus, they simply cannot be considered a cost-free source of capital. (*Id.*) Moreover, FIN 48 amounts are, for financial reporting purposes, expressly not to be classified as ADIT. (IAWC Cross Ex. 8 at 5; Tr. 709-710)

Recovering interest does not make IAWC whole, if, as the AG and Staff propose, rate base is reduced by the FIN 48 amounts. (IAWC RB at 28; Tr. 821-824) This is because the rate base deduction could continue even after IAWC has repaid the FIN 48 liability to the IRS as expected. The AG would treat the entire amount of potential tax liability as if IAWC will win on all positions and never have to pay the tax. That is contrary to the record, which make clears that more likely than not, IAWC will be required to repay the tax liability associated with the uncertain positions. (IAWC Ex. 13.00R at 22; Tr. 828-829) The result is too extreme: if IAWC loses the uncertain tax positions, as is expected, there would be no deferral of tax and no means by which IAWC could recover the amount of revenue requirement associated with the reduced rate base. (IAWC RB at 28-29)

The AG cites a recent order of the West Virginia PSC in support of its position this Commission should adopt the same ratemaking treatment of FIN 48 amounts sanctioned in that jurisdiction. (IAWC RB at 29, citing AG IB at 28-29) The AG makes no attempt to show the circumstances of that case are comparable to those here or to explain why this Commission should defer to that one. IAWC adds, “Notably, the AG fails to acknowledge that the West Virginia Commission, to guard against the revenue harm perceived by the utility and to encourage it to continue to adopt uncertain tax positions which ultimately benefit ratepayers, allowed the utility recovery on a regulatory asset equal to the related negative revenue requirement impact resulting from the disallowed ADIT….” (IAWC RB at 29)

Thus, the West Virginia Commission ordered a ratemaking outcome that recognized that the utility should retain the incentive to take uncertain tax positions. (*Id*. at 29-30)

As noted above, the Staff witness recommends that the Commission allow the Company to recover from ratepayers any interest accrued on FIN 48 funds in its cost of service as interest expense. In IAWC’s view, “this is not enough.” Staff’s proposal does not mitigate the impact of including FIN 48 in ADIT—a reduction of rate base of $1.529 million—and does nothing but discourage IAWC from ever taking uncertain tax positions. (IAWC RB at 30; IB at 40)

In response to Staff’s discussion of FERC guidance, IAWC asserts that FERC guidance is not an authority upon which the Commission should rely in this context. (IAWC RB at 30) Notably, FERC regulates electric and gas utilities. Therefore, it is unclear how its guidance is relevant to an Illinois water utility. Further, in its introduction to the guidance portion of the document, the FERC states: “This guidance is for Commission financial accounting and reporting purposes only and is without prejudice to the ratemaking practice or treatment that should be afforded items addressed herein.” In other words, the FERC explicit states it did not intend to prescribe ratemaking, but only financial reporting. The document, therefore, simply is not relevant to this Commission’s determination. (IAWC RB at 30, citing IAWC Ex. 13.00SR at 4-5)

In its BOE, IAWC takes issue with the conclusions contained in the Proposed Order. (IAWC BOE at 26-29)

4. Conclusion

IAWC has realized a tax savings which represents an interest free source of funds from the Federal and State government. The cumulative effect of the Company’s deferral of income taxes are credit balances of ADIT that are deductions from rate base. (Staff Ex. 9.0C at 10)

The Company proposes to reduce ADIT by an amount recorded as uncertain tax positions by the Company in accordance with Financial Accounting Standards Interpretation No. 48 ("FIN 48"). Since, in this case, ADIT is a deduction from rate base, the Company's reduction of ADIT by the FIN 48 amount results in an increase in rate base.

The AG and Staff recommendation would eliminate the reduction of ADIT by the FIN 48 amount thereby decreasing the Company's proposed rate base.

The Commission agrees with AG and Staff that the FIN 48 amount represents a source of cost-free capital that should be reflected as a rate base deduction. IAWC's proposal does not contain a mechanism to protect customers while awaiting an IRS review. Therefore, if the IRS does not disallow the tax deduction associated with the FIN 48 reserve, customers would not receive the benefit of the deferred tax credits, in the form of a rate base reduction, until the first rate case after tax returns are no longer subject to IRS review and adjustment.

As indicated above, the Staff witness made a recommendation intended to mitigate the Company's risk in adopting uncertain tax positions. While a proposal or mechanism for this purpose may well have merit, the one presented by the Staff witness is not clear in terms of how it would actually work. The Commission will not adopt it at this time.

In conclusion, the adjustment to rate base proposed by Staff and the AG is adopted.

E. Unamortized Management Audit Costs

IAWC incurred a cost of $392,100 owed to NorthStar for conducting, at the Commission's direction, a management audit of service fees paid to AWW Service Company. IAWC also purportedly incurred $722,000 for IAWC's internal, AWW Service Company, and contract audit related costs.

IAWC proposes to recover a ratable one-fifth portion of these costs as operating expenses annually. The AG challenges the reasonableness of these costs; this issue is addressed later in this order.

IAWC also proposes to include the unamortized balance of the costs in rate base.

The Commission notes that no exceptions were filed with respect to this issue. The reasonableness of incremental costs associated with the audit is a contested issue, and is addressed in a later section of this order.

1. AG Position

Section II.D of its Initial Brief is titled, "IAWC Should Not Be Allowed to Include the Unamortized Balance of the External Audit Cost in Rate Base but Should Treat it as the Commission Treats Rate Case Expense." (AG IB at 24)

IAWC asks the Commission to allow it to charge consumers $1.114 million for a $392,100 external management audit of affiliated Service Company charges. According to the AG, "In addition to being an 'excessive charge' (including $722,000 for IAWC's internal, AWWSC, and contract audit related costs), IAWC proposes to treat this expense differently from other rate case related costs, and to include the unamortized balance in rate base." (AG IB at 24)

By including the unamortized balance of this "excessive cost" in rate base, IAWC is asking consumers to pay a return on both its costs and on the NorthStar audit costs. In the AG's view, to the extent IAWC's costs are AWWSC costs (i.e. $225,000), including these costs in rate base violates the SC Agreement approved in ICC Docket 04-0595. In the AG's view, the AWWSC charges IAWC asserts are associated with the audit are past charges and not part of the test year, and IAWC does not cite to any authority for deferred recovery of this AWWSC cost. The SC Agreement provides the terms for billing and payment of AWWSC charges, and IAWC should not be able to earn a return on some of those charges by separating them from other AWWSC charges. (*Id*. at 24-25)

The AG recommends that the Commission reject IAWC's proposal and remove the total unamortized balance of $353,000 from rate base.

2. IAWC Position

According to IAWC, the AG's position disregards Commission precedent and indicates a fundamental misunderstanding of management audit costs. (IAWC RB at 31-32)

The Commission has "routinely authorized amortization of Section 8-102 management audit costs and inclusion in rate base of the unamortized balance. See, e.g., *Central Ill. Pub. Svc. Co*., Order, Docket 90-0072 … at 38-40 (Nov. 28, 1990) (approving five-year amortization period and including unamortized balance in rate base) (other case citations omitted)."

The AG's position "is based on a fundamental misunderstanding of Section 8-102 management audit costs." (IAWC RB at 32) IAWC states, "Without citation to authority, the AG asserts IAWC's audit costs should be excluded from rate base because they are 'rate case related costs.' That is wrong." (*Id*.) IAWC argues, "The AG misunderstands the difference between rate case expense and management audit costs. It is simple: rate case expense is the expense incurred by a utility to prepare and present a rate case. *Central Ill. Pub. Serv. Co. v. Ill. Commerce Comm'n*, 243 Ill. App. 3d, 421, 423

(1st Dist. 1993). In IAWC's view, "Section 8-102 management audit costs are not incurred by a utility to prepare and present a rate case; they are incurred in relation to a management audit undertaken pursuant to Section 8-102 of the Act. Thus, they are not rate case expense." (*Id*.)

For the first time in briefing, the AG also makes the "novel" argument that including Service Company-related management audit costs in IAWC's rate base somehow violates the Service Company Agreement provision directing the Service Company to provide its services at cost. (IAWC RB at 32-33) This position is not set forth in the testimony of any witness, and, in IAWC's view, is based on a fundamental misperception.

Consistent with the Service Company Agreement, Service Company labor costs are charged to IAWC at the Service Company's cost. IAWC pays these Service Company charges in full, then determines how best to treat the costs based on the ratemaking and accounting considerations most appropriate for IAWC as a regulated Illinois utility. Once included in IAWC's rate base, IAWC -- and not the Service Company -- will earn a return on them. According to IAWC, "This is routine. See, e.g., *Illinois-American Water Co*., Order, Docket 09-0319 (Apr. 13, 2010), pp. 21-22 (including in rate base the unamortized balance of IAWC's portion of the cost of the Service Company's Comprehensive Planning Study). In short, the AG is ignoring the distinction between the Service Company's provision of services at its cost with IAWC's treatment of the costs it pays as investment included in rate base." (IAWC RB at 32-33)

3. Staff Position

Since such audit costs are statutorily mandated costs, Staff agreed that it is appropriate to include the unamortized balance in rate base to earn a return for shareholders. The Commission has previously allowed the inclusion of unamortized management audit costs in rate base in order to provide a utility company with an opportunity to recover the capital costs associated with the management audit. (Staff IB at 27-28; Staff Ex. Ex. 11.0 at 9-10)

4. Conclusion

IAWC proposes to recover annually, as operating expenses, a ratable one-fifth portion of the costs related to the audit of fees paid to AWW Service Company. The reasonableness of these costs is addressed later in this order.

IAWC also proposes to include the unamortized balance of the costs in rate base.

To the extent the management audit costs are found reasonable, IAWC should be permitted to earn a return on the unamortized balance of them through rate base. The Commission agrees with IAWC that the costs are not "rate case related." That is, they were associated with the audit, not with the preparation and presentation of the rate case.

The Commission also agrees with IAWC and Staff that inclusion of the unamortized balance of management audit costs in rate base is consistent with past Commission decisions.

The AG's argument that including the costs in rate base would violate the SC Agreement is similar to the argument raised in connection with BT costs, and is disposed of in the conclusions on that issue.

F. Forecasted Additions to Utility Plant in Service

In direct testimony, Staff proposed an adjustment to the Company's proposed additions to Utility Plant-in-Service based upon a comparison of actual capital expenditures to proposed capital expenditures in 2009, 2010 and 2011. In rebuttal testimony, AG witness Mr. Smith concurred in the Staff adjustment.

In its rebuttal, an IAWC witness testified that the "gross capital expenditures" amounts relied upon by Staff included amounts over which the Company has little or no control, such as developer-funded and other contributed amounts, which are not included in rate base. IAWC presented a comparison of "net capital expenditures" which shows IAWC's actual expenditures exceeding budget over the 2009 - 2011 period. (IAWC IB at 44-45)

After reviewing the analysis in IAWC's rebuttal, Staff withdrew its adjustment. (Staff IB at 14)

No exceptions were filed with respect to this issue.

Having reviewed the record, the Commission finds that the amounts for forecasted additions to Utility Plant-in-Service as proposed by IAWC for the 12-month periods ended September 30, 2012 and September 30, 2013 are reasonable and should be allowed.

G. Approved Rate Bases

Upon giving effect to the determinations above, the Commission finds that the rate bases for the consolidated and standalone water and sewer divisions approved elsewhere in this order below are hereby approved as shown in the rate base schedules attached as Appendices to this Order.

V. OPERATING REVENUES AND EXPENSES

Test-year revenues was a contested issue, as were various operating expense items as discussed below. Certain adjustments related to a call center are addressed in the "Affiliated Interest Issues" section of this order below.

A. Test Year Sales Volumes and Revenues

IAWC's forecasted test-year revenues reflect a continuing decline in customer usage. The AG and IIWC/FEA contend that IAWC has understated test-year sales and revenues.

1. IAWC's Position

According to IAWC, usage by its residential customers has declined by 2.89 gallons per customer per day, or by approximately 1.90% per year for the last eight years. IAWC claims usage by its commercial customers has similarly declined by 8.59 gallons per customer per day, or by approximately 1.08% per year for the same period. As such, IAWC indicates it adjusted its projected test year level of present rate revenues to reflect that significant and continuing trend of declining residential and commercial customer water usage. (IAWC IB at 47)

IAWC says it used a declining residential and commercial customer usage model to forecast test-year sales for those customer classes. IAWC indicates that its approach consisted of a two-step process. IAWC first segregated out and examined that portion of annual usage not impacted by weather, or "base" usage. IAWC says it accomplished this by examining usage per-customer per-day data for the non-summer months of January through April of each year 2003-2011 to develop a trend line. Using the resulting regression equation, IAWC indicates it determined the linear "base" usage per customer per day for each month January 2003 through December 2010, and continued that trend through December 2013.

Next, IAWC says it determined customer usage that is impacted by weather and layered that usage atop the "base" usage. IAWC states that it accomplished this by first subtracting the trend line amounts calculated in step one from the actual usage per customer per day for the years 2003 through 2011. IAWC says it then averaged the remaining summer, weather-related usage for those periods and added that average back to the respective "base" amount for 2011 through 2013. IAWC claims the results of its analysis demonstrate a continuing annual usage decline across all of IAWC's service territories. (IAWC IB at 47-48)

IAWC asserts that the declining usage trend is not surprising. The increasing prevalence of high efficiency or "low flow" plumbing fixtures and more efficient appliances such as dishwashers and washing machines contributes to the decline in water consumption. When a customer replaces such a fixture or appliance the new model will use less water than the one replaced. Also, new homes will have more efficient water fixtures and appliances. IAWC also says that recent federal regulations have mandated the manufacture of water efficient toilets, showerheads and faucets and water-using appliances.

IAWC believes Federal regulation in this area will further increase the prevalence of water efficient household appliances and thus continue to drive down residential water consumption. Overall, with all other factors being equal, IAWC claims a typical residential household in a home with new fixtures and appliances would use 35% less water for indoor purposes than a non-retrofitted home built prior to 1994. IAWC also asserts that according to the U.S. Census Bureau’s 2005-2009 American Community Survey, over 80% of existing homes in Illinois were built prior to 1990. IAWC says those homes would have been constructed with more water-intensive plumbing fixtures and appliances than are now available. In IAWC's view, it is clear that water efficient fixtures will continue to drive down usage. (IAWC IB at 48-49)

In addition to the increasing prevalence of water-efficient plumbing fixtures and appliances, IAWC contends that increasing customer conservation ethic and utility conservation measures also attribute to the declining usage trend experienced by IAWC. IAWC says this is because, as awareness of water and energy efficiency increases, customers may replace plumbing fixtures and appliances with more efficient models before the older models require replacement, and may further reduce their water consumption by changing their water use habits. IAWC claims the 2.89 gallon per customer per day decline IAWC has experienced with respect to residential customer usage can be achieved by subtle changes in customer behavior such as running the dishwasher 5 times per week rather than 7.

IAWC states that it has taken numerous steps to promote consumer conservation activities, including providing customers with educational literature and initiating workshops, community events, conferences and speaking engagements related to conservation. IAWC asserts that these conservation initiatives and the resulting awareness also attribute to the declining usage experienced by IAWC. (IAWC IB at 49)

IAWC believes its declining usage experience is not unique. IAWC asserts that for other American Water subsidiaries and, for those states with climates similar to that of Illinois, the operating companies in those states are also experiencing declining usage. IAWC contends that of those studied all have experienced declining usage ranging from 1.09% to 2.47% per year. IAWC’s claims its own experience falls in the middle of that range. IAWC contends that the declining usage trend is industry-wide. IAWC expects the declining usage trend to not only continue, but also accelerate as a result of the increased prevalence of water efficient fixtures and conservation initiatives. (IAWC IB at 49-50)

While IAWC acknowledges there are environmental and operational benefits from lower water usage by residential and commercial customers, currently, it claims there is an economic disincentive to IAWC to sell less water in its service territories. IAWC contends it is fully committed to preserving natural resources and to encouraging the benefits of conservation, while continuing to provide safe, adequate and reliable utility service in accordance with its regulatory obligations. IAWC says the Commission's recognition in this case of the decline in water usage IAWC is experiencing will support this goal. IAWC claims its test-year projection of present rate revenues reflects all of these factors. (IAWC IB at 50)

IAWC states that the AG acknowledges there may be a declining long-term trend in consumption. IAWC also says the AG concedes advancements in water-using technologies, water conservation programs and reductions in household occupancy rates may reduce water usage levels. IAWC reports that the AG attacks the methodology underlying IAWC's declining usage analysis for a host of reasons. (IAWC IB at 50)

IAWC argues that despite the AG's "nit-picking" of IAWC's analysis, IAWC is experiencing significant and continual declining customer usage. IAWC believes that criticizing its analysis and arguing it could have been more robust does not make the trend any less apparent. IAWC claims the AG's own regression analysis suggests such a trend exists. IAWC also complains that the AG did not prepare a consumption forecast in this case. IAWC says the AG proposes using IAWC's 2011-2012 usage forecast simply because that forecast appeared to be a less extreme result than IAWC's test year forecast. In IAWC's view, this is not a basis to discard IAWC's comprehensive projection model. IAWC says the AG contends IAWC has not provided sufficient reasons to assume residential consumption will continue to decline. IAWC argues that contention is not credible, given the record evidence that a trend is affecting the entire water industry and will continue to do so. (IAWC IB at 50-51)

IAWC argues that absent from IIWC/FEA and the AG's condemnation of IAWC's test year usage forecast, is any recognition of the declining usage trend experienced by IAWC or the myriad drivers exerting downward pressure on usage per customer. IAWC says Staff does not dispute the accuracy of the decline in annual usage. (IAWC RB at 33-34)

According to IAWC, although IIWC/FEA claims its witness offers a more appropriate and conservative forecast than IAWC's, IIWC/FEA simply supplants IAWC's test year base usage with 2010 base usage for the Total Company and Zone 1. By so doing, IAWC claims IIWC/FEA ignores the fact that IAWC actually experienced a 1.90% annual decline in usage since 2010 and the effect of water efficient fixtures installed or conservation measures undertaken since that year. IAWC insists its forecast is based on a detailed projection based on multiple years of data and incorporates IAWC's analysis of declining per customer usage trends. IAWC asserts that IIWC/FEA's forecast lacks this level of detail. IAWC states that while its usage forecast methodology uses eight seasonal averages, IIWC/FEA looks at only one. IAWC believes this leads IIWC/FEA to the erroneous conclusion that IAWC has understated its test year usage. IAWC believers such a narrow approach cannot be the basis for IAWC's test year level of consumption. (IAWC RB at 34; IAWC RBOE at 12-14)

IAWC says that the AG did not prepare a consumption forecast. Despite this, IAWC says the AG mischaracterizes IAWC's consumption model as simplistic. According to IAWC, despite adopting IAWC's 2011-2012 forecast, the AG criticizes IAWC's forecast method as erroneous and ignoring factors that influence usage such as population, economic conditions, changes in water-use technologies, weather, climate and price. IAWC asserts that its forecast model considers exactly those factors. IAWC claims it is the AG that ignores a time-series analysis recognizing that multiple factors influence usage and do so over time.

IAWC says that rather than selectively including or excluding specific factors, as the AG suggests would be appropriate, IAWC's method quantifies the composite effect of all factors on usage over time. IAWC states that time, as the dependent variable, functions as a proxy for increased fixture and appliance efficiency, consumer conservation ethic and education, price changes and a host of other factors that influence usage. In IAWC's view, the AG's contrary contention here is not credible. (IAWC RB at 34-35)

IAWC says the AG also criticizes IAWC's projection because the AG believes the base period employed excludes the non-weather sensitive months of November and December. IAWC contends that this argument ignores the record evidence. According to IAWC, some of its residential customers whose data was used were billed on a bi-monthly basis. For this reason, IAWC says there is a lag between actual consumption and sales figures such that sales figures from November and December can include usage from September and October. IAWC claims the AG appears to agree that is potentially weather-sensitive usage because the AG identifies November and December, and not September and October, as non-weather sensitive months. IAWC insists it properly excluded weather-sensitive October and September usage from base period usage. (IAWC RB at 35)

According to IAWC, the AG claims, without citation to the record or further explanation, that IAWC's consumption forecast methodology, by averaging the demand for each year, ignores the variability in monthly usage. The AG argues that seasonal variability is precisely what must be removed to study an underlying trend in non-weather sensitive, base usage. IAWC says averaging accomplishes this. The AG also criticizes IAWC's methodology as using too limited a number of years. IAWC responds that the eight seasonal averages (2003 – 2011) on which IAWC based its analysis represents the maximum data set available and strikes a reasonable balance between providing sufficient statistical data for analysis and being representative of today's demographics and drivers. IAWC says the AG recommends a projection based on only one year. In IAWC's view, the AG's criticisms in this regard are baseless. (IAWC RB at 35-36)

In its BOE, IAWC takes issue with the Proposed Order for "cutting off [the] forecast at September 30, 2012, and not continuing it through the end of IAWC's test year." (IAWC BOE at 17)

2. The AG's Position

The AG states that in developing rates, the appropriate level of projected revenues must be determined so that the new rates accurately recover the revenue requirement. The AG contends that in this docket, IAWC has used a simplistic and ultimately erroneous method to predict its demand and understated its associated revenue in the future test year by $2,302,388. The AG says this adjustment is reflected in AG Ex. 2.2, Schedule C-1 for each operating district and claims the revenue projection must be corrected to set fair rates. (AG IB at 29)

According to the AG, IAWC's method for projecting consumption ignores key factors that affect demand forecasting, including population, economic conditions including inflation and household income, changes in water-use technologies, weather and climate, and price. The AG asserts that instead of using well established water demand forecasting methods, IAWC used a limited set of data that was made less representative of actual variability by being reduced to annual averages. (IAWC IB at 29)

Although IAWC claimed to base its analysis on base consumption or consumption that is not weather sensitive, it excluded demand data for November and December, reducing the number of months involved in its analysis for six (half a year) to four (only a third of a year). The AG argues that in Illinois, weather sensitive outdoor water use is limited to the summer months, making it appropriate to treat November and December as non-weather sensitive months. The AG also asserts that IAWC used an improperly small sample of months in its analysis, making the results less reliable. The AG contends the use of all non-weather sensitive months reduces the size of the change IAWC projects based on an unreasonably restricted data set. (AG IB at 29-30)

The AG also complains that IAWC's analysis averages the demand for each year, ignoring that monthly use varies. The AG argues that the effect of using an average of an unreasonably small number of months is compounded by the limited number of years used in the analysis. The AG contends that an unusually high starting point or an unusually low ending point would have a dramatic effect on the analysis because so few data points are included. The AG believes it is neither accurate nor fair to consumers to accept IAWC's analysis that does not follow accepted industry approaches to projecting demand and that has so many data limitations and biases. (AG IB at 30)

In effort to produce a more accurate demand and revenue projection, the AG says it analyzed IAWC's most recent consumption and customer figures for each of the years ending September 30, 2011 and 2012. The AG argues that this more precise projection of revenues is more appropriate for ratemaking, and includes a separately calculated revenue projection for each district. The AG claims actual data shows that there is significant variation among the districts. The AG states that from 2011 to 2012, revenues in some areas increased (Chicago Metro and Pekin) and revenues in other areas (Zone 1 and Lincoln) decreased. The AG says notwithstanding the fact that actual revenues increased in some areas from year to year, its recommendation, like IAWC's, results in lower total revenues in the test year compared to the year ending September 30, 2012 for all districts except Pekin. The AG contends IAWC over-stated the degree of decreased demand and revenues by $2,302,388. (AG IB at 30)

The AG says it recommends using IAWC's projected level of consumption and customer growth for the 2011-2012 period because it appeared to be a less extreme result than that proposed by IAWC, in that it has consumption higher than 2010-2011 in two rate areas and lower than 2010-2011 in the other two rate areas. (AG RB at 15-16)

The AG contends its analysis properly recognizes differences among IAWC's rate areas. The AG states that the number of people per household varies considerably from district to district, ranging from 2.62 to 4.18, and averaging 3.01, and the number of people per household affects total household water usage. In addition, the AG says in the pre-test year period ending September 30, 2012, IAWC projected more water usage for Chicago Metro and Pekin, contradicting its premise that water usage is steadily declining year-over-year. The AG suggests this shows the danger in applying general assumptions to disparate service areas, and also highlights that IAWC has under-projected overall water usage. (AG RB at 16)

IAWC relies on various factors that it argues justify its declining usage projections. The AG relies on the age of the housing stock, of which it asserts that 80% was built prior to 1990. Accepting that as true, the AG suggests it is unreasonable to expect that water fixtures have not been changed in these houses when the life expectancy of water fixtures is only 10-15 years. The AG also claims IAWC ignores that in several of its service areas, consumers' usage is already approaching or even exceeding efficient usage levels calculated by IAWC's own witness. The AG believes these customers' usage cannot be expected to continue to decrease in a linear fashion when they have already eliminated what IAWC considers inefficient usage. (AG RB at 16)

In its Reply Brief on Exceptions, the AG contends that the arguments in IAWC's Brief on Exceptions to extend declining usage beyond the current year should be rejected. (AG RBOE at 2-3)

3. IIWC/FEA's Position

IIWC/FEA states that IAWC forecasts an annual sales volume of 19,569,755 CCF which includes 13,999,507 CCF for Zone 1, for its test year. To arrive at this estimate, IIWC/FEA indicates IAWC used a declining residential and commercial model to forecast test year sales for the customer class. IIWC/FEA argues that IAWC's proposal for residential sales volumes understates the sales volumes for the test year as compared to historical sales levels and recommends IAWC's volumes be rejected. (IIWC/FEA IB at 5)

IIWC/FEA contends that by understating sales volume in the test year IAWC understates the revenues it receives from customers under current rates. Understating the revenues received increases IAWC's claimed revenue deficiency. (IIWC/FEA IB at 5)

IIWC/FEA offers what it believes is a more appropriate and conservative forecast. IIWC/FEA says it accepted IAWC's base level of usage for 2010 and applied it to the test year months of January-May and October-December. IIWC/FEA indicates it then averages the actual IAWC usage over the 5-year period 2005-2010 for the months of June-September to arrive at test year usage for the months of June-September. IIWC/FEA arrives at a calculated test year sales level of 20,992,514 CCF for IAWC in total, including 15,188,508 CCF for Zone 1. According to IIWC/FEA, this reduces IAWC's claimed revenue deficiency at current rates by $4,380,192 on a total company basis, which includes $3,570,144 for Zone 1. IIWC/FEA asserts that its calculated test year sales level results in a reasonable level of consumption as compared to IAWC's historical sales level. IIWC/FEA recommends that its proposed adjustment to IAWC's annual sales volume be adopted by the Commission. (IIWC/FEA IB at 5-6)

In its BOE, IIWC/FEA asserts that its use of measurable data results in a more reasonable test year usage forecast than either the Company's or AG's respective forecasts. (IIWC/FEA BOE at 2-4; RBOE at 8-9)

4. Commission Conclusions

The Commission has reviewed the three proposals and argument relating thereto regarding test year sales volumes. Both the AG and IIWC/FEA object to IAWC's forecast of test year residential sales volumes.

While the AG seems to acknowledge that per-customer usage has been declining, IIWC/FEA's position on this issue is not clear. For residential base usage, IIWC/FEA uses actual 2010 non-summer usage, which suggests IIWC/FEA does not believe residential usage will continue to decline. While IIWC/FEA suggests IAWC has understated residential sales for the test year, it is not clear how it reached that conclusion.

The Commission's review of the record supports IAWC's assertion that residential sales volume, on a per customer basis, has been declining and can reasonably be expect to continue to decline in the short term. Contrary to the AG's suggestion, it does not appear that IAWC believes residential sales volumes, on a per customer basis, will continue to decline indefinitely. Instead, using a linear regression of recent history, IAWC is forecasting reduced residential usage, on a per customer basis, for the test year.

It appears to the Commission that IIWC/FEA essentially proposes to mix historical residential usage data and use it for the future test year. In the face of declining residential sales volumes, on a per customer basis, the Commission finds the IIWC/FEA method and results to be less reliable than the other proposals in the record.

The AG identifies what it believes are numerous errors in IAWC's residential sales forecasting methodology. The AG's recommendation is to use IAWC's residential sales forecast for the year ending September 30, 2012, which as the Commission understands it, uses essentially the same forecasting methodology employed by IAWC. The AG claims its proposal produces a higher residential sales forecast for the year ending September 30, 2012 and is more consistent with actual sales in the year ending September 30, 2011.

The AG asserts that IAWC's regression analysis ignores factors that influence usage such as population, economic conditions, changes in water-use technologies, weather, climate and price. IAWC responds that time, as the dependent variable, functions as a proxy for increased fixture and appliance efficiency, consumer conservation ethic and education, price changes and a host of other factors that influence usage. As an initial matter, it appears to the Commission that in IAWC's regression analysis, residential usage is the dependent variable because it is the factor being influenced by independent variables.

It appears to the Commission that the record lacks any meaningful statistical information substantiating IAWC's suggested correlation between time and residential usage. Even if such statistical information were in the record, it would at best substantiate a correlation between two variables, time and residential usage. Such information would not demonstrate a causal relationship, that is, changes in residential usage that can be explained by the passage in time. Additionally, the record appears to contain no information to support IAWC's assertion that time is a reasonable proxy for the host of factors that influence usage, as it assumes.

In future rate cases where IAWC proposes to forecast residential usage, the Commission will expect a more complete analysis as outlined above, as well as a more reasonable amount of information by which the Commission may evaluate the forecasting methodology.

Having rejected IIWC/FEA's residential volume methodology and recommendation, the Commission will consider the load forecast for the year ended September 30, 2012, as recommended by the AG, and IAWC's load forecast for the test year.

Given the Commission’s concerns about IAWC’s methods of forecasting residential usage, as identified above -- which for the most part would also apply to the AG’s method -- the Commission is unable to find the results are sufficiently reliable to be used to predict further declines in usage beyond those reflected in the “current year” ending September 30, 2012. The Commission finds that IAWC’s forecasted test-year revenues shall be adjusted accordingly.

B. Staff Adjustments to Operating Expenses

Staff witnesses proposed adjustments removing, from test year expenses, amounts associated with incentive compensation, lobbying expense and certain social and service company dues.

Staff witnesses also proposed to eliminate, from charitable contributions expense, amounts contributed to a community and economic development organization and for corporate sponsorships deemed to be "of a goodwill nature." Staff also proposed an adjustment to remove advertising expenses that, in Staff's view, were of a promotional, goodwill or institutional nature. (Staff IB at 20-21)

The effect of the Staff adjustments is to lower recoverable operating expenses. For purposes of this proceeding, IAWC did not contest these adjustments. The Commission finds that the adjustments are appropriate, and they are hereby adopted.

C. Rate Case Expense

IAWC estimates that the total cost to prepare and present the instant rate case is $2,716,921. (IAWC IB at 51; Sch. C-10 First Revised at 1) That total level of expense encompasses the projected cost of four studies prepared in connection with the rate case filing -- a Cost of Service Study, a Direct Demand Study, a Depreciation Study and a Lead/Lag Study -- as well as the cost of an independent audit of the Company's test year projections; the fees and expenses of outside counsel and technical experts retained to prepare, litigate and support IAWC's request for an increase in rates; and additional, incremental expenses incurred by IAWC which the Company would not otherwise incur but for the filing of the proceeding at hand. (IAWC IB at 51; IAWC Ex. 7.00 at 11)

IAWC submitted extensive testimony and documentation in this proceeding supporting its projected level of the current rate case expense. (IAWC IB at 52) IAWC made repeated use of fixed fee or "not-to-exceed" arrangements with outside counsel and external consultants and negotiated a 29% reduction in external legal fees relative to IAWC's last rate case, among other efforts. Moreover, although the Company performed two studies in connection with this case which it did not prepare in connection with its last rate case -- the Direct Demand Study and the Depreciation Study -- IAWC's overall current rate case expense reflects an increase of only 3% above the actual level of expense incurred in the last case. (*Id.*)

The Company also provided Commission Staff with over 700 pages of requests for proposals ("RFPs"), RFP responses, engagement letters, contracts, invoices and other documentation supporting the rate case expense actually incurred by the Company throughout the course of this proceeding, as well as that expected to be incurred through the final stages of it. (*Id*. at 52-53; IAWC Ex. 7.03SR) In IAWC's view, the Commission should find IAWC's total level of rate case expense of $2,716,921 just and reasonable, and it should specifically and expressly find just and reasonable the amounts expended by IAWC to compensate attorneys and technical experts to prepare and litigate this general rate case filing encompassed in that total level of expense, per Section 9-229.

Staff and the AG proposed various adjustments to rate case expense as discussed below. The Staff adjustments would reduce recoverable rate case expense to $2,541,052.

1. Disallowance of SFIO Consultant Costs

a. Staff Position

In its testimony and briefs, Staff recommended disallowance of SFIO Consulting, Inc ("SFIO") consultant costs "due to the unnecessary services performed by SFIO." (Staff IB at 24) Those services primarily focused on review of Company, Staff, and Intervenor testimony and briefs.

According to Staff, such services are duplicative and redundant of Company management and legal counsel responsibilities. SFIO is not a consulting witness that is offering testimony or a tangible work product. The Company claims that "SFIO provides valuable insight into IAWC's case preparation and prosecution." (Staff IB at 24, citing IAWC Ex. 7.00R at 2) Staff states that no tangible evidence of such insights and perspectives has been provided to evaluate the just and reasonableness of the corresponding consulting expenses, and that "the Company has not provided any proof that the services SFIO is to perform are not duplicative and redundant of Company management and legal counsel responsibilities." (Staff IB at 24)

Staff also notes that the Commission disallowed the SFIO consulting expenses in the recent Utilities, Inc. consolidated rate cases. (ICC Docket Nos. 11-0561/11-0562/11-0563/11-0564/11-0565/11-0566 (Cons.), Order, May 22, 2012, at 19)

In Staff's view, the contracted costs of such services by IAWC are not just and reasonable rate case expenses. (Staff IB at 24-25)

b. AG Position

In its testimony and briefs, the AG recommended disallowance of the SFIO consultant costs, identified by the AG as $36,225. According to the AG witness, the services provided by SFIO are primarily to review Company, Staff and intervenor testimony and briefs. As such, this is duplicative of Company and legal counsel's responsibilities. Additionally, no witnesses or work product have been filed for SFIO. Thus, such expenses are not reasonable rate case expenses and should not be borne by ratepayers. (AG IB at 35; AG Ex. 4.0 at 35)

c. IAWC Position

In IAWC's view, "the arguments against recovery of SFIO's fee are unsupported, contrary to the record and unbalanced." (IAWC RB at 37-38; IAWC IB 54-56)

According to IAWC, neither Section 9-229 of the Act, 220 ILCS 5/9-229, nor any other authority deems only "tangible" evidence sufficient to support rate case expense. Nonetheless, "the record is replete with 'tangible evidence' -- in the form of testimony and other documentation -- of SFIO's value." (IAWC RB at 37, citing Exs. 7.00R at 2-3; 7.00SR at 2-4)

For this reason, IAWC argues, Staff's reliance on the Commission's recent Utilities, Inc. Order, which rejected the cost of SFIO's services as "vaguely documented," is inapposite.

Moreover, in preparing their cases, "both Staff and the AG's regulatory consultant relied on the services -- particularly, review of testimony -- of individuals who have not filed testimony or other work product in this proceeding." (IAWC RB at 37-38) They "cannot be heard to claim that what is valuable to them in preparing their cases is valueless to IAWC." (*Id*.)

Staff and the AG also argue SFIO's expense should be disallowed because (they believe) SFIO's work is duplicative of Company management and legal counsel's. IAWC's position is that the record supports the opposite conclusion; SFIO's extensive regulatory experience permits it to offer IAWC valuable insight from a global perspective not comparable to that provided by the Company's management or legal counsel. Again, Staff relies on similar services in preparing its case. Wholesale disallowance of SFIO's fee is therefore unbalanced and should be rejected. (IAWC RB at 38)

The Commission notes that no exceptions were filed with respect to this issue.

d. Conclusion

There are two competing proposals in the record. IAWC recommends that all SFIO consulting fees be recovered through rates, while Staff and AG recommend that all such fees be disallowed.

Of the two proposals of record, the Commission finds that the one advanced by Staff and AG is the more reasonable.

In making this finding, the Commission is not suggesting that all rate case work must take the form of testimony or tangible work product, or that SFIO is unqualified to provide such services. It is reasonable, however, to expect the Company to show, in some manner, how such services are not duplicative or redundant of those provided by others in the face of expert testimony to the contrary. Here, no such showing has been made.

The Commission finds, as it did in Dockets 11-0561 et.al, that the adjustment removing SFIO consulting fees from recoverable rate case expense is adopted.

2. Consultant's Hourly Rate

Staff adjusted allowable rate case expense to limit the hourly rate for rebuttal consultant, James Warren, "because his contracted hourly rate is in excess of a reasonable hourly rate for the services to be provided." (Staff IB at 25; Staff RB at 10-11)

a. Staff Position

Mr. Warren's hourly rate is significantly higher than any of the hourly rates of external attorneys and external technical experts participating in the current rate case as seen in the Company's response to Staff DR JMO 10.02. (*Id*.; IAWC Ex. 7.0SR)

Mr. Warren was retained to address tax issues related to FIN 48 and other tax related adjustments proposed by AG witness Smith. The tax issues regarding FIN 48 are complex and require specialized knowledge, "but a practicing CPA would have such knowledge" in Staff's view. Therefore, Staff concludes, Mr. Warren's hourly rate should be limited to the rate charged by the Quality Control Partner from the CPA firm of Kerber, Eck and Braeckel, which reviewed the Company's projected financial statements used in the current rate case. (Staff Ex. 16.0 Supplemental (Rev.) at 3-4; Staff BOE at 3-5)

In its Reply Brief, Staff argues, "The Company's interpretation that the Commission cannot determine the just and reasonable hourly rate of an attorney or technical expert must be rejected." (Staff RB at 19, citing IAWC IB at 56) Section 9-229 requires a finding that such costs are just and reasonable. According to Staff, "Costs are a function of the contracted services, whether a flat amount for the engagement or an hourly rate. As the Commission found in Commonwealth Edison Company's ("ComEd") last general rate case, 'A specific assessment of, and finding of, justness and reasonableness entails much more than approving an item that is generally included in rates. Otherwise, Section 9-229 would be meaningless.'" (Staff RB, citing Order, Docket No. 10-0467, May 24, 2011 at 83)

b. IAWC Position

IAWC's position is that Staff's Adjustment to Mr. Warren's hourly rate is not appropriate. (IAWC IB at 56-58; IAWC RB at 38-39; IAWC RBOE at 14-16)

According to IAWC, "The plain language of Section 9-229 does not direct the Commission (or its Staff) to determine the just and reasonable hourly rate of an attorney or technical expert. Rather, it requires the Commission to evaluate "amount[s] expended," 220 ILCS 5/9-229, not hourly rates." (IAWC IB at 56)

IAWC also disagrees with the recommendation by Staff that the rate for Mr. Warren be limited to that charged by the referenced CPA. In IAWC's view, the total level of expense related to Mr. Warren's services is reasonable given the size and complexity of the adjustments proposed by AG Mr. Smith. The Staff adjustment "ignores Mr. Warren's education, expertise and years of experience." it also ignores "the question of efficiency: whether Mr. Warren's education and experience enable him to address complex tax issues with precision and in less time than the CPA, such that the 'amount expended' by IAWC for his services may be more reasonable than an amount expended for someone with a lower rate who requires more time to address the issues." (IAWC IB at 57)

According to IAWC, Mr. Warren has provided his services to IAWC at a discounted rate, which is at or below the rate of other senior lawyers in his practice area. (IAWC IB at 58) Moreover, "he has a rare combination of relevant skill sets and, due to his training, education and experience, he is able to provide necessary services more efficiently (i.e., in less time) than other consultants who lack his skill set." (*Id*.) In response to a line of questioning by counsel for the AG, Mr. Warren was able to immediately recite -- without the aid of anything other than his own memory -- not only the complicated approach to consolidated tax savings applied by six separate states, but also the legal basis therefore. (*Id*.)

c. Conclusion

First of all, the Commission disagrees with the Company's assertion that Section 9-229 does not contemplate or even permit the scrutiny of the hourly rates charged as part of the Commission's assessment of rate case expense. After all, Section 9-229 requires the Commission to "specifically assess the reasonableness of the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing." In the Commission's opinion, evaluating the hourly rate can be a logical and appropriate element to consider in the performance of such an assessment.

In the instant situation, Staff contends Mr. Warren's rate is too high. Staff believes the tax issues addressed by Mr. Warren are ones for which "a practicing CPA would and should have such knowledge."

A review of the record indicates that the tax issues raised by the AG witness, to which Mr. Warren responded, are very complex. Mr. Warren is an expert in this area. IAWC's assertions that Mr. Warren exercised that expertise in an efficient manner -- including under examination at the hearing -- and that the rate charged is at or below those charged by others with similar expertise, are largely unchallenged.

Under the circumstances, relying solely on the CPA rate used by Staff would not be an accurate proxy. The Commission finds that averaging the CPA rate used by Staff with Mr. Warren's actual rate would provide a reasonable result.

3. Rebuttal Consultants

In its rebuttal schedule, Staff limited IAWC's to those consultants engaged at the time of the Company's rebuttal filing. No testimony was presented in support of this adjustment, and no explanation for it was provided in the rebuttal schedule or in Staff's Initial Brief.

IAWC provided the reasons for including these amounts in its testimony and Initial Brief.

The Commission notes that no exceptions were filed with respect to this issue.

The Commission finds that the Staff adjustment is not supported by the evidentiary record, and will not be adopted.

4. Demand Study Expenses

At the Commission's direction, IAWC engaged the services of a consultant to perform a Direct Demand Study. IAWC incurred legal expenses related to that study. It is noted that IAWC and Staff both address Demand Study costs under the category of rate case expense. The updated Demand Study cost was $763,159. No exceptions were filed with respect to this issue.

a. Staff Position

Staff witness Ostrander proposes a "disallowance of unsupported legal expenses related to the Demand Study." (Staff IB at 25-26)

According to Staff, the Company reported actual legal expenses of $44,119 but only provided invoices totaling $32,328 resulting in unsupported expenses of $11,791. Absent proper supporting documentation the subject expense cannot be deemed just and reasonable. The Staff adjustment to disallow unsupported legal expenses from the Demand Study is based on the Company's response to Staff DRs which are contained within IAWC Exhibit 7.0SR.

Staff's adjustment would reduce recoverable Demand Study costs to $751,368, to be amortized over a five-year period.

b. IAWC Position

According to IAWC, "Invoices are not a prerequisite to a just and reasonable rate case expense. See 220 ILCS 5/9-229." (IAWC RB at 39)

In IAWC's view, "Binding IAWC to estimates of the individual elements of a component of rate case expense (here, elements of the Direct Demand Study component) results in recovery of less than the total estimated level of that expense component and, by default, in denial of recovery of the other, non-disputed elements of that expense component." IAWC adds, "Such an approach is unfair and impractical; it is impossible for IAWC (or any utility) to project a future expense with the pinpoint precision Staff requires related to rate case expense." (IAWC RB at 39)

IAWC adds, "In testimony, Staff withdrew its previously proposed adjustment to remove estimated but un-incurred legal expenses related to the Direct Demand Study as 'too narrow in scope' because such an approach 'fails to consider the remaining estimates of the other expense components of the Demand Study.' (ICC Staff Ex. 16.0 Supp. (Rev.) (Ostrander Reb.), pp. 4-5, lines 85-87.) Inexplicably, however, Staff continues to recommend disallowance of components of the Direct Demand Study cost." (IAWC RB at 39-40)

c. Conclusion

IAWC argues that "Invoices are not a prerequisite to a just and reasonable rate case expense" under Section 9-229. While that may be true, Section 9-229 does require the Commission to "specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing." In that context, a review of invoices is a logical part of such an assessment, where some or all of such costs have been incurred. While invoices may not reflect all relevant costs in a future test year setting, there is no indication that legal costs related to the Demand Study are still being incurred.

IAWC also argues that targeting individual costs components is not appropriate. As noted above, however, IAWC is seeking recovery of these costs as a rate case expense, and Section 9-229 makes specific reference to legal costs.

In conclusion, the Commission finds that the adjustment made by Staff is appropriate.

5. Service Company Labor

The AG argues that affiliated service company labor costs of $288,956 should be excluded from rate case expense.

a. AG Position

According to AG witness Smith, the work that IAWC or Service Company personnel perform on the rate case does not require deferral or amortization; it is a normal job function. (AG IB at 34; AG Ex. 2.00 Rev. at 77)

The AG further argues, "Moreover, IAWC and Service Company internal labor costs should be removed because the future test year, as filed, includes a full year of

Service Company and IAWC labor costs. Finally, amortizing these costs over future years would essentially double-count the labor cost for the Company." (AG IB at 34; AG Ex. 2.00 Rev. at 77; AG BOE at 22-25)

b. IAWC Position

According to IAWC, "the record makes plain the Service Company labor included in rate case expense reflects the cost of services which are incremental to normal job duties and are services which would not be performed but for the filing of this rate case." (IAWC RB at 40; IAWC IB at 59-60; IAWC RBOE at 16-18)

For example, the cost would include direct charges for IAWC witness Karen Cooper's time, because her normal job duties as Manager of Business Services for the Service Company's Customer Service Center would not include assisting on IAWC rate cases. Ms. Cooper's participation as a witness in this case was necessitated by certain allegations raised by Staff related to the CSC. (IAWC IB at 60)

By contrast, "costs for Service Company employees for whom working on rate cases is part of their normal job duties are not included in rate case expense. (Tr. 271-73 (IAWC witness Mr. Bernsen testifying neither his time, nor that of IAWC witnesses Mr. Kerckhove or Mr. Rungren, are included in rate case expense).)" (IAWC RB at 39)

c. Staff Position

Staff disagreed with AG witness Smith's proposal to disallow Service Company labor as recoverable rate case costs. According to Staff, "The Company rebutted the AG position by providing information to support that the Service Company services and associated labor costs related to the rate case were incremental to the normal job duties performed for the Company and would otherwise not have been incurred if there was no rate case." (Staff IB at 26, citing IAWC Ex. 7.00R at 9 and IAWC Ex. 7.0SR)

d. Conclusion

Having reviewed the record, the Commission finds that the Service Company labor costs included in rate case expense are separate from and incremental to those included elsewhere in test year revenue requirement.

As such, there is not a duplication or double-counting. The AG adjustment will not be adopted.

6. Overall Conclusion

Section 9-229 of the Act provides, in part, "The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing."

Having reviewed the record, the Commission finds that the amounts of compensation for attorneys and technical experts to prepare and litigate this proceeding, subject to the adjustments by Staff and the AG found appropriate above, are just and reasonable pursuant to Section 9-229 of the Public Utilities Act.

Accordingly, rate case expense in the amount of $2,575,091, two-fifths of which is included in test year operating expenses based on a 2.5-year amortization period, as reflected in the Appendices hereto, is approved for recovery.

In making this assessment, the Commission observes the work performed for IAWC by the attorneys and technical experts, except where otherwise noted above, was reasonably necessary to prepare and litigate the proceeding. There were multiple parties, and numerous issues which were diverse in nature. Many of these ratemaking issues were complex, and were addressed by various parties through their respective expert witnesses. Such issues and areas included, among others, cost of capital; cost of service and rate design, including a direct demand study ordered by the Commission; depreciation studies; and an independent accountant review. IAWC, as the party with the burden of proof, and the party with the obligation to meet standard filing requirement under Part 285, properly relied on attorneys and technical experts to analyze these areas.

IAWC also made reasonable efforts to control the costs of those services from professional service providers. As described in the DR responses, IAWC selected providers based upon its review of bids and proposals received in response to requests for proposals. The DR responses also contained copies of proposals, RFPs and RFP responses, invoices and other documentation supporting the rate case expense invoices which identified the time spent and described the work performed.

D. Costs Related to Audit of Service Company Fees

In Docket 09-0319, the Commission entered an Amendatory Order which ordered a management audit ("Audit") of the fees charged to IAWC by its affiliated Service Company. The Commission opened Docket 10-0366 relating to the same. An independent auditor, NorthStar Consulting Group ("NorthStar"), was selected via a Commission-administered RFP process to perform the Audit. (IAWC IB at 61)

IAWC has incurred the cost of the fees charged by NorthStar. This amount, as set forth in the contract between NorthStar and the Commission, is $392,100.

In addition, IAWC states that it has incurred other incremental costs for the Audit including: charges for the services of outside counsel retained to represent IAWC in the Audit process and Docket 10-0366, estimated at $250,000; charges for the services of an outside audit support consultant retained to assist IAWC, estimated at $211,000; incremental charges for internal services (including Service Company services) specific to the management audit, estimated at $261,000.

The total estimated cost of the Audit is $1,114,100. IAWC is proposing to amortize that total cost over five years, and to reflect in rates an amortization amount of $222,820, as well as a return on the unamortized balance.

1. AG Position

The AG acknowledges that IAWC is entitled to recover the charges assessed by NorthStar, which were $392,100.

As for the other $722,000 in costs, the AG argues, “Those costs above and beyond the costs of the management audit itself are unreasonable, excessive and should not be recovered.” (AG IB at 31)

The AG explains, “The Company seeks to recover over 180% more than the actual costs of the audit as its own costs. This requested cost is grossly disproportionate to the $392,100 cost of the audit itself, is unreasonable, and should be rejected. Although the People do not contest the recovery of the cost of the audit, the Company’s attempt to recover an additional $722,000 -- 1.84 times the cost of the third party audit, is unreasonable.” (*Id*.)

The AG argues, “Merely incurring a cost is not sufficient to justify recovery in rates if that requested cost increase is excessive or unjustified. The Commission must assess whether large increases to expenses are reasonable.” (AG IB at 31, citing *Peoples Gas Light and Coke v. Slattery*, 373 Ill. 31, 66 (1940))

In the AG’s view, the details of IAWC’s costs demonstrate that IAWC failed to control its costs even when being audited due to repeated, large cost increases. To start, the Company incurred costs of $211,000 for an audit consultant in addition to the NorthStar auditor. It also identifies $225,000 for affiliated Service Company labor, $25,000 for a data room, $250,000 for additional legal costs, and $10,000 for travel. (AG IB at 32, citing IAWC Ex. 4.00 at 16) These costs, over and above the actual cost of the management audit, should be treated as a normal cost of doing business as a regulated public utility, i.e., as O&M expenses incurred between rate cases without any specific Commission authorization for deferral. (AG IB at 32; AG Ex. 4.00 Rev. at 35)

The charges classified as labor expenses are largely for service company employees and the Company has not provided any justification for recovery of these expenses, in the AG’s view. Only $1,000 of the charges for employee expense, of the $261,000 submitted for “internal services,” represents IAWC employees. (AG IB at 32) The AG argues, “The Company’s attempt to over-recover the Service Company’s labor expenses represents the very types of excessive service company charges that the audit was designed to catch and should be disallowed, particularly when they are so high relative to the total cost of the third party auditor.” (AG IB at 32)

The AG adds, “In addition to affiliated AWWSC support – which presumably consists of typical AWWSC functions such as accounting, finance and operations (see AG Cross Ex. 3), an outside firm was engaged to manage the audit process at an additional expense of $211,000. Tr. at 289-90. The Company has not explained how the $211,000 for an outside firm and the yet higher $261,000 for internal services are different.” (*Id*. at 32-33)

The AG further argues, “Moreover, it is apparent that IAWC was not able to control its costs adequately.” IAWC originally projected the costs associated with the audit to be $150,000 to $200,000 for outside counsel, $200,000 to $300,000 total for outside audit support, and $50,000 to $100,000 for internal services, or a range of $400,000 to $600,000. The projections were simply revised upwards to reflect the increase in costs. The Company “has not justified this up to 80% increase in projected cost estimates. These cost run-ups are indicative of a lack of cost control and the dangers of unrestrained use of the affiliated Service Company.” (AG IB at 33)

The AG did not file exceptions with respect to this issue. In its Reply Brief on Exceptions, the AG argues that Section 8-102 of the Act “does not provide for the recovery of unreasonable incremental costs. Costs that are over 180% of the costs of the audit itself are clearly unreasonable.” (AG RBOE at 9)

In its Reply Brief, the Village of Bolingbrook agrees with the position expressed in the AG’s Initial Brief.

2. IAWC Position

According to IAWC, “The AG makes much of the level of IAWC’s incremental audit costs relative to the level of the auditor’s fee. (AG Init. Br. p. 31-32, 33.) That is not the standard for recovery of audit costs. Section 8-102 of the Act and the Commission’s Dockets 09-0319 and 10-0366 Orders direct IAWC to recover the cost of the audit—and not of just the auditor—through normal ratemaking procedures.” (IAWC IB at 41)

IAWC identifies 1990 and 1991 cases purportedly defining the cost of the audit to include incremental expenses incurred -- including outside consultant and outside counsel costs. (IAWC RB at 41; IAWC IB at 63-65)

The costs IAWC has incurred related to the Audit are incremental costs of, and are incurred solely as a result of, the Audit. In IAWC’s view, they represent reasonable, prudent, and necessary expenditures to support and facilitate the performance of the Audit, and as such, they are recoverable. (IAWC RB at 41; IAWC IB at 61-63)

According to IAWC, the AG does not point to any record evidence suggesting any of those incremental costs are “excessive” despite such claims. No witness testified to the collective audit costs or any individual component thereof was unreasonable. (IAWC RB at 41-42)

IAWC states that its witnesses explained the necessity for additional Service Company labor related to the audit, the role of outside counsel, and the necessity for the audit consultant. (IAWC RB at 42)

The AG takes issue with the increase in IAWC's estimates of its audit costs from February 2011 to October 2011. IAWC responds that AG Cross Exhibit 8, the February 15, 2011 Affidavit of Edward J Grubb submitted in Docket 10-0366, notes the preliminary nature of the audit process. The Affidavit provides cost estimates but states Staff has only initiated a Request for Proposals process and an independent auditor has not yet been selected. The Affidavit sets an estimated cost of $400,000-600,000, excluding the cost of the independent auditor. It further states that the cost estimates contained therein "represent IAWC's best current estimate of the costs necessary to support the audit process and, if necessary, will be supplemented with updated estimates or actual costs." When IAWC filed its rate case on October 27, 2011, after an independent auditor had been selected and the audit process was in "full swing," the Company updated its estimates to reflect the current case amount of $1.114 million (the $392,000 auditor's fee plus $722,000 in incremental expenses). (IAWC RB at 42; IAWC Ex. 4.00 at 14-15)

In its BOE, IAWC argues that it should be allowed full recovery, rather than partial recovery, of incremental costs associated with support and facilitation of the audit. (IAWC BOE at 29-36)

3. Staff Position

Staff agreed with the Company that it is appropriate to include as recoverable operating expenses the incremental costs that were solely incurred to support and facilitate the performance of the management audit. (Staff IB at 27; Staff Ex. 11.0 at 10-11)

Staff proposed an adjustment to remove $225,000 in Service Company labor costs. Staff withdrew this adjustment after IAWC filed additional information intended to show such charges were a direct result of the audit. (Staff IB at 28)

4. Conclusion

The Audit of Service Company fees charged to IAWC, ordered by the Commission in Docket 09-0319, was performed by NorthStar at a cost of $392,100 following an RFP process overseen by the Commission Staff.

The NorthStar fee was assessed to IAWC, and IAWC now seeks to recover the fee through rates.

IAWC also seeks to recover an additional $722,000 in "incremental expenses," bringing the total recovery to $1.114 million.

The AG does not object to the recovery of the NorthStar fee of $392,100, but does object to the recovery of the $722,000 in incremental expenses.

The Commission acknowledges that the incremental costs of $722,000 – which include $225,000 in labor costs from the very affiliate whose fees are the subject of the Audit -- are disproportionate to the actual cost of the NorthStar audit, which was $392,100 pursuant to a Commission-administered RFP process. The incremental cost total was also above the upper end of the estimate prepared by IAWC.

However, is it clear to the Commission that the Company provided enough evidence to conclude that costs above and beyond the audit would be required. In addition, IAWC provided an estimate of supplemental costs, prior to initiation of the audit, which included a range of $400,000 to $600,000 in expenses. IAWC subsequently updated these amounts and provided evidence of the costs incurred. The Commission finds the Company's requested amount to be a good approximation of the additional costs to comply with an audit that the Commission itself ordered.

In conclusion, the Commission finds that IAWC has justified the reasonableness of the requested amount and therefore should be allowed recovery of incremental costs in the amount of $722,000.

E. Chemical Expense

According to IIWC/FEA witness Mr. Collins, the Company is forecasting a per-unit increase of 13% for Zone 1 in the test year chemical expense over the actual level of expense from 2010. (IIWC/FEA IB at 4, citing IIWC/FEA Ex. 2.0 at 15) He stated that using the actual sales volume and actual level of expense from 2010, the chemical expense is $0.1921 per thousand gallons on a total Company basis and $0.2411 for Zone 1.

IIWC/FEA contends that although IAWC witness Mr. Suits discusses the inputs used in his determination, he failed to explain how his inputs justified the necessity of a 13% increase in chemical expense. IIWC/FEA argues, "Absent such an explanation, IAWC has not justified a 13% per unit increase in test year chemical expense over actual 2010 chemical expenses." (*Id*. at 4)

IIWC/FEA recommends that the chemical expense "be held at $0.1921 per thousand gallons on a total Company basis." (*Id.* at 5) IIWC/FEA proposes that total-company chemical expense for water operations be reduced to $6,947,766. (*See also* IIWC/FEA RBOE at 9-11)

The Commission observes that IAWC did not address this issue in its post-hearing briefs. However, in his rebuttal testimony, IAWC witness Mr. Suits explains that his calculation methodology "takes into consideration historical dosage on a monthly basis over multiple years for each chemical. This more appropriately accounts for the variables that impact chemical usage and costs…" (IAWC Ex. 2.00R (2d Rev.) (Suits Reb.), p. 9.)

In its Brief on Exceptions, IAWC contends that the chemical calculation methodology used by IAWC witness Mr. Suits was superior to the "one-dimensional" analysis used by Mr. Collins. (IAWC BOE at 21-25) IAWC also argues, "Moreover, comparing IAWC's actual 2010 chemical expense as cited by IIWC/FEA…with IAWC's projected test year level of chemical expense…produces a projected increase of…only 6%. Over the period from December 31, 2010 to September 30, 2013, this equates to an annual increase of just over 2% per year -- a far cry from the 13% increase claimed by IIWC/FEA under its methodology." (*Id*. at 24)

Given that IAWC's detailed chemical expense projection model calculates dosage on a monthly basis over several years for each chemical, which appropriately accounts for the many variables that impact chemical costs, the Commission believes it produces a projected level of chemical expense that is reasonable. Of the two recommendations of record, the Commission finds that IAWC's analysis provides a better forecast of test year expense. For these reasons, the Commission finds that IIWC/FEA's adjustment should not be adopted. The expense should be allocated in the manner reflected in the Appendices to this Order, which include the adjustment addressed immediately below.

In its Brief On Exceptions, IAWC also argues, "If IAWC's new rates are to be established on its projected usage for the year ending September 30, 2012 [rather than September 30, 2013 as addressed above under Test Year Sales Volumes and Revenues], then, to be consistent, IAWC's purchased fuel and power and chemical expenses likewise should be set at a corresponding level." (*Id*. at 20, citing AG Ex. 2.2, Sch. C-1) No party objected to this adjustment, and the Commission finds that it should be made. It is identified in the attached schedules under fuel and power expense.

F. Depreciation Rates and Recordkeeping

Staff also addressed depreciation rates. Those proposed by IAWC are based upon a December 31, 2010 depreciation study that applies to all divisions served by IAWC. (IAWC Ex. 12.00 (Rev.) at 4) The Company utilized the Straight Line Method, the Broad Group Procedure, and the Average Remaining Life Technique to develop the proposed water and wastewater depreciation rates. Company witness Earl M. Robinson assembled the Company's historical investment cost records for each account into a depreciation database upon which detailed service life and salvage analyses were performed using standard depreciation principles.

Staff witness William R. Johnson found the approaches used by the Company to develop depreciation rates to be acceptable; he noted that they are used across the utility industry and have been used in previous IAWC proceedings.

Mr. Johnson recommended, and the Commission agrees, that that the proposed water and wastewater depreciation rates identified in IAWC exhibits be approved. (Staff IB at 22)

Regarding depreciation recordkeeping, the Commission's Order in Docket No. 07-0507 directed IAWC to review available alternatives that would facilitate more accurate recordkeeping of water meters with various average service lives ("ASL") in the next proceeding where a depreciation study is provided so that more accurate ASL are determined. According to Company witness Robinson, steps were taken to incorporate IAWC's policy governing the testing and replacement of 5/8-inch water meters into the depreciation study in the current proceeding. (IAWC Ex. 12.00 (Rev.) at 32) IAWC's current policy is that once a 5/8-inch water meter is pulled for its testing cycle, it is retired and disposed of, and a new meter is installed. Mr. Robinson incorporated the time limitations of the Company's water meter change-out policy for 5/8-inch meters into the ASL determination for one-inch and under meters. The Company's retention of 5/8-inch meter information by time limitations reflects more accurate ASL for those meters.

Staff witness Johnson testified that incorporating the Company's meter change-out policy when determining the ASL for water meters sized one-inch and under better reflects the service life of those meters and, therefore, is a more accurate method of recordkeeping for water meters. (Staff Ex. 8.0 at 4-5)

Mr. Johnson testified, and the Commission agrees, that IAWC's methodology should be accepted.

G. Approved Operating Income Statement

Upon reflecting on the effects of the determinations made above and elsewhere in this Order, the operating statements for IAWC's respective districts are approved as shown in the Appendices attached hereto.

VI. OTHER INCOME TAX ISSUES

The AG raised several income tax issues in this proceeding. One of them is addressed above under "Rate Base." Others are addressed in this section of the order.

A. DPAD – Section 199

The AG argues, "The Commission should impute the effect the Section 199 tax deduction on IAWC's taxes on separate return basis for ratemaking purposes." (AG IB at 35) IAWC contests the AG's recommendation.

1. AG Position

Although IAWC participates in a consolidated tax return and does not pay federal income taxes separately, it includes a calculation of income taxes as if it filed a separate return equaling $19.2 million. IAWC projects taxable income for the test year. (AG IB at 35)

The federal tax code includes a deduction ("DPAD") for "domestic production activities," also known as the Section 199 deduction. This deduction is for up to 9% of the lesser of taxable income or taxable income produced by domestic production activities such as the collection, storage and treatment of raw water. IAWC collects, stores, and treats raw water in all of its service areas, although many portions of the Chicago Metro area purchase Lake Michigan water. (*Id*.)

If IAWC were a stand-alone taxpayer, it would be eligible to take this deduction. However, because it files a consolidated tax return at the parent level, and the parent has no taxable income, it cannot take the deduction on the consolidated return. (AG Ex. 2.0 Rev. at 91-92) According to the AG, the result is that Illinois ratepayers lose the benefit of a substantial deduction that could reduce the substantial, $19.2 million stand-alone tax liability IAWC includes in its revenue requirement. (AG IB at 36)

IAWC argues that it cannot take this deduction because its parent has no taxable income. For ratemaking purposes, IAWC's tax liability is calculated on a stand-alone basis notwithstanding the fact that its actual tax liability is subsumed in its parent's consolidated tax return (which has zero tax liability). The AG states, "As a stand-alone company, IAWC is entitled to the Section 199 deduction because it produces potable water from domestic supply and it has taxable income in the test year. Accordingly, to consistently treat IAWC's ratemaking tax liability as a stand-alone company, the Commission should direct IAWC to incorporate the effect of the Section 199 deduction in its tax expense, calculated on a separate return basis." (AG IB at 36)

Unlike the depreciation deduction, the Section 199 deduction does not have a normalization requirement so there is no obstacle in calculating IAWC's stand-alone ratemaking tax expense, in the AG's view.

The AG states that on June 7, 2012, the California Public Utilities Commission voted to require California American Water Company ("Cal-Am") to impute the Section 199 deduction in calculating its income tax liability for ratemaking purposes. (AG IB at 36-37, citing *California-American Water Co*., Application No. 10-07-007 & 11-09-016, Order at 44 (June 14, 2012))

The AG adds, "Unlike in the CalAm case, here there is no question but that IAWC is present its IAWC tax expense for IAWC on a stand-alone basis, and showing a taxable income." The People request that the Commission direct IAWC to recalculate its income tax expense for ratemaking purposes to include the Section 199 Domestic Production Activities Deduction. (AG IB at 37)

In its BOE, the AG argues that the Commission "should direct IAWC to provide the effect of the DPAD on its federal income tax expense, and to reflect the DPAD in its compliance filing and rates in this docket." (AG BOE at 25-27)

The Village of Bolingbrook concurs in the position expressed by the AG. (Bolingbrook RB at 11)

2. IAWC Position

According to IAWC, absent from the record and the AG's Initial Brief is any quantification of such a deduction, how it would be calculated, or even to what IAWC production activities it would be applied. (IAWC RB at 105; IAWC IB at 139-140; IAWC RBOE at 20-21)

IAWC asserts that it cannot take the DPAD deduction as a member of the American Water consolidated tax group. (*Id*.) IAWC further states, "Instead, the AG continues to claim that IAWC could take the deduction on a standalone basis because IAWC, considered alone, has a positive test year taxable income of $19.02 million." (IAWC RB at 105) IAWC adds, "But the AG fails to take into account IAWC had net operating losses in 2008, 2009, 2010 and 2012, which would entirely offset its taxable income in the test year if it were to file its taxes on a standalone basis for the test year. (IAWC Ex. 13.00R, pp. 34, 38-39.) Therefore, there could be no DPAD." (*Id*.) In other words, IAWC argues, the AG's arguments about whether IAWC can "take" the deduction miss the point that there is no deduction to take. (IAWC RBOE at 19-20)

The AG relies on a recent order of the California Public Utilities Commission to support its decision. According to IAWC, the excerpt relied upon by the AG relates only to the tax treatment of California American Water Company's Water Revenue Adjustment Mechanism balances (a decoupling mechanism similar to the Revenue Adjustment Mechanism proposed by IAWC in this case). In IAWC's view, "The AG fails to demonstrate why the circumstances of the California case are comparable to those at bar. Nevertheless, there is one noticeable difference: in the California case, an actual, not theoretical DPAD calculation and methodology was offered by the party proposing imputation of the same." (IAWC RB at 105)

3. Conclusion

The AG argues, "The Commission should impute the effect the Section 199 tax deduction on IAWC's taxes on separate return basis for ratemaking purposes." (AG IB at 35)

Based on the record, the Commission finds that this recommendation should not be adopted in this proceeding.

As IAWC explains, if it were to file its taxes on a standalone basis for the test year, there would be no DPA deduction because operating losses in other years would entirely offset taxable income in the test year.

Furthermore, the record does not quantify such a deduction, and does not indicate how it would be calculated.

Whether such a deduction would be appropriate under circumstances present in a future case is an issue not reached in this order.

B. Bonus Depreciation

AG witness Ralph Smith raised a "Prudence Issue with IAWC opting out of 2011 Bonus Tax Depreciation." (AG Ex. 4.0C at 37; S*ee also* AG BOE at 28-32)

1. AG Position

According to Mr. Smith, "Taking 2011 bonus tax depreciation is a normal, prudent thing for a business, including a regulated utility, to do. As the Commission has seen or is seeing in other recent cases involving ComEd and Ameren Illinois, the impact of 2011 bonus tax deprecation typically increases utility ADIT significantly. The increased ADIT reduces rate base. The impacts can be very material to the utility's net rate base. In contrast, failure to take the 2011 bonus tax depreciation can result in increased rate base and harm to utility ratepayers from higher utility rate base not only in the current test year but also for years to come, as the effects of the higher rate base from not taking 2011 bonus tax depreciation linger." (AG Ex. 4.0C at 37)

He added, "The decision to not take 2011 bonus tax depreciation has apparently been made for IAWC by the parent company, American Water Works, based on parent company consolidated federal income tax return considerations, and without consideration of the impact on IAWC ratepayers. The parent company has a large net operating loss carry-forward and is not expected to pay federal income taxes for a lengthy period into the future. However, for ratemaking purposes, IAWC's income taxes have traditionally been calculated on a 'separate return' basis. As such, IAWC's customers (unlike customers in a number of other American Water Works operating jurisdictions) obtain no benefit from the American Water Works consolidated federal income tax return." (*Id*. at 37-38)

In Mr. Smith's view, the failure by IAWC to claim 2011 bonus tax depreciation based on parent company consolidated federal income tax return considerations thus represents one of the worst of all possible situations for IAWC ratepayers. IAWC ratepayers get no benefit from IAWC participating in the consolidated federal income tax return. Yet, IAWC's rate base prospectively is higher than necessary because IAWC has opted out of a normal, highly beneficial income tax deduction that a normal company operating in its own self-interests and the interests of its customers, would take. (*Id*. at 38)

IAWC's response to AG data requests have stated that no analysis was done for IAWC on a standalone basis. (*Id*. at 38-39)

IAWC shows $11.940 million of 2011 positive taxable income without the bonus tax depreciation. In Mr. Smith's view, "Taking the 2011 bonus tax depreciation thus could benefit IAWC on a separate return basis." (*Id*. at 39)

Mr. Smith said IAWC stated that it "believes individual members of a consolidated group could elect to take or not take bonus depreciation," even if other affiliates participating in the American Water Works Company, Inc., 2011 consolidated federal income tax return do not. (AG Ex. 4.0C at 39)

In Mr. Smith's view, "Where the decisions of the parent company, American Water Works, are causing IAWC rate base in this and future IAWC rate cases to be higher than it would be if IAWC took obvious tax deductions such as 2011 bonus tax depreciation, the Commission should be concerned regarding the adverse impacts of American Water Works' decisions on IAWC utility ratepayers." (*Id*. at 40)

Mr. Smith recommends "that the Commission find IAWC's (and American Water Works') decision for IAWC to not utilize 2011 bonus tax depreciation to be imprudent from the ratepayers' perspective. The decision whether or not to take the bonus tax depreciation deduction for a regulated public utility, such as IAWC, should be based on whether ratepayers, not shareholders, will benefit from the decision. Appropriate recompense should be made to IAWC ratepayers through some means, possibly either through a Commission order, ordering IAWC to claim 2011 bonus tax depreciation, or through bill credits, computed in a manner that would not result in a violation of IRS normalization requirements." (*Id*.)

He added, "The exact means of compensating ratepayers for such imprudent IAWC or parent company-imposed decisions would need to be determined after the issue is fully investigated. Because the federal income tax return for 2011 has not yet been filed, and could be filed as late as by September 15, 2012 (with extensions), there is time for IAWC and its parent, American Water Works, to re-evaluate and re-analyze their stated decision to not have IAWC claim 2011 bonus tax depreciation." (*Id*. at 40-41)

2. Municipalities' Position

The City of Champaign et al., argue that the Commission "should find that IAWC's failure to take the bonus depreciation expense imprudent and adjust the Company's rate base as if the bonus had been prudently taken." (Municipalities IB at 7-8)

3. IAWC Position

IAWC's position is set forth in its testimony, briefs and Reply Brief on Exceptions. (IAWC RBOE at 21-24) IAWC files its federal income tax return as part of a consolidated tax group of which American Water Works Company is the common parent. The consolidated tax group does not intend to take certain bonus depreciation tax deductions for 2011. (IAWC IB at 133-134)

Using the consolidated tax filing, the individual tax items for each corporation are aggregated and reflected on the first page of the return as consolidated items of income and deduction. The net consolidated taxable income or loss is computed and a tax is calculated on this amount. Companies forward to the parent their taxable amounts due. Companies are also compensated to the extent they contribute tax benefits to the group. This "produces a number of benefits for IAWC." (*Id*. at 134)

From a tax perspective, benefits do not occur every year for every group member, but individual members of the group benefit sufficiently often such that those times of benefit outweigh the times when there is a detriment. (IAWC IB at 134; IAWC Ex. 13.00R at 31) For example, as IAWC witness Mr. Warren explains, IAWC incurred tax losses in 2008, 2009 and 2010 (see table at IAWC Ex. 13.00R, p. 34), some of which IAWC could not have used if IAWC had been not part of the consolidated group. (IAWC IB at 134; IAWC Ex. 13.00R at 34) In certain of those years IAWC was compensated for an otherwise unusable tax loss because some other affiliate within the American Water group had taxable income. In other words, "IAWC received benefits in those years as part of the consolidated group that exceeded benefits IAWC would have had on a standalone basis." (IAWC IB at 135)

IAWC also benefits generally from the common ownership structure of which the consolidated tax grouping is part. These benefits include the ability of IAWC to obtain capital at lower cost through the American Water Capital Corp. and the economies of scale achieved by obtaining services through the Service Company. (*Id*.)

According to IAWC, it cannot opt out of the AWWC consolidated federal income tax return. Under the applicable tax rules, if a group elects to file a consolidated federal income tax return, every commonly controlled domestic corporation must be included in that return. Since IAWC meets that tax definition of a commonly controlled corporation, it is not possible for it to opt out. (IAWC Ex. 13.00R at. 31-32)

As Mr. Warren explained, the tax law permits taxpayers to claim depreciation deductions for tax purposes that exceed economic depreciation. This is done by allowing the use of accelerated calculation methods (i.e., declining balance, sum-of-the-years digits, etc.) and shorter depreciable lives. These "extra" depreciation deductions reduce the federal tax liabilities of these taxpayers that would otherwise have been due. Any "extra" depreciation deductions claimed in the early years of an asset's life are entirely offset by reduced depreciation deductions available in the later years of that asset's life. (*Id*. at 24)

The Company was able to claim unusually large depreciation deductions in 2010. It will be able to do the same in 2012. In 2011, the Company can claim even more unusually large depreciation deductions. (*Id*. at 26)

The tax law specifically permits taxpayers to elect not to claim bonus depreciation in any year. As of the end of 2010, the AWWC group had a consolidated net operating loss ("CNOL") carryforward of in excess of $1.2 billion. Part of that carryforward related to IAWC. AWWC management made the decision not to utilize 2011 bonus depreciation based on the potential adverse impact of the additional deductions on the CNOL carryforwards. AWWC management was concerned that the substantial amount of bonus depreciation to which the members of the AWWC group would be entitled with respect to 2011 capital additions would create a sizable CNOL for that year, thereby increasing the group's already considerable existing CNOL carryforward. The concern was that the AWWC group would be unable to generate sufficient consolidated taxable income within the carryforward period provided for in the tax law such that the augmented CNOL carryforward thereby created would be able to be used. Some portion of that CNOL carryforward would, therefore, expire unused. As a result, the decision was made to not take 2011 bonus depreciation. (IAWC IB at 136)

According to IAWC, AG witness Mr. Smith does not calculate any specific adjustment or otherwise explain how his recommendation should be quantified or implemented. Moreover, "his recommendation should be rejected because the decision not to take 2011 bonus depreciation is prudent, and there are no adverse rate consequences to IAWC of making that decision." (IAWC IB at 136)

In IAWC's view, it is prudent for AWWC management to make tax decisions based on what is best for the entire group. The decision to not take bonus depreciation was made to promote the best tax outcome for the consolidated group as a whole. Individual members, including IAWC, benefit from participation in the consolidated tax group. If decisions were made based on the interests of individual members, the overall outcome for the group would be worse, and some other group member could be forced to bear an incremental tax burden. (*Id*. at 137)

IAWC further asserts that bonus depreciation deductions would merely increase IAWC's net operating loss carryforward, and so they would have no current effect on the Company's cash flow or on its ADIT. (*Id*.; IAWC Ex. 13.00R at 33) ADIT represents the extra cash that is produced by deferring tax that would, absent a specified deduction, be otherwise payable. If the extra deduction merely increases a net operating loss carryforward, then there is no additional tax deferred. In the current year, the same amount of tax, zero, is paid with or without the extra deduction. The deduction only produces a cash benefit when the carryforward is used to reduce a future tax liability. However, in the year in which the deduction is claimed, there is no cash benefit and, consequently, there should be no incremental ADIT. (IAWC IB at 137)

For IAWC, net operating losses in 2008, 2009, 2010 and 2012, totaling \$104,123,796, will entirely offset its taxable income in all of the other years -- which totals \$73,752,349 -- even without bonus depreciation. In short, it will pay no tax for the period. Had the Company claimed bonus depreciation with respect to its 2011 additions, it would not have paid any less tax. It simply would have produced a larger CNOL carryforward. Thus, there would be no tax deferral and, critically, no incremental ADIT. (*Id*.; IAWC RBOE at 22)

In IAWC's view, Mr. Smith's recommendation also creates a concern about violation of tax normalization rules. Smith's proposal that this Commission order bill credits appears to be geared to produce a rate reduction to replicate what rates would have been had the Company claimed accelerated (i.e., bonus) tax depreciation it did not, in fact, claim. Bonus depreciation is clearly subject to the tax normalization rules. These rules limit the deferred tax balance that can reduce rate base to the amount of deferred taxes that have been reflected in cost of service. Since any imputed deferred taxes attributable to bonus depreciation would not have been so reflected in the cost of service, it is Mr. Warren's view that such imputation would create a tax normalization problem. As a general proposition, "in the tax normalization world, you cannot do indirectly what you cannot do directly." (IAWC Ex. 13.00SR at 7-8)

IAWC also states that the tax law imposes a penalty on taxpayers violating these rules. Specifically, a utility violating the depreciation normalization rules will be ineligible prospectively to claim accelerated tax depreciation (including bonus depreciation) on any of its jurisdictional assets. This ineligibility applies to existing assets as well as to new additions. The utility will have to use regulatory depreciation lives and methods for tax purposes. Thus, such a utility will generate no additional deferred taxes and, thereby, be denied the cost-free funding they represent. *(Id*.)

4. Staff Position

Staff "recommends that the Commission not find the Company imprudent in its election not to take bonus depreciation." (Staff IB at 19) Staff witness Mr. Kahle's understanding is that taxpayers may elect to claim or not claim bonus depreciation, and that the election must be made consistently for all groups in a consolidated return. (Staff Ex. 9.0-C at 13) IAWC's parent, American Water Works Company ("AWWC"), has a large net operating loss ("NOL") and it is uncertain that the entire NOL will be used. As a result, there could be no benefit from electing to take bonus depreciation. (Staff IB at 13-14)

5. Conclusion

As indicated above, AG witness Mr. Smith recommends that "that the Commission find IAWC's (and American Water Works') decision for IAWC to not utilize 2011 bonus tax depreciation to be imprudent from the ratepayers' perspective" and that "appropriate recompense should be made to IAWC ratepayers through some means." IAWC and Staff contend that the AG's recommendations should not be adopted.

Having reviewed the record, the Commission finds that Mr. Smith's recommendation should not be adopted.

There was a reasonable basis for the tax group not to elect 2011 bonus depreciation. As noted above, the AWWC group had a consolidated net operating loss ("CNOL") carryforward of in excess of $1.2 billion. Part of that carryforward related to IAWC. AWWC management made the decision not to utilize 2011 bonus depreciation based on the potential adverse impact of the additional deductions on the CNOL carryforwards.

In addition, there do not appear to be adverse consequences to IAWC as a result of AWWC's decision.

IAWC's losses in several years entirely offset taxable income for the other years. Had the Company claimed bonus depreciation with respect to its 2011 additions, it would not have paid any less tax. It simply would have produced a larger CNOL carryforward, with no tax deferral or incremental ADIT.

In addition, as noted by IAWC, Mr. Smith does not calculate any specific adjustment or otherwise explain how his recommendation should be quantified or implemented. This could raise concerns about tax normalization rules.

C. Consolidated Tax Returns

Section IV of the AG's Initial Brief is titled, "Illinois Consumers are losing significant tax advantages due to IAWC's participation in American water's consolidated tax return, requiring a commission rule to capture consolidated tax savings for Illinois consumers." (AG IB at 37)

Section IV consists of one subsection, A, titled, "IAWC's failure to take advantage of bonus depreciation unreasonably increases charges to Illinois consumers and puts the interests of IAWC's parent company in conflict the interest of Illinois consumers." It concludes with the statement, "The Commission should adopt the approach of the Indiana Commission, and order IAWC to apply it in this docket to mitigate the unnecessarily high federal income tax embedded in rates and to mitigate the loss of the rate base deduction that would have resulted had IAWC taken bonus depreciation, as it was entitled to do under federal tax law."

The Commission observes that the bonus depreciation issue is addressed above in a section of the order titled "Bonus Depreciation," and will not be further addressed here.

In its Brief on Exceptions, the AG argues that the Commission should "direct the Staff to initiate a rulemaking to develop a methodology to address the sharing of benefits when a utility's actual tax liability is determined in a consolidated tax return." (AG BOE at 32-33)

IAWC and Staff oppose this recommendation. They state that the recommendation first appeared in the AG's BOE. They argue, and the Commission agrees, that the scope of it is undefined and that it is not supported by the record. (IAWC RBOE at 24; Staff RBOE at 3-4) The recommendation will not be adopted.

VII. CAPITAL STRUCTURE AND RATE OF RETURN

A. Overview

A company utilizes various types of investor-supplied capital to purchase assets and operate a business. Utilities typically rely upon long-term debt and common equity, and in some instances preferred stock and short-term debt, to purchase assets and fund operations. The costs of different types of investor-supplied capital vary depending upon a multitude of factors, including the risk associated with the investment. As a result, the proportion of the different types of capital, also known as the capital structure, when combined with the costs of each different type of capital, affects the overall or weighted average cost of capital, which is the rate of return ("ROR") a utility is authorized to earn on its net original cost rate base.

The Commission relies on the cost of capital standard to determine a fair ROR. This cost, which can be determined from the overall ROR or weighted average cost of capital, should produce sufficient earnings and cash flow when applied to the respective company's rate base at book value to enable a company to maintain the financial integrity of its existing invested capital, maintain its creditworthiness, attract sufficient capital on competitive terms to continue to provide a source of funds for continued investment, and enable a company to continue to meet the needs of its customers.

These standards are effectively mandated by the U.S. Supreme Court decisions *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*") and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 391 (1944) ("*Hope*"). Meeting these requirements is necessary in order for a company to effectively meet the utility services requirements of its customers and provide an adequate and reasonable return to its investors, debt holders and equity holders, alike.

B. Capital Structure

IAWC's forecasted average capital structure for the test year ending September 30, 2013 is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. Staff proposes an imputed capital structure comprised of 1.30% short-term debt, 56.70% long-term debt and 42.00% common equity.

1. IAWC's Position

IAWC contends that Staff's proposed capital structure violates Section 9-230 of the Act. According to IAWC, Section 9-230 of the Public Utilities Act requires that the utility's stand-alone capital structure and risk be used as a starting point in determining its cost of capital. (IAWC IB at 67-68)

IAWC argues that Staff's proposal violates Section 9-230 of the Act by imputing incremental risk to IAWC. IAWC says AWW's ownership of multiple utilities is a form of diversification that allows it to mitigate its operating risk. IAWC asserts it cannot mitigate its operating risk in this fashion; it bears 100% of whatever its operating risk is. IAWC avers that since it cannot diversify its operating risk, its operating risk profile is greater than that of its parent. (IAWC IB at 68-69)

IAWC insists that IAWC's operating risk is greater than that of its parent, According to IAWC, Staff proposal would have the additional effect of imputing AWW's greater level of financial risk to IAWC. IAWC states that financial risk is largely a function of the capital structure. IAWC says a higher level of debt in the capital structure is generally perceived as increasing the level of financial risk. IAWC also says that imputing AWW's more highly-leveraged capital structure imposes greater financial risk to IAWC. (IAWC IB at 69-70)

IAWC's claims its affiliation with AWW produces tangible benefits to ratepayers. By virtue of ownership by AWW, IAWC says it has the ability to obtain financing through American Water Capital Corporation ("AWCC"). IAWC believes its affiliation with the parent company is a benefit insofar as it mitigates the effect of financial risk that IAWC would have as a stand-alone entity. IAWC notes it also has the ability to issue, and has issued, its own debt when it has been able to obtain financing more cheaply than it could through AWCC. To the extent AWW's risk increases, which would cause its cost of debt to also increase, IAWC retains the option to issue its own, lower cost debt. In IAWC's view, setting rates with a capital structure that disregards IAWC's lower financial risk, relative to its parent company, would be in direct conflict with the legislature's directive that IAWC's cost of capital exclude any "incremental risk" or "increased cost of capital" resulting directly or indirectly from its affiliation with AWW. (IAWC IB at 70-71; IAWC RBOE at 25-26)

Staff believes that the Commission should not determine the overall rate of return from a utility's actual capital structure if the Commission concludes that capital structure adversely affects the overall cost of capital. IAWC suggests that in order to determine whether IAWC's actual capital structure "adversely affects" its cost of capital, one would need to calculate the cost of capital based on IAWC's actual capital structure. IAWC notes Staff did not perform any analyses using IAWC's stand-alone capital structure and that did not assess the reasonableness of IAWC's proposed test-year capital structure with respect to its impact on IAWC's weighted average cost of capital. (IAWC IB at 71-72)

According to IAWC, the Commission has expressly refused to adopt an imputed capital structure absent any material facts that a utility's capital structure was manipulated. IAWC states that merely concluding that because the capital structure of a utility contains more common equity than its parent, it must have been manipulated, is not, by itself, evidence of manipulation. IAWC contends that Staff presents no evidence to suggest that AWW is manipulating IAWC's capital structure. (IAWC IB at 72; IAWC RBOE at 25)

IAWC argues that there is no economic incentive for AWW to inflate the common equity component of IAWC's capital structure to increase AWW's earnings. IAWC asserts that its and AWW's incentives are aligned to maintain reasonable costs of capital. IAWC says its risk profile decreases as the common equity ratio increases. IAWC also says this will improve AWW's risk-return profile and lower the debt financing costs to AWW and IAWC's financing affiliate, AWCC. IAWC claims this will allow AWCC to offer lower rate debt financing to IAWC. IAWC says further improvement to IAWC's risk profile will attract direct debt financing offers that may be lower than debt financing rates offered by AWCC. IAWC insists that the economic benefits of a higher equity component in its capital structure will be in the form of lower debt and equity costs to IAWC. (IAWC IB at 73)

IAWC claims it manages its capital structure independently from AWW. In managing its capital structure, IAWC says its goal is to maintain a reasonable weighted average cost of capital in light of the various operating risks it faces. IAWC also says it assesses its capital structure for reasonableness against that of other publicly traded water utilities. (IAWC IB at 73)

IAWC argues that its proposed capital structure is consistent with that of other water companies. IAWC states that in the recent Aqua Illinois rate case, Aqua Illinois proposed, and the Commission authorized, a capital structure that contained an equity ratio of 53.31%, notwithstanding its parent company equity ratio of 43.40%. According IAWC, Staff's imputed equity ratio of 42% is almost five percentage points lower than that of the average equity ratio of its water utility sample as of 2010, which is 46.99%. (IAWC IB at 74)

IAWC contends that a debt ratio of 56.70% would substantially increase IAWC's financial risk, which would result in significant increases to IAWC's debt and common equity costs. IAWC says the appellate court case cited by Staff recognized that a higher level of financial leverage increases a firm's costs of capital. IAWC argues that Staff's capital structure would result in an increase to both IAWC's cost of debt, due to lower credit ratings, and to its cost of common equity, as investors would demand higher returns to compensate them for IAWC's increased risk. (IAWC IB at 74-75)

IAWC argues that Section 9-230 of the Act imposes a causation requirement, but claims Staff has not even attempted to show that any increased cost of capital is the result of IAWC's affiliation with AWW. IAWC disputes Staff assertion that the Commission cannot adopt a capital structure that reflects a higher cost of capital due to the higher equity ratio of the utility. IAWC argues that Section 9-230 does not allow, much less require, reductions to equity simply for the sake of a lower equity ratio. IAWC insists the higher cost of capital must be caused by affiliation. According to IAWC, Section 9-230 does not just allow the Commission to change debt-to-equity ratios whenever it is of the mind to lower rates. IAWC asserts such reductions are only permitted if certain facts have been proved: that the higher costs were caused by affiliation. IAWC claims Staff has not made that showing. (IAWC RB at 43-44)

In IAWC's view, Staff has it backwards. Staff argues that IAWC's common equity ratio is more than eight percentage points higher than that of its parent company. IAWC asserts that less equity means more risk, and Staff acknowledges that the imputed capital structure adds to IAWC's risk. According to IAWC, Staff would impute the riskier capital structure of AWW in the name of a statute prohibiting the inclusion of AWW's incremental risk. IAWC argues that to the extent the statute applies in this case, it prohibits Staff's recommendation, not IAWC's. (IAWC RB at 44-45)

In its BOE, IAWC reiterates its objections to the capital structure recommended by Staff. IAWC also takes issue with the capital structure found appropriate in the Proposed Order. (IAWC BOE at 14-17)

Staff proposes, as an alternative, a capital structure that subtracts the balance of goodwill from the balance of common equity. IAWC complains that the proposal was advanced for the first time in briefing and is not supported by the testimony of any witness. IAWC asserts that it should be rejected for this reason alone. (IAWC RB at 45)

According to IAWC, Staff's alternative proposal is flawed because external funds that are used to finance Goodwill, defined as the value of assets acquired above that of the book value of those assets, are sourced through the capital components that comprise IAWC capital structure and in proportion to each capital component's percentage of total capital. IAWC contends that it is not appropriate to attempt to trace the external funding of an acquisition to a specific source of capital, such as long-term debt or common equity, since that acquisition is financed by the mix of capital comprising IAWC's overall capital structure. IAWC says Staff asserts that it is "Commission practice" to subtract goodwill from the common equity balance, but the Commission has approved a common equity balance including goodwill in at least each of IAWC's last two rate cases, Docket Nos. 07-0507 and 09-0319. (IAWC RB at 45)

IAWC proposes a proportion of short-term debt of 0.26% of total capitalization, net of Construction Work in Progress ("CWIP") accruing Allowance for Funds Used During Construction ("AFUDC"), based on projections from IAWC's 2011-2013 business plan. IAWC notes that Staff proposes, and AG witness Mr. Smith adopts, a short-term debt proportion of 1.30% based on an average of projected balances plus an amount intended to represent the difference between IAWC's historical projected and actual short-term debt balances. (IAWC IB at 75)

According to IAWC, historic short-term debt balances have no relevance to the calculation of its projected test year short-term debt balances. IAWC insists that the best data to use for the test year short-term debt balances are the projections from IAWC's 2011-2013 business plan. IAWC claims that using an historical short-term debt ratio results in a disconnect between IAWC's planned financing activities and its impact on future levels of short-term debt. IAWC also claims that short-term debt balances have greater volatility than the Company's sources of permanent capital, such as long-term debt and common equity. IAWC suggests there are time periods in which short-term debt projections were higher than actual balances, and other time periods where short-term debt projections were lower than actual balances. (IAWC IB at 75-76)

In response to IAWC's Brief on Exceptions, the AG argues that IAWC's proposed capital structure should be rejected. (AG RBOE at 1-2)

2. Staff's Position

Staff's proposed capital structure for IAWC imputes the September 30, 2011 equity ratio of parent company American Water Works, 42.00%, for IAWC's average 2013 common equity ratio. Staff says it also used the actual proportion of short-term debt in IAWC's forecasted average 2013 capital structure. To calculate the balance of short-term debt, Staff first calculated the monthly ending net balance of short-term debt outstanding from September 2012 through September 2013. Staff says the net balance of short-term debt equals the monthly ending gross balance of short-term debt outstanding minus the corresponding monthly ending balance of construction-work-in-progress, accruing an allowance for funds used during construction times the lesser of the ratio of short-term debt to total CWIP for the corresponding month or one.

According to Staff, that adjustment recognizes the Commission's formula for calculating AFUDC which assumes short-term debt is the first source of funds financing CWIP and addresses the double-counting concern the Commission raised in a previous Order, Docket No. 95-0076. Staff next calculated the 12 monthly averages from the adjusted monthly ending balances of short-term debt and then averaged the 12 monthly balances of short-term debt for October 2012 through September 2013. Staff's analysis then added $8,406,022 to that balance to recognize that IAWC's actual short-term debt balances have exceeded its projections by that amount on average over the period from May 2009 through December 2011. Staff recommends a short-term debt balance of $10,493,865. (Staff IB at 29-30, RB at 12-13)

To calculate IAWC's long-term debt ratio, Staff added its average 2013 short-term debt ratio and the imputed 42.0% common equity ratio (1.30% + 42.00% = 43.30%) and then subtracted that from 100% to derive the long-term debt ratio of 56.70% (100% - 43.30% = 56.70%). (Staff IB at 30, RB at 14)

In Staff's view, the fundamental flaw in IAWC's proposed capital structure is that its common equity ratio is more than 8 percentage points higher than that of its parent company, AWW. Staff states that as of September 30, 2011, the equity ratio of AWW was 42.36%, while that of IAWC was 50.73%. Staff also states that equity is a more expensive form of capital than debt. Consequently, the more equity in a utility's capital structure, the higher the rate of return must be to recover the cost of capital. Staff believes that IAWC's proposed capital structure is needlessly expensive due to an excessive amount of equity. (Staff IB at 31-32, RB at 14; Staff BOE at 11; Staff RBOE at 4)

Staff believes IAWC has an incentive to use a higher proportion of common equity than its parent, which would then allow AWW a greater return on its capital, while leaving ratepayers to shoulder the costs. (Staff BOE at 9) Staff argues that unless IAWC's operating risk is sufficiently higher to justify that differential, its 50% common equity ratio would produce a rate of return that violates Section 9-230. (Staff IB at 32, RB at 17; Staff BOE at 11)

Staff states that since a company with less business risk can carry a lower percentage of equity on its balance sheet than a company with greater business risk, Staff asked that IAWC demonstrate that it has higher risk than AWW to justify the higher common equity ratio for the utility. Staff claims IAWC failed to quantitatively demonstrate that IAWC has significantly more operating risk than AWW and therefore has not justified the need for the higher common equity ratio for ratemaking at IAWC and failed to meet its burden pursuant to Section 9-230 of the Act. (Staff RB at 17; Staff BOE at 11)

Staff contends that the only evidence to justify its proposal, that IAWC is less diversified than AWW because of the former's smaller service territory, is insufficient on two levels. First, Staff says it focuses on only one source of operating risk. Staff adds that it fails to consider other sources, such as construction risk. Second, even if one assumes that IAWC's operating risk is higher than AWW's, Staff claims IAWC failed to quantify that alleged difference in operating risk, which is necessary for the Commission to assess whether that difference in operating risk justifies keeping IAWC's common equity ratio eight percentage points higher than that of AWW. Staff believes its proposed imputed capital structure both complies with the mandatory requirements of Section 9-230 of the Act and indicates adequate financial strength, according to Staff's pro-forma ratio analysis. (Staff IB at 32-33; Staff BOE at 11-12)

Staff disputes IAWC's claims that its risk profile decreases as its common equity ratio increases, which will then result in lower debt financing for IAWC. According to Staff, since American Water Capital Corp ("AWCC") raises the debt financing for IAWC and AWCC's rating reflects the consolidated credit quality of AWW, IAWC is paying the debt costs that reflect the lower equity ratio of AWW. Staff contends that IAWC does not get the benefit of lower debt costs as a result of its higher equity ratio. (Staff IB at 33; Staff BOE at 12)

According to Staff, the Commission cannot consider the reasonableness of a proposed capital structure until it makes a threshold determination that the capital structure in question satisfies the requirements of Section 9-230. (Staff BOE at 8) Staff also asserts that Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital. Staff says Section 9-230 is designed to preclude parent companies from realizing greater returns from ratepayers by proposing a capital structure with a greater percentage of common equity at the utility level. (Staff RB at 16-17; Staff BOE at 8, 12)

IAWC claims that Staff's imputed capital structure violates Section 9-230 of the Act because it adds debt which thereby increases the level of financial risk faced by the utility. According to Staff, IAWC argues that imputing AWW's more highly-leveraged capital structure imposes greater financial risk to IAWC. Staff says it conducted a principal components analysis using IAWC's pro-forma ratios to reflect Staff's proposed 42% imputed equity ratio to ensure that the Water and Utility samples are comparable to IAWC with a lower equity ratio, and therefore higher leverage. Staff states that this analysis indicated that the financial risk of IAWC was greater than both of Staff's samples and verified that increasing the financial leverage does not affect operating risk. Staff says it then adjusted the cost of common equity to reflect the higher financial risk that results from imputing a 42% equity ratio. (Staff RB at 18)

Staff notes that IAWC argues that its risk profile decreases as it increases its common equity ratio which will result in economic benefits in the form of lower debt and equity costs. Staff says that conversely, IAWC argues that Staff's imputed capital structure results in increased leverage at IAWC, which would lead to significant increases to IAWC's financing costs. Staff insists that IAWC is already paying the debt financing costs that reflect the higher leverage of AWW, since the rating of the financing affiliate, American Water Capital Corp., reflects the consolidated credit quality of AWW. (Staff RB at 18)

Staff contends that even with higher financial leverage resulting from its imputed capital structure, IAWC's rate of return is lower than it would be with a 50% common equity ratio. Staff says IAWC's cost of debt would not change since it reflects AWW's financial leverage, not IAWC's financial leverage. According to Staff, using IAWC's proposed 50.51% common equity ratio and Staff's cost of common equity results in a 7.64% weighted average cost of capital. Staff asserts that using its imputed 42% common equity ratio and Staff's cost of common equity adjusted upward to reflect the higher financial risk results in a 7.39% weighted average cost of capital. (Staff RB at 18-20)

If the Commission concludes that IAWC's higher equity balance has not increased its cost of capital due to IAWC's affiliation with AWW, Staff proposes, in its Initial Brief, an alternative capital structure. Citing Docket No. 10-0467, Staff says its alternative proposal follows Commission practice of subtracting the balance of goodwill from the balance of common equity. Staff states that subtracting IAWC's $24,818,000 forecasted balance of goodwill from the $404,617,972 Average September 30, 2013 common equity balance results in an Average September 30, 2013 common equity balance of $379,799,972. According to Staff, this common equity balance results in a capital structure comprised of 1.34% short-term debt, 50.23% long-term debt and 48.44% common equity. (Staff IB at 33-34)

3. Conclusions

As discussed above, IAWC's forecasted average capital structure for the test year ending September 30, 2013 is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. Staff proposes an imputed capital structure comprised of 1.30% short-term debt, 56.70% long-term debt and 42.00% common equity. The table below compares the two proposed capital structures in this proceeding.

	IAWC Proposed	Staff Proposed
Short-term debt	0.26%	1.30%
Long-term debt	49.23%	56.70%
Common equity	50.51%	42.00%

As described in more detail above, Staff believes that IAWC's proposed capital structure contains too much common equity and must be adjusted to comply with Section 9-230 of the Act. Conversely, IAWC's view is that Staff's proposed capital structure contains too much long-term debt and that using it would result in a violation of Section 9-230 of the Act.

The Commission notes that Staff's discussion of how capital structure affects the overall cost of capital is very informative. (Staff Ex. 6.0 at 3-4) Also of interest to the Commission is the parties' discussion of the potential incentives IAWC and/or its parent may or may not have to manipulate IAWC's capital structure as well as the discussion of Section 9-230 of the Act.

The Commission also observes that although the issue of capital structure was contested in IAWC's last rate case, IAWC and Staff were in agreement on the issue in that proceeding. The table below shows the IAWC/Staff proposed capital structure as well as the capital structure adopted for ratemaking purposes in Docket No. 09-0319.

	Docket No. 09-0319	
	IAWC/Staff Proposed	Approved
Short-term debt	0.15%	2.83%
Long-term debt	51.22%	49.84%
Common equity	48.63%	47.33%

The Commission is aware that neither IAWC nor the Staff has any obligation to begin with or compare its proposed capital structure to what it proposed or what was adopted in the previous rate case. The Commission nevertheless finds such information useful. The Commission finds it curious that there is such a significant disagreement in this proceeding over an issue on which the same parties were in agreement in the previous case. The Commission does not believe either party provided a compelling explanation why its proposal in this proceeding varies so far from what it proposed in Docket No. 09-0319. Similarly, the Commission believes that the record is devoid of any persuasive reason the capital structure approved in this proceeding should vary significantly from the one approved in Docket No. 09-0319.

The Commission concludes that for purposes of this proceeding, the proportion of short-term debt in the capital structure should be lower than was approved in Docket No. 09-0319 but higher than what IAWC projects for the test year. For purposes of establishing an authorized rate of return on rate base in this proceeding, the Commission finds the record supports a capital structure that includes 1.30% short-term debt. While the Commission does not necessarily agree with the specific method by which Staff derived this proportion, it does believe the result is reasonable.

To determine the proportion of long-term debt and common equity in the capital structure, the Commission concludes it should begin with the proportions found to be reasonable for ratemaking purposes in Docket No. 09-0319. The Commission finds it appropriate to increase the proportion of each by one half of the proportion by which the short-term debt proportion was decreased. The table below shows the capital structure which the Commission finds appropriate for purposes of establishing an authorized rate of return on rate base.

	Approved Proportion
Short-term debt	1.30%
Long-term debt	50.60%
Common equity	48.10%
Total	100.00%

As noted above, Staff appears to be arguing that the Commission may not even consider the reasonableness of a capital structure until it makes a “threshold determination” that the capital structure in question satisfies the requirements of Section 9-230. The Commission finds this argument to be curious, given that Staff has not made the same argument in other rate cases, including the previous IAWC rate case in Docket No. 09-0319. In any event, the record in the instant case does not indicate that the capital structure approved above includes any incremental risk or increased cost of capital which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies. The Commission also observes that the approved equity ratio is relatively close to the average equity ratio of Staff's water utility sample.

Before leaving this issue, the Commission notes that Staff also offered an alternative capital structure, as described above. As IAWC points out, however, this proposal was not presented by any witness. Rather, it was advanced for the first time in briefing. The proposal is essentially the result of an expert analysis which did appear in the expert witness' testimony. As such, there has been no opportunity to conduct discovery or cross-examination, or to submit responsive evidence. The proposal will not be adopted.

C. COST OF COMMON EQUITY

IAWC, Staff and IIWC/FEA presented expert testimony estimating IAWC's cost of common equity. On this issue, exceptions were filed by IAWC. (IAWC BOE at 4-14) Responses taking issue with IAWC's exceptions were set forth in Reply Briefs on Exceptions filed by Staff, IIWC/FEA and the AG.

1. IAWC's Position

According to IAWC, the rate of return testimony offered in this proceeding places the Commission in the familiar place of determining a return on equity based on IAWC's recommendation (11.25%) and the recommendations offered by Staff (9.42%) and Intervenors (9.3%). IAWC suggests the tendency in this situation is for the Commission to fashion a return on equity somewhere in between. IAWC also suggests that there is an easier solution in this case: the Commission could leave return on equity where it currently is, at 10.38% as authorized in Docket No. 09-0319. In IAWC's view, the evidence supports such an outcome. (IAWC IB at 77)

In support of the suggestion contained in its Initial Brief, IAWC cites the U.S. Supreme Court decision in *Hope* and *Bluefield*. IAWC also discusses authorized returns for its regulated affiliates. (IAWC IB at 77-79)

IAWC asserts that any return on equity below its current authorized return of 10.38% is unreasonable and could impair the ability of IAWC to attract the capital necessary to fulfill its planned investment needs. IAWC says Staff and IIWC/FEA attempt to justify their recommendations by observing that capital costs in the market generally have declined since 2010, as evidenced by decreasing bond yields and other factors. IAWC contends that even if this premise were assumed to be true, IAWC's cost of equity surely has not declined by 100 basis points or more since its last case. Citing decisions in other states, IAWC argues that Illinois would clearly become an outlier jurisdiction if the Commission accepted the return on equity recommended by either Staff of IIWC/FEA in this proceeding. (IAWC IB at 79-80)

IAWC states that notwithstanding lower interest rates, the cost of common equity has actually risen as the equity risk premium has risen. According to IAWC, the decrease in bond yields has been coupled with an increase in the volatility of the stock market as measured by the VIX Index, which measures the implied volatility of Standard & Poor's ("S&P") 500 index options. (IAWC IB at 81)

IAWC states that the recommendation of its witness, Ms. Ahern, is based on an assessment of market-based equity cost rates of nine publicly traded companies of relatively similar risk. She employed market-based cost of common equity models to the proxy group data: the single-stage constant growth Discounted Cash Flow ("DCF") Model, the Risk Premium Model ("RPM") and the Capital Asset Pricing Model ("CAPM"). (IAWC IB at 82)

In its Brief on Exceptions, IAWC argues that the analyses applied to non-water company proxy groups, as discussed below, should not be considered. IAWC further submits that if the "non-constant DCF analyses performed by Staff and IIWC/FEA applicable to their respective water proxy groups" are relied upon, along with "Staff's and IAWC's CAPM analysis as applied to their respective water proxy groups," then "the minimum authorized return on common equity for IAWC in this proceeding should be 9.84%." (IAWC BOE App. A at 2-3; S*ee also* IAWC BOE at 4-14)

According to IAWC, its currently authorized return of 10.38% also is supported by the record as the greatest reasonable ROE. In its view, this finding is "bolstered by the 9.99% average of the three expert's recommendations," and the Commission should "authorize an ROE of 10.11%, which is the midpoint of the range of 9.84 - 10.38%." (*Id*.)

a. DCF

IAWC reports that the median result of the single-stage DCF model is 9.96% for the nine water companies in Ms. Ahern's proxy group. In arriving at a conclusion of a DCF-indicated common equity cost rate for the proxy group, IAWC says Ms. Ahern relied upon the median of the results of the DCF, due to the wide range of DCF results as well as the continuing volatile capital market conditions and to not give undue weight to outliers on either the high or the low side. IAWC claims the median is a more accurate and reliable measure of central tendency, and provides recognition of all the DCF results. (IAWC IB at 82-83)

According to IAWC, Ms. Ahern utilizes the single-stage constant growth DCF model because it is the most widely utilized version of the DCF used in public utility rate regulation. IAWC says it is widely utilized because utilities are generally in the mature stage of their lifecycles and not transitioning from one growth stage to another. IAWC alleges this is especially true for water utilities. IAWC states that all companies, including utilities, go through typical life cycles in their development, initially progressing through a growth stage, moving onto a transition stage, and finally assuming a steady-state or constant growth stage. IAWC says the U.S. public utility industry is a long-standing industry, dating back to approximately 1882. In IAWC's view, the public utility industry in the U.S. is a stable and mature industry characterized by the steady state or constant-growth stage of a multi-stage DCF model. (IAWC IB at 83)

IAWC argues that although its currently authorized ROE was based in part upon a non-constant growth DCF, the Commission does not require use of a non-constant growth DCF in all cases. IAWC says the Commission has recently indicated that the type of DCF model used should be determined in each case. According to IAWC, there is no basis for applying multi-stage growth versions of the DCF model to determine the common equity cost rates of mature public utility companies, such as water utilities. (IAWC IB at 83-84)

b. Risk Premium Model

IAWC says Ms. Ahern's application of the RPM model produced a common equity cost rate of 10.41%, slightly above its current authorized return. According to IAWC, the RPM is based upon the basic financial principle of risk and return, namely, that investors require greater returns for bearing greater risk. IAWC says the RPM recognizes that common equity capital has greater investment risk than debt capital, as common equity shareholders are last in line in any claim on a company's assets and earnings, with debt holders being first in line. IAWC states that investors require higher returns from common stocks than from investment in bonds, to compensate them for bearing the additional risk. (IAWC IB at 84)

While investors' required common equity return cannot be directly determined or observed, IAWC indicates it is possible to directly observe bond returns and yields. According to RPM theory, one can assess a common equity risk premium over bonds, either historically or prospectively, and then use that premium to derive a cost rate of common equity. IAWC asserts that the cost of common equity equals the expected cost rate for long-term debt capital plus a risk premium over that cost rate to compensate common shareholders for the added risk of being unsecured and last in line for any claim on the corporation's assets and earnings. (IAWC IB at 84)

c. CAPM

IAWC states that CAPM theory defines risk as the co-variability of a security's returns with the market's returns as measured by beta. The CAPM assumes that all other risk, i.e., all non-market or unsystematic risk, can be eliminated through diversification. The risk that cannot be eliminated through diversification is called market, or systematic, risk. In addition, the CAPM presumes that investors require compensation only for those systematic risks which are the result of macroeconomic and other events that affect the returns on all assets. The model is applied by adding a risk-free rate of return to a market risk premium, which is adjusted proportionately to reflect the systematic risk of the individual security relative to the total market as measured by beta. (IAWC IB at 85)

Because both ratemaking and the cost of common equity are prospective, IAWC says the risk-free rate for Ms. Ahern's CAPM analysis is based on the average consensus forecast reported in the August 1, 2011 Blue Chip of the expected yields on 30-year U.S. Treasury bonds for the six quarters ending with the fourth calendar quarter 2012. (IAWC IB at 85)

IAWC states that numerous tests of the CAPM have measured the extent to which security returns and betas are related as predicted by the CAPM confirming its validity. According to IAWC, the empirical CAPM ("ECAPM") reflects the reality that, while the results of these tests support the notion that beta is related to security returns, the empirical Security Market Line ("SML") described by the CAPM formula is not as steeply sloped as the predicted SML. Ms. Ahern applied both the traditional CAPM and the ECAPM to the companies in the proxy group and averaged the results. The risk-free rate adopted for both applications of the IAWC's CAPM is 4.67%. (IAWC IB at 85)

d. Response to Staff

IAWC alleges that Staff's recommended cost of common equity of 9.42% violates the economic principle of opportunity cost, meaning the return given up or foregone by investing in one investment as opposed to an alternative investment of comparable risk. IAWC further alleges that Staff's recommended 9.33% ROE, should the Company's revised RAC be adopted, and 9.19%, should "Staff's revised RAC" be adopted, result in effective authorized ROEs for IAWC of 8.35% and 8.24%, respectively. IAWC says these returns are applied to a capital structure containing significantly greater financial risk than IAWC's actual capital structure. IAWC claims there is little incentive for American Water to invest in IAWC if the parent could forego ROEs of 9.42%, 9.33% or 9.19% on alternative investments with business and financial risks comparable to the actual business and financial risks which IAWC faces. (IAWC IB at 86)

IAWC contends that Ms. Freetly's use of a non-water utility sample group is inappropriate because the water utility industry faces unique investment risks relative to the electric, combination electric and gas and natural gas utility industries. In addition, IAWC says its 2010 capital intensity as measured by net plant divided by total operating revenues of $3.70 relative to $2.08 for the non-water utility sample group indicates significantly greater capital intensity and thus greater risk.

Based upon total debt to earnings before interest, taxes, depreciation and amortization, before-income tax interest coverage and earned returns on common equity for the ten years ending 2010, IAWC asserts it is more risky, notwithstanding a 2010 depreciation rate similar to that of Ms. Freetly's non-water utility sample. IAWC argues that using a proxy group comprised of non-water utilities for an ROE analysis for a water company (like IAWC) cannot reflect specific water industry risk, and is therefore inadequate for water utility cost of capital purposes. IAWC believes Ms. Freetly's non-water utility sample group is neither reflective of the unique risks of water utilities in general, nor of IAWC specifically. (IAWC IB at 87, RB at 46)

Ms. Freetly relies upon a non-constant growth DCF model, in part, to arrive at her recommended common equity cost rate of 9.42%. IAWC claims she has not provided sufficient evidentiary support for her non-constant growth model in this case. Ms. Freetly utilizes the non-constant growth DCF model based on her belief that the average 3-5 year growth rates for her Water and Utility samples are not sustainable over the long-term. IAWC says she provides the following three reasons: (1) in theory, no company could sustain indefinitely a growth rate greater than that of the overall economy; (2) since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious; and (3) given that the average growth rate for the Water sample companies was greater than the overall growth expectations for the economy, the sustainability of the average 3 - 5 year growth rates for the Water sample is unlikely. According to IAWC, these conclusions are not supported by academic literature or empirical evidence. (IAWC IB at 87-88, RB 46-47)

IAWC asserts that there is no empirical evidence from which one could conclude that any individual company, especially relatively stable and mature utility companies, will grow at the average historical or projected growth rate of the U.S. economy. IAWC says the average growth in the U.S. economy is just that, an average. IAWC states that from 2009-2010 nominal Gross Domestic Product ("GDP") grew 3.83% and from 2001 - 2010, nominal GDP grew 4.73%. IAWC says the utilities component of nominal GDP grew 2.83% from 2009 to 2010 and an average 6.14% for the nine years ending 2010. IAWC says utilities experienced greater than average growth during the past decade. (IAWC IB at 88-89, RB at 47)

IAWC claims security analysts' earnings projections should be used in a cost of common equity analysis because security analysts' earnings growth rate projections are available to investors and investors know whether and to what degree these projections are accurate. IAWC asserts that Staff would have the Commission ignore this reality by disregarding the largest influence on individual investors, who own approximately 54% of all the common shares, on average, of the companies in Ms. Ahern's proxy group of nine water companies. In IAWC's view, rate of return analysts who attempt to emulate investor behavior should not ignore how investors behave. (IAWC IB at 89-90)

Ms. Freetly utilized a 3.03% February 1, 2012 effective yield on 30-year U.S. Treasury Bonds as the risk-free rate in her risk premium or CAPM analysis to which IAWC objects. IAWC believes this is not appropriate as Ms. Freetly's use of a spot 30-year U.S. Treasury Bond yield is inconsistent with both the prospective nature of the cost of capital and ratemaking because it merely provides a snapshot of yields at a point in time. IAWC says prospective yields may be derived from various forecasts that are widely and readily available, such as the forecasted 30-year U.S. Treasury Bond yields. IAWC notes that Ms. Ahern derived a forecasted yield of 3.42% based upon the consensus forecast of about 50 economists for the six calendar quarters ending with the second calendar quarter of 2013. IAWC claims investors are more likely to rely on this information than information on spot yields. (IAWC IB at 90)

IAWC argues that Staff's approach essentially equates spot prices with forecasts, which is IAWC believes is wrong. IAWC also claims this fails to account for the fact that spot prices do change; a forecasted price takes that reality into consideration and uses the best information available to account for it. (IAWC RB at 47)

IAWC agrees that the Commission elected to use a spot price rather than a forecasted price in Docket No. 09-0319. According to IAWC, the Commission neither analyzed the issue in detail nor settled it once and for all. IAWC says it essentially decided the issue on the record in that case and on the basis that Staff's overall result was reasonable. IAWC asserts that in this case, Staff's overall approach is not sound, but is founded on the large-scale error of imputing an artificial capital structure to IAWC and would drastically cut IAWC's cost of equity with no substantial justification. (IAWC RB 47-48)

IAWC also complains that Ms. Freetly failed to apply the ECAPM to account for the fact that the SML as described by the traditional CAPM is not as steeply sloped as the predicted SML. According to IAWC, the traditional CAPM does not fully capture the greater returns required by increased risk. (IAWC IB at 90-91, RB at 48)

e. Reply Brief

In its Reply Brief, IAWC asserts that Staff offered no valid critique of Ms. Ahern's use of historical data in her analysis. According to IAWC, Staff misunderstands IAWC's position. IAWC claims that absent empirical evidence to the contrary, it is reasonable to assume that investors utilize the types of historical data in arriving at their expectations and required returns. (IAWC RB at 48-49)

IAWC also asserts that Staff offered no persuasive reasons for rejecting IAWC's proposed investment-risk adjustment. According to IAWC, there is no direct way to quantify an adjustment for the combined impact on common equity cost rate of IAWC's somewhat lower financial risk and greater unique business risks. IAWC says this is true of numerous elements of cost-of-capital issues, but claims "that does not mean there is no analysis." According to IAWC, despite Staff's assertions, Ms. Ahern did furnish an analysis that it says explained the magnitude of such an adjustment for IAWC's collective unique business risk and says she explained her methodology and the "conservative" assumptions she used. (IAWC RB at 49-50)

In its Reply Brief, IAWC also asserts that the Commission should adopt its proposed flotation cost adjustment. IAWC believes that the Commission's approach to flotation costs, which describes as applying an operating-expense standard to a cost-of-capital issue, is erroneous. IAWC argues that flotation costs are charged to capital accounts and are not expensed on a utility's income statement and are analogous to capital investments reflected on the balance sheet. IAWC believes flotation costs should be recovered through an adjustment to common equity cost rate even when there has not been an issuance during the test year, or in the absence of an expected imminent issuance of additional shares of common stock. IAWC believes the Commission should reconsider its approach to this issue. (IAWC RB at 50-51)

f. Response to IIWC/FEA

In response to IIWC/FEA, IAWC believes Mr. Gorman's use of a gas utility proxy group is inappropriate because the water utility industry faces unique investment risks relative to the electric, combination electric and gas, and natural gas utility industries. IAWC contends using a proxy group comprised of natural gas distribution companies for an ROE analysis for a water company (like IAWC) cannot reflect specific water industry risk, and is therefore inadequate for water utility cost of capital purposes. IAWC claims Mr. Gorman's gas utility proxy group results are not reflective of the unique risks of water utilities in general, let alone IAWC specifically. (IAWC IB at 91, RB at 51-52)

IAWC also complains that Mr. Gorman's water proxy group includes a negative 1.15% constant growth DCF result for Middlesex Water Company because the single security analysts' forecast of EPS growth for Middlesex is a negative 1.15%. Since it is illogical that investors would invest with the expectation of losing money, IAWC believes Mr. Gorman's DCF result is not meaningful. (IAWC IB at 92)

Mr. Gorman derived an average constant growth DCF model cost rate of 10.18% for his water proxy group and a median of 10.36%. IAWC says Ms. Ahern recalculated Mr. Gorman's average and median constant growth DCF results excluding Middlesex producing results of 11.06% and 11.24%, respectively. (IAWC IB at 92, RB at 52-53)

IAWC reports that Mr. Gorman concludes that the constant growth DCF result for his water proxy group is unreasonably high because it reflects a growth rate which is far too high to be a reasonable or reliable estimate of a long-term sustainable growth rate. IAWC says his conclusion is premised on a belief that projected growth in GDP represents a ceiling, or high-end, sustainable growth rate for a utility over an indefinite period of time because the dividend growth for the market as a whole tracked the GDP growth rate during the period 1926 through 2008. (IAWC IB at 92)

According to IAWC, since the stock market as a whole, whether measured by the New York Stock Exchange or the S&P 500, is a broad based representation of all the common stocks traded in the U.S., it stands to reason that the earnings and dividends of the market as a whole would track GDP growth. IAWC says Mr. Gorman did not provide any empirical support that the earnings and dividends of utility companies in general, or water companies in particular, or indeed any specific company or industry, track GDP growth. (IAWC IB at 92-93)

IAWC asserts it is a mismatch to use five- to ten-years growth in GDP as a proxy for the years eleven through perpetuity. IAWC also claims there is no evidence that a five- to ten-years growth rate in GDP accurately represents the in perpetuity growth rate in GDP and there is no valid rationale for undertaking a multi-stage DCF analysis. (IAWC IB at 93, RB at 53)

IAWC avers that Mr. Gorman's sustainable growth DCF methodology is flawed because he calculates sustainable growth for each company in his water proxy group based upon 3-5 year projections from Value Line. IAWC says his allowance for growth caused by the sale of new common stock above book value also is based upon the five-year growth in shares from 2010 through 2014-2016. IAWC contends that Mr. Gorman's sustainable growth methodology is a short-term forecast, no longer than the security analysts' five-year forecasts of EPS growth used in his first consensus analysts' growth constant growth DCF analysis. IAWC also complains that he provides no empirical support that “sustainable growth” accurately represents investors’ expected growth. (IAWC IB at 93)

In IAWC's view, the sustainable growth methodology is inherently circular because it relies upon an expected ROE on book common equity, which is then used to establish a common equity cost rate related to the market value of the common stock which, if authorized, will become the expected ROE on book common equity. IAWC says Mr. Gorman’s 9.58% sustainable growth constant growth DCF result, which forms the basis, in part, of his recommended allowed DCF-derived ROE on book common equity, is lower than the expected average Value Line ROE of 10.57% for the same proxy group used to derive his recommended allowed ROE. (IAWC IB at 93-94, RB at 53)

According to IAWC, Mr. Gorman’s sustainable growth DCF ignores the basic principle of rate base/rate of return regulation that the cost of equity authorized in this proceeding will be applied to the jurisdictional book value rate base of IAWC and become the allowed future earned return on book common equity, i.e., the expected ROE component of the sustainable growth method. IAWC argues that there is no need to reject the empirical evidence of the proven reliability of analysts’ forecasts of EPS by turning to either a sustainable growth constant growth or a multi-stage DCF model. (IAWC IB at 94)

IAWC states that Mr. Gorman’s market equity risk premium is the difference between the arithmetic mean 1926 to 2010 total return on large company stocks of 11.9% and the arithmetic mean 1926 to 2010 total return on long-term government bonds of 5.9% from the SBBI-2011 which results in a 6.0% market equity risk premium. IAWC contends that the correct derivation of the historical market equity risk premium is the difference between the total return on large company stocks of 11.9% and the arithmetic mean 1926-2010 income return on long-term government bonds of 5.2%, resulting in a market equity risk premium of 6.7%. IAWC believes the correct historical market equity risk premium is 6.7% and not 6.0%. (IAWC IB at 94-95, RB at 53)

IAWC asserts that Mr. Gorman’s “forward-looking” equity risk premium is not truly forward-looking. IAWC says Mr. Gorman derived his “forward-looking” equity risk premium by merely adding a current consensus analysts’ inflation projection to the SBBI-2011 long-term historical arithmetic mean real market return for the years 1926-2010. IAWC believes it is not appropriate to try and match a current forecast of inflation, 2.3% from Blue Chip, with an average real market return over a period of 85 years. IAWC claims investors would not attempt to do such a thing. According to IAWC, they would be influenced by a forecast such as that published by Value Line, which is widely subscribed to and is available in the business reference section of most libraries.

IAWC suggests a more appropriate method of deriving the prospective equity market return is based upon Value Line’s projected 3-5 year market appreciation potential, which when converted to an annual rate plus the market’s median expected dividend yield results in a forecasted total annual market return of 16.30% for the thirteen-weeks ending February 17, 2012. IAWC claims this methodology yields a truly prospective market return which is based upon public information relied on by investors. (IAWC IB at 95)

In IAWC's view, Mr. Gorman should have included an ECAPM analysis in deriving his CAPM-based common equity cost rate. IAWC maintains that the empirical Security Market Line described by the traditional CAPM is not as steeply sloped as the predicted SML. IAWC says low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted. IAWC believes both the traditional CAPM and ECAPM should be used in deriving a CAPM-based common equity cost rate. (IAWC IB at 95-96)

IIWC/FEA asserts that Ms. Ahern should have used actual observable utility bond yields rather than inflated projected utility bond yield estimate. IAWC claims IIWC/FEA's argument is wholly circular. IAWC says that argument boils down to: "projected" yields are greater than "observable"; therefore, the projections are "overstated." IAWC claims this ignores the issue in dispute: whether projected yields match investor expectations better than observed yields. In IAWC's view, asserting that one is overstated simply because it is higher is conclusory. IAWC contends that using projected bond yields is more sensible, as both the determination of the cost of capital and the ratemaking are prospective in nature, so events that affect the future, impact market activity, volatility and investor expectations and are relevant to the determination of the cost of common equity. (IAWC RB at 54)

IAWC disputes the claims that Ms. Ahern skewed the equity risk premium estimate by subtracting from the total return on the market only the income return on the corporate bonds, which IIWC/FEA asserts does not reflect the true investment risk differential between investing in stocks relative to a corporate bond. IAWC asserts that using the yield, and not the total return, presumes that the bond will be held to maturity and thus its yield over the life of the bond is the total return. IAWC also says that the academic literature uses a bond yield, and not the total bond return. (IAWC RB at 54-55)

IIWC/FEA also asserts that the ECAPM study should be rejected because it relied on adjusted utility betas, which it says leads to double-counting. In response, IAWC argues that the ECAPM is a return adjustment which accounts for this reality, and not an adjustment to beta which is an x-axis adjustment accounting for regression bias. IAWC contends that the use of adjusted betas is not equivalent to the ECAPM, so contrary to IIWC/FEA's argument, using both does not double-count anything. (IAWC RB at 55)

IAWC disputes IIWC/FEA's suggestion that Ms. Ahern used a comparable earnings model. IAWC says she analyzed the earnings of companies with similar measures of total risk as IAWC, which IAWC insists is both appropriate and consistent with the Hope doctrine that the return to the equity investor should be commensurate with returns on investments in other firms having corresponding risks. IAWC also claims that contrary to IIWC/FEA's assertion, Ms. Ahern did show that the nonregulated companies manifested comparable risk. IAWC claims her selection criteria for the proxy group of non-price regulated companies were based upon measures of total risk, i.e., systematic (non-diversifiable) risk as measured by betas and non-systematic (diversifiable) risk as measured by the standard errors of the regression giving rise to the betas. (IAWC RB at 55-56)

g. RAC

IAWC also believes Staff's recommendation that IAWC's cost of common equity be adjusted downward if the Commission approves the Revenue Adjustment Clause, in any form, should be rejected. (IAWC IB at 116-117, RB at 51)

IAWC notes that Staff recommends a downward adjustment of 23 basis points to IAWC's cost of equity should the Commission adopt the RAC as proposed by IAWC on rebuttal, because the RAC promotes revenue stabilization which, Staff alleges, provides IAWC greater assurance that its authorized rate of return will be earned. IAWC urges the Commission to reject that adjustment as ad hoc and arbitrary. IAWC complains that Staff provides no empirical support quantifying its 23 basis points as reasonable. IAWC says studies have concluded that there is no measurable difference in the volatility of equity risk premiums or in systematic risk as measured by beta due to the presence of a decoupling mechanism. According to IAWC, there is no empirical evidence that the magnitude of impact of a decoupling mechanism on a common equity cost rate can be quantified. IAWC suggests this is most likely due to the myriad factors collectively affecting investor perceptions of risk. (IAWC IB at 116-117)

IAWC argues that Staff's contention on rebuttal that the return on equity deduction should be increased from 10 basis points to 23 basis points is based on a simplistic calculation of revenues IAWC could have collected had the RAC been in effect in prior years. IAWC says this calculation ignores IAWC's usage projection in this case, which is intended to provide an accurate projection reflecting declining usage such that amounts surcharged or refunded would be smaller than in the past. IAWC calls Staff's attempt to quantify such an impact baseless and suggests it should be afforded no weight. (IAWC IB at 117)

IAWC claims that in other jurisdictions where a decoupling mechanism similar to the RAC has been approved for a water utility, there has been no reduction to the authorized rate of return on common equity to reflect the existence of that mechanism. IAWC says that in making permanent Rider VBA, the Commission also did not impose any return of equity deduction. (IAWC IB at 117)

2. Staff's Position

Staff witness Ms. Freetly estimated IAWC's investor-required rate of return on common equity to be 9.42%. Ms. Freetly measured the investor-required rate of return on common equity using DCF and CAPM analyses. Ms. Freetly applied those models to a sample of water utility companies ("Water sample") and a sample of comparable public utility companies ("Utility sample"). (Staff IB at 34)

a. Sample

To select her Water sample, Ms. Freetly started with a list of all publicly traded, domestic water utilities included in S&P Utility Compustat. She then removed any company that did not have the data needed for her cost of capital analyses. The seven remaining companies compose the Water Group. AWW and SJW Corp. were not included in Ms. Freetly's Water sample because they lacked the necessary data to perform the cost of common equity analysis. (Staff IB at 34-35)

The companies in Ms. Freetly's Utility sample were chosen through a principal components analysis using 12 financial and operating ratios. Data from the period 2008-2010 were averaged to normalize the first nine ratios. The last three ratios were measured over the period 2006-2010 with the coefficient of determination of a least squares regression of the natural logarithm of the respective quarterly data against time. After calculating the scores for each principal component, she rank-ordered the companies in terms of least relative distance from IAWC's target scores.

The witness then eliminated: (1) water utilities to avoid doubling the weight given them, as they were already considered in her Water Group; (2) any non-investment grade utilities; (3) any company that reduced its dividend or does not consistently pay a dividend; (4) any company that was in the process of being acquired by another company or acquiring a company of similar size; and (5) any company that lacked the data needed for her cost of capital analysis. Staff says the Utility sample consists of the 12 utilities the least distance from, and therefore, the most comparable to, IAWC. (Staff IB at 35-36; Staff RBOE at 5-6)

b. DCF Analysis

Section IV.D.2 of Staff's Initial Brief addresses its DCF Analysis. Ms. Freetly employed a non-constant-growth DCF ("NCDCF") model that reflects a quarterly frequency in dividend payments. Staff claims Ms. Freetly implemented the NCDCF model in this proceeding because the level of growth indicated by the average 3-5 year growth rates for her Water sample is not sustainable over the long-term. Staff says the average 3-5 year growth rate was 6.12% for the Water sample, while Staff's estimate of the long-term growth rate was 4.81%. Since the near-term growth rates for the Water sample exceeds the expected long-term overall economic growth rate, Staff believes the sustainability of the average 3-5 year growth rates for the samples is unlikely.

Staff calculated the ROE implied by the 3-5 year growth rates, based on the dividend payout and other data published in Value Line for each company in the Water and Utility samples. That calculation produced an average ROE of 18.65% for the Water sample and 12.19% for the Utility sample. Staff states that in comparison, Value

Line forecasts an implied average ROE for the 2014-2016 period of 11.64% for the Water sample and 10.12% for the Utility sample. In Staff's view, it is unlikely that investors expect the sample companies to sustain an 18.65% or 12.19% rate of return on equity indefinitely. (Staff IB at 36-37)

Ms. Freetly modeled three stages of dividend growth. For the first five years, she used market-consensus expected growth rates published by Zacks and Reuters as of February 1, 2012. For the second stage, a transitional growth period that spans from the beginning of the sixth year through the end of the tenth year, Ms. Freetly used the average of the first- and third-stage growth rates. Finally, for the third or "steady-state" growth stage, which commences at the end of the tenth year and is assumed to last into perpetuity, Ms. Freetly calculated a 4.81% expected long-term nominal overall economic growth rate beginning in 2022. That growth rate was calculated using the expected real growth rate (2.6%) based on the average of the Energy Information Administration's ("EIA") and Global Insight's long-term forecasts of real gross domestic product ("GDP"), and the expected inflation rate (2.5%) based on the difference between yields on U.S. Treasury bonds and U.S. Treasury Inflation-Protected Securities. She then combined the resulting 5.2% growth estimate with the 4.5% average nominal economic growth forecasted by EIA and Global Insight. (Staff IB at 37)

The growth rate estimates were combined with the closing stock prices and dividend data as of February 1, 2012. Based on these growth assumptions, stock price, and dividend data, Ms. Freetly's DCF estimate of the cost of common equity was 8.53% for the Water sample and 9.19% for the Utility sample. (Staff IB at 37-38)

c. CAPM

Ms. Freetly performed a CAPM analysis. Staff states that the CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Freetly combined adjusted betas from Value Line, Zacks, and a regression analysis to estimate the beta of the Water and Utility sample. For the Water sample, the average Value Line, Zacks, and regression beta estimates were 0.66, 0.59, and 0.55, respectively. For the Utility sample, the average Value Line, Zacks, and regression beta estimates were 0.75, 0.72, and 0.69, respectively. The Value Line regression employs weekly observations of stock return data while both the regression beta and Zacks betas employ monthly observations.

To equally weight the weekly and monthly return interval betas, Staff indicates Ms. Freetly averaged the Zacks and regression beta estimates first and then averaged the resulting monthly beta with the Value Line weekly beta, which produced a beta of 0.61 for the Water sample and 0.73 for the Utility sample. (Staff IB at 38)

For the risk-free rate parameter, Ms. Freetly considered the 0.05% yield on four-week U.S. Treasury bills and the 3.03% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of February 1, 2012. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.4% and 5.2%. According to Staff, Ms. Freetly concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (Staff IB at 38-39)

Finally, for the expected rate of return on the market parameter, Ms. Freetly conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market was 13.18% for the fourth quarter of 2011. Inputting those three parameters into the CAPM, Ms. Freetly calculated a cost of common equity estimate of 9.22% for the Water sample and 10.44% for the Utility sample. (Staff IB at 39)

d. COE Recommendation

In Ms. Freetly's judgment, the investor-required rate of return on common equity is 9.42%. She determined that by first estimating the investor-required rate of return for the two samples from the results of the DCF and risk premium analyses for the samples and then adding seven basis points to reflect the higher financial risk of IAWC that results from imputing the common equity ratio at 42%.

The average investor required rate of return on common equity for the Water sample (8.88%) is based on the average of the DCF-derived results (8.53%) and the risk premium-derived results (9.22%). Staff indicates that adding seven basis points results in an 8.95% cost of common equity for the Water sample. The average investor required rate of return on common equity for the Utility sample (9.82%) is based on the average of the DCF-derived results (9.19%) and the risk premium-derived results (10.44%). Adding seven basis points results in a 9.89% cost of common equity for the Utility sample. Staff indicates Ms. Freetly then averaged the risk-adjusted cost of common equity for the Water and Utility samples to derive her 9.42% cost of common equity recommendation because the operating risk of IAWC is between that of the two samples. (Staff IB at 39-40)

To assess the similarity of her Water and Utility samples to IAWC with an imputed 42% equity ratio, Staff states that Ms. Freetly adjusted IAWC's scores on the financial and operating ratios that she used to select her Utility sample to reflect a $32.8 million exchange of 6% long-term debt for common equity at IAWC. Staff says this exchange of long-term debt for common equity lowers IAWC's 3-year average common equity ratio from 46.50% to 42%. Ms. Freetly then conducted a principal components analysis using those pro-forma ratios and compared the four principal components scores for IAWC, her Water sample, and her Utility sample to assess their relative risk.

According to Staff, each utility's principal components factor score represents the number of standard deviations that utility falls from the utility average in terms of that specific risk factor. The standard deviation is a statistic that explains how tightly the observations are clustered around the mean in a set of data. Under a normal distribution, Staff says approximately 68% of all observations will fall within one standard deviation of the average; approximately 95% will fall within two standard deviations. (Staff IB at 40)

In Staff's view, the principal components analysis of IAWC's pro-forma ratios indicates that the financial risk of IAWC is greater than that of both samples and the operating risk of IAWC is between that of the Water and Utility samples. To assess the degree to which IAWC's financial risk is greater than that of the of Staff's Water and Utility samples, Ms. Freetly compared the pro-forma ratios for IAWC and the three-year average financial ratios for the Water and Utility samples to Moody's key credit metrics for global regulated water utilities. (Staff IB at 40-42)

Staff states that the three-year pro-forma ratios, which reflect Staff's proposed 42% equity ratio for IAWC, indicate financial strength commensurate with a Baa2 credit rating when weighted in accordance with the Moody's rating methodology for regulated water utilities. In comparison, the three-year financial ratios for the Water and Utility Samples indicate financial strength commensurate with a Baa1 credit rating when weighted in accordance with the Moody's rating methodology for regulated water utilities. According to Staff, financial theory posits that investors require higher returns to accept greater exposure to risk. Conversely, the investor-required rate of return is lower for investments with less exposure to risk. Since the weaker pro-forma ratios for IAWC indicate higher financial risk than the Water and Utility samples, Staff says Ms. Freetly adjusted the cost of equity estimates for the Water and Utility samples upward. (Staff IB at 42-44)

To estimate the adjustment to the cost of common equity to reflect the higher financial risk that results from imputing a 42% common equity ratio, Ms. Freetly began with the 55 basis-point spread between 30-year utility debt with credit ratings of A and BBB. Next, she divided that spread by 3 to estimate the spread for each of the three notches between A and BBB (i.e., A-, BBB+, and BBB). Ms. Freetly then multiplied the resulting 18.3 basis points by 40%, which is the percent of the overall credit rating that Moody's assigns to the financial ratios for water utilities. She then added the resulting seven basis points to the investor-required rate of return for her Water and Utility samples to reflect the increase in risk due to imputing the common equity ratio at 42%. (Staff IB at 44)

Staff states that Ms. Freetly's 9.42% cost of common equity recommendation does not account for the lower risk associated with the revenue decoupling mechanism (RAC) proposed by IAWC in this proceeding. If the Commission approves IAWC's proposed RAC, then Staff believes a downward adjustment to Ms. Freetly's cost of common equity recommendation would be appropriate since it is based on the Company's risk without the RAC. (Staff IB at 44-45)

e. RAC

In direct testimony, Ms. Freetly recommended that if the Commission approves the RAC, IAWC's cost of capital should be computed to give slightly more weight to the cost of equity results for her Water sample. Applying 60% weighting to the 8.95% risk-adjusted investor-required rate or return on common equity for the Water sample and a 40% weighting to the 9.89% risk-adjusted investor-required rate or return on common equity for the Utility sample results in a 9.33% risk-adjusted investor-required rate of return on common equity for IAWC. Hence, if the Commission approves the Company's original RAC proposal with the ±5% limit for recovery, Staff believes its cost of common equity recommendation should be reduced by nine basis points, to 9.33%. (Staff IB at 45-46)

Staff indicates that in rebuttal testimony, IAWC revised its proposed RAC to allow all over and under collections to eventually be passed through to customers. Staff says the total amount that would have been recovered under the Revised RAC during 2006-2010 is 2.4x the amount that would have been recovered under the ±5% limit in IAWC's original RAC proposal. According to Staff, the reduction to IAWC's cost of common equity would be greater. Staff recommends that the adjustment should be 2.4x the adjustment for IAWC original RAC proposal, which is a reduction of 23 basis points from Staff's risk-adjusted investor-required rate of return for IAWC. Therefore, if the Commission approves the Revised RAC, Staff recommends that its cost of common equity recommendation be reduced by 23 basis points, to 9.19%. (Staff IB at 46)

f. Response to IAWC's Criticisms and to IAWC's Analysis

Staff disputes Ms. Ahern's assertion Staff's use of spot-30-year U.S. Treasury bond yields as the risk-free rate in inconsistent with the prospective nature of the cost of capital, ratemaking, and the Efficient Market Hypothesis ("EMH"). Staff states that a U.S. Treasury yield is the cost of capital for that U.S. Treasury security. Staff says Ms. Ahern's argument implies that the yield on a U.S. Treasury security is inconsistent with the prospective nature of the cost of capital, which Staff claims is nonsensical. According to Staff, U.S. Treasury yields are the investor-required returns for an investment in U.S. Treasury securities, just as the cost of common equity represents the investor-required return on a share of common stock. Staff asserts that both reflect investors' expectations for the future. Staff insists that its use of the most recently available U.S. Treasury spot rates is perfectly consistent with the prospective nature of the cost of capital, ratemaking, and the EMH. (Staff IB at 47-48)

Staff also takes issue with Ms. Ahern's suggestion that investors are more likely to rely on forecasted 30-year U.S. Treasury bond yields from Blue Chip and therefore, the forecasted yield should be used as the risk-free rate in the risk premium analysis. Staff claims interest rates are constantly adjusting, and accurately forecasting the movements in interest rates is problematic. Staff believes the current U.S. Treasury yields that it used to estimate the risk-free rate reflect all relevant, available information, including investor expectations regarding future interest rates. According to Staff, investor appraisals of the value of forecasts are also reflected in current interest rates. Staff contends that if investors believe that the forecasts are valuable, that belief would be reflected in current market interest rates. Likewise, Staff claims if investors believe that the forecasts are not valuable, that belief would be reflected in current market interest rates.

Staff concludes that if one uses current market interest rates in a risk premium analysis, speculation of whether investor expectations of future interest rates equals those from a particular forecast reporting service is unnecessary. Staff also contends it is important to note that T-bond yields reflect market forces, while forecasts do not. Staff believes the true risk-free rate is reflected in the return investors are willing to accept in the market. As of February 1, 2012, Staff says investors were willing to accept a 3.03% return on T-bonds, which includes an interest rate risk premium associated with its relatively long term to maturity. According to Staff, that the T-bond yield includes such a premium indicates that the true long-term risk-free rate is actually below 3.03%. In Staff's view, the Commission should continue to rely on current, observable market interest rates in the risk premium analysis. (Staff IB at 48)

Staff says IAWC presented similar arguments that the forecasted T-bond yields were superior in its last rate case, Docket No. 09-0319. Staff asserts that the Commission was not convinced by IAWC's arguments and rejected its analysis in favor of Staff's, which included a risk premium analysis that employed current T-bond yields as the risk-free rate. (Staff IB at 49)

Staff reports that Ms. Ahern criticized Staff for not applying the ECAPM to account for the fact that the SML as described by the traditional CAPM is not as steeply sloped as predicted by the SML. Ms. Freetly replied that the ECAPM should not be used to estimate the investor-required rate of return on common equity. According to Staff, a study by Litzenberger et al. suggests that adjusted betas are a solution to the discrepancy between the theoretically predicted and empirically observed relationship between risk and return. Staff asserts that by using adjusted betas, Ms. Freetly already effectively transformed her traditional CAPM into an ECAPM. Staff claims that including an additional beta adjustment in the ECAPM model would result in inflated estimates of the samples' cost of common equity. Staff also says the Commission rejected the ECAPM analysis in Docket No. 03-0403, a rate proceeding for Aqua Illinois, with Ms. Ahern as the cost of equity witness. (Staff IB at 49-50)

In response to IAWC's ROE analysis**,** Staff contends that Ms. Ahern's use of historical data to estimate the current dividend yield in her DCF analysis and the equity risk premium in her RPM and CAPM analysis is problematic. Staff argues that historical data favors outdated information that the market no longer considers relevant over the most-recently available information. Staff also contends that historical data reflects conditions that may not continue in the future. According to Staff, use of average historical data implies that securities data will revert to a mean. Staff claims that implication is even more questionable for security returns since they approximate a random walk, which suggests no tendency of mean reversion. Staff further asserts that even if securities data were mean-reverting, there is no method for determining the true value of that mean. Consequently, sample means, which depend upon the measurement period used, are substituted. In Staff's view, any measurement period chosen is arbitrary, rendering the results uninformative. (Staff IB at 50-51)

Ms. Ahern argues that the constant-growth DCF is the most appropriate to determine the cost of common equity for IAWC because the stability and maturity of the water industry and the regulated utility industry at large warrants its use, and further notes that it is the most widely utilized version of the DCF used in public utility rate regulation. Staff believes that just because one version of the DCF model might be used more frequently than another does not mean its use is appropriate in all circumstances. Staff argues that just as each case needs to be judged on its own merits, the decision regarding which version of the DCF model is most suitable depends on the facts and circumstances at the time of the particular analysis. (Staff IB at 51)

In Staff's view, the maturity of the water utility industry does not preclude abnormal growth in the shorter term. Ms. Ahern argues that the maturity of the water utility industry has rendered its growth stable, but Staff does not believe this is true. According to Staff, the idea of a single, steady-state growth rate is a simplifying assumption made in a DCF analysis because the alternative, forecasting an infinite number of discrete periodic growth rates, would be impossible. Staff contends that while a mature industry might not experience the extreme growth of a burgeoning industry, its growth can vary over time. Staff suggests this is true of water utilities. Staff further suggests that from time to time a water utility might experience a build-out period when it expands its service territory into a newly developed area. As new customers come on-line, Staff says new plant is added to the utility's rate base. Staff claims earnings enter a period of abnormal growth. According to Staff, if an analyst's 3-5 year growth rate is estimated during such an expansionary time, it would likely overstate the typical growth for the water utility. (Staff IB at 51-52)

Staff complains that Ms. Ahern did not perform any analyses to ascertain whether the average projected five-year growth rates that she used for her water proxy group are sustainable for the long-term. Staff says that according to the analysis performed by Staff, Ms. Ahern's growth rates are not sustainable over the long-term. Staff repeats that the expected long-term growth of the overall economy is 4.81% while the average growth rate for Ms. Ahern's water sample is 7.10%. Staff contends that since utilities are generally considered below average growth companies, it is highly unlikely investors expect the companies in Ms. Ahern's water sample to be able to sustain above average growth. (Staff IB at 52)

Staff notes that Ms. Ahern cites various sources to demonstrate the superiority of analysts' forecasts of EPS as measures of investor growth expectations in a DCF analysis. According to Staff, none of her citations refute Staff's arguments for the use of a non-constant DCF model. Although many of Ms. Ahern's arguments suggest otherwise, Staff did not criticize the use of analyst growth rates. Staff reports that Ms. Freetly used them in her non-constant DCF analysis. Staff says Ms. Freetly would not have used analysts' 3-5 year growth rate forecasts for the first-stage of her non-constant growth DCF analysis, if she believed them to be "biased" estimators of growth over the next 3-5 years. While Staff agrees with the essential argument behind Ms. Ahern's citations (that analysts' forecasts remain proper for use in performing a constant growth DCF analysis), the pertinent question is not which growth rate is best suited for use in a constant growth DCF model, but rather, whether a constant growth model should be used in the first place. (Staff IB at 53)

g. Investment Risk and Flotation Cost Adjustments

Ms. Ahern made an upward adjustment to the cost of common equity to reflect IAWC's combined financial risk and unique business risks relative to her proxy group. Staff states that Ms. Ahern claims the 25 basis point adjustment is appropriate in her judgment while admitting that there is no way to directly quantify the impact of risk on the cost of capital. Staff argues that since Ms. Ahern failed to put forward any analysis to demonstrate the higher relative risk of IAWC relative to her proxy group, her investment risk adjustment should not be included in the cost of common equity. (Staff IB at 54)

Staff says Ms. Ahern proposed similar upward adjustments in Docket No. 09-0319 to reflect business and financial risk. Staff also states that, based on the record in that proceeding, the Commission did not make the adjustments because IAWC did not demonstrate that IAWC's business or financial risk was higher than that of the sample companies. Staff urges the Commission to again reject Ms. Ahern's proposed risk adjustment. (Staff IB at 54)

Ms. Ahern proposed a flotation cost adjustment of 0.16% to reflect the flotation costs applicable to her proxy group. Staff believes the proposed flotation cost adjustment is not appropriate for inclusion in the cost of common equity for IAWC. Staff reports that the Commission Order from Docket No. 94-0065 (Commonwealth Edison Company) states that the Commission has traditionally approved flotation cost adjustments only when the utility anticipates that it will issue stock in the test year or when it has demonstrated that costs incurred prior to the test year have not been recovered previously through rates. According to Staff, flotation costs are to be allowed only if a utility can verify both that it has incurred the specific amount of flotation costs for which it seeks compensation and that those costs have not been previously recovered through rates. Staff claims IAWC has done neither. (Staff IB at 54-55)

h. Reply Brief

Staff responds to a suggestion by IAWC that the Commission could leave the return on equity at 10.38%, as authorized in Docket No. 09-0319. Staff indicates that IAWC states that any return on equity below IAWC's current authorized return of 10.38% is unreasonable and could impair the ability of IAWC to attract the capital necessary to fulfill its planned investment needs. According to Staff, since the Commission Order was issued in Docket No. 09-0319, on April 30, 2010, market capital costs have declined. Staff asserts that market information suggests that IAWC's current market cost of equity is much lower than its last authorized return on equity. Staff says this decline was recognized by Ms. Ahern, who lowered her recommended return on equity from 12.28% in Docket No. 09-0319 to 11.40% in this case. (Staff RB at 20-21; Staff RBOE at 4-5)

In its Reply Brief, Staff also responds to IAWC's argument that Staff's use of a non-water utility sample is not appropriate for determining the cost of common equity for IAWC. IAWC also criticizes Staff's Water sample for excluding American Water Works and SJW Corp. Staff insists it did a thorough risk analysis to ensure that the Water and Utility samples were comparable to IAWC and appropriate for determining the investor-required return on common equity for IAWC. Staff says American Water Works and SJW Corp. were excluded from Staff's Water sample because the necessary data was not available on the date on which Staff performed its cost of common equity analysis. (Staff RB at 21-22)

3. IIWC/FEA'S Position

IIWC/FEA recommends that the Commission approve a rate of return of 9.3% in this proceeding. IAWC is proposing to set rates in this proceeding based on an 11.4% return on common equity. IIWC/FEA asserts that by virtually any measure, IAWC's requested return on equity of 11.4% is excessive. (IIWC/FEA IB at 7)

IIWC/FEA asserts that a comparison of capital market costs in this case, compared to Illinois-American's last case, proves that IAWC's last authorized return on equity of 10.38% should be reduced in this proceeding because capital market costs have declined. IIWC/FEA claims that utility bond yields have decreased by approximately 110 to 150 basis points, or 1.1% to 1.5%, since IAWC's last rate case. IIWC avers that the reasonable applications of the DCF, risk premium, and CAPM approaches used by Ms. Ahern show that IAWC's current market cost of equity in this case is well below 10%. (IIWC/FEA IB at 7)

IIWC/FEA alleges that IAWC's analyses were biased, or reflect inappropriate data. According to IIWC/FEA, corrections to IAWC's cost of common equity testimony show that IAWC's return on equity recommendation of 11.4% would be reduced to 9.37% with reasonable applications of the DCF and risk premium studies, rejection of flawed flotation cost adjustment, and investment risk adjustments recommended by IAWC. (IIWC/FEA IB at 9)

a. Proxy Groups

IIWC/FEA witness Mr. Gorman relied on two proxy groups to estimate Illinois-American's cost of capital. The first group was the water utility proxy group developed by Ms. Ahern. Second, he developed a gas utility proxy group. These two proxy groups together produce the most reasonable estimate of investment risk for Illinois-American. (IIWC/FEA Ex. 1.0 at 11) Use of two proxy groups (including a gas proxy group) was necessary for several reasons.

IIWC/FEA asserts that a gas proxy group's securities are more widely followed by securities analysts than are water utility stocks, and therefore the estimated cost of equity from a gas proxy group provides a more robust estimate of Illinois-American's current market cost of equity. IIWC/FEA also claims that considering water utility proxy groups in conjunction with gas utility proxy groups is consistent with industry reports published by S&P. IIWC/FEA says S&P typically combines water utilities and gas utilities in providing industry report assessments to investors. (IIWC/FEA IB at 10-11)

IIWC/FEA contends that the assets capitalization and operations of gas utilities and water utilities are very similar. IIWC/FEA says both utility groups' operations are dependent on large main investment and operations, infrastructure replacement and upgrades, and reliability and safety compliance with state, local and federal regulations. IIWC/FEA believes the two groups produce a better investment risk proxy than only a water group. (IIWC/FEA IB at 11)

In its Reply Brief on Exceptions, IIWC/FEA argues, "[t]he Company incorrectly claims [in its BOE] non-water proxy groups should not be considered." (IIWC/FEA RBOE at 5-7)

b. DCF Model

IIWC/FEA reports that Mr. Gorman used a constant growth DCF model for his analyses. He relied on the average of the weekly high and low stock prices of the proxy groups over a 13-week period ended February 17, 2012. In his view, an average stock price is less susceptible to market price variations than a spot price, and a 13-week average stock price is still short enough to contain data that reasonably reflect current market expectations, but is not so short a period as to be susceptible to market price variations that may not be reflective of the security's long-term value. (IIWC/FEA IB at 13)

For dividend growth rates, Mr. Gorman relied on two sources of growth for a constant growth DCF model. For his first constant-growth DCF analysis, Mr. Gorman relied on a consensus, or mean, of professional security analysts' earnings growth estimates as a proxy for the investor consensus dividend growth rate expectations. He then used the average of three sources of analysts' growth rate estimates: Zacks, SNL Financial, and Reuters. IIWC/FEA says all consensus analysts' projections used were available on February 24, 2012, as reported online. (IIWC/FEA IB at 14)

IIWC/FEA states that the average constant growth DCF returns for the two proxy groups are 10.18% for Water, and 8.53% for Gas. According to IIWC/FEA, the constant growth DCF return for the water utility proxy group is not reasonable and represents an inflated return for IAWC. IIWC/FEA claims this is because it is based on a growth rate of 6.56%, which is so high that it does not constitute a reasonable estimate of a long-term sustainable growth rate that is key to such a model. (IIWC/FEA IB at 14)

Mr. Gorman also used a sustainable growth rate DCF analysis to develop his return on equity recommendation. IIWC/FEA state that a sustainable growth rate is based on the percentage of the utility's earnings that are retained and reinvested in utility plant and equipment. IIWC/FEA says these reinvested earnings increase the earnings base (rate base). According to IIWC/FEA, earnings grow when plant funded by reinvested earnings is put into service, and the utility is allowed to earn its authorized return on such additional rate base investment. As the payout ratio declines, IIWC/FEA claims the earnings retention ratio increases. IIWC/FEA states that an increased earnings retention ratio will fuel stronger growth because the business funds more investments with retained earnings. IIWC/FEA says the data used to estimate the long-term sustainable growth rate is based on the proxy group companies' current market to book ratios and on Value Line's three- to-five year projections of earnings, dividends, earned returns on book equity, and stock issuances for each company. (IIWC/FEA IB at 14-15)

IIWC/FEA indicates the average and median sustainable growth rates for the water utility proxy group using this internal growth rate model are 6.12% and 6.39%, respectively. According to IIWC/FEA, the average and median growth rates for the gas utility proxy group are 6.05% and 5.65%, respectively. IIWC/FEA reports that a sustainable growth DCF analysis for the water utility proxy group produces average and median DCF results of 9.58% and 9.68%, respectively. IIWC/FEA says the average and median DCF results for the gas utility proxy group are 9.82% and 9.50%, respectively. (IIWC/FEA IB at 14-15)

Mr. Gorman also performed a multi-stage growth DCF analysis to reflect one of the limitations of the constant growth DCF models. IIWC/FEA claims that limitation is that the constant growth DCF model cannot reflect a rational expectation that a period of high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth level. (IIWC/FEA IB at 15)

For the short-term growth period, Mr. Gorman relied on the consensus analysts' growth projections described above in relationship to his constant growth DCF model. For the transition period, IIWC/FEA says the growth rates were reduced or increased by an equal factor, which reflects the difference between the analysts' growth rates and the GDP growth rate. For the long-term growth period, Mr. Gorman assumed each company's growth would converge to the maximum sustainable growth rate for a utility company as proxied by the consensus analysts' projected growth for the U.S. GDP of 5.0%. (IIWC/FEA IB at 16)

Mr. Gorman developed his long-term sustainable growth rate based on the latest issue of Blue Chip Financial Forecasts, which published a GDP growth rate outlook of 5.1% to 4.8% over the next 5 and 10 years, respectively. He then used the midpoint of the consensus economists' projected 5- and 10-year GDP consensus growth rate of 4.95% (rounded to 5.0%), as an estimate of long-term sustainable growth. Mr. Gorman also considered the U.S. Energy Information Administration's ("EIA") projection of the real GDP. In its 2011 Annual Report, the EIA projects real GDP through 2035 to be in the range of 2.1% to 3.2%, with a midpoint or reference case of 2.7%. (IIWC/FEA IB at 16)

Mr. Gorman used the same 13-week stock price, dividend, and growth rates he used for his constant growth DCF analysis. According to IIEC/FEA, the average multi-stage growth DCF returns on equity for his proxy groups are 8.95% for the water proxy group, and 8.7% for the gas proxy group. (IIWC/FEA IB at 16-17)

c. CAPM

Mr. Gorman also used the CAPM to estimate the required return on equity for IAWC. The CAPM requires an estimate of the market risk-free rate, the company's beta, and the market risk premium. Mr. Gorman used Blue Chip Financial Forecasts' projected 30-year Treasury bond yield of 3.8% for his CAPM analysis, because long-term Treasury bonds are considered to have negligible credit risk. For a beta value, Mr. Gorman used the water and gas utility proxy groups' average Value Line beta estimates of 0.68 and 0.69, respectively. Mr. Gorman then derived two market risk premium estimates, a forward-looking estimate and one based on a long-term historical average. (IIWC/FEA IB at 17-19)

Based on the results of his CAPM study, Mr. Gorman testified that a return on equity for IAWC will fall in the range of 8.42% to 8.36%. However, IIWC/FEA says Mr. Gorman placed primary weight on the high-end of this CAPM return estimate. (IIWC/FEA IB at 19)

d. Recommended ROE

Based on his analyses, Mr. Gorman estimates IAWC's current market cost of equity to be 9.30%. Mr. Gorman's recommended return on common equity of 9.30% is based on his DCF studies. IIWC/FEA says that although his CAPM study indicates a lower return on equity estimate than his DCF study, he placed less weight on the CAPM results reflecting today's very low bond yields. (IIWC/FEA IB at 20)

IIWC/FEA's asserts that its recommended return will support an investment-grade bond rating for IAWC. IIWC/FEA says Mr. Gorman reached this conclusion by comparing the key credit rating financial ratios for IAWC at its proposed capital structure, and his return on equity to S&P's benchmark financial ratios using S&P's new credit metric ranges. IIWC/FEA states that based on an equity return of 9.30%, IAWC will be provided an opportunity to produce a debt to EBITDA ratio of 2.9x. IIWC/FEA claims this is within S&P's "Intermediate" guideline range of 2.0x to 3.0x and is stronger than the "Aggressive" guideline. IIWC/FEA believes this ratio supports an investment grade credit rating. (IIWC/FEA IB at 20)

e. Response to IAWC Analysis

IIWC/FEA contends that Ms. Ahern's DCF analysis was overstated and flawed because she used growth rates which were far too high to be reasonable estimates of long-term sustainable growth. IIWC/FEA asserts that her growth rates were unreasonably high because they substantially exceeded the growth rate of the U.S. economy, which in effect assumes the growth in demand for utility services would exceed the growth of the service area economy itself. IIWC/FEA believes this is irrational because the service area economy creates the demand for utility services, which drives utility plant investment and earnings growth. It is simply not rational to expect that over the long term a utility's growth rates can exceed the growth of its service area economy, which is represented by the U.S. GDP proxy. IIWC/FEA contends that using a rational growth outlook in Ms. Ahern's DCF study would reduce her DCF return estimate from 9.96%, down to 9.44%. (IIWC/FEA IB at 21)

According to IIWC/FEA, corrections to Ms. Ahern's risk premium study would reduce her return on equity estimate from 10.41% down to 9.17%. These corrections include use of actual observable utility bond yields rather than Ms. Ahern's projected utility bond yield estimate, and use of a reasonable equity risk premium estimate rather than Ms. Ahern's equity risk premium. Ms. Ahern projected a utility bond yield of 5.74% to reflect her proxy group companies. IIWC/FEA claims observable utility bond yields for these companies are in the range of 4.34% to 5.05%. (IIWC/FEA IB at 22)

IIWC/FEA believes Ms. Ahern's equity risk premium estimate was also overstated. Ms. Ahern's low-end estimated equity risk premium was 4.12% for utility companies but her high-end estimated equity risk premium of 5.22% has a flawed beta approach for these same companies. The average supported her equity risk premium of 4.67%. IIWC/FEA does not take issue with her low-end equity risk premium of 4.12% but claims her 5.22% high-end equity risk premium is flawed. IIWC/FEA argues that Ms. Ahern's high-end equity risk premium is flawed because she essentially developed a modified CAPM approach using utility betas to adjust the market risk premium down to a utility risk premium.

According to IIWC/FEA, the flaw is that the beta adjustment was meant to adjust the market risk over Treasury bonds and not corporate bonds. IIWC/FEA believes Ms. Ahern overstated the equity risk premium that would apply to a utility investment. In IIWC/FEA's view, Ms. Ahern skewed the equity risk premium estimate by subtracting, from the total return on the market, only the income return on the corporate bonds. IIWC/FEA asserts that this is not appropriate because it does not reflect the true investment risk differential between investing in stocks relative to a corporate bond. (IIWC/FEA IB at 22-23)

IIWC/FEA contends that Ms. Ahern's ECAPM study should be rejected because it relied on adjusted utility betas for use in her ECAPM analysis, despite the ECAPM not being designed to use adjusted betas. According to IIWC/FEA, the ECAPM was designed to use unadjusted betas. IIWC/FEA asserts that the ECAPM accomplishes the same thing (using unadjusted betas) as a traditional CAPM does using adjusted betas – that is, it increases the CAPM return for low beta stocks. By using adjusted betas in an ECAPM, IIWC/FEA claims she double counts the return adjustment for low beta stocks. By using adjusted betas in an ECAPM analysis, IIWC/FEA says Ms. Ahern overstated the return differential created by low beta stocks, like utilities. (IIWC/FEA IB at 24)

IIWC/FEA states that Ms. Ahern developed a return on equity estimate for IAWC based on comparable earnings analysis using a group of non-regulated companies as a proxy group. She then developed a DCF and CAPM return on equity adjustment for this same proxy group. IIWC/FEA says this later analysis is referred to as a “market based study." Ms. Ahern averaged the comparable earnings and the market-based study result to develop a return on equity of 13.30%. IIWC/FEA believes these return estimates do not produce a reliable or accurate estimate of IAWC's current market cost of common equity. (IIWC/FEA IB at 24)

IIWC/FEA claims the comparable earnings analysis does not measure the return investors require in order to assume the investment risk characteristics similar to Illinois-American. IIWC/FEA also claims Ms. Ahern has provided little to no proof that her non-price regulated proxy group has risk characteristics similar to that of IAWC. IIWC/FEA contends that while the companies may have comparable betas, she has not shown they have comparable business and operating risk to a low-risk regulated utility company. IIWC/FEA says comparable risk factors are commonly used by investment professionals to identify and measure investment risk differentials between different investment alternatives. It is IIWC/FEA's position that without a demonstration of comparable operating risk, the Commission cannot have confidence that this proxy group reasonably approximates the investment risk of IAWC. IIWC/FEA also claims the Commission has consistently dismissed the use of the comparable earnings test determining the return on equity for utilities. (IIWC/FEA IB at 25)

According to IIWC/FEA, the DCF and CAPM analyses applied to Ms. Ahern’s non-utility proxy group in her market-based analysis also produced unreliable results. IIWC/FEA says the DCF estimate used a 9.80% growth rate that was too high to be sustained in the long term. In addition, IIWC/FEA claims the risk premium she developed for this analysis is flawed, because it exceeded reasonable estimates of market risk premiums. IIWC/FEA also asserts that the CAPM method she used in her market-based study was also flawed, because it was based on an excessive market risk premium as well. (IIWC/FEA IB at 25)

IIWC/FEA argues that Ms. Ahern’s flotation cost adjustment should be rejected because it does not relate specifically to IAWC's common equity issuance cost. IIWC/FEA claims this adjustment for IAWC represents an expense that is not known and measurable and should not be included in the development of rates.

IIWC/FEA also contends that Ms. Ahern’s investment risk adjustment of 25 basis points to apply to her proxy group return to develop an appropriate return for IAWC is flawed. IIWC/FEA claims all the risks she outlined in support of this are not unique to IAWC. IIWC/FEA believes many of the companies in the proxy group also reflect these risk characteristics and therefore the identified risks are not distinctive to IAWC. IIWC/FEA asserts that fair compensation for all these risks is already picked up in her return on equity studies. In IIWC/FEA's view, an external adjustment is unjustified. (IIWC/FEA IB at 26)

f. Reply Brief

IIWC/FEA states that IAWC, in its Initial Brief, encourages the Commission to adopt the last authorized return on equity from Docket No. 09-0319 of 10.38% in lieu of weighing the merits of the arguments in this case. (IIWC/FEA RB at 2)

In support of the adoption of a 10.38% return on common equity, IAWC points to several public utility commission decisions in other jurisdictions granting equity returns of less than 10.38% between 2010 and 2012. IIWC/FEA asserts that these cases, while hardly a ringing endorsement of a return on common equity of 10.38%, demonstrate that the 11.25% ROE, which IAWC says is supported by the record, is unreasonably high. (IIWC/FEA RB at 2-3)

IIWC/FEA contends that IAWC overlooks or ignores the fact that the return on common equity approved in Docket No. 09-0319 was approved on the basis of an analysis offered by Staff, which was similar to the analysis offered by IIWC in that case. IIWC/FEA says the Commission adopted Staff's analysis in Docket No. 09-0319 and found that the analysis produced reasonable results. (IIWC/FEA RB at 4)

IIWC/FEA says the analysis that produced that result in Docket No. 09-0319 is the same as, or similar to, the analyses that produced Staff's 9.42% return on common equity and IIWC/FEA's 9.30% return on common equity in this case based on updated data. Under such circumstances, IIWC/FEA suggests it is reasonable for the Commission to use or rely on those analyses to approve a return on common equity for IAWC of 9.42% or 9.30%. (IIWC/FEA RB at 4-5)

IIWC/FEA reports that IAWC also argues that the observable decline in bond interest rates does not support Staff's and IIWC/FEA's findings that IAWC's required return on equity is much lower in this case compared to the last case. IAWC cites its witness Ms. Ahern's observation that equity costs have actually increased while bond yields have decreased. IIWC/FEA asserts that the testimony is based on Ms. Ahern's flawed and inaccurate conclusion that equity risk premiums are higher today than they have been in the past.

IIWC/FEA contends that because observable utility capital costs are significantly lower in this case than they were in the last case, IAWC's proposal for the Commission to again approve its last authorized return on equity of 10.38% is unjust and unreasonable. IIWC/FEA urges the Commission to reject IAWC's recommendations and to instead, adopt a return on common equity in the range of 9.30% to 9.42%, which it says is based on the principals and observations the Commission found just and reasonable in IAWC's last rate case. (IIWC/FEA RB at 6; RBOE at 4-5)

IAWC argues that water utilities face unique investment risk relative to electric and gas utility companies; therefore, use of a gas utility proxy group does not reflect that unique risk and is not proper for determining a water utility return on common equity. IIWC/FEA contends that risk characteristics for the water industry are not so distinct that they fail to properly reflect similar risk experienced by other types of regulated utility operations. IIWC/FEA notes that Mr. Gorman testified that gas and water utilities all must meet environmental regulations, modernize, and expand their infrastructure. IIWC/FEA also says that ratings agencies have lumped the water and gas industries together for credit quality forecasting purposes. IIWC/FEA asserts that gas and water companies have similar infrastructure investment in a system that consists of pipes and mains used to distribute their gas and water.

IIWC/FEA also claims gas utilities may be somewhat riskier in that they face significant commodity cost recovery risk which water utilities do not have. According to IIWC/FEA, IAWC's proxy group argument in this case contradicts its argument in its last rate case that the use of both a water proxy group and a utility proxy group helps to measure a reasonable return. In IIWC/FEA's view, the use of a gas proxy group to assist in the measurement of IAWC's required return on common equity is reasonable. IIWC/FEA says Mr. Gorman used a gas proxy group in his analyses in Docket No. 09-0319 and the Commission found his analyses, together with those of the Staff, to be generally sound. (IIWC/FEA RB at 7-8)

IAWC claims that Mr. Gorman's DCF analyses are flawed primarily because the results of his constant growth DCF model are premised on the mistaken belief that the projected growth in the GDP constitutes the high end growth rate for a utility. IIWC/FEA responds that IAWC is missing an important point that both IIWC/FEA witness Gorman and Staff witness Freetly found in both this case and in IAWC's last case. According to IIWC/FEA, the three- to five-year growth projections made by security analysts may not be appropriate for the constant growth DCF model, if those three- to five-year growth rates are not reasonable estimates of long-term sustainable growth as required by the constant growth model. (IIWC/FEA RB at 8)

IIWC/FEA indicates that IAWC also argues that Mr. Gorman's sustainable growth DCF methodology is flawed because it is based on three-five year projections from Value Line. IIWC/FEA contends that the reliability of the sustainable growth DCF model largely depends on whether or not the parameters used in that model reasonably reflect investor growth outlooks. IIWC/FEA says Value Line is a source used by all parties in this proceeding in cost of capital studies. IIWC/FEA believes that Value Line's projections of the sustainable growth parameters out over the next three to five years are reasonable measures of parameters that will influence investors and it is reasonable to believe that they do reflect investor growth outlooks. IIWC/FEA asserts that while the sustainable growth model may not be appropriate on its own, it is appropriate to support the estimates made by multi-stage growth DCF analyses using security analysts' growth projections. (IIWC/FEA RB at 9)

IIWC/FEA indicates that IAWC is also critical of Mr. Gorman's capital asset pricing model. It specifically says the CAPM is flawed for three reasons. First, the derivation of the market equity risk premium is incorrect. Second, the forward-looking risk premium is not really a prospective equity risk premium. Third, Mr. Gorman failed to use the ECAPM in addition to the traditional CAPM. (IIWC/FEA RB at 10)

IIWC/FEA responds that IAWC's estimate of the market risk premium is not reliable and is overstated. According to IIWC/FEA, its use of a market risk premium that substantially over-estimates investor expectations does not produce a reliable or meaningful CAPM return estimate. IIWC/FEA also maintains that IAWC provided little to no credible support that Mr. Gorman's use of historical data to derive investors' outlooks of the future is without merit. IIWC/FEA asserts that Mr. Gorman's use of a risk premium type methodology to make projections of market outlooks for expected returns on the market is reasonable. IIWC/FEA believes IAWC's apparent reliance on only a DCF method of estimating the market's forward-looking required return contradicts its own studies in this case attempting to estimate a utility-required return using both DCF and risk premium methodologies. In IIWC/FEA's view, IAWC's arguments on a market risk premium methodology are without merit. (IIWC/FEA RB at 10)

4. Conclusions

Evidence regarding IAWC's cost of equity was provided by IAWC, Staff, and IIWC/FEA. IAWC witness Ms. Ahern recommended a return on equity of 11.25% based on constant-growth DCF, risk premium, CAPM, and ECAPM analyses applied to a sample of water utilities.

Staff witness Ms. Freetly recommended a return on equity of 9.42% based on DCF and CAPM analyses applied to a sample of water utilities as well as a utility sample.

IIWC/FEA witness Mr. Gorman recommended a return on common equity for IAWC of 9.3% based on DCF and CAPM analyses applied to a sample of water utilities and a sample of gas utilities.

Composition of Samples

IAWC takes issue with the IIWC/FEA's use of a gas sample and Staff's use of a utility sample. IAWC alleges that water utilities face unique investment risks that are different than other types of utilities. IIWC/FEA responds that water and gas utilities are similar in risk, noting that S&P typically combines the two types of utilities in industry report assessments to investors. Staff also contends that there are similarities among all regulated utilities. Staff believes that its quantitative approach to selecting samples ensures that the firms in its samples are similar in risk to the target company, in this case IAWC.

On one level, the Commission believes that IAWC is correct that the water industry is different than other regulated industries. It is not clear; however, that the water industry is so different from the electric and gas industries that a sample of firms in those industries could not have similar risk to IAWC. Given the relatively small number of firms that make up the water industry, it is plausible that a sample from the gas or electric industry might be more similar to a target water utility than a sample from the water industry. In fact, it is not unusual for expert witnesses to utilize firms from another utility industry in estimating the required return on equity in proceedings before the Commission. In Docket No. 11-0436, it appears the water utility's expert used both a water sample and a gas sample in estimating the required return on equity for a water company.

In this proceeding, the record suggests that IIWC/FEA and Staff have done rigorous analyses in an effort to identify firms in the electric and gas industries that are similar in risk to IAWC. The Commission concludes, IAWC's arguments notwithstanding, that IIWC/FEA and Staff have adequately demonstrated that their samples are reasonably similar in risk to IAWC and can be used as proxies in estimating IAWC's cost of common equity.

DCF Analyses

As explained by Staff, a DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments to the holders of that stock. Staff witness Ms. Freetly employed a non-constant growth DCF (“NCDCF”) model that reflects a quarterly frequency in dividend payments.

IAWC insists that a constant-growth DCF model must be used in estimating the return on equity for water utilities because the industry is mature.

Both IIWC/FEA and Staff disagree, arguing that in some circumstances a non-constant DCF model should be used. They believe that in the current situation, three to five-year analyst growth rates are not sustainable; therefore, it is necessary to use a non-constant DCF model to produce reliable cost of equity estimates for IAWC.

Staff and IIWC/FEA argue that in the long run, it is not possible for any firm to grow at a rate higher than GDP. IAWC claims there is no empirical evidence that water utilities will grow at the growth rate of the U.S. economy. IAWC says that for approximately the last 10 years, utilities have experienced greater than average growth. IAWC believes rate of return analysts should rely on analyst growth rates because that it what investors rely on.

It appears to the Commission that an important element of IAWC's position is that water utilities have experienced growth greater than the rate of growth in GDP over the last decade and that investors rely on analysts' forecasts of growth. IAWC's position is based in part on the notion that the recent past is an indicator of what may happen in the future over the long term. The Commission is concerned that such a view, which suggests that realized growth is an appropriate proxy for expected growth, is shortsighted.

Neither Staff nor IIWC/FEA disagree that rate of return analysts should rely on analysts growth rates; however, both use them as proxies for the short-term growth rates in their non-constant DCF analyses. It appears to the Commission that IAWC's position simply ignores the possibility that these analysts' growth expectations are not sustainable in the long run. In this proceeding, the record supports a conclusion that short-term analysts' forecasts of growth are not sustainable. As a result, given the circumstances present here, the Commission finds that it is appropriate to rely on a non-constant DCF model in estimating IAWC cost of common equity. As for the long-term growth rate, the Commission notes that it has utilized estimates of GDP as a proxy for long-term growth in some previous proceedings. The record here supports the conclusion that estimates of future GDP are a reasonable proxy for long-term growth.

IAWC also takes issue with IIWC/FEA's sustainable growth methodology. Among other things, IAWC claims that the method is circular, relying on expected returns on book common equity, which is then used to establish a common equity cost rate related to the market value of the common stock which, if authorized, will become the expected ROE on book common equity. IAWC also suggests the sustainable growth ignores that the market return on common equity authorized in this proceeding will be applied to book value rate base.

The Commission notes that in establishing the market required return on common equity, it does not typically rely on the sustainable growth methodology. As IAWC suggests, establishing the authorized return on equity by relying on forecasts of the return on equity as one input in the model appears to be circular. The Commission concludes that the record does not support of the use of the sustainable growth method in this proceeding.

CAPM Analyses

The witnesses for all three parties undertook CAPM analyses. As explained by Staff, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market.

Rather than rely on spot Treasury yields for the risk-free parameter as Staff has done, IAWC believes it is better to rely on forecasts of Treasury yields. While acknowledging that the Commission relied on spot data in Docket No. 09-0319, IAWC contends the issue is not settled and argues that Staff's overall approach is unsound.

To the extent IAWC suggests that a decision in this proceeding must be based on evidence of record, the Commission agrees. It is also important, however, that there be some rationale for reaching a conclusion that deviates from the Commission's past practice. With regard to the use of spot yields, the Commission believes the Staff proposal is better supported by the record and past Commission treatment of the issue.

IAWC argues that IIWC/FEA's historical market equity risk premium is improperly calculated using a "current" total long-term return on government bonds rather than an "historical" total long-term return on long-term government bonds. IAWC argues, and the Commission agrees, that IIWC/FEA's forward-looking market equity risk premium is not truly forward-looking because it relied on historic real market returns rather than a projected total market return.

Staff complains about the use of historical data in IAWC's estimate of the equity risk premium in the CAPM. IIWC/FEA takes issue with one of IAWC's estimates of the market risk premium used in its CAPM. IIWC/FEA believes the 12.40% growth rate and associated 14.39% market return are overstated and cannot be sustained in the long-run. As the Commission understands it, IAWC produced two estimates of the market risk premium which were averaged to produce its CAPM results. It appears that one of the estimates relies heavily on historical return data, a practice that the Commission believes is less reliable in estimating a forward looking cost of equity. The suggestion that historical earned returns reasonably represent expected future returns is not convincing.

With regard to IAWC's second market risk premium, IIWC/FEA correctly points out that it suffers from the same shortcoming as IAWC's DCF analysis. The Commission finds that IAWC's market risk premium relies on a growth rate that is significantly higher than projected GDP growth rate and is unsustainable. The Commission concludes that IAWC's CAPM is not sufficiently reliable and should not be used for purposes of this proceeding.

ECAPM Analysis

IAWC's witness relied on the ECAPM and insists that Staff and IIWC/FEA should have utilized the ECAPM in estimating the cost of common equity. Staff and IIW/FEA object to IAWC's ECAPM analysis primarily because IAWC relied upon adjusted betas in implementing the ECAPM.

The Commission cannot recall a proceeding in which it relied upon the ECAPM in establishing the cost of common equity for a utility. In the instant proceeding, the record supports a finding that use of adjusted betas in the ECAPM is inappropriate. As Staff witness Ms. Freetly explained, by using adjusted betas she already effectively transformed her Traditional CAPM into an ECAPM. Therefore, including an additional beta adjustment in the ECAPM model would result in inflated estimates of the samples' cost of common equity. (Staff Ex. 14.0 at 16-17)

Risk Premium Model

Other than CAPM analyses, only IAWC conducted a risk premium analysis in this proceeding. The IIWC/FEA witness indicated that he would normally rely on the risk premium model, but did not do so in this proceeding because the Commission has consistently rejected this approach. In response to IAWC's RPM analysis, IIWC/FEA asserts that IAWC's reliance on projected bond yields is inappropriate because it significantly exceeds currently observable utility bond yields. IIWC/FEA also takes issue with one of IAWC's equity risk premium estimates. Among other things, IIWC/FEA argues that it improperly uses beta to measure a risk premium over a corporate bond yield, not a risk-free rate. IIWC/FEA claims that a corporate bond yield includes systematic market risk which should be adjusted by beta to arrive at a utility-adjusted common stock risk premium, not a market equity risk premium.

As suggested by IIWC/FEA, the Commission does not typically rely on the risk premium model to establish the cost of common equity in rate proceedings and believes that the record does not support a change in this proceeding. In addition, the Commission believes that IIWC/FEA has identified flaws in IAWC's risk premium analysis, including its use of betas as a measure of risk premium over corporate bond yield rather than over a risk-free rate, indicating that IAWC's risk premium analysis should not be relied upon in this proceeding.

IAWC Specific-Risk Adjustment

IAWC believes an upward adjustment should be made to the results of the cost of equity analyses performed on the sample of water utilities. IAWC asserts that it has financial risk and unique business risk relative to its water proxy group that justifies a 25 basis point upward adjustment to the results of its cost of equity analyses. In its direct testimony, IAWC relied exclusively on the informed judgment of its expert witness for its proposed investment risk adjustment. In its rebuttal testimony, IAWC's witness presented a quantitative analysis relating to the relative size of IAWC compared to its proxy group.

Staff notes that IAWC proposed a similar upward adjustment in Docket No. 09-0319 which was not adopted by the Commission. Staff recommends the Commission reject IAWC's proposal in this case. Both Staff and IIWC/FEA suggest that the risk factors to which IAWC refers are not really unique and are already incorporated in IAWC's cost of equity analysis for its proxy group.

The Commission finds that the record does not demonstrate a higher relative risk of IAWC relative to the proxy group. IAWC's proposed adjustment should not be adopted.

Flotation Cost Adjustment

IAWC proposed to include, in the cost of common equity, a flotation cost adjustment of 16 basis points. The Commission notes that IAWC explained the basis for and quantified its proposal in direct testimony. The record demonstrates that IAWC's proposed flotation cost adjustment is based upon information relating to flotation costs incurred by firms in IAWC's proxy group, not IAWC or its parent company.

There is no information in the record that indicates that IAWC or its parent company has incurred flotation costs that were not previously recovered. The Commission concludes that IAWC's proposed flotation cost adjustment will not be adopted.

Revenue Adjustment Clause Adjustment

Staff argues that, in the event the proposed RAC is approved by the Commission, IAWC's cost of common equity should be reduced to reflect the reduction in risk face by IAWC. IAWC argues such an adjustment is not necessary and that even if the proposed RAC were approved, it is not possible to reasonably estimate the impact on cost of equity.

Because the Commission will not approve the proposed RAC in this proceeding it is not necessary to address this issue in detail here. The Commission notes, however, that the purpose underlying the proposed RAC is to decouple utility revenues from sales. The suggestion that such a proposal would not reduce the risk of investing in a utility is difficult for the Commission to accept and the record in this proceeding would not support such a finding.

Authorized Return on Common Equity

As always, estimating the cost of common equity is one of the more challenging tasks the Commission undertakes in a rate case. The differences of opinion of experts, the variety of financial models, and the many different methods of estimating inputs for the variables into the financial models contribute to the difficulty. The Commission has attempted to review all of the evidence as well as the arguments in this proceeding in a careful and thoughtful manner. The preceding portion of this order constitutes an attempt to summarize and articulate much of that review.

All things considered, the Commission believes that in estimating IAWC's cost of common equity for purposes of this proceeding, the non-constant DCF analyses performed by Staff and IIWC/FEA may be relied upon. For the reasons stated earlier, the Commission does not believe that the other DCF analyses presented, whether due to fundamental problems with the model or inputs thereto, should be relied upon in this proceeding. With regard to the CAPM, the Commission concludes that only Staff's CAPM analysis should be relied upon in this proceeding. The Commission finds that the remaining analyses, including the ECAPM and risk premium analyses, should not be used for reasons stated above.

The table below shows the Commission's derivation of the authorized return on common equity for IAWC in this proceeding, 9.34%.

Authorized Return on Common Equity

	DCF		CAPM	
Staff	8.53%	9.19%	9.22%	10.44%
IIWC/FEA	8.70%	8.95%		
Average	8.84%		9.83%	
Authorized	9.34%			

The Commission notes that the previous discussion addresses IAWC's proposed adjustments to the cost of common equity and that IIWC/FEA did not propose any such adjustments. The Commission has reviewed Staff's evaluation of IAWC's risk relative to the proxy groups it used. While Staff made adjustments to the results obtained for its proxy groups, its analyses and proposed adjustments reflected its proposed capital structure, which was not adopted by the Commission. The Commission does not believe that any additional adjustment to the 9.34% cost of common equity is appropriate or necessary.

Before leaving the issue of return on equity, the Commission notes that in its Initial Brief, IAWC suggested the Commission could set the return on equity at the 10.38% authorized in Docket No. 09-0319. The Commission observes that while some factors or variables in the ratemaking process tend to be stable over time, the cost of common equity is not. A number of factors, some specific to a utility others more generally applicable in the economy, vary over time and cause the cost of common equity to vary over time. The Commission is required to evaluate the evidence in the record and while previous Commission decisions may be useful in some instances, the Commission declines to adopt the suggestion in IAWC's brief.

Authorized Return on Rate Base

As discussed previously in this Order, IAWC's cost of short-term debt and long-term debt are not contested. Reflecting these costs of debt, as well as the previous determinations regarding capital structure and cost of common equity, the Commission concludes that for purposes of this proceeding, IAWC should be authorized to earn a 7.56% rate of return on original cost rate base as shown in the table below and reflected in the appendices to this Order.

	Approved Proportion	Cost	Weighted Cost
Short-term debt	1.30%	0.52%	0.01%
Long-term debt	50.60%	6.04%	3.06%
Common equity	48.10%	9.34%	4.49%
Total	100.00%		**7.56%**

VIII. COST OF SERVICE STUDY

IAWC used the Base-Extra Capacity Method in its COSS. Costs were allocated to "basic functional cost components," which were identified as base costs, extra capacity costs, customer costs and direct fire protection costs. The next step entails the distribution or allocation of component costs to the various customer classes to reflect the cost of serving those classes. (Staff Ex. 4.0 at 16-17)

Staff states that IAWC's use of the Base-Extra Capacity Method in its COSS shows that currently, most customer classes provide revenues that generally reflect the underlying costs. Staff considers the Base-Extra Capacity approach appropriate for ratemaking in this case, noting its acceptance by the Commission in prior cases and by the American Water Works Association. (Staff IB at 56)

The Commission concludes that the Base-Extra Capacity Method approach is supported by the record, and is acceptable for use in this proceeding.

A. Direct Demand Study

At the Commission's direction, IAWC presented a direct demand study to measure and update the demand factors to be used in the cost of service study filed in the current proceeding. (Staff Ex. 5.0 at 12-15).

Staff does not contest IAWC's direct demand study report ("Demand Study"). Although IAWC's Demand Study only has one season of updated direct data, Staff notes that it is the most updated data available to use in this proceeding and is an improvement over the data IAWC has used over the past 10 years in its cost of service studies. Staff says the Demand Study has been completed based on the Commission's requirements in Docket No. 09-0319 and the results have been verified through two models. (Staff IB at 55)

Staff found the samples of customers who participated in the demand data collection process to be representative of the IAWC customer classes in each district. Staff reviewed the procedures used to collect the hourly usage data for input into the Demand Study and found the method to be reasonable for updating information on customer usage profiles. (*Id.*)

Staff recommends the demand factors be used as an input to the cost of service study as IAWC has proposed. Staff also recommends that the Commission direct

IAWC to assume control of the demand data collection and the incorporation of the new demand data collected into its future cost studies. Staff believes this should be an ongoing process where data is updated automatically in the future to avoid repeating IAWC's previous problem of using outdated information for the demand factors in its cost of service study. (Staff IB at 56)

Upon reviewing the record, it appears that no party takes issue with IAWC's direct demand study report or the inclusion of the results of that study in IAWC's cost of service study. As a result, for purposes of this proceeding, the Commission finds that including the results of IAWC's demand study report in the COSS is reasonable.

Additionally, the Commission finds Staff's recommendation for IAWC to assume control of the demand data collection and the incorporation of the new demand data collected into its future cost studies to be reasonable. The Commission concludes that IAWC should routinely update such data for future rate cases to ensure the most current demand factors are reflected in its cost of service studies.

B. LOWU Contracts

There is a dispute between IAWC and IIWC/FEA about how Large Other Water Utility (“Large OWU”) Service contracts should be treated in the COSS. As the Commission understands it, IAWC’s direct testimony included both the costs and the revenues associated with Large OWU contracts in its COSS, essentially treating Large OWU contracts as a separate customer class. In its rebuttal testimony, it appears that IAWC essentially eliminated the Large OWU contracts as a separate customer class. This was accomplished by allocating costs across the remaining, non-Large OWU, customer classes. The revenue from the Large OWU contracts was classified as Other Water Revenue and allocated across those same remaining customer classes.

1. IAWC's Position

IAWC says it revised its Cost of Service Study (“COSS”) to remove the allocation of contract customer costs for the combined Zone 1 and Chicago Metro service area. By removing these customers, IAWC indicates it then classified contract customer revenue as Other Water Revenue, and allocated this revenue across the remaining tariff customer classes, thus reducing the cost of service for those classes. IAWC believes this change more accurately reflects the benefits of contract customers and appropriately allocates the benefit of having contract customers in IAWC’s system. IAWC also asserts that showing the full cost to serve contract customers in the COSS is effectively an exercise in futility as contract rates are less than full-tariff rates. (IAWC IB at 96-97; IAWC RBOE at 27)

IAWC states that although removing contract customer more accurately portrays reality, IIWC/FEA disagree with the COSS revision. By removing contract customers, IIWC/FEA believe the COSS distorts the allocation of costs to the remaining customer classes and raises the possibility of other customers subsidizing contract customers’ cost of service. IIWC also claims that the revised COSS allocates an addition $2.3 million in costs to Zone 1. (IAWC IB at 97)

IAWC believes any concern of other classes subsidizing contract customers is unfounded. IAWC contends that because the contract customers' revenue exceeds the incremental costs to serve these customers, the contract customers are contributing towards the fixed costs of the system, as is reflected in the revised COSS. IAWC claims these incremental costs include the short-term variable costs of power and chemicals. IAWC asserts that IIWC's concerns that Zone 1 was allocated $2.3 million in costs mistakes additional costs for the same level of revenue applied to Zone 1. In response to IIWC-3.1, IAWC says it allocated the same level of costs to the Zone 1 stand-alone COSS as it did to the direct COSS. IAWC asserts, however, that the data request used the consolidated Zone 1 and Chicago Metro revenues. Because of this disparity, IAWC believes IIWC incorrectly perceived an additional $2.3 million cost allocation. IAWC insists that its revised COSS, as supported by Mr. Herbert, correctly reflects the cost to serve IAWC's customers and accurately reflects the reality of recovering those costs. (IAWC IB at 97-98)

IAWC states that the Large OWU Service class comprises customers with contracted rates. According to IAWC, because these customers have contracted rates, their rates cannot be raised outside the terms of the agreement. IAWC says that irrespective of these Commission-approved contractual obligations, IIWC/FEA recommend unilaterally raising this class's rates to recover the full cost of service. IAWC claims IIWC/FEA's recommendation creates an inaccurate and unreliable rate design.

IAWC asserts that increasing contract customer rates beyond the terms of contract is an attempt by IIWC/FEA to artificially increase revenue received by IAWC that will never be recovered from Large OWU customers. IAWC states that most Large OWU contracts include provisions for annual increases that were built into its future test year projection of current revenues. IAWC says an example of such a contract provision is contained in the confidential exhibit to Mr. Herbert's surrebuttal testimony. IAWC argues that because it correctly allocated revenue to these customers after reviewing their contracts, the Commission should adopt IAWC's rates. (IAWC IB at 105-106)

In its Reply Brief, IAWC claims that IIWC/FEA misunderstands Mr. Herbert's testimony and the revised COSS. IAWC insist that to the extent Large OWU contracts include provisions for annual increases, the most recent annual increases are built into IAWC's future test year projection of current rate revenues. According to IAWC, the Large OWU revenue in the "Revenues, Present Rates" column shown in the COSS, whether separately in IAWC Exhibit 11.01 or redistributed in IAWC Exhibit 11.03R, has the most recent annual increases built into this number. IIWC/FEA has not provided any evidence to show that this amount was not properly reflected. (IAWC RB at 68)

IAWC also contends that IIWC/FEA's criticism of its revised COSS misses the forest for the trees. IAWC claims it restated its COSS because Commission-approved

Large OWU contracts dictate the terms of any price increase and rates cannot be raised beyond limits on rate increases authorized in the contracts. IAWC asserts that allocating costs to this class by assuming an artificial increase not contemplated in the Large OWU contract for purposes of designing rates creates an inaccurate and unreliable rate design. IAWC suggests that even though the full cost to serve these customers was included in the original COSS, this has little value since it is known that the contract rates are less than the full-tariff rates, which is why contract rates exist. (IAWC RB at 68-69; IAWC RBOE at 27)

2. IIWC/FEA's Position

IIWC/FEA states that IAWC modified the treatment of contract customers in its class cost of service study. According to IIWC/FEA, in its direct case, IAWC recognized contract customers as a class of customers in its class cost of service study. IIWC/FEA says that in its rebuttal case, even though no party objected to its treatment of contract customers in direct, IAWC made a significant modification by eliminating contract customers from its Class Cost of Service Study (“CCOS”) study, and classified the revenue paid by these customers as a component of “Other Water Revenue.” IIWC/FEA indicates that this Other Water Revenue was then allocated across all remaining tariff classes to reduce the cost of service for those classes. (IIWC/FEA IB at 35-36, RB at 11)

According to IIWC/FEA, IAWC states to the extent Large OWU Service contracts include provisions for annual increases, the most recent annual increases are built into IAWC’s future test year projection of current rate revenues for the Large OWU class. IIWC/FEA contends that based on IAWC’s future test-year projection contained in its CCOS for the Large OWU class, it would seem that all the Large OWU contracts prevent any kind of increase to the rate. IIWC/FEA asserts that IAWC has assumed no increase in the revenues for this class. In IIWC/FEA's view, this would seem to contradict Mr. Herbert’s testimony, or suggest that the entire Large OWU Class has a provision in their contracts preventing any type of rate increase. IIWC/FEA believes IAWC has not sufficiently provided proof on whether the entire class should be exempt from an increase, or whether the class revenues will increase by virtue of the price increase provisions within the contracts. (IIWC/FEA IB at 36, RB at 26)

IIWC/FEA claims this exclusion is in contrast to these customers’ inclusion in the CCOS in IAWC’s last rate case. IIWC/FEA contends this exclusion distorts the allocation of total IAWC costs to all remaining classes and skews IAWC’s estimate of its cost of service for the remaining customers. As a result of the Large OWU removal, IIWC/FEA claims IAWC's rebuttal CCOS study provides no indication as to what the actual cost of service is to serve these customers. IIWC/FEA also contends that the rebuttal CCOS provides no indication as to whether any cost subsidies are being provided to the Large OWU Class. IIWC/FEA believes those customers should remain included in the CCOS and their rates should be brought to cost of service. According to IIWC/FEA, cost of service would result in an increase for the Large OWU Class of $2,904,327. (IIWC/FEA IB at 36-37, RB at 26-27)

In its Reply Brief, IIWC/FEA contends that IAWC's significant modification of its direct case cost of service study, offered in its rebuttal case, is significantly flawed and should be rejected. IIIWC/FEA insists that IAWC's arguments are erroneous and do not support this substantial modification to its direct case class cost of service study. IIWC/FEA states that while IAWC's class cost of service study offered in its direct case contains some errors, it was largely uncontested. (IIWC/FEA RB at 11-12)

While IAWC claims that its modification more accurately reflects the benefits of contract customers and allocates those benefits across other classes, IIWC/FEA believes this is erroneous. IIWC/FEA says that IAWC's modified cost of service study does not directly measure the benefits and costs of contract customers; IIWC/FEA argues its rebuttal COSS simply pretends these customers do not exist. (IIWC/FEA RB at 12)

IIWC/FEA contends that in its rebuttal COSS, IAWC ignored contract customers' base load and extra capacity loads on the system, and therefore did not accurately measure the base and extra capacity loads of all customers on the system. In IIWC/FEA's view, because IAWC's measurement of its customers' actual test year loads was flawed, its cost allocation was biased and unreliable. Without accurately estimating its cost of providing service to its remaining customers, IIWC/FEA claims it could not then properly measure the benefits and costs associated with retaining contract customers on the system via discounted prices.

According to IIWC/FEA, the cost and benefits of contract customers were accurately measured by IAWC in its direct case COSS. In its direct case COSS, IIWC/FEA says IAWC did allocate its costs across all customers based on all customers' base and extra capacity demands on the system. IIWC/FEA asserts that at that point, the determination could be made as to how much discount is offered to contract customers, because the cost to serve other classes was reasonably measured, and the allocation of discounts was transparent. It is IIWC/FEA's view that this direct-case COSS more properly measures the direct incremental cost other customers must pay to retain the benefit of contract customers on the system. IIWC/FEA contends IAWC's modification to its cost of service study in rebuttal makes this determination of costs and benefits non-transparent and inexact, because the cost to serve all customers is not properly and accurately measured. (IIWC/FEA RB at 13)

IIWC/FEA argues that this is true because in rebuttal, IAWC at no point accurately measured its cost of service for full tariff rate customers before it allocated the discount offered to contract customers. IIWC/FEA believes there is no way to measure the actual allocation of the contract customer discount to other classes of customers. IIWC/FEA also believes there is no way to determine whether or not the reallocation of the discount to contract customers to full tariff customers is just and reasonable and ensures that all customers receive an allocated share of the benefit associated with contract customers. (IIWC/FEA RB at 13)

IIWC/FEA also contends there is no way to determine how much, if any, benefit contract customers provided to the system based on IAWC's rebuttal cost of service study. IIWC/FEA asserts the variable cost of providing service to all customers, including contract customers is not directly measured by IAWC in its rebuttal case. IIWC/FEA claims the IAWC rebuttal case excludes base volume and, therefore, does not accurately measure its variable costs. IIWC/FEA states that "the amount of economic contribution the discount customers make to the system is clearly defined under the revised rebuttal cost of service study. The same is not true under the traditional COSS IAWC offered in its direct case." (IIWC/FEA RB at 13-14)

IIWC/FEA also suggests that IAWC's significant change in its cost of service resulted in a substantial allocation of $2.3 million for Zone 1 without any change in customer makeup or load profiles. IIWC/FEA says IAWC claims that IIWC/FEA mistake the addition of $2.3 million in cost for the same level of revenue applied to Zone 1. IIWC/FEA insists that claim is without merit. According to IIWC/FEA, the problem with IAWC's rebuttal cost of service study is allocation of costs between customer classes, not the revenue produced from the customers. IIWC/FEA says it is not a matter of identifying additional revenue available for the Chicago Metro area to serve Zone 1. Rather, IAWC's "rebuttal cost of service did not accurately measure cost of service to Zone 1 customers, therefore, it is not possible to determine whether or not Zone 1 customers' rates already fully recover IAWC's test year cost of service." (IIWC/FEA RB at 14) IIWC/FEA claims IAWC's "distortion of combining the cost of service studies for the two zones into a single zone" produced an inaccurate and variable cost of service estimate for both zones. IIWC/FEA believes use of IAWC's rebuttal COSS should be rejected, and use of the COSS presented by IAWC in its direct testimony should be approved. (IIWC/FEA RB at 14; BOE at 5-8)

In its BOE, IIWC/FEA urges the Commission to find "the direct case COSS study to be more transparent and consistent with what the Company did in its last rate case." (IIWC/FEA BOE at 8)

3. Conclusion

There is a dispute between IAWC and IIWC/FEA about how Large OWU Service contracts should be treated in the COSS. As the Commission understands it, IAWC's direct testimony included both the costs and the revenues associated with Large OWU contracts in its COSS, essentially treating Large OWU contracts as a separate customer class. In its rebuttal testimony, it appears that IAWC essentially eliminated the Large OWU contracts as a separate customer class. This was accomplished by allocating costs across the remaining, non-Large OWU, customer classes. The revenue from the Large OWU contracts was classified as Other Water Revenue and allocated across those same remaining customer classes.

IAWC contends that treating Large OWU contracts as it did in its rebuttal testimony better reflects reality. Among other things, IAWC claims that because Large OWU customers have competitive water supply alternatives, contracts are intentionally priced below the cost of service. IAWC also argues that neither it nor the Commission can increase the prices charges outside the provisions contained in the contracts.

IIWC/FEA objects to the treatment of Large OWU contracts in IAWC's rebuttal testimony COSS. IIWC/FEA believes that the manner in which IAWC treated Large OWU contracts in its direct testimony COSS is superior and consistent with how Large OWU contracts were treated in IAWC's last rate case. IIWC/FEA believes the approach in IAWC's direct testimony is more transparent and more accurately reflects the cost of service. Among other things, IIWC/FEA asserts that IAWC has failed to demonstrate that prices charged to Large OWU contracts cannot be increased. IIWC/FEA also suggests that prices to Large OWU contracts should be increased.

The Commission observes that customers who are parties to the Large OWU contracts at issue here are customers with competitive water supply options who are provided utility service at a price below the embedded COS because other customers benefit when such customers pay more than the incremental cost of providing service and do not abandon the utility.

Additionally, while the Commission has authority over utility rates and tariffs, the question of whether the Commission should modify the prices in an existing contract and potentially cause the loss of Large OWU contract customers is a difficult one, particularly where, as here, the LOWU issue arose relatively late in the case and was only addressed by two parties. As indicated above, IAWC represents that the contracts in question were approved by the Commission, and there do not appear to be any contentions to the contrary. To the extent questions are raised in future dockets regarding whether or in what manner the contracts or rates are approved by the Commission, those and related issues can be explored at that time.

According to IIWC/FEA, IAWC's rebuttal COSS pretends that these customers do not exist. This assertion is not completely correct. While it is true that IAWC's rebuttal COSS spreads the costs caused by Large OWU contracts over remaining customers, the Commission observes that IAWC's approach also reduces the revenue required from the remaining customers by treating the revenue Large OWU contracts as Other Water Revenue. The Commission does believe, however, that IIWC/FEA's suggestion -- that fundamentally, the COSS should focus solely on cost -- has some validity. In that regard, simply disregarding IAWC's direct testimony COSS would not be useful.

As a practical matter, neither approach is perfect. Under either one, Large OWU contracts should always pay more than the incremental cost of providing service and should not be expected to pay the full embedded cost of service they impose on the utility. As a result, under both approaches, even though remaining customers will pay in excess of their embedded cost of providing service, they benefit to the extent Large OWU make a contribution to the recovery of fixed costs.

Thus, the Commission finds that for purposes of this proceeding, giving consideration to both IAWC's direct testimony COSS as well as its rebuttal testimony COSS will have some value.

The Commission also finds that to the extent IIWC/FEA's recommendation is to bring the Large OWU contract customers' rates to the full COSS identified in IAWC's direct testimony COSS, it is not reasonable and should be rejected. Such an action would be problematic on many levels, including the potential for severe adverse impacts on remaining customers in future rate cases. In its BOE, IIWC/FEA indicated that "for the purpose of narrowing the issues, IIWC/FEA do not take exception to the Proposed Order's failure to move the LOWU class to cost of service in this case." (IIWC/FEA BOE at 5)

If IAWC's next rate filing reflects cost service in the manner shown in its rebuttal filing, it should also provide schedules that reflect COS in the manner shown in its direct testimony filing.

IX. RATE DESIGN

As discussed above, IAWC performed a COSS to functionalize, classify and allocate costs to each of its customer classes. Rates within each class are designed to recover class revenues, and consist of fixed customer charges that vary by meter size, unit rates that are based on customer usage levels, and fire protection charges.

A. Customer Charges

1. IAWC's Position

IAWC states that it proposes, based on its cost of service study, that customer charges be set at a level to recover the full amount of fixed customer costs. IAWC says these costs include meter reading, customer billing, customer accounting, allocable portion of administrative and general expenses, and other customer-service-related functions. (IAWC IB at 99)

According to IAWC, as a matter of policy, the Commission has consistently supported the recovery of a greater portion of a utility's fixed costs through the customer charge across all types of utility service. IAWC says the Commission has stated this policy in IAWC's previous two rate cases. IAWC asserts that pursuant to these policy directives, it proposes to recover all customer costs through customer charge and make all customer charges uniform across the state, except for the Chicago Metro and Lincoln 5/8-inch meter customer charges. IAWC says its proposed customer charges will recover IAWC's fixed costs incurred to serve all customers, regardless of use or physical customer location. (IAWC IB at 99-100)

IAWC states that although its proposed customer charges move it towards the goals set forth in the Commission's prior orders, other parties claim that the proposed customer charges over-recover customer costs. Staff claims that the over recovery is due to IAWC setting rates for the 5/8-inch meter without regard to the revenues that Customer Charges for meter sizes larger than 5/8 inch would generate. Staff also faults IAWC for increasing its customer charges for meters larger than 5/8 inches at different meter ratios, or meter equivalents, than the AWWA meter factor approach. IAWC also notes that the AG criticizes its proposed customer charges for failing to use meter equivalents to calculate the service cost and billing and collection cost per meter. (IAWC IB at 100-101)

IAWC argues that its proposed customer charges represent a balanced approach to recover customer costs. IAWC says it designed the cost-based 5/8-inch customer charge to fully recover those customers' costs since 92% of residential customers have 5/8-inch meters. IAWC suggests that to look to 8% of residential ratepayers to subsidize the recovery of costs to serve 5/8-inch meter customers is contrary to the basic regulatory principle of cost causation. IAWC also asserts that an over-recovery for meters larger than 5/8-inches is based on the calculation of larger meter charges using the meter capacity ratios (or meter equivalents). IAWC believes the Commission should not set a precedent of allowing the majority of residential ratepayers to forego paying their cost of service. (IAWC IB at 101)

IAWC describes the AG's proposal "one-size-fits-all" approach. IAWC insists it correctly applied the appropriate ratio for each category of costs. IAWC says it applied the "meter equivalents" to the 5/8-inch meter cost to determine the larger meter cost by size. IAWC also says it applied the "service equivalents" to the 5/8-inch service costs to determine the service cost by meter size. IAWC claims it did not use any equivalents to increase the billing and collection costs by meter size because IAWC's cost to bill a 4-inch customer is the same as a 5/8-inch customer (i.e. it is a 1:1 ratio for meter to billing costs, for 5/8-inch meters to 10-inch meters). IAWC contends that applying "meter equivalents" to non-meter costs of the customer charge is effectively using a "hypothetical ratio" to artificially depress the customer charge. (IAWC IB at 101-102)

IAWC asserts that the meter equivalent methodology it used also conformed to the methodology used in its last rate case. IAWC says it increased the existing customer charges by a uniform percent consistent with the relationship among the meter sizes. IAWC states that for example, the capacity for a 5/8-inch meter is 20 gallons per minute ("gpm") while the capacity for a 4-inch meter is 500 gpm. IAWC says the meter equivalent or meter capacity ratio it used Company was 25, since the 4-inch meter's capacity is 25 times more than the 5/8-inch meter. IAWC insists that utilizing any other methodology, including the AWWA meter factor approach, would be deviate from past IAWC precedent. (IAWC IB at 102, RB at 62)

IAWC argues that to the extent its customer charges over-recover costs for larger meters, such a result would be consistent with the Commission's policy. IAWC believes the Commission should not approve the customer charges proposed by Staff, including the increase of South Beloit's customer charge, or proposed by IIWC/FEA. IAWC contends that these rates are contrary to its cost of service study for customer costs, and are contrary to the Commission-approved methodology used by IAWC. IAWC urges the Commission to look to its precedent and approve its proposed rate design. (IAWC IB at 102)

In its Reply Brief, IAWC asserts that the AG fails to present any evidence supporting deviation from prior precedent, and claims the AWWA meter capacity ratios have not been used by IAWC in its rate cases. According to IAWC, the AG can only claim IAWC would over-collect costs by understating them. IAWC says the AG incorrectly calculated the customer costs associated with each meter class by applying the meter capacity ratios to all customer costs (meter, service, and billing and collection costs). (IAWC RB at 62-63)

IAWC contends the AG should have applied the meter capacity ratios or "meter equivalents" only to the meter costs, and it should have applied the service equivalents to the service costs and no ratios to the billing and collection costs, because these are the same for all meters. IAWC insists that meter capacity ratios should only apply to meter costs since the costs to install service lines vary much less than the cost of the meter and the cost to bill a 4-inch customer is the same as a 5/8-inch customer, not 25 times more. IAWC argues that because the AG failed to apply the correct ratios to the appropriate costs, the AG's costs are understated. IAWC urges the Commission to reject the AG's criticisms and proposed customer charges based on the AG's flawed methodology, and adopt IAWC's proposed customer charges. (IAWC RB at 62-63)

IAWC asserts that Staff's proposal creates a cross-subsidy. IAWC claims any over-recovery produced by its proposed customer charges is due to the use of meter capacity ratios for the larger meter sizes. IAWC asserts that meters larger than 5/8-inches over-recover costs because meter capacity ratios are higher than what actual cost of service ratios would produce. According to IAWC, because the customer charges for meters larger than 5/8-inches collect more revenue than costs, Staff advocates transferring this over-collected amount to the 5/8-inch meter customers. (IAWC RB at 63-64)

It is IAWC's position that Staff's methodology is inherently flawed by cross-subsidizing the 5/8-inch meter customers with revenue from meters larger than 5/8 inches. IAWC says it set the proposed 5/8-inch meter customer charge to recover the customer costs for the 5/8-inch meter size. IAWC believes it is vital for the 5/8-inch meter customer charge to recover the 5/8-inch meter customer costs because 92% of residential customers have 5/8-inch meters. IAWC argues that each customer should pay the appropriate level of customer costs so that intra-class subsidies are avoided. IAWC claims that under Staff's proposal, rates are not cost-based by class meter size. IAWC says Staff would have 5/8-inch meter customers under-recovering their customer costs. (IAWC RB at 64)

IAWC notes that Staff proposes that the Commission reject its use of a uniform percentage to set customer charges for meters larger than 5/8-inches and instead use adopt the AWWA meter factor approach. IAWC says it increased the customer charges for meters larger than 5/8-inches using the same methodology as in IAWC's last rate case. IAWC states that it chose to increase the customer charges by a uniform percentage rounded to the nearest $0.10. IAWC argues that this method would produce reasonable customer charges that were consistent with the AWWA factors and also the customer charges previously approved by the Commission. IAWC contends that the ratios it used are lower than the AWWA meter factors. IAWC states that for example, the ratio used by IAWC to increase its 1-inch meter customer charge was 2.17 versus the AWWA factor of 2.5. IAWC says that although its ratio to increase customer charges is lower, Staff claims its approach is preferable since it approved customer charges using meter ratios in other water companies' rate cases. IAWC claims Staff has not offered persuasive reasons for changing course here. (IAWC RB at 64-65)

IAWC observes that Staff also recommends that the Commission reject IAWC's proposed customer charge for South Beloit customers because it would result in three different 5/8-inch meter customer charges for the consolidated Zone 1 and Chicago Metro district. Staff contends that because these consolidated customers face the same set of costs, the reasonable approach is to develop a single set of rates that apply to all similar customers within the consolidated territory rather than charging them different rates. According to IAWC, Staff cites no testimony supporting the benefits of its proposed charge, and its rationale of a single set of rates for the consolidated district is flawed. IAWC claims Staff's proposed customer charge fails to recover the costs for all 5/8-inch meter customers and thus will require an inappropriate cross-subsidy.

IAWC says that contrary to Staff, its proposed charge uses the existing Zone 1 customer charges which reflect a more gradual increase and should be adopted. IAWC also says it would support consolidating customer charges in the next rate case. IAWC recommends that the Commission use its proposal and adopt what it views as a more reasonable customer charge for the South Beloit Customers. (IAWC RB at 65; IAWC RBOE at 31)

In its Reply Brief on Exceptions, IAWC comments on the AG's argument that the Company-proposed "residential customer charge for all zones should be reduced to reflect that the Commission is reducing IAWC's requested revenue requirement." IAWC states that this suggestion appeared for the first time in BOEs, and that the approach was not utilized in Docket 09-0319. (IAWC RBOE at 30)

2. Staff's Position

Staff's position is explained in its testimony, Initial and Reply Briefs, and Brief on Exceptions. (Staff BOE at 15-22) In Staff's view, IAWC's customer charge calculation methodology is flawed and should be rejected by the Commission. Staff says the revenues the customer charges would generate would allow recovery of significantly greater than 100% of customer costs. IAWC's residential customer charges will recover approximately $3.3 million more than the residential customer costs.

Staff notes that IAWC set the proposed 5/8-inch meter customer charge to recover customer costs for the 5/8-inch meter size without regard to the revenues that customer charges for meter sizes larger than 5/8-inch would generate. IAWC states that the extent to which the larger meter sizes over-recover the customer costs should not affect the customer charge proposed for the 5/8-inch meter. Staff argues that this is improper because ultimately, the goal of rate design is to set rates so that the revenues the rates generate recover the costs to serve each customer class.

Staff urges the Commission to approve its proposed customer charges for the consolidated Zone 1 and Chicago Metro division which its says recovers 99.9% of all customer costs through the customer charge, applies the concept of gradualism and uniformity to all ratepayers of various meter sizes in the proposed consolidated Zone 1-Chicago Metro water division, and conforms to AWWA ratio recommendations for meter sizes greater than 5/8-inch. Staff believes this same Customer Charge approach should be applied as well to the Pekin and Lincoln divisions with the result being that IAWC would recover approximately 100% of customer costs from each water division. (Staff IB at 59-60, RB at 24-25)

Staff notes that IAWC cites the Commission's decisions in Docket Nos. 07-0507 and 09-0319 in support of its proposed customer charges. Staff alleges that IAWC's rate design proposal goes far beyond these directives because $3.3 million of variable costs would be recovered through fixed charges. Staff maintains that the Commission should approve Staff's recommended customer charge calculation methodology so that no more than the full customer cost recovery is attained by IAWC. (Staff RB at 24-25)

Staff believes that IAWC's proposed customer charges for meters larger than 5/8-inch should also be rejected. Staff says IAWC proposes for the charges for meters larger than 5/8-inch increase at a different ratio than is used in the AWWA meter factor approach. Staff advocates that customer charges be based on the AWWA meter factor approach which relates the flow for meters larger than 5/8-inch to that of the volume of flow for a 5/8-inch meter. Staff proposes for equivalent meter ratios expressed in terms of the ratio of related meter capacity for each meter size relative to a 5/8-inch meter size. Staff claims IAWC agrees that this AWWA method is appropriate. Staff believes its approach is preferable in this proceeding, is consistent with the method used to set customer charges in the Commission's Orders in recent Utilities Inc. water cases (Docket Nos. 11-0141, 11-0142, 11-0561, et al. (Cons.)) and the Aqua, Illinois rate case, Docket No. 11-0436, and should be approved by the Commission. (Staff IB at 60-61)

Staff also believes IAWC's proposal to set the 5/8-inch meter customer charges for South Beloit equal to the customer charges that are currently in effect for the Zone 1 division (i.e., $14.50) should be rejected by the Commission. Staff says IAWC's proposal would result in three different 5/8-inch meter customer charges for the proposed Zone 1-Chicago Metro Water division (i.e., $18 for Zone 1 customers, $17 for Chicago Metro customers and $14.50 for South Beloit customers). Staff argues that since these consolidated customers face the same set of costs, the reasonable approach is to develop a single set of rates that apply to all similar customers within the consolidated territory rather than charging them different rates. (Staff IB at 61, RB at 25-26)

Staff proposes customer charges for the South Beloit division that are identical to the meter charges in the rest of the proposed consolidated Zone 1-Chicago Metro water service area. For the 5/8-inch meter, the customer charge that Staff proposes for South Beloit customers and for the consolidated Zone 1-Chicago Metro district in this rate case is $14.75. Staff says its proposal is lower than the 5/8-inch meter customer charges proposed by IAWC for the Zone 1 and Chicago Metro consolidated districts (i.e., $18 and $17 respectively); is uniform with Staff's proposed 5/8-inch meter customer charges for the other Zone 1–Chicago Metro Water consolidated division ratepayers; and would recover 99.9% of customer costs when combined with the customer charge revenues from the other Zone 1–Chicago Metro Water consolidated division ratepayers. Staff believes its proposal to set South Beloit customer charges equal to the customer charges of the consolidated Zone 1-Chicago Metro district to which it belongs should be approved by the Commission. (Staff IB at 61-62, RB at 25-26)

In Staff's view, its "rate design adequately balances bill impacts to customers, conformity to the AWWA meter ratio approach, further approaches STP and recovers all customer costs through the proposed customer charges." (Staff BOE at 19, 22)

In their BOE, the Municipalities support the customer charges proposed by Staff for 5/8-inch meters in Zone 1. (Municipalities BOE at 1-5)

3. The AG's Position

The AG's position is explained in its testimony, briefs and BOE. (AG BOE at 33-39) According to the AG, IAWC requests customer charges that are excessive, and that over-collect customer costs by $10.76 million. IAWC recommends that the Commission not allow IAWC to recover non-customer related costs through unnecessarily high customer charges. (AG IB at 63)

The AG asserts that IAWC's residential (5/8") customer charges should be increased to no more than $15.20 in Zone 1 and Chicago Metro, and Pekin, and $12.85 for South Beloit and Lincoln in order to collect the appropriate amount of revenue. The AG argues that its proposed rate design maintains consistency by establishing only two customer charge rate levels while limiting the increases in areas that currently have substantially lower customer charges. The AG insists that its recommendation is cost based, recovering only $135,000 more than IAWC's calculated customer costs, whereas IAWC's proposed rate design would collect $10,760,000 more in customer charges than justified by its customer costs. (AG IB at 63-64)

The AG notes that Staff recommends a $14.75 customer charge in its rebuttal testimony for Zone 1 and Chicago Metro, a lower rate for Lincoln and a higher rate for

Pekin. The AG argues that IAWC's proposed rate design would over-collect customer costs by using multiple customer class ratios. The AG says a consistent use of the AWWA meter ratios to set the customer charge rate design is consistent with past Commission practice and will assure that customer charge revenues closely match customer costs. (AG IB at 64)

The AG requests that the Commission reject IAWC's customer charge because it is not cost-based, resulting in an over-collection of customer costs and an under-collection of other charges, in violation of cost of service principles. The AG urges the Commission to adopt its proposed customer charge levels and use the AWWA meter ratios to develop total customer charges. (AG IB at 64; AG BOE at 33-35)

The AG claims IAWC cannot dispute the fact that its rate design will recover $10.76 million more in customer charges than it has identified as customer costs. The AG says IAWC achieves this result by ignoring the effect of AWWA meter ratios that are used throughout the industry as well as in Illinois to set customer charges in proportion to the volume delivered by various meter sizes. (AG RB at 34)

According to the AG, IAWC suggests that customer charges should be increased to cover other, unspecified fixed costs. The AG asserts that IAWC’s loose use of the term “fixed costs” should be rejected. The AG says IAWC would have the Commission set rates based on costs that are fixed only in the short-run. AG claims water utilities provide service over the long-run, and treating all costs except those that vary in the short term as fixed ignores the long term nature of water service and the relevant economic principles. The AG claims ignoring that costs vary in the long term (e.g. costs of treatment facilities, water tanks, mains) and treating them as if they are fixed transfers consumer welfare from those who use small quantities of water to large users. (AG RB at 35)

The AG believes the Commission should reject IAWC’s argument that the Commission should allow it to over-collect customer costs through higher than appropriate customer charges because it is thereby collecting additional fixed costs. The AG believes this is contrary to the economic foundation of utility regulation, and contradicts IAWC’s own cost of service study that classifies non-customer related costs as variable and demand related. The AG suggests the Commission should limit the size of customer charges to approximate recovery of customer costs as closely as possible and set usage charges to recover the remaining demand-related, variable costs. (AG RB at 35)

In its BOE, the AG argues that the Company-proposed “residential customer charge for all zones should be reduced to reflect that the Commission is reducing IAWC’s requested revenue requirement.” (AG BOE at 35-36) The Municipalities appear to make a similar argument in their BOE. (Municipalities BOE at 3)

4. Conclusion

IAWC argues that because approximately 92% of residential customers have 5/8-inch meters, it is important that each customer pay the appropriate customer costs to avoid intra-class subsidies. IAWC objects to Staff and the AG's proposed customer charges because, IAWC claims, they would cause customer costs for 5/8-inch customers to be recovered through the volumetric charges. IAWC says such proposals would cause customers that consume more to pay more customer-related costs than smaller users, which it believes is inappropriate and unfair.

Both Staff and the AG take issue with IAWC's proposed customer charges, complaining that the customer charge revenue exceeds customer-related costs. Both propose customer charges that are intended to produce revenue that is closer to customer-related costs.

The Commission has reviewed the extensive testimony and briefs regarding the development of customer charges. Turning first to the calculation of customer-related costs, the Commission finds that IAWC Ex. 11.01SR represents a reasonable estimate of these costs, at IAWC's proposed revenue requirement, particularly for 5/8-inch meters as shown on page 2 of that exhibit. IAWC's COSS, as well as IAWC Ex. 11.01SR and AG Ex. 3.02, indicates that the total customer-related costs for 5/8-inch metered customers are slightly more that $55 million.

It appears that neither Staff nor the AG has estimated customer-related costs as accurately as IAWC did, or proposed modifications that should be made to IAWC's estimated cost of service. IAWC's position that the cost of the larger meters is greater than the cost of service lines or billing services for large meters is more logical than the AG's suggestion that all three components increase at the same rate that the cost of the meter increases.

It appears that both Staff and the AG have, to some extent, mixed the cost of service study and rate design steps and concepts in a manner which the Commission believes should not be utilized for setting the charge for 5/8-inch meters in this proceeding, as discussed below. The record supports a finding that the best estimate of customer-related costs for 5/8-inch metered customers, at IAWC's proposed revenue requirement, is $17.25 per month.

The table below shows the current as well as proposed monthly customer charges for 5/8-inch meters for the various customers in the consolidated Zone 1 Chicago Metro district. The use by IAWC of three different charges in its proposal is intended to reflect a more gradual increase.

	Current	IAWC	Staff	AG
Zone 1	14.50	18.00	14.75	15.20
Chicago Metro	13.50	17.00	14.75	15.20
South Beloit	10.50	14.50	14.75	12.85

Having found that IAWC's estimate of the customer related costs for 5/8-inch metered customers is the most accurate, the Commission is concerned that the Staff and AG proposals would produce a customer charge that for most residential customers does not recover the cost of service. It appears to the Commission that IAWC's proposed customer charges for 5/8-inch meters would produce total revenue of approximately $53 million; the AG's proposed charges would produce approximately $46 million; and Staff's would produce even less. Given that the customer-related costs for 5/8-inch metered customers were slightly more than $55 million at IAWC's proposed revenue requirement, IAWC's proposal is the most reflective of cost.

It appears to the Commission that the primary factor driving the Staff and AG recommendations of lower proposed customer charges for 5/8-inch meters is the fact that total revenues produced by customer charges – i.e. when considering all customer classes in total -- exceed customer-related costs. However, it appears this excess of revenues over costs is attributable to meters larger than 5/8-inch, not to the 5/8-inch meters. As previously discussed, the Commission believes this led Staff and the AG to mix cost of service determinations with rate design in a manner that should not be utilized to set the charge for 5/8-inch meters in this proceeding. That is, the amounts by which customer charge revenues from customers exceed customer-related costs, although attributable to larger meters, would essentially be used by AG and Staff to reduce customer charges for 5/8-inch meters even though IAWC's proposed charges for those meters are not being set above costs.

As stated above, Staff also advocates a uniform customer charge for 5/8-inch metered customers throughout the consolidated Zone 1 - Chicago Metro district. The Commission notes that the uniform charge offered by Staff is tied to Staff's overall proposed for setting customer charges for 5/8-inch meters, which is not adopted as indicated above. The Commission also notes that there are three existing customer charges for Zone 1, Chicago Metro, and South Beloit. In the Commission's view, Staff's argument for a uniform charge is not persuasive.

All things considered, the Commission concludes that the methodologies utilized by IAWC in developing cost-based proposed customer charges for 5/8-inch meters in the consolidated Zone 1 and Chicago Metro district are reasonable and are adopted for purposes of this proceeding. The Commission observes that the specific charges proposed by IAWC were based on its proposed revenue requirement, which is higher than what is approved in this order. Therefore, the specific customer charges for 5/8-inch meters to be filed by IAWC pursuant to its cost of service analysis should be updated to reflect the revenue requirement approved herein.

With regard to meters larger than 5/8-inches, rather than disagreements about cost of service, it appears this is primarily a disagreement over rate design. Staff recommends the AWWA meter-factor approach. While IAWC does not dispute that the meter-factor approach is a reasonable one, it proposes increasing existing customer charges by a uniform percentage based upon the relationship among meter sizes. It again appears to the Commission that the proposed rate design of both Staff and the AG may have been focusing on the objective of aligning total customer charge revenue for all classes to total customer related costs.

IAWC is not overly concerned that its proposed customer charges, primarily for nonresidential customers, would produce revenue that exceeds the customer-related costs. IAWC says this would cause usage charges to be reduced slightly. IAWC claims that since such a high proportion of its costs are fixed rather than variable, this result is reasonable.

The Commission is not convinced that IAWC has accurately estimated its proportion of fixed and variable costs. As the AG suggests, it appears that in estimating variable costs, IAWC has emphasized those costs that are variable in the short-run and ignore some costs which may be variable in the long-run. The Commission is persuaded, however, that IAWC has fixed costs other than those costs associated with customer-related activities and investments. As a result, it is not clear to the Commission that there is validity to Staff's argument that IAWC's proposed customer charges will recover $3.3 million of variable costs through fixed charges. As explained above, the alleged $3.3 million over-recovery relates only to meters larger than 5/8 inches.

The Commission believes that rates should be based, to the extent possible given other rate design objectives, on the cost of service. Given the Commission's belief that IAWC has fixed costs other than customer-related costs, the Commission is not overly concerned if the customer charges for meters larger than 5/8-inches exceed the customer-related costs. The record supports a finding that IAWC's proposed customer charge for these larger meters is reasonable. The Commission adopts IAWC's proposal to increase these customer charges by a uniform percentage based on the relationship among meter sizes. Given the starting point -- that the customer charge for 5/8-inch meters is cost-based -- the Commission finds this proposal to be reasonable.

It appears to the Commission that no party takes issue with the customer charges proposed by IAWC for the other districts. The Commission concludes that the record supports a finding that IAWC's proposed customer charges for the remaining districts are reasonable and the Commission adopts them for purposes of this proceeding.

B. Usage Charges

1. IAWC's Position

IAWC proposes usage charges to recover the remaining revenue not recovered by IAWC’s proposed customer charges. IAWC states that although its methodology is not contested, the shifting of cost recovery from customer charges to usage charges is in dispute.

IAWC notes that Staff recommends higher usage charges to recover the increased revenue requirement from lowering the customer charge. Staff contends that this rate design will allow customers to control the increases in their water bills by conserving water usage. In IAWC's view, this methodology results in significant rate increases to the third and fourth consumption block customers. IAWC contends that Staff's proposed rate design disproportionately increases Other Water Utility and Industrial customer usage rates by 48.25% and 42.92%, respectively. IAWC says these increases are more than twice the average overall increase of 18.42%. IAWC says Staff characterizes these as the appropriate price signals to users of the largest volume of water. IAWC believes such “drastic” increases, contrary to the rate principle of gradualism, should not be approved. (IAWC IB at 102-103; IAWC RBOE at 32)

According to IAWC, Staff’s proposed rates also under-recover IAWC's required water cost of service. IAWC argues that Staff’s proposed usage charges produce $235,863,477 in revenue, short of its revenue requirement. IAWC claims its rate design appropriately produces its required cost of service, $235,941,089. IAWC says Staff neither explains why its designed rates do not recover IAWC’s cost of service, nor how it would recover the $77,612 difference. IAWC contends that with the unexplained shortfall and the disproportionate increases to the third and fourth consumption block customers, the Commission should approve IAWC’s proposed usage charges. (IAWC IB at 103; IAWC RBOE at 32)

IAWC asserts that by shifting more customer costs to volumetric rates as Staff proposes, customers that consume more, such as large families, would pay more for customer-related costs than small users. IAWC believes Staff’s methodology violates the rate principle of gradualism and fails to produce its requested cost of service. (IAWC RB at 66)

IAWC indicates that it proposes increases to the commodity charges for Non-Residential Metered General Water Service and the University of Illinois. IAWC says it varied the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service. According to IAWC, in lieu of the varied increases, IIWC/FEA proposes adjusting the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. IAWC argues that a uniform percentage adjustment would not move revenues more in line with the allocated cost of service. IAWC states that IIWC/FEA's recommendation is based upon its concerns with IAWC’s COSS, which IAWC believes are unfounded. (IAWC IB at 106; IAWC RBOE at 32)

2. Staff's Position

Staff states that it and IAWC agree that the usage charges should be set to recover the non-production related costs for the Zone 1, Chicago Metro Water, Pekin and Lincoln divisions. Staff claims the recommendations differ in two ways: (a) the manner in which both parties calculate the customer charge affects the remaining revenues to be recovered through the usage charge which, in turn, affects the resulting usage rate proposed; and (b) the increases proposed for the third and fourth usage blocks for non-residential customers. (Staff IB at 62)

Staff believes IAWC's proposed usage charge proposal should be rejected because it is directly affected by what it views as IAWC's improper customer charge calculation approach that recovers $3.3 million more than the customer costs and it does not appropriately recover non-production costs. Staff claims its usage charge approach and rate recommendations send appropriate price signals to users of the largest volume of water, promotes water conservation and allows greater control of water bills to customers who strive to conserve and, therefore, should be approved by the Commission. (Staff IB at 63, RB at 26; Staff BOE at 22)

Staff says a second usage charge issue pertains to the increase that results for the third and fourth block rates for non-residential customers. Staff states that on this issue, IAWC's position is that Staff's proposed rates for the third and fourth block are more than twice the overall average increase of 18.42% IAWC has proposed in this rate case and should be rejected. (Staff IB at 63)

Staff does not dispute IAWC's statement that under Staff's rate design proposal, Other Water Utility revenue would increase by 44.72% and Industrial revenue by 40.44%. Staff believes these increases are necessary to properly recover the non-production costs. Staff asserts that IAWC has improperly understated non-production costs to be recovered through the Usage Charge by $3.3 million. Staff contends that while IAWC's rate design proposal results in what appears to be a lower increase for Other Water Utility revenue (18.4%) and Industrial revenue (23.5%) than what Staff proposes, those lower increases are illusory because they reflect recovery of an artificially lower amount of non-production costs recovered through the usage charge. (Staff IB at 63-64, RB at 27)

Staff also argues that it is incorrect to dismiss Staff's proposed rate design based on IAWC's assertion that it would result in rate shock primarily because the increases cited are based upon IAWC's proposed revenue requirement which is significantly higher than Staff's proposed revenue requirement. Staff states that IAWC is proposing a revenue requirement percentage increase that is more than 100% higher than the revenue requirement percentage increase proposed by Staff (i.e., IAWC proposes a total revenue increase of 16.21% in its surrebuttal testimony vs. 7.77% as proposed by Staff in its rebuttal testimony). Staff suggests that if the Commission adopts a revenue requirement closer to Staff's proposal and Staff's proposed rate design, the resulting rate increase for Other Water Utility and Industrial classes would be far less than that projected by IAWC. (Staff IB at 64, RB at 27; Staff BOE at 22-23)

3. IIWC/FEA's Position

IIWC/FEA notes that IAWC proposes increases to the commodity charges for Non-Residential Metered General Water Service by varying the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service. IAWC rejects the IIWC/FEA recommendation to adjust the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case.

According to IIWC/FEA, IAWC claims a uniform percentage adjustment will not move revenues more in line with the allocated cost of service. IIWC/FEA argues that IAWC's rebuttal CCOS study suffers from the distortion of combining the cost of service for Zone 1 and Chicago Metro as well as the removal of the Large OWU class from the allocation of costs in the CCOS study. In IIWC/FEA's view, these two issues render IAWC's rebuttal CCOS critically flawed. Since the rebuttal CCOS is flawed, IIWC/FEA contends IAWC's argument that a uniform percentage increase would not move revenues more in line with the allocated cost of service is without merit and should be rejected. (IIWC/FEA RB at 27)

IIWC/FEA argues that although IAWC's direct CCOS study is far more reasonable than its rebuttal CCOS, the direct CCOS study still suffers from some errors. IIWC/FEA contends that IAWC failed to allocate any of the requested revenue increase to the Large OWU class, and it misallocated purchased power cost on only base volume rather than a combination of base and extra capacity allocation. Even with these errors, IIWC/FEA asserts IAWC's direct CCOS study shows that most customer classes should receive a close to system average increase to bring their rates to cost of service. IIWC/FEA argues that because of the errors in the direct CCOS study and the general finding that most class rates are generally close to cost of service, IIWC/FEA recommends a uniform percentage increase to IAWC's commodity block structure as a fair and appropriate rate adjustment. (IIWC/FEA RB at 27-28)

IIWC/FEA says that Staff proposes increases to the usage blocks for non-residential customer rates. Specifically, the Staff recommends a commodity block structure for non-residential customers that includes increases for the third and fourth consumption blocks of over 48.25% and 42.92%, respectively. IIWC/FEA believes that Staff's proposal should be rejected. IIWC/FEA contends that Staff's proposal is not cost-based and results in an unjustified allocation of the rate increase to large users. IIWC/FEA asserts that Staff's proposed allocation of a large portion of the increase in this case to large users is not supported by IAWC's direct CCOS study which shows that large users' rates are fairly close to cost of service. (IIWC/FEA RBOE at 12)

As noted above, IIWC/FEA believes that IAWC's direct CCOS study already over-allocated cost to large users. IIWC/FEA also believes Staff's proposed rate design is severely flawed and prejudicial to large users. IIWC/FEA claims Staff's proposal would result in a 41.35% increase for the Industrial class in Zone 1. IIWC/FEA says IAWC's direct CCOS study proposes a 28% increase for the Industrial class which results in the collection of revenue in excess of this class' cost of service. IIWC/FEA contends Staff's proposal would only exacerbate the over-collection of revenue from this class in excess of its cost of service. IIWC/FEA insists that since the Staff's proposal to increase the third and fourth consumption blocks is not based on cost of service, it results in drastic increases and should be rejected. (IIWC/FEA RB at 28; IIWC/FEA RBOE at 12)

In their BOE, IIWC/FEA argues that “[b]ecause of the errors in both the direct and rebuttal COSS studies and the general finding that most class rates are generally close to cost of service,” the Commission should adopt a uniform percentage increase to the Company’s commodity block structure “as a fair and appropriate rate adjustment.” (IIWC/FEA BOE at 10)

4. Conclusions

IAWC and Staff are in disagreement regarding the third and fourth block usage blocks for non-residential customers. Under Staff’s rate design proposal, Other Water Utility revenue would increase by 44.72% and Industrial revenue by 40.44%. Staff believes these increases are necessary to properly recover the non-production costs. Staff asserts that IAWC has improperly understated non-production costs to be recovered through the Usage Charge by $3.3 million. Staff contends that while IAWC's rate design proposal results in what appears to be a lower increase for Other Water Utility revenue (18.4%) and Industrial revenue (23.5%) than what Staff proposes, those lower increases are illusory because they reflect recovery of an artificially lower amount of non-production costs recovered through the usage charge.

IAWC says Staff's proposed increases are more than twice the average overall increase of 18.42%. IAWC believes Staff’s proposed increases are contrary to the rate principle of gradualism and should not be approved. IIWC/FEA also opposes Staff's proposed usage charges.

IAWC indicates that it proposes increases to the commodity charges for Non-Residential Metered General Water Service and the University of Illinois. IAWC says it varied the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service.

Rather than varied increases, IIWC/FEA proposes adjusting the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. IAWC argues that a uniform percentage adjustment would not move revenues more in line with the allocated cost of service. IAWC claims that IIWC/FEA's recommendation is based upon its concerns with IAWC’s COSS, which IAWC believes are unfounded.

It appears to the Commission that between the IAWC proposal and the IIWC/FEA proposal, IAWC's is more consistent with the principle that rates should reflect cost of service. The Commission is concerned that IIWC/FEA's proposal is similar to an "across-the-board" rate increase that is sometimes used when there are serious problems with a cost of service study or to mitigate disproportionately or abnormally high rate impacts. In this proceeding, the Commission does not believe such an approach is warranted and IIWC/FEA's approach for developing usage charges is rejected.

While it is not entirely clear, it appears that the primary, and perhaps only, reason for the disagreement between IAWC and Staff regarding usage charges results from their disagreement regarding customer charges. It appears that both recommend the Commission approve usage-block charges that allow IAWC to recover non-production costs and the remainder of the revenue requirement not recovered from the customer charge. In part because IAWC's proposed usage charges produce the desired revenues, while Staff's do not, the Commission adopts IAWC's proposed method for developing proposed usage charges in this proceeding.

It appears that no party takes issues with the usage charges proposed by IAWC for the other districts and the Commission adopts them for purposes of this proceeding. It also appears that IAWC's proposed rates for the Chicago Metro Sewer district are not contested. IAWC's proposed one-block rate structure for residential customers is reasonable and is hereby approved. Additionally, the Commission finds IAWC's proposed two-block rate structure for nonresidential customers to be reasonable and it is hereby approved.

C. Fire Protection Charges

1. IAWC's Position

IAWC did not propose any increase to the Chicago Metro Public Fire Protection Charges if the Zone 1 and Chicago Metro consolidation is not approved. IAWC believes an increase was not required since Chicago Metro’s current rates currently recover 99.78% of this service territory’s costs of service. IAWC says the 0.22% shortfall equates to only $9,568 of revenue.

IAWC indicates that to correct this shortage, Staff recommends increasing Chicago Metro’s rates by 0.44%, to recover 100.22% of the costs to achieve conformance with Section 9-223(a) of the Act. Section 9-223(a) of the Act requires fire protection charges to “reflect the costs associated with providing fire protection service for each municipality or fire protection district.”

IAWC contends that Public Fire Protection Charges for Chicago Metro meet this statute by reflecting the costs associated with providing fire protection service. Unlike Staff’s proposed Lincoln Public Fire Protection Charge that does not reflect the costs of service, the Chicago Metro Fire Protection Charge reflects the cost of service by recovering 99.78% of these costs. IAWC urges the Commission to reject Staff’s recommended increase. (IAWC IB at 104)

IAWC proposes a public fire protection charge for the Zone 1-Chicago Metro consolidated service area that would recover 101.05% of cost of service.

IAWC states that to ensure that the Lincoln service area fully pays its cost of service, it proposes to increase the Lincoln Public Fire Protection Charges. Though Staff encourages IAWC to recover the full cost of service from the Chicago Metro service area, Staff recommends that the increase to the Lincoln Public Fire Charges be rejected. IAWC says Staff proposes to limit the increase to 27% from the 53.8% IAWC proposed, based on unacceptable bill impacts. According to IAWC, the plain language of Section 9-223(a) is that “Any fire protection charge imposed shall reflect the costs associated with providing fire protection service for each municipality or fire protection district.” IAWC contends there is not the exception in the statutory language that Staff suggests. In IAWC's view, Staff's recommended charges do not reflect the costs of fire protection. (IAWC RBOE at 33)

IAWC argues that irrespective of the statute, when viewed in dollar terms, IAWC’s proposed increase in the monthly Fire Protection Charge per customer is only $2.35, from approximately $3.83 to $6.18, which IAWC believes is not unreasonable. IAWC contends that its proposed rate is, in a dollars sense, similar to the Chicago Metro’s current Fire Protection Charge of $6.55, for which IAWC did not proposed an increase. IAWC believes the Commission should approve its proposed increase of the Lincoln Public Fire Charge. (IAWC IB at 105)

2. Staff's Position

Staff notes that IAWC’s recommended Public Fire Protection Charges for the Chicago Metro Water standalone division have not changed since direct testimony and would recover revenues that would be $9,568 short of full Public Fire Protection cost of service for this division. Staff recommends that the Commission reject IAWC's recommended Public Fire Protection Charges for the Chicago Metro Water standalone division because it is not consistent with Section 9-223(a) of the Act. (Staff IB at 65, RB at 28)

Staff asserts that IAWC has not provided adequate support for its proposal to recover only 99.78% of the cost of service from this customer group. In order to recover the full cost of service for Public Fire Protection, Staff recommends IAWC's proposed rates be multiplied by 100.22% to increase revenues by $9,568. Staff claims this calculation would conform to Section 9-223(a) of the Act and would be spread out over more than 44,000 customers so that the impact on their monthly bills would be minimal. (Staff IB at 65, RB at 28)

IAWC’s recommended 53.8% increase in the Public Fire Protection Rates for the Lincoln division should be rejected by the Commission. Staff contends that a sudden 53.8% increase in Public Fire Charges is inconsistent with the principle of gradualism. It is Staff’s opinion that consideration should be given to significant bill impacts. (Staff IB at 65-66, RB at 29)

Staff says that Lincoln needs to recover an additional $177,606 in revenues spread over 6,000 customers to recover its full Public Fire Protection cost of service.

According to Staff, this equates to a $2.47 per month increase for Lincoln customers. An alternative approach is to gradually bring the Lincoln division to full cost of service starting with the current rate case. (Staff IB at 66)

Staff recommends that the Commission approve a 27% increase to Lincoln Public Fire Charges to mitigate the bill impact to customers for this charge in this district. While Staff supports compliance with Section 9-223(a) of the Act, Staff says it is also sensitive to the heightened concern expressed by the Commission on high bill impacts particularly in more recent water rate case orders. (*Id.*, citing Docket Nos. 11-0059/11-0141/11-0142 (Cons.)) Staff asserts that its recommendation provides an alternative option for the Commission to consider should it be interested in mitigating the bill impacts to Lincoln customers. Staff's recommended Public Fire Protection Charges would cut the cost of service revenue recovery deficit for Public Fire Charges in half at the conclusion of this rate case and would pave the way for full cost recovery considerations in IAWC's next rate case. (Staff IB at 66; Staff BOE at 26)

According to Staff, IAWC's argument here regarding Lincoln Fire Protection Charges contradicts its position regarding Chicago Metro's Fire Protection Charges. Staff says it is aware that there is no exception in the statutory language but it is also cognizant of the heightened concern expressed by the Commission on high bill impacts particularly in more recent water rate case orders. Staff further recommends that, to be consistent with Section 9-223(a) of the Act and the principle of gradualism, the Commission direct IAWC to analyze the bill impacts of increasing Public Fire Protection revenues the rest of the way to full cost of service for the Lincoln tariff group in its next rate case. (Staff RB at 29-30; Staff BOE at 26)

3. Conclusions

IAWC proposes that the Lincoln Public Fire Protection Charge be set to recover the cost of service, which would increase the charge by approximately $2.35 per month or 53.8%. Staff proposes a more gradual increase in charges for Lincoln, suggesting a limit of 27% in this proceeding. The Commission believes that IAWC's proposal for the Lincoln Public Fire Protection Charge is reasonable and it is hereby adopted. The Commission concludes that while the proposed percentage increase is somewhat large, in dollar terms the increase is reasonable. In addition, IAWC's proposal will ensure full compliance with Section 9-223(a) of the Act in a timely manner. Section 9-223(a) requires that "[a]ny fire protection charge imposed shall reflect the costs associated with providing fire protection service for each municipality or fire protection district."

With regard to the other Public Fire Protection Charges, whether IAWC and Staff are in agreement is unclear. For example, Staff suggests that in the event the consolidation of Zone 1 and Chicago Metro is not approved, it agrees with IAWC's proposed charges. (Staff IB at 59) IAWC, however, indicates that in the event consolidation of Zone 1 and Chicago Metro is not approved, it does not agree with Staff's proposed Public Fire Protection Charges. (IAWC Ex. 11.00R at 10) Whether

IAWC and Staff agree about Public Fire Protection Charges in the event consolidation is approved is also unclear to the Commission.

In any event, the Commission is approving the consolidation of Zone 1 and Chicago Metro district, as addressed below. The question before the Commission is whether to require IAWC to set Public Fire Protection Charges at a level that recovers 100.00% of the cost of service for the consolidated Zone 1 and Chicago Metro district as suggested by Staff, at least initially, or set those charges such that it recovers 101.05% of the cost of service as proposed by IAWC.

The proposals of IAWC and Staff are very close in terms of cost of service recovery. If Staff is arguing that these charges must be set at exactly 100% of cost of service, its position is not reconciled with its proposed Public Fire Protection Charges for Lincoln. The Commission finds IAWC's proposal for the consolidated Public Fire Protection Charges to be lawful and reasonable, and it is hereby approved.

There is no dispute regarding Public Fire Protection Charges in the remaining districts; the Commission concludes that IAWC's proposed Public Fire Protection Charges for those districts are reasonable and they are hereby approved.

D. Consolidated of Volumetric Charges

1. IIWC/FEA's Position

According to IIWC/FEA, IAWC's proposed rate design for non-residential customers includes a customer charge and multiple declining block volumetric rates. The customer charges are designed to recover the fixed customer costs which are not related to the volume of water used. Included in these costs are expenses dealing with meters such as operation and maintenance, depreciation and meter reading. IIWC/FEA says IAWC's discussion of the customer costs excludes distribution main capital costs.

According to IIWC/FEA, IAWC designed its volume charges to recover its costs from the customers for whom the costs were incurred. From this IIWC/FEA infers that the distribution main costs are applied to the non-residential customers in the initial volume block rates of IAWC's declining block volumetric rates. IIWC/FEA asserts that this rate structure will ensure that all customers, regardless of volume load, will fairly compensate IAWC for its distribution costs. IIWC/FEA says that once a customer pays the initial volume rate charges for its entire load, it has fully compensated IAWC for its distribution main costs. (IIWC/FEA IB at 37)

IIWC/FEA states that Air Products currently takes service from two separate meters that are served by the same distribution main. Since Air Products' volumes are not combined, IIWC/FEA says it pays the initial IAWC volume block rates for the volumes passed through each of its two meters. As a result, IIWC/FEA claims Air Products pays for IAWC's distribution main costs twice, via each of the meter bills, despite the fact that IAWC only uses one distribution main to serve Air Products.

IIWC/FEA believes that Air Products charges are excessive. IIWC/FEA argues that the volumetric charges for the two meters should be consolidated since they are served by the same distribution main. By consolidating the volumes, IIWC/FEA suggests Air Products' total volume load will be run through IAWC's declining block volume rate structure and it will fairly compensate IAWC for the single distribution main costs incurred to serve Air Products. (IIWC/FEA IB at 37-38)

IIWC/FEA says that in surrebuttal testimony, IAWC witness Mr. Kerckhove testified that if there is only one distribution system behind the meters then the billing of the two meters can be consolidated. IIWC/FEA alleges that during cross-examination, Mr. Kerckhove was not able to substantiate the notion that the volumetric costs of service would vary based on whether the distribution system was consolidated behind the meter. (IIWC/FEA IB at 35, citing Tr. at 446)

IIWC/FEA insists that IAWC's surrebuttal position is without merit. IIWC/FEA argues that the rates customers pay should reflect IAWC's cost to provide them service. IIWC/FEA believes IAWC's rate should not be conditioned on how the customer installs plumbing behind IAWC's meters. If Air Products is not allowed to consolidate its volume charges as they are applied under IAWC's tariff, IIWC/FEA claims it will pay for the single IAWC distribution main that connects Air Products to the IAWC system twice. IIWC/FEA argues that IAWC's implementation of its tariffs results in Air Products paying twice for IAWC's distribution cost in serving Air Products. IIWC/FEA believes this excessive pricing is unjust, discriminatory and should not be allowed. (IIWC/FEA IB at 38; BOE at 12-13)

In its BOE, IIWC/FEA proposes a language revision whereby the Commission would find that the consolidated billing issue may be addressed in IAWC's next rate case. (IIWC/FEA BOE at 13)

2. IAWC's Position

IAWC notes that IIWC/FEA proposes that the volumetric charges for the Air Products' two meters should be consolidated since they are served by the same distribution main. IIWC/FEA concludes that rates should not be conditioned on how the customer installs plumbing behind IAWC's meters; it claims that Air Products will otherwise pay twice for IAWC's distribution costs. (IAWC RB at 69)

IAWC contends that its rules and regulations state, "When more than one meter setting is installed on a Customer's Premises, each meter setting shall be treated separately (i.e., as if it belonged to a separate Customer). The registrations of such meters will not be combined unless such meters measure water being received by a common distribution system." IAWC states that according to its records, Air Products' 2-inch meter is located in a meter vault, while its 4-inch meter is located within the facility. IAWC argues that this justifies separate billing. (IAWC RB at 69-70)

In IAWC's view, IIWC/FEA provided no evidence that its meters “serve a common distribution system” in accordance with IAWC’s tariff provision. To consolidate its billing, IAWC asserts that Air Products must have a common distribution system behind the meters. IAWC says this has not been shown. IAWC claims it cannot confirm that the tariff applies. (IAWC RB at 70; *See also* IAWC BOE at 37; BOE App. A at 17-18)

In its Reply Brief on Exceptions, IAWC takes issue with the above-referenced language revision proposed in IIWC/FEA’s BOE. (IAWC RBOE at 34)

3. Conclusion

IIWC/FEA states that Air Products currently takes service from two separate meters that are served by the same distribution main. IIWC/FEA argues that the volumetric charges for the two meters should be consolidated since they are served by the same distribution main.

IAWC states that IIWC/FEA provided no evidence that the meters “serve a common distribution system” in accordance with IAWC’s tariff provision, and that according to IAWC’s records, Air Products’ 2-inch meter is located in a meter vault, while its 4-inch meter is located within the facility. IAWC believes that this justifies separate billing pursuant to its tariffs.

In the Commission's view, it may be appropriate in some instances to address a specific tariff dispute between a utility and customer in a general rate case. In this instance, however, the Commission does not believe that the record of this proceeding is sufficient to allow it to make a fully informed decision regarding the various issues relating to IIWC/FEA's proposal. What information is in the record is not sufficient to support a finding that IAWC is failing to comply with its tariffs, or alternatively, that its tariff should be modified. As a result, the Commission rejects IIWC/FEA's proposal without prejudice so that the issue may be addressed, if necessary, in a later proceeding.

E. Section 8-306(i)

Staff states that it and IAWC disagree as to whether IAWC is in compliance with Section 8-306(i) of the Act, which Staff says requires it to offer separate rates for water and sewer customers who use separate meters. IAWC claims it complies with this requirement through two different methods. The first method is the installation of separate water and sewer meters at a customer’s premise, while the second method is the installation of multiple water meters at a customer’s premise, with the water usage, as measured by a water meter, which does not reach the sanitary sewer system, excluded from the total quantity of water sales for billing waste water service. Staff says the current tariff language is in ILL.C.C. No. 25, Original Sheets No. 4 and No. 5, items (I), (J), and (K). (Staff IB at 66-67)

It is Staff's opinion that this does not directly address the relevant statutory requirement. In order to eliminate confusion, Staff recommends that IAWC be directed to draft language similar to what is contained in Aqua Illinois, Inc.'s University Park Schedule of Rates for Sewer Service tariff. Staff says the language is shown on Staff Ex. 12.0 at 17. (Staff IB at 67)

In its surrebuttal testimony, IAWC agreed to include in its sewer service tariffs to be filed in compliance with the final order language similar to what is contained in Aqua Illinois, Inc.'s University Park Schedule of Rates. (IAWC Ex. 5.00SR at 5) Thus, it appears this issue is no longer contested, and no exceptions were filed. The Commission directs IAWC to include in its tariffs the language described in its surrebuttal testimony.

F. Other Issues

As noted by Staff, an IIWC/FEA witness recommended, at least initially, that Scott Air Force Base ("AFB") start taking service under a Competitive Service rate to reflect its service characteristics and that IAWC refund over-collections for costs to maintain and operate Scott AFB's small distribution system for the last four years.

Staff believes these recommendations should be rejected by the Commission. (Staff IB at 71; Staff Ex. 12.0 at 22)

Staff says IAWC indicates that IAWC's customers are divided into only two categories: residential and non-residential. All non-residential customer classes are charged the same non-residential rate and, therefore, there is no other rate that Scott AFB could be placed upon. (Staff IB at 71)

Staff recommends that Scott AFB remain classified as a Sale for Resale customer and be accorded a non-residential rate. Staff contends that Scott AFB is not a residential customer so IAWC is justified in charging Scott AFB a non-residential rate. Staff also recommends that if Scott AFB wants to be considered for the Competitive Tariff, it should apply to IAWC for this rate to see if it meets the qualifications to be placed in the Competitive Tariff classification. (Staff IB at 71-72)

IIWC/FEA witness Mr. Collins testified, on rebuttal, that Scott AFB plans to apply to the Company to take service under the Metered Large User Water Service tariff ("Large User tariff") rate because it believes service under that tariff rate will address the concerns raised by IIWC/FEA. (IIWC/FEA Ex. 4.0 at 7) In surrebuttal testimony, in anticipation of Scott AFB's switch to the Large User tariff rate, the Company adjusted its test-year present rate revenues downward by $111,808. (IAWC BOE at 36-37)

In its BOE, IAWC argues that "a revenue reduction of $111,808 [in forecasted test year revenues at present rates] is necessary to reflect Scott AFB's expected move (prior to the test year) to the Large User tariff rate…." (*Id.*; BOE App. A at 15-16) In their

Reply Briefs on exceptions, no parties objected to this adjustment and the Commission agrees with IAWC that it should be made.

Having reviewed the evidentiary record and the arguments, the Commission declines to adopt IIWC/FEA's suggestions made in its direct testimony. Staff correctly points out that Scott AFB is currently classified and billed as a nonresidential customer. Scott AFB is free to apply for the Competitive Tariff if it chooses. It is not necessary for the Commission to further consider or rule upon IIWC/FEA's proposal in this proceeding.

X. CONSOLIDATION OF ZONE 1 AND CHICAGO METRO

IAWC proposes to consolidate the Chicago Metro and Zone 1 districts with respect to non-production related costs. Testimony in support of the proposal was presented by Staff. IIWC/FEA opposes consolidation in their testimony and briefs. The Village of Bolingbrook did not present testimony; however, it did oppose consolidation in its briefs and BOE.

A. IAWC's Position

According to IAWC, consolidating these two districts will move IAWC's rates towards single-tariff pricing, a policy explicitly endorsed in the Commission's Docket No. 07-0507 Order and consistent with IAWC's consolidation of Champaign and Sterling into Zone 1 in Docket No. 09-0319. (IAWC IB at 98)

Though the consolidation is supported by IAWC and Staff, IIWC/FEA argues that the consolidation should be rejected because it ignores the concept of consolidation, the geographical distinctness of each service area, and the different zonal class structures. As a result, IIWC/FEA believes the consolidation will erode system efficiency by creating subsidies between the two districts. (IAWC IB at 98)

According to IAWC, the IIWC/FEA position appears to ignore the Commission's history of approving consolidation of IAWC's rate zones, dating back to the consolidation of the Zone 1 service area over time. IAWC asserts that any apparent disparity between Chicago Metro and Zone 1's zonal class structures is minor and does not affect consolidated pricing. IAWC contends that zonal class differences currently exist within the Zone 1 consolidated areas, and this will not change with the addition of Chicago Metro. IAWC also asserts that any difference in base cost and capacity costs of non-production costs between Zone 1 and Chicago Metro is reflected in IAWC's cost allocation.

In IAWC's view, any assertion that the consolidation will result in subsidies eroding system efficiency is unfounded, unsupported, and contrary to IAWC precedent. IAWC says the Commission recently approved consolidating IAWC's Champaign and Sterling service districts. IAWC claims no witness in this case testified that "efficiencies" have "eroded" as a result. IAWC claims that the evidence supports consolidating the two service areas, and the proposed rate design adequately allocates cost recovery to the appropriate classes. IAWC urges the Commission to approve the consolidation of Chicago Metro and Zone 1. (IAWC IB at 98-99)

In its Reply Brief, IAWC says Bolingbrook asserts that, with respect to consolidation, non-production related costs were not defined, nor was any sufficient testimony or evidence presented to the Commission in this proceeding that the proposed consolidation is in the best interests of Illinois ratepayers. IAWC claims this is incorrect. IAWC says its witness, Mr. Herbert, defined non-production costs, explained the methodology by which non-production costs were determined and provided a detailed calculation in support. (IAWC RB at 58)

IAWC also claims it presented evidence that the consolidation is in the best interests of ratepayers, including extensive cost of service studies and rate design information reflecting both Chicago Metro and Zone 1 consolidated and stand-alone, for comparison purposes. IAWC says Staff witness Mr. Boggs found that IAWC's proposed consolidation of the Zone 1 and Chicago Metro Water divisions would lower monthly bills for Chicago Lake Water and Chicago Moreland typical-use residential customers. IAWC contends that this consolidation will actually be in Bolingbrook customers' interest, with its rates increasing slightly at most, or potentially decreasing. If the consolidation is not approved, IAWC asserts that Chicago Metro rates will increase more significantly.

According to IAWC, for Chicago Metro on a standalone basis, the proposed customer charges are equal to the Zone 1 present rates but with higher consumption rates to recover the cost of service on a stand-alone basis. IAWC also asserts that consolidating the districts will spread capital improvement costs over a larger customer base, lower rate case expense, and lower administrative fees. IAWC also claims it designed rates in the consolidated district to ensure Chicago Metro ratepayers would not pay for water treatment costs in Zone 1, established separate production costs for each district, and equalized the rate for non-production costs. (IAWC RB at 58-59)

IAWC also believes Bolingbrook's legal arguments are flawed. Bolingbrook claims that the Act's provisions militate against consolidation of service areas, in general. IAWC claims that the authorities it cites stand only for the general proposition that costs should be allocated to cost causers and rates should not be unreasonably different. IAWC maintains that the Commission has routinely, over a series of prior IAWC rate cases, approved consolidation of IAWC's rate areas. (IAWC RB at 59)

IAWC disputes Bolingbrook's legal conclusion that the Commission's regulations indicate that separate service areas should be maintained. IAWC says Bolingbrook reaches this conclusion by citing the Commission's regulation requiring a public utility to provide separate rate base schedules for each applicable service and for each service area for which separate tariffs exist (e.g., district, division, etc.) where a requested change in rates is being proposed. IAWC argues that 83 Ill. Adm. Code 285.2000(b) says nothing about whether those service areas can be consolidated. Instead, IAWC claims the Commission's regulations expressly contemplate consolidation. (IAWC RB at 59-60)

In response to IIWC/FEA's claims that IAWC ignores the distinctiveness and geographic characteristics of each service territory, differences in rate base and non-production costs, and cross-subsidies created by the consolidation, IAWC maintains that the differences in customer composition between Chicago Metro and Zone 1 are minor and would not affect the consolidated pricing. IAWC also contends that any differences in load characteristics between the two zones are addressed in IAWC's rate design. According to IAWC, IIWC/FEA's concern regarding different base and capacity costs between districts is also a non-issue, because production costs, which comprise a large portion of base and extra capacity costs, are maintained separately in the rate design. (IAWC RB at 60-61)

IIWC/FEA argues that the creation of price subsidies will erode system efficiency by erasing economic incentive for customers in higher cost districts to be more efficient in placing demands on the water system because the prices they pay will not accurately reflect the cost of delivering the water service. IAWC responds that IIWC/FEA fails to offer any analysis to show that inefficiencies exist or price signals would be distorted under the consolidated pricing. IAWC claims the Commission previously found the consolidation of the Champaign and Sterling districts into Zone 1 to be reasonable based on the record in prior cases. IAWC suggests that IIWC/FEA simply asks the Commission to accept its assertions without offering any proof that harm will occur. (IAWC RB at 61)

IIWC/FEA argues that IAWC still has the burden to demonstrate the appropriateness and reasonableness of the proposed consolidation. IAWC insists it has met that burden. IAWC maintains that consolidating Chicago Metro and Zone 1 will move IAWC's rates towards single-tariff pricing, a policy it says was explicitly endorsed in Docket No. 07-0507 and is consistent with IAWC's consolidation of the Champaign and Sterling into Zone 1 in Docket No. 09-0319. IAWC states that similar to the Champaign and Sterling consolidation, the Chicago Metro consolidation moves IAWC towards the Commission's policy of single-tariff pricing. (IAWC RB at 61-62)

In its Reply Brief on Exceptions, IAWC responds to arguments in the BOEs filed by IIWC/FEA and Bolingbrook. (IAWC RBOE at 34-40)

B. IIWC/FEA's Position

As explained in its testimony, briefs and BOE, IIWC/FEA opposes the proposed consolidation. (IIWC/FEA BOE at 13-18) It is IIWC/FEA's position that IAWC's proposal fails to recognize that the distribution network for each district is distinct and the geographic characteristics of each service territory impact costs related to storage, pressure and other costs associated with providing water service in those areas. In IIWC/FEA's view the proposal also ignores the differences in rate base investment in each district, and the differences in non-production related costs of providing service in each non-interconnected district. IIWC/FEA also argues that IAWCs proposal fails to recognize the cross-subsidies being created and ignores traditional cost of service principles and the concept of cost-causation. (IIWC/FEA IB at 27-28)

IIWC/FEA argues that all water companies are similar in that way but such similarities would not justify their consolidation. IIWC/FEA claims this is especially true given the differences between Chicago Metro Water and Zone 1. According to IIWC/FEA, Chicago Metro Water and Zone 1 have “very different” customer compositions and therefore different zonal class structures. IIWC/FEA states that Zone 1 consists of 68.8% residential and commercial customers, while Chicago Metro Water consists of 79.7% residential and commercial customers. IIWC/FEA also indicates that Zone 1 consists of 3.4% industrial customers and 1.2% large industrial customers, while Chicago Metro Water does not have any large industrial customers and consists of only 0.4% industrial customers. (IIWC/FEA IB at 28)

IIWC/FEA believes the differences in the customer class structure provide different load characteristics and different base and extra capacity costs for Chicago Metro Water and Zone 1. IIWC/FEA states that customers that have a higher than average peak rate water use and thus low load factors, such as the residential and commercial classes of customers, require larger capacity pumps, pipes, and other system facilities, as opposed to customers with an equal total volume of use and high load factors, such as industrial class customers, who take water at a uniform rate. As a result, IIWC/FEA claims a zone with a higher concentration of residential and commercial customers, such as Chicago Metro Water, will have different base costs (costs associated with average water use) and extra capacity costs (costs associated with water use in excess of average) than a zone, such as Zone 1, with a lower concentration of residential and commercial customers. IIWC/FEA argues that these differences demonstrate the consolidation of Chicago Metro Water and Zone 1 is inappropriate. (IIWC/FEA IB at 29)

According to IIWC/FEA, consolidated pricing in this instance will result in price subsidies to customers in high-cost districts at great cost to customers in low-cost districts. IIWC/FEA believes the consolidated pricing will also have the unintended consequence of eroding the efficiency of IAWC's water system. IIWC/FEA claims the rate subsidies in essence erase economic incentive for customers in higher cost districts to be more efficient in placing demands on the water system because the prices they pay will not accurately reflect the cost of delivering the water service. IIWC/FEA contends that this would result in customers with subsidized prices possibly imposing greater inefficient demand on high-cost districts thereby causing greater cost in the high-cost district while increasing customer subsidies from the lower cost district to bring the high cost district price down to the consolidated rate. IIWC/FEA asserts that consolidation of Zone 1 and Chicago Metro Water is likely to create such subsidies in favor of customers in the Chicago Metro Water District which is the higher cost district. (IIWC/FEA IB at 29-30, RB at 16-17; BOE at 16)

In addition to the effect consolidation will have on customer efficiency, IIWC/FEA contends it creates a similar disincentive for cost control on the part of IAWC. IIWC/FEA argues that if all costs are averaged across all districts the incentive to control costs in a high cost district is greatly reduced after it is averaged across all districts, because it will not stand out as a cost outlier. In IIWC/FEA's view, this is the result of a failure to recognize and give effect to the principle of cost causation. IIWC/FEA believes the consolidation of Zone 1 and the Chicago Metro Water district largely ignores that principle. (IIWC/FEA IB at 30, RB at 17)

According to IIWC/FEA, if these zones were to be consolidated, there would be little reason to maintain separate books and records for each operating district. IIWC/FEA claims this loss of transparency for operating and financial data for each district would make it very difficult to evaluate the efficiency and effectiveness of each operating district. IIWC/FEA expresses concern that this would then make it difficult for the Commission to exercise proper regulatory oversight of IAWC's operations. (IIWC/FEA IB at 30)

IIWC/FEA disputes the suggestion that it is ignoring the Commission’s approval of any past rate consolidation. IIWC/FEA says it understands that the Commission found the consolidation of the Champaign and Sterling districts with Zone 1 to be reasonable based on the record in prior cases and therefore approved the consolidation. IIWC/FEA argues that all decisions made by the Commission must be made based on the merits of record evidence in each case. The Commission decisions are not *res judicata*. In IIWC/FEA's view, the simple fact that evidence presented in another case justified the consolidation does not mean the evidence in this case justifies consolidation of Zone 1 and the Chicago Metro Water District. IIWC/FEA insists that the utility has the burden of demonstrating the reasonableness and appropriateness of proposed changes in its rates. (IIWC/FEA IB at 30-31, RB at 17-18) IIWC/FEA believes IAWC has not met its burden. (IIWC/FEA IB at 31)

IIWC/FEA notes that Staff also supports consolidation of Zone 1 and the Chicago Metro Water District contending the arguments of IIWC/FEA against such consolidation ignore rewards that consolidation affords all ratepayers. IIWC/FEA asserts that Staff fails to identify any evidence in this proceeding that identifies or discusses in any way the rewards that are allegedly afforded to all customers from such a consolidation. Staff opines that the advantages of consolidation include having a larger customer base over which to spread plant and operating expense costs. According to IIWC/FEA, Staff dismisses the fact that this advantage would be derived from the misallocation of IAWC's cost of service and would produce rates that are not just and reasonable.

IIWC/FEA contends that Staff’s “advantage” produces winners (customers who are subsidized and benefit from the unjust and unreasonable rates) and losers (customers who provide the subsidy to the winners). IIWC/FEA claims Staff is left with arguing that the Commission has approved single-tariff pricing for IAWC in prior dockets, relying on speculation, that if the Chicago Metro Water District and Zone 1 remain separate, rate impacts that may result from future construction replacement projects for either Zone 1 or Chicago Metro could become problematic. (IIWC/FEA RB at 18-19)

IIWC/FEA complains that Staff relies on testimony presented in another case as support for consolidation here. IIWC/FEA suggests the record in this case is devoid of evidence to support its position. IIWC/FEA says the Commission must base its decision on the evidence in this record, not the evidence presented from the record in another case. Citing Section 10-103 of the Act, IIWC/FEA argues that findings and decisions of the Commission must be based exclusively on the record evidence in this case. (IIWC/FEA RB at 19)

According to IIWC/FEA, circumstances in this case have not been shown to justify the consolidation of Zone 1 and Chicago Metro Water District. IIWC/FEA states that in the Docket No. 02-0690 case, the Commission stated that one factor the Commission believes must be considered before implementing standardized rates or incorporating the rate area into a single pricing group is whether the resulting rates bear a reasonable relationship to cost of service. IIWC/FEA argues that given the flaws in IAWC's rebuttal cost of service study, one cannot determine whether the rates resulting from the consolidation of Zone 1 and the Chicago Metro Water District bear a reasonable relationship to cost of service. (IIWC/FEA RB at 19-20)

IIWC/FEA says the Commission has also concluded that differences in water sources mitigate against consolidation and single tariff pricing. IIWC/FEA contends that water supply sources in Chicago Metro Water District and Zone 1 are substantially different. (IIWC/FEA RB at 20)

IIWC/FEA states that there are rate classes which would see significant increases as a result of the consolidation of Zone 1 and the Chicago Metro District. IIWC/FEA claims the Large Industrial rate class in Zone 1 would see an increase of 22.5% as a result of the consolidation based on IAWC's rebuttal COSS study as opposed to 15.1% on a Zone 1 stand-alone basis. (IIWC/FEA RB at 20)

IIWC/FEA suggests that Staff overlooks or ignores that the Commission has previously rejected proposals for single tariff pricing (consolidation) involving the Chicago Metro Water District and what is now Zone 1, while at the same time authorizing single tariff pricing (consolidation) of other downstate IAWC water districts. IIWC/FEA believes that simply because the Commission has previously authorized consolidation of some IAWC rate districts, does not mean it must or should authorize consolidation of the Chicago Metro District and Zone 1. (IIWC/FEA RB at 20-21)

Staff argues that its bill impact analysis supports consolidation of Zone 1 and the Chicago Metro District. According to IIWC/FEA, Staff focuses only on the bill impact for certain rate classes. IIWC/FEA alleges that Staff ignores, overlooks, or fails to consider impacts for customers in rate classes other than the residential class. IIWC/FEA claims the Commission, in evaluating consolidations (single tariff pricing), has been concerned about the impact on all rate classes, not just the residential class. In IIWC/FEA's view, as a result of Staff's failure to consider the impact on all of IAWC's rate classes, Staff's recommendation that Zone 1 and Chicago Metro District be consolidated should be rejected. (IIWC/FEA RB at 21)

C. Staff's Position

As explained in its testimony, briefs and Reply Brief on Exceptions, Staff believes the advantages of and efficiencies created in consolidating Zone 1 and the Chicago Metro Water division outweigh the benefits that IIWC/FEA claims will be maintained if the Zone 1 and Chicago Metro divisions remain standalone. (Staff RBOE at 7-9)

Staff contends that IIWC/FEA's arguments, summarized above, ignore the rewards that consolidation affords all ratepayers and the fact that the Commission has supported consolidation in its Orders for recent rate cases. Staff notes that the Commission has approved consolidation of rate divisions and movement toward Single Tariff Pricing for IAWC in several dockets, most recently, in Docket Nos. 07-0507 and 09-0319. Staff states that the advantages of consolidation include having a larger customer base over which to spread plant and operating expense costs which would mitigate the potential for future large rate increases. Staff suggests that if the water divisions remain independent, rate impact issues to any of the individual rate divisions that would result from future construction and replacement projects necessary to serve that specific rate division could become problematic. (Staff IB at 68-69, RB at 24)

Staff also says that contrary to what IIWC/FEA suggests, in IAWC's last rate case, Docket No. 09-0319, IAWC maintained that the underlying costs of service are similar regardless of the physical location of the customers. According to Staff, IAWC stated that it uses similar meters, incurs similar costs to read the meters, sends bills from the same corporate location and oversees the operations with the same corporate employees. (Staff IB at 69)

Staff also maintains that the consolidation proposal is supported on the basis of bill impacts. Staff states that under IAWC's consolidation proposal, the Chicago Lake Water and the Chicago Moreland rate areas would benefit from the proposed consolidation. Staff says a typical Chicago Lake Water residential customer would have an 11.63% bill increase under IAWC's proposed rates if the division remained stand alone and a 2.66% increase if the division was consolidated with the Zone 1 division. Staff adds that a typical Chicago Moreland residential customer would have a 57.18% bill increase under IAWC's proposed rates if the division remained standalone and a 52.45% increase if the division was consolidated with the Zone 1 division.

Staff says that for the Zone 1 division, the increase would be 19.28% on a standalone basis compared to 21.06% under consolidation. For the Chicago Well rate area the increase would be 21.31% on a stand alone basis compared to 25.79% under consolidation. Staff also asserts that consolidation would reduce water bills for Zone 1 residential customers by an average of 1.3% and raise Chicago Metro bills by an average of 3.8%. Staff indicates the consolidation proposal has no impact on bills for South Beloit, Pekin and Lincoln water customers. (Staff IB at 69-70, RB at 24)

Staff also argues that consolidation is beneficial because it allows the utility to spread out capital improvement costs over a larger customer base thereby mitigating potential rate shock when large improvement projects need to be made. Staff opines that the benefits outweigh the slight increases that a typical Zone 1 and Chicago Well residential customer would experience in his or her monthly bill upon consolidation compared to the alternative of no consolidation. Finally, Staff suggests rate case expenses can be lowered by reducing the number of divisions for which a future rate case would be prepared and litigated from five to three. Staff says this reduces potential legal and administrative expenses, accounting expenses, expert witness expenses and other miscellaneous costs involved in filing a rate case. (Staff IB at 70-71, RB at 24)

Staff contends that contrary to IIWC/FEA's assertion, the proposal to consolidate does not ignore the differences between each district. Staff believes that IIWC/FEA's arguments against the consolidation ignore the similarity in cost of service that exists in Zone 1 despite the diversity of the service areas that have been consolidated into Zone 1. Staff states that currently, Zone 1 consists of many consolidated small water districts that span the state from Cairo to South Beloit. (Staff RB at 23)

D. Bolingbrook's Position

Bolingbrook expresses its opposition to consolidation in its briefs and BOE. According to Bolingbrook, IAWC seeks to consolidate the Chicago Metro Water District with Zone 1 in this proceeding for nothing more, apparently, than administrative convenience or for reasons pertaining to its own vague and unspecified non-production related costs. Bolingbrook asserts that because IAWC has not proven that the proposed consolidation is in the best interests of the Illinois ratepayers and, indeed, because the relevant statute, regulations, and prior Commission orders counsel against such a move, the proposed consolidation should be rejected. (Bolingbrook IB at 4)

According to Bolingbrook, a utility company like IAWC may not unilaterally make a change in any rate or other charge or classification, or in any rule, regulation, practice or contract relating to or affecting any rate or other charge, classification or service without first giving notice to the Commission and the public. Bolingbrook also asserts that in this proceeding, the burden of proof to establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part, shall be upon the utility and that no rate or other charge, classification, contract, practice, rule or regulation shall be found just and reasonable unless it is consistent with the Act. (Bolingbrook IB at 4-5, RB at 2-3)

In Bolingbrook's view, IAWC has failed to carry its burden in this regard. Bolingbrook says IAWC asserts that this proposed consolidation is for non-production related costs. Bolingbrook complains that its non-production related costs were not defined, nor was any sufficient testimony or evidence presented to the Commission in this proceeding that the proposed consolidation is in the best interests of Illinois ratepayers. (Bolingbrook IB at 6, RB at 3-4)

Bolingbrook contends that Chicago Metro Water District is markedly different than the Zone 1 service area in that Chicago Metro is a purchased Lake Michigan water area, whereas Zone 1 is largely not a purchased water area and involves substantial water treatment costs. Bolingbrook alleges there was no analysis by IAWC presented to the Commission regarding the impact that the proposed consolidation may have, including discussion regarding the infrastructure improvements made or needed in Zone 1 compared to those made or needed in Chicago Metro. If the consolidation is approved, Bolingbrook questions whether Chicago Metro users end up paying for infrastructure improvements in Zone 1 that have already been accomplished in Chicago Metro. According to Bolingbrook, the answer is not known given the testimony presented by IAWC in this proceeding. Bolingbrook says the Commission must take into account the fair treatment of consumers in order that the cost of supplying public utility services is allocated to those who cause the costs to be incurred. (Bolingbrook IB at 6, RB at 4-5)

Citing Section 1-102(d)(iii) of the Act, Bolingbrook says the statute militates against consolidation of service areas, in general. Bolingbrook also says the Act requires that the cost of supplying public utility services is allocated to those who cause the costs to be incurred. (Bolingbrook IB at 7, RB at 5)

According to Bolingbrook, the Act requires a critical analysis of separate geographic areas, i.e., “localities,” such that the Commission would be better able to determine whether any proposed change from IAWC in a charge, service, facility, or other matter would be unreasonable. Bolingbrook argues that by approving IAWC's request for consolidation of the Chicago Metro Water Service Area with Zone 1 without an in-depth analysis of the consequences, the Commission would hamstring itself in ensuring that the terms of the Act are being met. (Bolingbrook IB at 7)

Citing 83 Ill. Adm. Code 285.2000(b), Bolingbrook asserts that separate service areas should be maintained. In determining rate base, utilities are required to provide separate rate base schedules for “each applicable service and for each service area for which separate tariffs exist (e.g., district, division, etc.) where a requested change in rates is being proposed. (*Id.*)

Bolingbrook emphasizes that the Chicago Metro Water District is unique. Bolingbrook notes that it became a division of IAWC when this Commission approved the merger between IAWC and CUCI in Docket No. 00-0476, on May 15, 2001. Bolingbrook claims Commission approval was based on the promise of protection for customers in the former CUCI service areas. Bolingbrook says the Commission stated, “From and after the effective date of the Acquisition and until such time as a change(s) is (are) approved by the Commission, Illinois-American will maintain in effect the various rates, rules, regulations, terms and conditions of service to the public heretofore approved by the Commission for each of its service areas, including the area previously served by CUCI." (Bolingbrook IB at 8, RB at 5-6, citing Docket No. 00-0476, Order at 5)

Bolingbrook also says the Commission required IAWC to file Standardized Rules for the CUCI service areas. Bolingbrook notes that the Commission found that the merger with CUCI would not have an adverse rate impact on the retail customers in CUCI's various service areas. Bolingbrook argues that in light of the Act's prohibition of maintaining any unreasonable differences between localities, the Commission's prior order that authorized IAWC to purchase the assets of CUCI indicates that this Commission has a continuing obligation to ensure that IAWC's merger with CUCI does not harm ratepayers in the various CUCI service areas. (Bolingbrook IB at 8)

According to Bolingbrook, IAWC must clearly demonstrate that the proposed consolidation is, without question, in the best interests of the ratepayers. To meet this burden, Bolingbrook claims IAWC must bring a separate proceeding where all of the ramifications, including detrimental effects, of this proposed consolidation are presented, analyzed in detail, and a proper determination can then be made as to the impact of this move on Illinois ratepayers, especially Chicago Metro ratepayers. In Bolingbrook's view, a rate case proceeding is not the proper venue in which to decide this issue. (Bolingbrook IB at 9)

Bolingbrook's position is summarized on page 12 of its BOE.

E. Conclusion

IAWC proposes to consolidate the Chicago Metro and Zone 1 districts with respect to non-production related costs. IAWC claims consolidating these two districts will move IAWC's rates towards single-tariff pricing, a policy which it says is endorsed by the Commission. Staff supports the proposal to consolidate Chicago Metro and Zone 1 districts. Both Bolingbrook and IIWC/FEA oppose the proposed consolidation. As with other issues in this order, summaries of the parties' positions are set forth prior to the Commission's conclusions, and are not repeated in detail in the conclusions.

Some of the primary concerns raised by IIWC/FEA are the differences in the distribution systems, the differences in customer class load characteristics, resulting price subsidies, and potential adverse impacts on efficiencies.

In its Reply Brief, IIWC/FEA asserts that the Large Industrial rate class in Zone 1 would see an increase of 22.5% as a result of the consolidation based on IAWC's rebuttal COSS study as opposed to 15.1% on a stand-alone basis. (IIWC/FEA RB at 20, citing IAWC Ex. 11.01, Sch. A-Z-1 and IAWC Ex. 11.01, Sch. A-Z-1) Given that this argument was presented in the Reply Brief, the Commission notes that no party had an opportunity to respond to it. Additionally, the Commission believes a proper comparison of consolidation to standalone cost of service studies for the Large Industrial Rate class (e.g., IIAWC Ex. 11.01, Schedule A-Z-1w/CMW and IIAW Ex. 11.01, Schedule A-Z-1) suggests that cost of service for the Large Industrial Rate class increases by 15.1% regardless of whether or not consolidation is approved.

It appears to the Commission that neither IIWC/FEA's opposition to consolidation of Zone 1 and Chicago Metro, nor its assertion that the Large Industrial rate class would see a larger increase as a direct result of the proposed consolidation, is supported by the underlying document cited in IIWC/FEA's Reply Brief or by cost of service and rate design principles.

Aside from general, conceptual principles, IIWC/FEA has provided no evidentiary basis that supports its opposition to the proposed consolidation of Rate Zone 1 and the Chicago Metro District. Given the lack of accurate, meaningful information underlying IIWC/FEA's opposition to consolidation, the Commission rejects its arguments on the issue.

Bolingbrook argues, among other things, that this is not the appropriate forum to consolidate rate districts. In its BOE, Bolingbrook seems to question this characterization of its position; however, the Commission notes that Bolingbrook stated, in its Initial Brief, “A rate case proceeding is clearly not the proper venue in which to decide this issue….” (Bolingbrook IB at 9)

Bolingbrook also argues that the Commission previously found the current standalone rates to be appropriate, and that IAWC has not adequately demonstrated that consolidation is beneficial or in keeping with the general provisions in the Act regarding consolidation of rate districts.

As an initial matter, the Commission notes that this proceeding is addressing a proposed general increase in rates. Proper notice of the proposed general rate increase has been made and contrary to Bolingbrook's assertion, this is the proper type of proceeding in which to consider the potential consolidation of rate districts or any other proposed change in tariffs.

The Commission agrees with IAWC and Staff that consolidation of the Zone 1 and Chicago Metro divisions would provide benefits, such as increased efficiencies. Consolidation would allow the recovery of costs to be spread over a larger customer base, thereby benefiting customers in divisions that could face larger increases without consolidation. Consolidation would also lower the rate impact for some areas without unduly impacting the other areas in terms of bill impacts or cost of service standpoints.

The Commission finds that the record, including the testimony of several expert witnesses on this issue, supports a conclusion that the consolidation of Zone 1 and the Chicago Metro districts is reasonable and should be adopted.

Based upon the record, the Commission concludes that the proposed consolidation of the non-production related costs of Chicago Metro and Zone 1 districts is reasonable, and in the public interest, and should be approved.

XI. PROPOSED REVENUE ADJUSTMENT CLAUSE

IAWC has proposed a mechanism, the Revenue Adjustment Clause or "RAC," which would "decouple" its recovery of fixed costs in providing water utility service to its customers from the volume of water it actually sells. The other parties oppose this proposal. No exceptions were filed with respect to this issue.

A. IAWC's Position

IAWC states that it must stand ready to provide and deliver water to customers if and when called upon, and it maintains a significant infrastructure to provide that service. IAWC says nearly 94% of its costs are fixed. IAWC states that under the traditional ratemaking paradigm, IAWC's revenues, and, thus its ability to recover its costs, are directly dependent upon its customers' water usage. IAWC says it will only recover its costs if the level of water usage upon which its rates are premised is actually achieved. (IAWC IB at 107)

IAWC claims it has experienced a significant and continuing trend of declining usage in water consumption. IAWC asserts that declining usage has a considerable impact on IAWC's water sales. According to IAWC, the declining usage results from changes in usage due to federal and state water efficiency standards, increased customer installation and use of more efficient plumbing and water-using appliances, and heightened interest in natural resources, including water, conservation. IAWC says all of these factors are outside utility control. IAWC states that as the interest in and adherence to water conservation measures grows and the presence of more efficient plumbing fixtures and appliances increases, it can no longer anticipate increased water sales.

IAWC's projections in this case, based on a study of usage, purport to show residential water sales declining annually by nearly 2%. IAWC has proposed a mechanism which would "decouple" its recovery of its fixed costs in providing water utility service to its customers from the volume of water it actually sells. IAWC says this mechanism, the Revenue Adjustment Clause or "RAC," will provide IAWC with a measure of revenue stability which will enable it to champion water conservation measures without the fear of undermining business interests in the face of the declining usage trend IAWC has and expects to continue to experience. (IAWC IB at 107-108)

According to IAWC, the proposed RAC is a transparent decoupling mechanism that would enable IAWC to recover on a current basis the level of revenue the Commission authorized it to recover in the preceding rate case, no more and no less. IAWC claims it is symmetrical in that it accounts for both the over- and under-recovery of that revenue requirement. In IAWC's view, the RAC will not have any impact on IAWC's overall revenue requirement. (IAWC IB at 108)

IAWC states that under the RAC, the levels of revenue and production expense (i.e., for fuel, power and chemical) authorized by the Commission in this case constitute "base" levels. Going forward, IAWC says the actual monthly levels of revenue and production expense will be booked and compared to those base levels. IAWC says that at the end of 12 months, the difference between the base revenue level, net of base production costs, and the actual revenue level, net of actual production costs, will be determined. Under its plan, IAWC indicates it will then file with the Commission on an annual basis a request to issue a refund to customers or to collect a surcharge, as the case may be, reflecting that difference. (IAWC IB at 108)

Under IAWC's proposal, metered customers would receive the corresponding refund or surcharge in its entirety on their next monthly bill. IAWC says the refund or surcharge will not exceed -5% or +5% of any customer's water bill for the applicable 12-month period. IAWC believes that in this way, customer bill impact is mitigated. To the extent the difference exceeds the 5% cap, IAWC proposes for the excess to be deferred to a future period with interest at the AFUDC rate. According to IAWC, this entitles customers to a refund, over time, of any revenues collected above the Commission-approved level. IAWC contends that the function of the RAC ensures that IAWC recovers its required level of revenue as sanctioned by the Commission, no more and no less, while also ensuring IAWC's customers pay the amount of fixed cost contribution authorized to be included in their monthly bills. (IAWC IB at 108-109)

IAWC argues that as the traditional ratemaking model is premised on the establishment of properly recoverable costs and a projection of a volume of sales over which those costs will be recovered, it fails that goal when the actual sales volume is less than the projection used to set rates. IAWC says recent history has proven that to be the case for it. IAWC maintains it is experiencing a significant trend of declining annual water sales. IAWC complains that other variables also outside its control, including weather and changing customer numbers, contribute to its inability to forecast with precision its test year level of water consumption. IAWC claims the RAC effectively eliminates the resulting concerns related to the process of projecting the pro forma water sales volumes used to establish its rates. IAWC repeats that fixed costs remain the same regardless of sales volumes and says the RAC recognizes this. IAWC asserts that the RAC ensures it receives, and customers supply, the level of required revenue approved by the Commission despite the decline in usage, the unpredictability of weather and changes in customer numbers. (IAWC IB at 109)

In its Initial Brief, IAWC argues that Illinois law and Commission practice and policy support approval of the RAC. Among other authority purportedly supporting its position, IAWC cites the Commission's decisions in Docket Nos. 07-0241/07-0242 (Cons.), Docket No. 10-0467, Docket No. 08-0363, Docket No. 07-0585, et al., Docket No. 07-0507, Docket No. 09-0319, Docket Nos. 11-0280/11-0281 (Cons.), and *City of*

Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 611 (1958). (IAWC IB at 110-112)

According to IAWC, the record evidence shows that the significant annual decline in customer usage, unpredictability of weather and changes in customer numbers make the accurate establishment of projected pro forma sales volumes problematic. Citing Docket Nos. 07-0241/07-0242 (Cons.), IAWC claims this is one of the reasons the Commission approved Rider VBA in that proceeding. (IAWC IB at 113)

IAWC disputes Staff's assertion that it has not explained why the RAC is needed now when IAWC has been able to function without that decoupling mechanism until the present. IAWC contends that simply because the RAC has not been in place before does not mean circumstances do not warrant its adoption in this case. IAWC argues that like the energy utilities at issue in Docket Nos. 07-0241/07-0242 (Cons.), climate, demographic, political and economic shifts impacting IAWC and the water industry have been considerable, yet water rate structures have not adapted. (IAWC IB at 114)

IAWC disputes the contention by both Staff and IIWC that the RAC should be rejected because it reduces IAWC's incentive to control costs. IAWC believes this argument is misplaced because the RAC only impacts revenues, and the refund or surcharge amounts are net of production costs. IAWC claims that it remains at risk for fluctuations in fixed costs or unit production costs. IAWC says its management must actively and efficiently manage the cost elements that comprise IAWC's total cost of service. (IAWC IB at 115)

IAWC also disputes the contention of Staff and IIWC that the RAC discourages voluntary water conservation efforts on the part of customers because it imposes a surcharge when their consumption levels decline. IAWC claims it is traditional use of volumetric rate designs to recover fixed costs that implies that a utility can reduce those costs if customers reduce their usage. IAWC asserts that in reality, that is not the case. IAWC claims the price signals customers receive under the RAC will be more aligned with the reality of the provision of water utility service. IAWC contends that even if customers use less water, because the utility's costs are fixed in the short-term and revenues are predominately volumetric, it is still necessary for them to pay for the fixed costs. IAWC also claims Staff and IIWC's contention in this regard ignore there are myriad environmental and operational benefits from lower water usage, including the maintenance of source water supplies. (IAWC IB at 115-116)

IAWC notes that the AG also presents a conservation-related argument against the RAC. The AG contends IAWC has presented no conservation rationale for the RAC and that it is not engaged in aggressive water conservation efforts. IAWC believes it presented ample evidence that conservation measures, both its own and regulatory ones, are a significant driver of the need for decoupling. IAWC also claims the Commission has made clear decoupling mechanisms need not be solely tied to conservation measures to be appropriate. IAWC says Rider VBA was not conditioned on the utilities increasing their energy efficiency initiatives and believes the RAC also should not be so conditioned. (IAWC IB at 116)

B. IIWC/FEA's Position

IIWC/FEA believes IAWC is attempting to shift, to its customers, operating risk that is traditionally borne by the utility and adequately addressed through a traditional ratemaking proceeding. IIWC/FEA says the RAC rider adjusts rates on the basis of only selected cost elements, namely metered revenue and production expenses, without taking into consideration other cost factors that would affect the utility's overall profitability. According to IIWC/FEA, the RAC rider has the potential to provide additional revenue to IAWC without the traditional Commission review to determine the prudence of the cost and revenue elements. IIWC/FEA also believes the ratemaking approach represented by the RAC rider bears a striking resemblance to past instances of "single issue ratemaking" and therefore should be avoided. (IIWC/FEA IB at 32-33; RB at 22-23)

IIWC/FEA also expresses concern that the RAC rider may also distort or otherwise compromise the incentives for prudent and efficient utility operation built into the regulatory oversight and ratemaking process. IIWC/FEA claims that when investors bear the risk of regulatory lag, the utility's management has a strong incentive to control cost escalations. IIWC/FEA says this is due to the fact that any cost increase affects the utility's bottom line until the next rate case. IIWC/FEA also claims the existing regulatory framework also gives IAWC a strong incentive to control its costs in order to avoid upward pressure on rates, as its shareholders are currently at risk for a loss of revenues resulting from a decline in sales levels between rate cases. IIWC/FEA believes that when the risk of such cost increases and sales revenue reductions between rate cases is shifted to customers through the use of tracking mechanisms, the utility's motivation to control costs is significantly reduced. (IIWC/FEA IB at 33, RB at 23)

IIWC/FEA also suggests that revenue decoupling reduces IAWC's financial incentive to control increases and to promote economic development in its service territory. IIWC/FEA contends that the RAC rider restricts IAWC's incentive to manage costs to achieve targeted profits and to mitigate the profit impact created by sales volume variations in its service area. IIWC/FEA also claims IAWC will have little financial interest to attract new commercial and industrial customers to its service area, because the profits from increased sales could be flowed back to customers in the RAC. In IIWC/FEA's view, the RAC would discourage efficient cost management and economic development. According to IIWC/FEA, this is true because all increased revenues would have to be flowed back to customers under the RAC rider. (IIWC/FEA IB at 33-34, RB at 23)

If the Commission approves the RAC rider, IIWC/FEA suggests the Commission should set base levels for both revenue and production expenses and should reject the proposal to reset the base level of production in between rate cases. IIWC/FEA suggests that removing IAWC's ability to automatically pass through annual production cost increases will encourage IAWC to aggressively manage its production expenses and provide an incentive for it to continue implementing cost saving measures. (IIWC/FEA IB at 35)

IAWC argues that it must operate its source of supply, treatment and transmission and distribution system to provide water service to its customers whether those customers use no water, or 100,000 gallons of water, in a given month. IIWC/FEA contends that while the comparison does hold some truth it should not serve as the foundation for a Rider designed to guarantee revenues with no regard as to how much water IAWC actually delivers and sells. (IIWC/FEA RB at 22)

According to IIWC/FEA, Rider RAC has the potential to violate the rule against single issue ratemaking. IIWC/FEA says each of the expense adjustments that occur in the future can be made without regard to other changes that may lower IAWC’s overall revenue requirement. IAWC is proposing a mechanism which decouples its recovery of fixed costs in providing water utility service to its customers from the volume of water it actually sells. IIWC/FEA says IAWC believes Rider RAC will not have any impact whatsoever on IAWC’s overall revenue requirement. IIWC/FEA argues that despite what IAWC claims, the proposed Rider adjusts rates on the basis of only selected cost elements, namely metered revenue and production expenses, without taking into consideration other cost factors that would affect the utility’s overall profitability. IIWC/FEA says the Rider has the potential to provide additional revenue to IAWC without the traditional Commission review to determine the prudence of the cost and revenue elements. IIWC/FEA insists that it is improper to consider changes to components of the revenue requirement in isolation. IIWC/FEA says a change in one item of the revenue formula is often offset by a corresponding change to another component of the formula. (IIWC/FEA RB at 24)

IIWC/FEA disagrees with IAWC's argument that Illinois law and Commission practice and policies support approval of Rider RAC. IIWC/FEA notes that IAWC cites a number of Commission cases in support of this proposition. IIWC/FEA believes it is worth noting that in only one case has the Commission approved a decoupling mechanism similar to RAC. IIWC/FEA says that in the remaining Illinois cases cited by IAWC, the Commission basically rejected the implementation of a rider mechanism similar to Rider RAC. IIWC/FEA states that the Commission elected to address utility concerns on this issue through appropriate rate design changes to allow the utility to recover more of its fixed costs through fixed charges. IIWC/FEA believes this type of redesign is easier for customers to understand than rider mechanisms, such as Rider RAC. (IIWC/FEA RB at 25-26)

C. Staff's Position

Staff believes IAWC has not provided a sound basis for the Commission to adopt the proposed RAC and, therefore, it should be rejected. Staff says that all of the factors cited by IAWC in favor of an RAC were present in its past rate cases, and yet, it was able to function without need of an RAC. (Staff IB at 72)

According to Staff, if the RAC were adopted, ratepayers would potentially be subject to higher rates for service than they would otherwise incur under the traditional regulatory process. Staff believes the RAC proposal will undermine IAWC's incentive to control costs because it would guarantee recovery of the approved revenue requirement. Additionally, Staff claims that having a RAC in place would remove the proper price signals that customers currently receive. Staff states that if the target revenues do not match the actual revenues, both net of production costs, IAWC proposes to add the resulting percentage from the RAC formula to each metered water customer’s bill for one year. Staff says future customer bills will not necessarily decline or increase as a direct result of respectively using less or more water. Staff also expresses concern that ratepayers may not receive the benefit of any reductions in costs or operating efficiencies related to costs. (Staff IB at 72-73)

Staff notes that in rebuttal testimony, IAWC proposed a modification to the design of the RAC allegedly in response to Staff’s concern that the RAC could lead to higher rates. Staff contends that this proposed modification exacerbated Staff’s concern by deferring, to an unspecified future period, any surcharge percentage ("SC%") in excess of 5% with interest charges accruing on the deferred balance. Staff says that under its original proposal, any SC% amount greater than 5% or less than -5% would not be charged or refunded, respectively, to customers and would have been absorbed by shareholders. Staff states that under IAWC's modified proposal, if an SC% surcharge is greater than 5% in one year, then the additional amount will accumulate with interest and be an added surcharge in future years for recovery from ratepayers. It is unclear to Staff how this modification mitigates Staff’s concern that the customers will potentially be subject to higher rates if the RAC is implemented. Staff maintains that this modification to the RAC should be rejected. (Staff IB at 73)

If the Commission decides to adopt an RAC, which Staff does not believe it should, Staff urges the Commission to adopt the version of the RAC proposed in IAWC's direct testimony. Staff notes that the version proposed in IAWC's direct testimony would have shareholders absorb any SC% that is greater than 5%. Staff states that under that version, if IAWC under collected the RAC revenue, no further adjustment was proposed. (Staff IB at 73)

In the event the Commission approves the RAC, Staff witness Hathhorn made several technical changes to the language of the proposed RAC. (Staff Ex. 2.0 at 10-14) In rebuttal testimony, IAWC presented IAWC Ex. 14.02R, which reflects its revised RAC tariff with several modifications adopted from Ms. Hathhorn’s testimony. Staff believes that two issues remain outstanding between IAWC and Staff if the Commission approves RAC. Staff’s final position regarding proposed changes to the RAC, in the event the commission approves it, is included in Staff Ex. 10.0, Attachment B. (Staff IB at 74)

With regard to IAWC's deferral proposal, Staff's Initial Brief indicates that Staff witness Harden opposed the proposal for deferrals. Staff's Initial Brief also indicates that, in the event the Commission authorizes a deferral, Staff witness Freetly proposes that the appropriate interest rate would be the Commission-authorized interest rate for customer deposits. (Staff IB at 74-75)

Staff proposed that IAWC conduct an annual internal audit of RAC, with specific objectives defined in the rider. IAWC believes the internal audit is unnecessary. Staff argues that IAWC's position is inconsistent with many automatic fully tracking cost recovery or revenue balancing mechanisms in operation in Illinois, which Staff says require annual internal audits. In Staff's view, the record has not demonstrated any reason to allow IAWC to receive less monitoring of a tariff with objectives similar to the Peoples/North Shore’s Rider VBA tariffs. (Staff IB at 75-76)

According to Staff, IAWC proposes that if the Commission orders the annual internal audit, that $7,500 be included in the revenue requirement for the incremental expense. Staff contends that there is no basis for this recommendation and it provided no supporting analysis for evidence that the internal audit requirement would increase its costs by $7,500. Staff believes the point is moot, because of the timing of the rider’s implementation and the test year. Staff claims IAWC admits that it would not incur any additional internal audit costs during the test year. Staff insists IAWC's proposal to increase the revenue requirement if the audit requirement is adopted by the Commission must be rejected. (Staff IB at 76-77)

Staff notes that IAWC proposed to use the AFUDC rate as the interest rate to be applied to the deferral of recovery or refund amounts if the surcharge or credit percentage (“SC%”) in the current year exceeds ±5%. Staff believes that the AFUDC rate is not the appropriate interest rate to apply to the deferral of the SC% amount to be refunded or surcharged above or below 5%. Staff says deferred amounts are recovered dollar for dollar. Since under-recovered amounts are essentially a loan from IAWC to customers, Staff contends the interest rate should reflect the credit risk of the customers. Staff also asserts that ComEd and Ameren Illinois affiliates have issued securitized debt whose credit risk were wholly based on the ability of utility customers’ collective ability to pay and those securities were rated AAA/Aaa.

Staff concluded that the default risk of IAWC’s collective obligation to pay under collected revenues would also be rated AAA/Aaa. In contrast, Staff says IAWC’s financial ratios are more indicative of a BBB/Baa credit rating. Unfortunately, Staff is not aware of any readily available publication of either one-year AAA/Aaa or BBB/Baa utility bond yields. Therefore, Staff suggests the Commission-authorized interest rate on customer deposits, determined in accordance with 83 Ill. Adm. Code 280.70(e) should be applied to any deferred amounts under Rider RAC. Given the ease of administration in connection with Staff and IAWC relying on a rate published annually by the Commission, and the small difference between the customer deposit rate and current 0.68% yields on one-year AA financial securities, Staff recommends applying the Commission-authorized customer deposit rate to under-recovered amounts and refunds associated with the formula rate, if the Commission approves a deferral. (Staff IB at 77-78)

D. The AG's Position

The AG urges the Commission to reject IAWC's proposed Rider RAC because it contravenes accepted ratemaking principles, and is the same type of prohibited single-issue ratemaking device that has been rejected by Illinois courts. According to the AG, IAWC's RAC is an unlawful rider that does nothing more than guarantee revenues while shifting costs across customer classes and districts, and ignoring both the quantities of water sold and the wide disparities in production costs across districts. The AG also claims IAWC has not proven that the proposed RAC and its guaranteed revenues are necessary. (AG IB at 43-44, RB at 25)

The AG states that proposed rider RAC delivers a predetermined level of revenues to AIWC without any consideration of how much water customers actually use. The AG also says proposed RAC applies the same surcharge to every gallon of water IAWC sells regardless of location, despite the extreme variances in costs and charges among districts, customer classes, and usage levels. (AG IB at 44)

The AG asserts that although IAWC describes the RAC as a simple mechanism, calculation of the amount payable to IAWC is anything but simple, involving a series of calculations that ultimately lead to the subtraction of "Actual Revenues" from "Target Revenues" – essentially guaranteeing a predetermined level of revenues. (AG IB at 44)

In the AG's view, the proposed RAC violates the commonly accepted principles that underlie the treatment of revenues for a water utility, including that revenues are always subject to the amount of water sold to customers, the numbers of customers added or lost, or any other volume or demand factor. The AG states that instead, it is based exclusively on a predetermined "target revenue." The AG contends that the proposed RAC places the risk associated with revenues on the ratepayers, not on shareholders, who are compensated for such risk through a Commission-established rate of return on investment. (AG IB at 45, RB at 25-26)

The AG argues that this risk-shifting to ratepayers defeats the very purpose of a regulatory system. The AG contends that generally, the competitive market does not set prices for regulated water utilities in Illinois. The AG states that in its simplest terms, because utilities have a captive base of customers and operate under a monopoly franchise, regulators set the price that utilities may charge to that captive base of customers. The AG claims that the very purpose of regulation is to set fair, just and reasonable prices for those customers, not to guarantee that the utility and its investors receive a guaranteed stream of revenue. The AG asserts that regulation fixes the prices that customers pay for their utility service, while the revenues that the utility receives will vary based on the number of customers served and the volume each customer uses. According to the AG, the regulatory bargain is based on the utility receiving a return on investment well in excess of a risk-free rate of return to compensate it for the risk of consumers buying more or less of its service than projected. (AG IB at 45-46)

The AG contends that with proposed RAC, IAWC attempts to reverse this basic principle of regulation. According to the AG, IAWC suggests that the very purpose of regulation should be to deliver a fixed revenue recovery to the utility and adjust the price to the consumer as the utility sees fit. The AG says IAWC would shift risk to the captive utility customer and strip that customer of the certainty of having a stable and known price. (AG IB at 46)

The AG asserts that for each of the years between 2005 and 2010, IAWC's “targeted revenues” exceeded actual revenues, meaning ratepayers would incur surcharges each year, amounting to a 5% annual rate increases without the traditional Commission oversight present in a rate case. The AG also claims that in the years 2005 and 2006, IAWC sold more water than projected, but collected less revenue. The AG says IAWC's revenues in those years fell short of projected revenues by $13.6 million and $21.1 million respectively. The AG believes these revenue shortfalls are likely the result of more water being sold to lower-margin customers in these periods than had been projected. In the AG's view, this actual data demonstrates that the proposed Rider RAC is not designed to address sales reductions resulting from efficiency efforts, as claimed by IAWC, but rather designed to guarantee revenue streams. (AG IB at 46, RB at 26)

While IAWC argues that the rider provides symmetrical benefits, noting that the rider provides for customer refunds when actual revenues exceed forecasted revenues in a given year, the AG claims the record evidence demonstrates the unlikelihood of such a benefit incurring to ratepayers. The AG maintains that for each of the years it analyzed, IAWC failed to meet its targeted revenues despite selling more water than it had projected. Had Rider RAC been in effect, the AG says ratepayers would not have seen a single refund. In the AG's view, despite the so-called symmetrical aspect of the rider, IAWC's own data demonstrates that ratepayers are more likely pay surcharges to ensure IAWC reaches its guaranteed level of revenues even when IAWC sells more water than it had projected. (IAWC IB at 47, RB at 26-27 and 32-33)

The AG argues that Rider RAC does more than “decouple” usage from revenues. The AG avers that it also shifts costs among customer groups and usage levels so that even in years where usage is constant or increases, the RAC would lead to surcharges. (AG IB at 47. RB at 27)

The AG believes a key design flaw of the proposed Rider RAC is that it ignores a more than 400% difference in production costs from one location to another in IAWC's service territory. The AG claims there are significant variations in production costs across locations in IAWC's service territory. The AG says production costs, a vital variable that the RAC fails to acknowledge, range from a high of 52.43 cents to a low of 9.88 cents per 1,000 gallons. (AG IB at 47-48)

The AG states that proposed RAC is based on the margin (or mark-up) between the rate per unit of water (typically ccf or 1,000 gallons) to customers and IAWC's production costs per unit of water, both of which it says vary widely. The AG claims that the varying rates, production costs, and margins demonstrate that the RAC is not a “decoupling” mechanism in the traditional sense of the word, but rather is a faulty ratemaking tool that undermines cost allocation, rate design, and the fundamental relationship between usage and revenue. (AG IB at 48)

According to the AG, these sizable rate, production cost, and margin variances between rate areas will ultimately impact the calculation of the proposed RAC, even if IAWC does not sell less water. As an example, the AG says if sales were to decline by 1 million gallons in Zone 1, IAWC would lose $5,175 in margin. The AG also states that if sales increased by exactly the same 1 million gallons in Pekin, IAWC would gain $2,984. The AG contends that under the RAC revenue recovery mechanism, customers would be assessed a surcharge even though IAWC sold exactly the same amount of water as it projected merely because the water was sold in a different location. The AG states that variations in the level of sales among districts – not reduced overall usage – drives the RAC calculation. (AG IB at 48-49)

The AG claims the proposed RAC also ignores the effects of a shift in usage among customer classes, resulting in ratepayers paying surcharges even if IAWC sells as much water overall as projected. The AG says IAWC's present and proposed rates contain declining block rates for large commercial, public, and industrial customers, meaning that margins are lower from high-usage, non-residential customers than for residential customers in the same rate area. That AG asserts that if non-residential consumption increased and at the same time residential consumption decreased by exactly the same amount of water, under the proposed RAC, its total margin would decrease due to the lower non-residential margins. The AG says in that situation, ratepayers would pay more to cover IAWC's guaranteed revenue despite selling an identical amount of water in total and the lower costs associated with large volume usage. The AG believes this is not an appropriate use of the ratemaking process. Customers should not be required to guarantee revenues and insulate a utility from the effects of changes in consumption. (AG IB at 49)

In the AG's view, another serious flaw of this proposed revenue-generating device is that it does not distinguish the recovery of revenues based on the source of the water. The AG suggests that Chicago Metro customers, who receive purchased water rather than water produced by IAWC, would be responsible for paying the purchased water surcharge as well as any RAC surcharge based on the difference in revenues net of production costs in the non-purchased water rate areas. (AG IB at 49)

The AG argues that another reason for Commission rejection of the rider is that IAWC failed to prove that such an extreme and unusual ratemaking device is financially necessary. The AG claims IAWC provided questionable evidence as to declining water usage and no financial evidence that the test year demand levels would not enable it to recover its costs of providing safe and reliable service and provide an opportunity to earn a reasonable return. The AG asserts that despite repeatedly claiming the need for this guaranteed revenue stream, IAWC relies primarily on its repeated statements that it is entitled to the additional revenues the RAC would generate rather than evidence of sustained financial hardship. (AG IB at 49-50)

According to the AG, IAWC relies heavily on statements and calculations that it is experiencing a downward trend in residential water usage that averages about a 1.9% decline each year. The AG believes IAWC's projections are based on flawed and overly-simplified analyses. In projecting its consumption levels, the AG says IAWC did not consider a large enough sample of data and failed to account for major influences in water demand forecasting, including population, economic factors, changes in water-using appliances, weather, climate, price, and conservation programs. In the AG's view, the bases for IAWC's statements about declining usage are therefore unreliable and should be rejected. (AG IB at 50, RB at 28)

The AG avers that although there appears to be a currently declining long-term consumption trend, this does not translate to a year-after-year reduction in consumption or a reduction in total revenue. As is true in any long-term forecast, there will be year to year fluctuations. The AG suggests that eventually, the trend will level off as more homes become equipped with efficient fixtures and appliances. The AG says at no point will this trend line reach zero because there will always be some demand for water. Until that potentially theoretical date when the demand trend does level off, however, the AG believes a rate case is the appropriate forum in which to determine IAWC's revenue requirements. The AG says IAWC has been seeking rate changes every two years and already has an infrastructure rider, Rider QIPS, reducing the time during which its demand projections will be in place and covering its investment needs. The AG suggests that these regulatory tools already address any reduction in demand and need for revenue and an automatic revenue guarantee is unnecessary and redundant. (AG IB at 50-51, RB at 30)

The AG says this identical issue was rejected by the Indiana Utility Regulatory Commission (“IURC”) earlier this month in a rate case involving IAWC's affiliate, Indiana American Water Company. The AG also complains that IAWC's alleged financial justification for the rider also inappropriately ignores the reduced risk to shareholders a revenue guarantee mechanism like the RAC provides IAWC. The AG says IAWC argues that there was no way to quantify adjustments to risk premiums and return on equity as a result of the RAC. The AG believes that position belies IAWC's argument that it needs the RAC to address revenue risk and exposes the RAC as nothing more than a revenue guarantee for IAWC shareholders at ratepayer expense. (AG IB at 51-52)

The AG believes IAWC's claim that it is necessary to implement the RAC due to variability in weather should also be rejected. The AG notes that this is a variable that has always existed in the water industry and in other utility industries as well. The AG says there is no evidence in the record that the utility could predict weather more accurately in the past, necessitating the proposed RAC. The AG urges the Commission to reject this attempt to guarantee revenue to investors. (AG IB at 52)

According to the AG, the proposed Rider RAC violates the Commission's test year rules. The AG says a necessary component of setting utility rates is the synchronized examination of each aspect of a utility's cost of service and each source of revenue, which the AG describes as the "matching principle." (AG IB at 52-53)

The AG argues that proposed RAC ignores the established relationship between utility rates and levels of cost and investment, contravening established ratemaking practice and shifting unnecessary risk to the ratepayers. The AG states that under Parts 285 and 287 of the Commission's rules, a utility seeking to increase revenues must file a rate case using a proposed test year if it wants to increase revenues by more than 1%, the purpose of which is to require the utility to match revenues, expenses, rate base, and capital costs to the same time period. The AG says estimating sales is a key component of the ratemaking equation, and the variability in demand provides utilities with the incentive to achieve efficiencies (when sales decline) and the opportunity to exceed the allowed return on investment (when sales increase). (AG IB at 53)

The AG contends that a revenue requirement established in a rate case represents the Commission's best estimate of revenues that a utility needs to both recover its costs and earn a reasonable profit. The AG states that while rates are set based on the specific revenue requirement set in a rate case, monopoly regulation in no way assumes that utility expenses and revenues will remain static or that the utility is guaranteed a certain level of revenues. The AG says expenses, revenues and the cost of capital are inherently dynamic and ever-changing. According to the AG, rate of return regulation in Illinois, a key part of the regulatory bargain, sets rates based on prudently incurred and reasonable expenses based on a test year that serves as a snapshot in time of the utility's revenue needs, including a reasonable return on the utility's rate base. The AG avers that when rates are set using a designated revenue requirement based on the test year expense and revenue levels, utilities are given the opportunity, not a guarantee, of earning a designated profit level. (AG IB at 53-54)

The AG states that the traditional rate-setting process was designed to allow a utility the opportunity to earn a reasonable rate of return on investment; a utility has never been guaranteed a specific margin revenue level. While rates should never be set so low as to be confiscatory to the utility, the AG says Illinois Courts have explained that, within this outer boundary, if the rightful expectations of the investor are not compatible with those of the consuming public, it is the latter which must prevail. (AG IB at 55)

According to the AG, IAWC asserts that it needs Rider RAC in order to ensure cost recovery, and assumes that it is entitled to a guaranteed specific revenue level until rates are reset in a future rate case. The AG argues that riders are a mechanism to be used in very specific circumstances, to recover very specific kinds of expenses. Using a rider to guarantee a designated level of revenues violates the rules governing riders established by the Illinois courts. (AG IB at 55-56)

The AG asserts that as a general rule, an automatic rate adjustment mechanism should be used, if at all, only for significant expenses that are volatile and largely outside of the utility's control. The AG says every Illinois court to review a non-statutory Commission-approved rider has judged it against the limits established by the rule against single-issue ratemaking. (AG IB at 56-57)

In the AG's view, Rider RAC, as proposed by IAWC, is inconsistent with the parameters identified by Illinois courts. The AG says recovery of designated revenue forecasts is not recovery of a pass-through expense. The AG also says the sole purpose of the rider is to increase income (when revenues are less than expected), thereby directly impact the utility's rate of return. (AG IB at 57)

The AG argues that Rider RAC is unlawful because its purpose of guaranteeing revenue streams has the effect of adjusting utility rates based solely upon changes in revenues, without regard to other changes in the utility's rate base, operating expenses, customer numbers or the cost of capital. The AG says RAC assumes, inappropriately, that the utility's financial health is dependent on ensuring that an established revenue level is maintained between rate cases. The AG asserts that this unjustified premise for the RAC revenue-recovery mechanism ignores the fact that utility expenses, rate base, customer numbers and cost of capital are dynamic and ever-changing. The AG contends that the RAC fails to properly account for (1) changes in operating expenses, such as labor force reductions and operating efficiencies gained through new technology; (2) changes in the rate base; and (3) changes in the cost of capital – all elements that affect a utility's revenue requirement. The AG complains that Rider RAC changes future customer rates to account for changes in only a single element of the revenue requirement formula – forecasted customer revenues, while ignoring all other changes. (AG IB at 58-60)

The AG notes that IAWC attempts to compare this proposed revenue-guaranteeing device with riders that have been approved in other jurisdictions or other Commission dockets. According to the AG, these other riders are distinguishable and should not be considered persuasive by the Commission. (AG IB at 60-61, RB at 29 and 34)

In response to IAWC's comments about what other states have done, the AG asserts that the Commissions in those states did not want to penalize the utilities for the State's mandated, aggressive water conservation programs, and allowed the revenue requirement to be decoupled from the volume of water sold. The AG says Illinois is not engaging in any mandatory conservation efforts, particularly aggressive efforts. The AG also disputes IAWC's efforts to compare its situation to that addressed Docket Nos. 07-0241/07-0242 (Cons.) and 11-0280/11-0281 (Cons.). (AG IB at 60-61, RB at 30-33)

The AG asserts that the purposes for which a water utility may file an information sheet are referenced in section 8-306(c) of the Act, which requires water utilities to notify consumers when rates are changed pursuant to a Section 9-201 rate case or an information sheet. The AG states that Section 8-306(c) recognizes that information sheets are allowed for a purchased water surcharge, purchased sewer treatment surcharge, or qualifying infrastructure plant surcharge. The AG insists that it is inappropriate to expand that list of automatic rate adjustments in light of the legislature's specific requirement that consumers must be notified if the enumerated information sheets change rates. (AG IB at 62-63)

The AG says IAWC provides a lengthy string of cites to numerous orders for the proposition that recovery of fixed costs through fixed charges is an important issue before the Commission. The AG asserts that the Commission did not approve a revenue-adjusting rider in any of these cited cases. The AG asserts that although the Commission did approve certain straight fixed-variable surcharges in some of these cases, these were largely rate design issues and still require the utility to recover a portion of fixed charges through a volumetric rate. The AG insists IAWC's proposed RAC is not comparable to these rate design riders because it focuses solely on guaranteeing IAWC's revenue. (AG RB at 33)

E. The Municipalities' and Bolingbrook's Positions

The Municipalities contend that the Act does not guarantee that the utility will earn its revenue requirement. The Municipalities assert that the Act is designed to permit the utility to have an opportunity to earn its revenue requirement. In the Municipalities' view, the Act does not grant an entitlement to the utility to earn its approved revenue requirement. (Municipalities IB at 2, RB at 1-2)

According to the Municipalities, IAWC has presented no credible evidence that its rider is justified in this docket. The Municipalities assert that IAWC has not demonstrated that its revenues are subject to unpredictable, highly fluctuating factors that require rider treatment. (Municipalities IB at 2) The Municipalities state that nothing has changed since IAWC's last rate case that supports IAWC's contention that changing business realities warrant the RAC. The Municipalities say there always has been variability in weather, and customer usage has been declining for some time. (Municipalities RB at 2)

The Municipalities assert that IAWC erroneously attempts to justify the RAC rider by arguing that its water sales have been declining and will continue to decline because customers are installing more efficient plumbing fixtures and appliances. To offset this alleged decline in usage, IAWC argues that the Commission should decrease test-year projected sales when computing the rates in this docket and implement the RAC rider to protect the Company from further reductions in usage. (Municipalities IB at 4)

IAWC contends that, because the Energy Policy and Conservation Act of 1992 ("EPCA") mandated the manufacture of more efficient toilets, showerheads, faucet fixtures, and appliances, that water usage will decline in its service territories thereby requiring approval of the RAC as well as an adjustment downward in consumer usage in the test year. According to the Municipalities, IAWC offers no explanation as to why suddenly, two decades after passage of the EPCA, that declining water usage has become unexpected and volatile requiring the extraordinary remedy of a rider. (Municipalities IB at 4)

The Municipalities believe IAWC’s assumption concerning the replacement of plumbing fixtures and appliances is flawed. IAWC argues that all homes constructed before the mid-1980s will have new fixtures and appliances installed in the next several years, thereby causing water usage to decrease and necessitating the RAC rider to recover lost sales revenue. The Municipalities contend that IAWC ignores the fact that newer, water-conserving fixtures and appliances already have been installed in much of the housing stock in IAWC’s service territory. The Municipalities believe IAWC's argument that there will be volatile, unanticipated decreases in water consumption in the future to justify a rider is flawed. (Municipalities IB at 4-5)

The Municipalities also believe the RAC should be rejected because it is bad public policy. They believe the rider sends the wrong signal to customers who take measures to conserve water usage. The Municipalities state that under the RAC, IAWC is free to increase annually its rates to make up for any “shortfall” in its revenue requirements. The Municipalities states that if a customer engages in water conservation and the conservation results in IAWC receiving less revenue, then IAWC will increase the charge to the customer in the next year. Rather than being rewarded for water conservation by seeing a lower bill, the Municipalities say IAWC would increase the customer’s bill. (Municipalities IB at 5)

The Municipalities contend that IAWC is wrong when it argues that the RAC will not discourage voluntary water conservation efforts. Contrary to IAWC's argument, the Municipalities assert that customers who engage in water conservation, which could result in a decrease of IAWC’s actual revenues, would pay higher bills the following year if the RAC were adopted. The Municipalities say this result would occur because the RAC allows IAWC to surcharge customers for any revenue shortfall. The Municipalities state that increasing the cost of water to customers who are conserving water sends a price signal to the customer that conservation only results in a higher bill, a result that discourages water conservation. (Municipalities RB at 2-3)

In its Reply Brief, Bolingbrook urges the Commission to deny IAWC's proposed rider RAC. In support of its position, Bolingbrook cites testimony offered by the AG. (Bolingbrook RB at 8-9)

Bolingbrook contends that the RAC, if implemented, would shift risk to the ratepayer and get rid of price certainty for the ratepayer. Bolingbrook claims IAWC sets forth no compelling evidence or reason for this dramatic change. (Bolingbrook RB at 9)

Bolingbrook asserts that for customers in the Chicago Metro service area, which includes users within Bolingbrook, IAWC's residential production costs are much lower than they are elsewhere in the State. Bolingbrook says IAWC's proposed rate to Chicago Metro is different from its proposed rates to other service areas. Bolingbrook states that despite the fact that Chicago Metro has the lowest residential production cost, it does not receive the lowest proposed rate. Bolingbrook also states that IAWC's profit margins vary in the differing service areas, but the RAC does not take this into account such that members of the Chicago Metro service area may end up paying for a decrease in usage in other service areas despite the fact that the usage in Chicago Metro stayed the same or increased. (Bolingbrook RB at 9)

Bolingbrook also argues that the RAC violates the Commission's test year rules and established ratemaking principles, which are based upon an overall evaluation of each aspect of a utility's cost of service and each source of revenue. Bolingbrook states that a just and reasonable rate does not ensure that the business shall produce net revenues. (*Id.*)

F. Conclusions

IAWC has proposed a mechanism, the Revenue Adjustment Clause or "RAC," which would "decouple" its recovery of fixed costs in providing water utility service to its customers from the volume of water it actually sells. IAWC says the proposed RAC would provide it with a measure of revenue stability which would enable it to champion water conservation measures without the fear of undermining business interests in the face of the declining usage trend IAWC has and expects to continue to experience.

Under the proposed RAC, the levels of revenue and production expense authorized by the Commission constitute "base" levels. IAWC proposes that the actual monthly levels of revenue and production expense be booked and compared to those base levels. IAWC says that at the end of 12 months, the difference between the base revenue level, net of base production costs, and the actual revenue level, net of actual production costs, would be determined. Under its plan, IAWC indicates it would then file with the Commission, on an annual basis, a request to issue a refund to customers or to collect a surcharge, as the case may be, reflecting that difference.

Under IAWC's proposal, metered customers would receive the corresponding refund or surcharge in its entirety on their next monthly bill. IAWC says the refund or surcharge would not exceed -5% or +5% of any customer's water bill for the applicable 12-month period. To the extent the difference exceeds the 5% cap, IAWC proposes for the excess to be deferred to a future period with interest at the AFUDC rate.

The proposed RAC is opposed by Staff, IIWC/FEA, the AG, the Municipalities and Bolingbrook. These parties argue, among other things, that the proposed RAC is unlawful, unnecessary, inconsistent with traditional ratemaking in Illinois, and unfair to ratepayers. The extensive arguments on this issue are summarized above and are not repeated in this conclusion. The Commission has, however, carefully reviewed the testimony and arguments regarding this issue.

The purpose of utility regulation is to substitute for competition in markets where government has determined that monopolies are either natural, or more efficient than a competitive marketplace. An important aspect of utility regulation involves balancing the competing interests of ratepayers and utility investors. Generally, the Commission believes that the interests of water/wastewater ratepayers and investors in Illinois have been well served by the traditional regulatory scheme. Having said that, it is important to constantly monitor the regulatory environment and, when necessary, make appropriate modifications or accommodations that are in the public interest.

The Commission notes, for example, that Public Act 91-638 added Section 9-220.2 to the Act. Through Section 9-220.2, which became effective January 1, 2000, the General Assembly added a provision whereby the Commission may authorize a water or sewer utility to file a surcharge which adjusts rates and charges to provide for recovery of (i) the cost of purchased water, (ii) the cost of purchased sewage treatment service, (iii) other costs which fluctuate for reasons beyond the utility's control or are difficult to predict, or (iv) costs associated with an investment in qualifying infrastructure plant, independent of any other matters related to the utility's revenue requirement. These surcharges are essentially exceptions to test-year ratemaking, and Section 9-220.2 protects ratepayers by requiring a reconciliation process where recoveries are limited to “prudently incurred costs.”

As discussed above, IAWC proposes a mechanism which would decouple the recovery of fixed costs from the volume of water sold. IAWC's underlying basis for proposing the RAC is a trend of declining water usage by residential customers. It appears that IAWC does not suggest that the proposed RAC falls within the provisions of Section 9-220.2 of the Act.

That a decoupling mechanism, such as the proposed RAC, is not explicitly authorized by the Act does not necessarily make it unlawful, but should not be ignored. Clearly, Section 9-220.2 already provides water utilities with several mechanisms that provide them with levels of revenue stability and investment recovery between rate cases. In its water operations, IAWC is in fact benefitting from two of those mechanisms authorized in Section 9-220.2. As such, IAWC is experiencing a reduction of the uncertainties and risks that it would otherwise be facing between rate cases. Whether the record in this case supports the approval of an additional mechanism providing protections beyond those already in place is the question before the Commission. In the Commission’s opinion, it does not.

IAWC claims that residential water sales are projected to decline each year. However, the record does not indicate why water sales are more difficult to predict than other elements in a forecasted test year. Test-year sales volume is one of the many variables that in combination produce the test year revenue requirement and ultimately, utility rates. There is uncertainty associated with most of these variables, including sales volume. The entire test-year ratemaking concept is premised on the fact that these uncertainties exist and will offset one another to some extent during the period rates are in effect.

Further, under IAWC's formula, the RAC as proposed would remove the proper price signals that customers currently receive. If the target revenues do not match the actual revenues, the resulting percentage from the RAC formula would be added to each metered water customer's bill for one year. Thus, future customer bills will not necessarily decline or increase as a direct result of respectively using less or more water.

In conclusion, the Commission finds that approval of the proposed RAC is not supported by the record and is not in the public interest, and will not be granted.

XII. AFFILIATED INTEREST ISSUES

Staff has concerns regarding affiliated interest arrangements between or affecting IAWC, American Water Works Service Company ("AWWSC") and American Water Resources ("AWR"), as discussed below.

A. Staff Position

1. Overview

IAWC's current agreement with its affiliated service company, AWWSC, was approved in Docket No. 04-0595. The preceding agreement with AWWSC was approved in Docket 88-0303. These agreements outlined services that AWWSC could provide to IAWC, established the method of cost recovery for AWWSC, and provided certain restrictions on the behavior of AWWSC in its actions with other companies. (Staff IB at 78)

In Docket No. 02-0517, IAWC requested Commission approval of an agreement with another affiliate, American Water Resources. This agreement would have authorized IAWC (and AWWSC) support of AWR through letters, mailings, billing and repair service initiation. In its Order on Reopening, the Commission declined to approve any assistance to AWR and denied approval of the agreement. (Staff IB at 79; Staff Ex. 7.0 at 3-4)

According to Staff, "Despite the Commission's refusal to approve the proposed agreement above, IAWC has ignored and circumvented this prohibition by allowing its affiliated service company, AWWSC, to interact with AWR on its (i.e. IAWC's) behalf." (Staff IB at 79) AWWSC has entered into several agreements that enable AWR to benefit from its indirect association with IAWC. Specifically, AWWSC has set forth methods of allocating costs to AWR "that do not adequately reflect AWWSC's own incursion of these costs." (*Id.*)

As a direct result, Staff argues, IAWC ratepayers are currently paying and will continue to pay for costs that should have been assigned to AWR. In addition, AWWSC and IAWC "provide other services to AWR that have not been approved by the Commission and for which inadequate compensation is received." (*Id.*, citing Staff Ex. 7.0 at 3, 8-10) In order for the Commission to determine the presence and extent of any misconduct between IAWC, AWWSC and its affiliates, these agreements and their subsequent interactions must be reviewed.

In Staff's view, the Commission should "open an investigation into whether the IAWC-AWWSC AIA is in the public interest, given AWWSC and IAWC's failure to abide by their agreement and their joint provision of services both directly and indirectly apart from the AIA." (Staff IB at 81)

In his rebuttal testimony, Staff witness Mr. Sackett made "three specific recommendations." They are (1) Open a proceeding to determine whether IAWC is in violation of Section 7-101 of the Public Utilities Act ("Act") by allowing its affiliate, acting as its agent, to provide services not approved by the Commission and consider whether imposing penalties on IAWC for violating the Act would be appropriate; (2) Order that IAWC prohibit AWWSC employees from referring IAWC's ratepayers to any affiliate providing non-regulated services; and (3) Reduce test year depreciation expense by $44,120 [later reduced to $10,268]."

Section VII.B.1 of Staff's Initial Brief is titled, "IAWC, AWWSC and AWR Affiliated Interest Agreements ('AIA')." Staff states, in part, "The IAWC–AWWSC AIA allows AWWSC to provide services to regulated affiliates as long *as the terms of this agreement are equal to or better than those offered to regulated affiliates*. Additionally, the agreement allows AWWSC to provide services to non-regulated affiliates (and non-affiliates) as long as no costs from serving these other parties are passed on the IAWC." (Staff IB at 81)

VII.B.2 of Staff's Initial Brief is titled, "AWWSC AIA and MOU." In addition to the aforementioned agreements that require Commission approval, AWWSC entered into other agreements "that do not require Commission approval but, nevertheless, do impact rates to IAWC ratepayers." (Staff IB at 83)

In February of 2007, AWWSC entered into an agreement with AWR ("AWR–AWWSC AIA") in support of the Call Center Awareness Program ("CCAP"). Under the AWR–AWWSC AIA, AWWSC provided Call Center Awareness Program or Service Line Awareness Program ("SLAP") services. These services consisted of reading scripts about AWR products to all callers from certain states and transferring calls to AWR. (*Id.* at 83-84)

In December of 2007, AWWSC entered into an agreement with AWR (AWR–AWWSC Memorandum of Understating ("MOU")). The agreement outlines the allocation and assignment of costs for a facility in Alton, Illinois that is jointly used by AWWSC and AWR but does not provide for services between the two parties.

Section VII.C of Staff's Initial Brief discusses, "Commission Decisions Regarding Actions of Service Companies." (Staff IB at 84-96) Staff states that in Docket No. 11-0046, "the Commission ordered Nicor Gas to stop soliciting on behalf of its affiliates. The Commission ruled that Nicor Gas ratepayers were subsidizing its affiliate because the value of a service exceeded the cost that was paid by an affiliate." (Staff IB at 84-85)

In the North Shore Gas Company and The Peoples Gas Light and Coke Company rate proceedings, Docket Nos. 11-0280 and 11-0281 (Cons.), "the Commission ordered an adjustment to operating expense for the market value of services provided to a marketing affiliate by an affiliated service company which provided customer service to utility ratepayers." (Staff IB at 85)

In Docket No. 11-0561, et al., the Commission approved an agreed to adjustment for the provision of information to a third party and an investigation into the AIAs between all Illinois Utilities Inc. utilities and their service company.

Staff argues, "Similarly, in this case, an investigation into the AIA is an appropriate outcome in a rate case where there is evidence of suspected or actual impropriety." (Staff IB at 86)

2. Cost Shifting Issues; Phone Charge Adjustment; Other Phone Charge Issue

Section VII.D of Staff's Initial Brief is titled, "Cost Shifting Issues." Staff witness Sackett "outlined two things that must occur in order for the Commission to ensure that AWWSC charges under the IAWC–AWWSC AIA to IAWC do not include costs from other parties." (Staff IB at 86)

First, because any improper terms could lead to subsidization of affiliates by ratepayers, the terms of any other agreements to which AWWSC is a party must be made available for Staff/Commission review. Second, all costs allocated or assigned according to those various agreements must be verified to know that the terms are being followed.

Staff complains that "such verification has not been not possible because IAWC has refused to provide some of these agreements. … Moreover, IAWC has refused to provide documentation about the costs and the basis, again stating that such costs are not relevant to this case. … Thus, the Commission does not have the benefit of a complete record. However, even with the incomplete record in front of it, there are several clear instances where such inappropriate cost-shifting has occurred." (Staff IB at 86-87)

Regarding IAWC's "refusal" to provide information, the Commission observes that no motions to produce or compel formal discovery were filed by Staff.

Staff offers two adjustments “which reflect inappropriate cost shifting on the part of IAWC and its affiliates.” (Staff IB at 87)

Section VII.D.1 of Staff’s Initial Brief is called, “Phone Charge Adjustment.” AWWSC incurs charges from the phone company based upon the duration of the calls. According to Staff, “because AWWSC has decided to charge phone costs in a different manner than it incurs charges from the phone company, costs are shifted from other affiliates to IAWC.” (*Id*. at 88)

Under Section VII.D.1.a, “CCAP/SLAP,” Staff recommends “an adjustment of $75,000 in total due to AWWSC’s overcharges to IAWC.” The overcharges to IAWC are a result from AWWSC charging AWR for the number of transfers, not the “actual time spent” or even the number of statements read. (*Id*.)

The Commission observes that the methodology used to calculate the adjustment involves a series of calculations discussed for the first time over a several-page portion of Staff’s Initial Brief. As IAWC points out in its Reply Brief, neither the adjustment itself, nor the multi-step methodology used to calculate it, were proposed in the evidentiary record.

In its Brief on Exceptions, Staff indicates that it does not take exception “to the PO’s conclusion not to order a Phone Charge Adjustment in this case.” (Staff BOE at 28)

Section VII.D.1.b of Staff’s Initial Brief is titled, “Other Phone Charge Issue.” As noted above, the IAWC-AWWSC AIA allows AWWSC to provide services to unregulated affiliates as long as no costs associated with that service are charged to IAWC.

AWWSC charges costs to its affiliates, both AWR and the regulated affiliates, based on the average cost-per-call times the number of calls. According to Staff, this means that the service company is made whole but those affiliates that have shorter calls than average are subsidizing those affiliates that have longer calls. Historically, those regulated affiliates that have participated in the CCAP/SLAP would have a statement read to all calls that came into the call center on the toll-free telephone lines. (Staff IB at 92)

AWWSC incurs the costs for those charges even when the ratepayer is talking to AWR. In Staff’s view, these increased charges should have been allocated to those regulated affiliates that had agreed to allow the CCAP/SLAP to occur within their jurisdictions; however, the increased charges are spread equally across all affiliates. Additionally, some regulated affiliates bill on behalf of AWR and, thus, their ratepayers will likely spend more time on the phone with AWWSC. Both of these circumstances likely make the duration of IAWC’s calls in the Customer Service Center (“CSC”) less than average. (*Id*. at 92-93)

Since IAWC "refused to provide" the actual average duration of calls for AWWSC as a whole, a separate average duration for IAWC or any duration for AWR, it is not possible to calculate the amount of this effect on the proposed rates at this time. Although, a specific adjustment cannot be determined in this instance, this choice of method further illustrates that these cost-shifting issues should be reviewed in Staff's recommended investigation. (*Id*.)

3. Joint Facilities Expansion Adjustment

Section VII.E of Staff's Initial Brief is titled, "Joint Facilities Expansion Adjustment." Staff recommends that the Commission disallow $10,268 "for IAWC's portion of costs related to AWR's expansion of joint facilities with AWWSC." (Staff IB at 93) Staff had originally proposed an adjustment of $44,120. The amount was revised to $10,268 based on a corrected DR response from IAWC.

AWR shares a joint facility in Alton that is leased from Alton Center Business Park ("ACBP"). The sharing of these costs is governed by the AWR-AWWSC MOU. Because AWR shares some of the costs of this facility, all costs associated with that facility that are not assigned or allocated to AWR remain in AWWSC's pool and are allocated to other parties, including IAWC. Staff recommends "that the Commission hold IAWC responsible for establishing that costs are not improperly included in the operating expenses in this case." (Staff IB at 93-94; Staff Ex. 7.0 at 16)

There have been two expansions at Alton since the AWWSC Customer Service Center began its operations there in 2001. Both expansions required one-time and ongoing upgrade costs. The first expansion occurred in 2004 and was primarily to gain space to establish a call center for AWR. The one-time costs of this expansion were paid for directly by AWR to ACBP. Both parties paid increased rent based on the increased space each used. (Staff IB at 93-94)

The second expansion occurred in 2007 and was to provide space for both AWR and AWWSC. The one-time costs of this expansion were apparently paid for entirely by AWWSC to ACBP because, while AWWSC incurred $2.8 million which were capitalized in November 2007, AWR did not bear any portion of the one-time, incremental costs. (*Id*.)

While IAWC claims that AWR pays for its portion of the second expansion with an increase in rent, this does not address the one-time costs needed to expand the facility. (*Id*. at 94-95; Staff Ex. 15.0 at 32) AWWSC faced both one-time costs and increased rent for this expansion. In contrast, AWR also faced increased rent from the 2004 expansion and still paid the incremental portion of costs. (Staff Ex. 15.0 at 33)

Although IAWC asked for and received documentation from ACBP for 2004 expansion, IAWC did not provide any documentation of AWR costs for 2007.

Currently $10,268 "from IAWC's portion of the $2.8 million was capitalized with this expansion and has not fully depreciated and still remains in the test year." In Staff's view, since IAWC has not provided any proof that the costs included in this amount do not include some AWR costs in violation of Article 5.2 of the IAWC-AWWSC AIA, the full amount of this cost expense should be excluded in this case. (Staff IB at 95)

In its Reply Brief, Staff sates, "While IAWC claims that the allowance for AWWSC's 2007 expansion is overstated by Mr. Sackett because 'only a small portion of the total expansion was related to AWR's facilities' (IAWC IB, pp. 65-66), Mr. Kerckhove explained that 'a small portion' equals one-third. (Tr. (May 16, 2012), at 386) Thus, about a third of the $2.8 million in costs pertained to AWR's operations." (Staff RB at 48-49)

According to Staff, it is not possible to determine if the portion remaining in IAWC's costs belong to AWR. Some of these $2.8 million in costs are for investments that have been completely depreciated. It is unlikely that they have all been fully depreciated, which is what IAWC's recommendation to disregard them would require.

In its Briefs On Exceptions, Staff indicates that it "does not take exception to the Joint Facilities Adjustment ordered in the PO." (Staff BOE at 28)

4. Recommendation for Investigation

Section VII.F of Staff's Initial Brief is titled, "Recommendation for Investigation." Staff argue, "IAWC President Ms. Teasley has the right to review that entire Service Company budget but failed to exercise that right. In order to ensure that the costs did not include improper and illegal charges, the entire budget should have been reviewed and questions should have been raised regarding the charges and allocations to IAWC and other affiliates under these agreements." (Staff IB at 96-97)

Ms. Teasley "also failed to review either agreement between AWR and AWWSC that would have at least made her aware of the potential for costs to be passed on from AWR via AWWSC." (*Id.*)

Staff concludes, "Furthermore, IAWC and AWWSC's actions justify greater scrutiny in light of their joint role in this matter. Thus, Staff recommends that the Commission open a proceeding within sixty days of the Order in this case, to review the AIA between AWWSC and IAWC to determine if it is in the still in the public interest given the disregard of compliance by both parties to that agreement. Staff also recommends that the Company be ordered to make the necessary showing that they are in compliance with the terms of the AIA." (*Id*. at 97)

In Section XII of its BOE, Staff continues to argue that an investigation should be ordered. Staff offers replacement language on this issue on pages 46-47 of its BOE. Among other things, Staff argues that "the scope of this audit [in Docket 10-0366] is limited to the market value of such services and does not address the allocations of those costs, which are the crux of Staff's recommendation." (BOE at 46)

5. Non-Cost Issues, Referrals and Other Issues

Section VII.G of Staff's Initial Brief is called, "Non-Cost Issues." According to Staff, there are several other issues that pertain specifically to the provision of services directly or indirectly by IAWC for AWR for which Commission approval has not been granted. When the Commission originally approved the IAWC – AWWSC AIA in Docket No. 88-0303, it did not include the provision of any services by IAWC for AWWSC. In Docket No. 02-0517, the Commission specifically declined to allow IAWC to provide any services directly or indirectly to AWR. Despite these facts, Staff believes that IAWC has provided services for AWR as outlined below. (Staff IB at 97)

Section VII.H of Staff's Initial Brief is titled, "Referrals." According to Staff, AWWSC Customer Services Representatives ("CSRs") "refer IAWC ratepayers that call into the Customer Service Center on IAWC's toll-free number and ask for information about warranty products to AWR. These calls are billed to IAWC." (Staff IB at 97-98) Mr. Sackett recommended "that the Commission order that IAWC prohibit AWWSC from referring IAWC's ratepayers to any affiliate providing non-regulated services." (Staff Ex. 15.0 at 39)

In Staff's view, these referrals lead to a situation in which IAWC ratepayers call IAWC regarding AWR products because IAWC and AWR have failed to clarify that AWR products are not IAWC products. AWR shares the same star logo that IAWC uses on its webpage and bill to market AWR products. At no time do AWWSC CSRs clarify the regulated status of AWR. Correcting such a misperception is ultimately in the best interest of the ratepayer.

Staff concludes, "While it may be in AWW's corporate best interest that ratepayers are left in the dark about its affiliate relationship with AWR by simply transferring the unsuspecting ratepayer to 'another department,' it is not in that ratepayer's best interest (nor is it in the public interest)." (Staff IB at 98)

In a footnote, Staff also states, "Staff witness Sackett defined his usage of the term 'refer' and distinguished it from the term 'transfer' to mean a physical action conducted within a phone system; he used the terms 'refer' and 'referral' more broadly to mean any method of getting ratepayers connected with AWR. Ratepayers can call IAWC's toll-free number and end up talking directly to AWR, be provided with a toll-free number to AWR, or be given the AWR website address." (Staff IB at 98)

In its Brief on Exceptions, Staff suggests the Commission find that IAWC customers who call the IAWC toll-free number should not be transferred or otherwise referred to any affiliate providing non-regulated services. In the alternative, Staff suggests the Commission find that IAWC customers who call the IAWC toll-free number should not be transferred or otherwise referred to any affiliate providing non-regulated services without being provided with information clarifying that affiliate products are not IAWC products. (Staff BOE at 45)

Section VII.I of Staff's Initial Brief addresses "Emergency Service Orders." In Docket No. 02-0517, IAWC requested permission to assist AWR with its duty to verify responsibility for service of water leaks under WLPP. The Commission declined to allow this or any other support of AWR and WLPP. Staff witness Sackett provided testimony that claimed that the AWWSC CSR training manual indicates that Emergency Service Orders ("ESO") are reported for those ratepayers who have WLPP. (Staff IB at 98-99; Staff Ex. 7.0 at 13, 23-24)

It appears to Staff that the utility technician is the one who makes this determination. However, it is possible that the report from IAWC technician is used by the Field Resource Coordination Center ("FRCC") to communicate with AWR. The FRCC has no procedure manuals to verify any of this. Either way, Staff asserts, it is a service to AWR that is provided pursuant to utility business.

The fact that this so-called "customer convenience" could theoretically apply to another warranty provider does not in any way keep it from being an "assistance" to AWR. The only conclusion that is consistent with this evidence is that WLPP ESO's send the utility technician out to determine if the repair is AWR's responsibility. (Staff IB at 99)

The IAWC technician (or the FRCC) makes this determination of responsibility at no cost to AWR. Apart from IAWC, AWR must dispatch its own technician to determine if the leak is covered by WLPP. In Staff's view, this is a service to AWR as they do not have to dispatch a technician to determine if it is AWR's responsibility. (*Id*.)

Staff also made a recommendation, which first appeared in a recap on the last page of its Initial Brief, that the Commission should "prohibit AWWSC and IAWC from making determinations for any affiliate regarding leak repair responsibility." (Staff BOE at 45)

Section VII.J of Staff's Initial Brief is titled, "Customer Information." According to Staff, the record is unclear whether ratepayer information is passed directly or indirectly from IAWC or AWWSC to AWR. (Staff IB at 99)

Staff witness Sackett asked IAWC to provide information from AWRs training practices and procedures manuals to show that they do not receive this [IAWC customer] information from any source. IAWC refused to provide this information because it believes the information was not relevant to the proceeding.

Staff is concerned that "IAWC is subsidizing AWR because the value the services that AWR is receiving from IAWC (which is positive) is greater than the amount paid for those services (which is nothing)." (Staff IB at 100) Thus, the Commission should thoroughly investigate these allegations in the Staff recommended proceeding, in Staff's view.

B. IAWC Position

1. Cost-Shifting Issues

In its Reply Brief, IAWC argues, "The Commission Need Not Consider the Cost-Shifting Arguments on which Staff Now Primarily Focuses." (IAWC RB at 87)

These "cost-shifting" issues, including the $75,000 "phone charge adjustment" and the "other phone charge issue," were raised for the first time in Staff's Initial Brief. They were not set out in the testimony of any witness. (IAWC RB at 89) In IAWC's view, "Because they were raised for the first time in briefs, IAWC has no opportunity to test these assumptions or conclusions through discovery or cross-examination. IAWC cannot provide responsive testimony. Thus, by withholding these issues until essential procedural steps had passed, Staff has waived the opportunity to raise these issues. Were the Commission to rule against IAWC on this record, it would deny the Company due process of law. Thus, the Commission should simply disregard these new issues." (*Id*.)

IAWC next argues, "Staff's Cost-Shifting Recommendations Fail on the Merits." (IAWC RB at 89)

Staff's first new recommendation is "an adjustment of $75,000 in total due to AWWSC's overcharges to IAWC."

According to IAWC, the Adjustment reflects costs outside of the Test Year. (*Id*.) The program under which AWWSC call handlers read scripts to non-Illinois customers, known as the CCAP program, was terminated in February 2012. Any costs related to the program or its script reading, including the costs "calculated" by Staff for 2011, cannot occur in the test year, because the program terminated before the test year begins in October 2012. Staff's proposed adjustment to IAWC's test year expenses is therefore improper, in IAWC's view.

IAWC next argues, "Numerous essential steps in Staff's recommendation lack any record support." (*Id*. at 90) The recommendation itself, and numerous elements, lack any support in the record. First, no witness testified to this issue *per se* in any way at the hearing. This issue was never heard nor was this recommendation ever made on the record. And numerous, essential factual points lack any supporting citation to the record. IAWC adds, "Indeed, this confusion of random statistics, dubious inferences, and outright guesses is what happens when a party waits until a hearing ends to put a theory together." (*Id*. at 91)

IAWC also responds to Staff's second "cost shifting" issue, called the "other phone charge issue." Staff proposes no adjustment, asserting that "IAWC refused to provide" the figures necessary to calculate one. (Staff IB at 93)

IAWC states, “Again, this issue was raised for the first time in Staff’s post-hearing brief, so the issue is waived and threatens due process. Again, IAWC did not refuse to provide the requested information—IAWC did not have it. Again, Staff is merely speculating as to any overcharges.” (IAWC RB at 93)

In IAWC’s view, “Staff’s position essentially boils down to the overbroad argument that because phone costs were allocated, they might have been misallocated, so there must be a full investigation and IAWC called on to prove that no misallocations occurred.” IAWC argues, “Staff investigated this issue but points to no signs that suggest any improper allocation occurred. The issues must be decided on the record, and the record provides no support for Staff’s theory.” (IAWC RB at 93)

2. Joint Facilities Expansion Adjustment

Regarding the Joint Facilities Expansion Adjustment, IAWC states that Staff proposed a reduction to test year depreciation expense by $10,268, “related to a 2007 expansion of the Alton facility that the Service Company incurred $2.8 million in capitalized costs related to the expansion.” (IAWC IB at 65)

AWR paid increased rent after the second expansion and only a “small portion” of the total expansion was related to AWR’s facilities. In other words, AWR does not occupy the entire space associated with the expansion, so the disallowance is overstated. (IAWC IB at 65-66; IAWC RB at 93-94)

IAWC argues that the Staff adjustment to disallow $10,268 for IAWC’s portion of costs related to AWR’s expansion of joint facilities with AWWSC should not be adopted.

3. Investigation

IAWC next argues, “Staff Has Provided No Reason for Launching a Massive Investigation.” (Staff RB at 94)

Staff recommends that “the terms of any other agreements to which AWWSC is a party must be made available for Staff/Commission review,” and that “all costs allocated or assigned according to those various agreements must be verified to know that the terms are being followed.” (Staff IB at 86)

In IAWC’s view, this is an extremely broad request. The Commission is being asked to review all the Service Company’s agreements, with affiliates and non-affiliates, and without regard to whether those agreements bear any relationship with charges or services provided to IAWC. It is also being asked to “verify” every cost relevant to those agreements, whether they have any relationship to IAWC or not, and regardless of whose cost information must be verified. (IAWC RB at 94-95)

IAWC next argues that Staff’s request comes with no support. The only factual support Staff provides is the generic allegation that IAWC “refused to provide some of these agreements" and certain cost information. But Staff does not explain with any specificity what agreements or information were not provided, whether they were relevant to any issue in this case, or even whether they should have been provided. IAWC adds, "Moreover, if one examines the four unexplained citations to attachments to Mr. Sackett's rebuttal testimony—it is clear that IAWC did provide agreements where requested, and voluminous other information besides." (IAWC RB at 95)

In IAWC's view, Staff has asked for a maximal investigation with less than minimal support. It has not adduced evidence of utility-affiliate problems that would justify such a massive and expensive effort. The Commission cases cited by Staff are all distinguishable but they do stand for an important point: the current review model works. According to IAWC, "If utilities are subsidizing affiliates, or affiliates are shifting costs to utilities, that will show up either in the utility's books or practices or in the affiliate agreements themselves. Mr. Sackett's investigations have turned up nothing. He points to no charges from AWWSC that are either above-market or other than least-cost. The worst he has found (if it can be called that) are two practices, not even involving IAWC, in which AWWSC acts for the benefit of IAWC customers." (IAWC RB at 95-96)

IAWC further asserts that costs allocated to IAWC as well as direct-charged have been reviewed in every rate case since the Service Company Agreement was approved, and presumably will continue to be reviewed in subsequent cases. IAWC argues, "These costs and the activities of the Service Company generally were exhaustively reviewed in the Service Company cost study performed in IAWC's last rate case, as well as the recent management audit. The multiple rate case reviews and prior studies and audits provide sufficient assurance that IAWC and AWWSC abide by the terms of the Service Company Agreement. Mr. Sackett's investigations in this case do not support a different conclusion, much less the need for further investigation." (IAWC RB at 96)

4. Transfer of Requesting Customers and Other Issues

In its Reply Brief, IAWC states, in a heading, "Staff Has Shown No Impropriety in AWWSC's Transfer of Requesting Customers." (IAWC RB at 98; IAWC RBOE at 47)

IAWC states, "Staff points out that those 'ratepayers that call . . . and ask for information about warranty products' are asked if they would like to be transferred to AWR. … It asserts that transferring the call of a customer who asked about warranty products and wanted the call transferred 'is not in [the customer's] best interest.'" (IAWC RB at 98, citing Staff IB at 97-98)

According to IAWC, "This is the only alleged misdeed. It is altogether unclear how doing something specifically requested and desired by the customer is against that customer's best interests." (IAWC RB at 98) IAWC adds, "Nor is it clear how that customer's interests would be furthered by being … told that Illinois-American does not offer any service line protection plans, and . . . that [the call center is] not allowed to provide that information." (*Id*.; IAWC IB at 126)

According to IAWC, it is important to note that AWWSC is not "offering" customers to AWR when it transfers them pursuant to a direct inquiry by the customer him/herself. (IAWC IB at 126) Transferring an Illinois-American customer to AWR when the customer specifically asks about the AWR program is not a service to AWR; it is a service and convenience to Illinois-American's own customers. Calls are transferred for the convenience of the customer, not as a means of "indirectly" benefiting AWR. (*Id.* at 127)

IAWC further states, "Nevertheless, at the end of the day, despite the inconvenience and confusion it could cause to IAWC's own customers, and the potential increased costs that could be allocated to IAWC, the Commission could simply require IAWC to prevent any transfer of calls involving IAWC customers, regardless of whether the customer requests a transfer. The fact remains that no 'investigation' is necessary or warranted to determine whether IAWC should adopt such a practice." (IAWC RB at 98)

In its Reply Brief on Exceptions, IAWC takes issue with certain language regarding transfers that was proposed on pages 39 and 45 of Staff's Brief on Exceptions as noted above. IAWC asserts that this "substantive recommendation" was not raised until Staff's Brief on Exceptions, and lacks record support. (IAWC RBOE at 47)

In its Reply Brief, IAWC next responds to Section VII.I of Staff's Initial Brief, "Emergency Service Orders." IAWC states, "Staff Has Shown No Impropriety Concerning Leak Investigations." (IAWC IB at 99-100; IAWC RBOE at 47-48)

According to IAWC, it is not a question of utility field service representatives determining whether a leak is "AWR's responsibility." Rather, it is a requirement that the utility determine if the leak is the utility's or the customer's responsibility. Prudent utility operation and Commission service regulations require IAWC technicians to respond to emergency service orders, and this is the case regardless of how the customer may ultimately go about fixing a customer-side leak, and regardless of whether the customer has a warranty protection program from AWR or any other entity. (IAWC RB at 99)

IAWC further states that its technicians do not talk to AWR about the results of water line investigations. To the extent such communications occur, they are strictly between AWWSC and AWR, and the approved Service Company Agreement contemplates that communications like this may occur. Also "left unanswered" by Staff is how any interactions between AWWSC and AWR affect costs to IAWC ratepayers, since IAWC has an affirmative obligation to investigate service line leaks, regardless of whether the customer has a warranty product. (IAWC RB at 100)

IAWC also responds to Staff's arguments regarding sharing of customer information. According to IAWC, "The record is clear, and it all points to the same conclusion: IAWC did not share customer information with its affiliates. As IAWC noted in its Initial Brief, Ms. Teasley testified that IAWC does not provide customer information to AWR…, and Ms. Cooper, that AWWSC does not provide IAWC customer information to AWR, either…. No evidence points the opposite direction." (IAWC RB at 100)

IAWC next argues, "The Cases Relied upon by Staff Are Distinguishable." In the North Shore/Peoples case, Dockets 11-0280/0281 (cons.), the regulated utilities' "agreement with [the service company] provide[d] that [it] charge the Companies for expenses less revenues provided to IBS by other parties." Order, Dockets 11-0280/0281 (Jan. 10, 2012) at 88-89. IAWC asserts, "But contrary to the agreement, the evidence showed that the unregulated affiliate was not charged at all from 2008 until sometime in 2011." (IAWC RB at 101)

In Docket No. 11-0046, Nicor Gas, its affiliated service company and its unregulated affiliate sought re-approval of an affiliated interest agreement. The facts were plainly distinguishable. The utility in that case had its own call center, staffed by utility employees, who after handling the regulated business would try to sell a gas line protection program offered by its affiliate (and thereby earn a commission from the service company). (IAWC RB at 101, citing Order, Docket No. 11-0046 (Dec. 7, 2011) at 40)

According to IAWC, this case is distinguishable. IAWC does not operate its own call center, and its employees do not handle customer service calls. AWWSC's employees do not solicit every caller with a sales pitch for AWR. They respond to inquiries about AWR by transferring the caller to AWR or providing AWR's phone number or email. It is also notable that in the Nicor case the Commission still approved a modified version of the agreement but merely required the utility to quit soliciting on behalf of its affiliate. (*Id*. at 102)

In Docket No. 11-0561, when the service company enrolled new customers, it would sell the customers' account information to a warranty line protection provider. As discussed above, the unrebutted evidence in this case is that IAWC, AWWSC, and AWR do not share customer information. (IAWC RB at 102)

According to IAWC, the Commission resolved the issues raised by Staff based on "the Companies' concessions to reduce its revenue requirements" and to participate in an additional proceeding. (*Id*., citing Order, Docket No. 11-0561 (May 22, 2010) at 29) The Commission otherwise declined "to approve Staff's proposal to make a finding in this proceeding that the Companies have violated the Public Utilities Act." (*Id*.)

C. Conclusions

In his rebuttal testimony, the Staff witness made "three specific recommendations." The first was to open an investigation. The second was to "order that IAWC prohibit AWWSC employees from referring IAWC's ratepayers to any affiliate providing non-regulated services." The third was to disallow $10,268 of test year depreciation expense for what was sometimes referred to as "IAWC's portion of costs related to AWR's expansion of joint facilities with AWWSC." In its brief, Staff also proposed a "phone charge adjustment" of $75,000 "due to AWWSC's overcharges to IAWC."

Joint Facilities Adjustment

Staff recommends that the Commission disallow $10,268 of test year depreciation expense "for IAWC's portion of costs related to AWR's expansion of joint facilities with AWWSC." American Water Resources, or "AWR," is an affiliate of IAWC.

IAWC opposes the adjustment. IAWC argues that AWR paid increased rent after the second expansion and only a "small portion" of the total expansion was related to AWR's facilities, so the disallowance is overstated.

An IAWC witness testified that approximately one-third of the expansion was related to AWR's operations.

In its Brief on Exceptions, Staff indicates that it "does not take exception to the Joint Facilities Adjustment ordered in the PO." (Staff BOE at 28)

The Commission finds that one-third of the $10,268 in depreciation expense related to the facility should be removed from IAWC's test-year operating expenses to reflect the portion of the expansion costs properly attributable to AWR.

Phone Charge Adjustment

In its Initial Brief, Staff recommends "an adjustment of $75,000 in total due to AWWSC's overcharges to IAWC." The purported overcharges to IAWC are a result from AWWSC charging AWR for the number of transfers, not the "actual time spent" or even the number of statements read.

As indicated by IAWC, however, the methodology used to calculate the adjustment involves a series of calculations discussed for the first time over a several-page portion of Staff's Initial Brief.

As IAWC points out in its Reply Brief, neither the adjustment itself, nor the multi-step methodology used to calculate it, were proposed anywhere in the evidentiary record.

The adjustment is essentially the result of an expert analysis which did appear in the expert witness' testimony.

As such, there has been no opportunity to conduct discovery or cross-examination, or to submit responsive evidence.

In its Brief on Exceptions, Staff indicates that it does not take exception “to the PO’s conclusion not to order a Phone Charge Adjustment in this case.” (Staff BOE at 28)

The Commission finds that adjustment is not supported by the evidentiary record, and it is not adopted.

Transfers and Referrals; Other Issues

Staff complains that AWW Service Company representatives “refer IAWC ratepayers that call into the Customer Service Center on IAWC’s toll-free number and ask for information about warranty products to AWR.” In Staff’s view, these referrals lead to a situation in which IAWC ratepayers call IAWC regarding AWR products because IAWC and AWR have failed to clarify that AWR products are not IAWC products. Staff believes “Correcting such a misperception is ultimately in the best interest of the ratepayer.” (Staff IB at 98)

IAWC asserts that transferring an IAWC customer to AWR when the customer specifically asks about the AWR program is a service and convenience to IAWC’s own customers, and that the “clarifications” suggested by Staff could lead to customer inconvenience and confusion, and increased costs.

Having reviewed the record, the Commission finds that IAWC customers who call the IAWC toll-free number should not be transferred or otherwise connected to AWR without being provided with information clarifying that AWR products are not IAWC products.

As noted above, Staff also made a recommendation that the Commission “prohibit AWWSC and IAWC from making determinations for any affiliate regarding leak repair responsibility.” (Staff BOE at 45) IAWC responded, in part, that it has an affirmative obligation to investigate service line leaks, and to assess whether the leak is the responsibility of the utility or the customer. Staff does not indicate how IAWC would be able to fulfill these responsibilities under the terms of Staff’s recommended prohibition. The Commission finds that Staff’s recommendation will not be adopted at this time.

Investigation

Staff recommends that an investigation be opened “to review the [Affiliated Interest Agreement] between AWWSC and IAWC to determine if it is in the still in the public interest.” (Staff IB at 97; Staff BOE at Section XII)

In considering this request, the Commission notes that one of the reasons offered repeatedly by Staff in support of initiating an investigation is that Staff was unable to properly assess some of the issues because IAWC refused to provide information requested by Staff. While the Commission encourages the voluntary submission of requested information, there are remedies available when the DR process has not been successful. Here, the Commission observes that no motions to produce or compel formal discovery were filed by Staff.

In those instances where the Staff witness did make adjustments or other specific recommendations, the Commission has made determinations as set forth above.

The Commission also observes that a lengthy and detailed management audit of the fees assessed by the Service Company under the same Service Company agreement was recently completed by NorthStar Consulting Group. That audit was conducted at the direction of the Commission, and is the subject of a pending case in Docket No. 10-0366.

Upon consideration of the record in this case and other findings and considerations in this Order, the Commission does not believe that opening a new investigation at this time “to review the AIA between AWWSC and IAWC to determine if it is in the still in the public interest,” as urged by Staff, would be efficient or otherwise warranted while the proceeding in Docket 10-0366 is pending.

XIII. FINDINGS AND ORDERING PARAGRAPHS

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

(1) IAWC is in the business of furnishing water and sewer service to the public in various areas in the State of Illinois and is a public utility as defined in the Act;

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

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

(4) the test year in this proceeding is a future test year consisting of the 12 months ending September 30, 2013; this test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, IAWC's net original cost rate bases are set forth in Appendices A through F;

(6) the Company's June 30, 2111 plant balance of $1,304,723,156 identified in IAWC Exhibit 6.00R, page 18, is approved for purposes of an original cost determination, subject to any adjustments contained in this order;

(7) a just and reasonable rate of return which IAWC should be allowed an opportunity to earn on its net original cost rate base is 7.56%; this rate of return incorporates a rate of return on common equity of 9.34%;

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

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

(10) the rates proposed by IAWC would produce a rate of return in excess of a return that is fair and reasonable; IAWC's Proposed Tariffs should be permanently canceled and annulled;

(11) IAWC should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendices A through F, such tariff sheets to be applicable to service furnished on and after their effective date; the terms and conditions in these tariff sheets should be consistent with Finding (12) below;

(12) the cost of service, interclass revenue allocation, rate design, and tariff terms and conditions found appropriate in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted; IAWC shall make all filings determined to be appropriate in the prefatory portion of this order above;

(13) the new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than five working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary, except as is otherwise required by Section 9-201(b) of the Act as amended.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the Proposed Tariffs proposing a general increase in rates, filed by Illinois-American Water Company on October 27, 2011, are hereby permanently cancelled and annulled.

IT IS FURTHER ORDERED that Illinois-American Water Company is authorized and directed to file new tariff sheets with supporting workpapers in accordance with Findings (11), (12), and (13) of, and other determinations in, this Order, applicable to service furnished on and after the effective date of said tariff sheets.

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

IT IS FURTHER ORDERED that Illinois-American Water Company shall make all filings found appropriate in the prefatory portion, and in the findings, of this order.

IT IS FURTHER ORDERED that all petitions for leave to intervene that have not been previously ruled on are granted, and that all other all motions that have not been ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions herein contained.

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

By order of the Commission this 19th day of September, 2012.

(SIGNED) DOUGLAS P. SCOTT

Chairman

PENNSYLVANIA
PUBLIC UTLIITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held December 19, 2013

Commissioners Present:

Robert F. Powelson, Chairman, Statement
John F. Coleman, Jr., Vice Chairman
James H. Cawley
Pamela A. Witmer
Gladys M. Brown

Pennsylvania Public Utility Commission	R-2013-2355276
Office of Consumer Advocate	C-2013-2362470
Office of Small Business Advocate	C-2013-2364641
Brian L. Casper	C-2013-2364664
Dawn B. Spielvogel	C-2013-2364692
Robert Redinger	C-2013-2364773
Rita Sherman	C-2013-2366095
Guy & Nedra Visconti	C-2013-2367036
Russell Vankoughnet	C-2013-2367041
Doris Miller	C-2013-2369063
Jon & Dorothy Pichelman	C-2013-2369095
Jane Neufeld	C-2013-2369464
Georgia L. Dicko	C-2013-2369925
Carly J. Dunn	C-2013-2370649
William B. Kazimer	C-2013-2372396
S. Stockton Alloway	C-2013-2366239
Thad Shirey	C-2013-2372641
Paul Trizonis	C-2013-2379466

v.

Pennsylvania-American Water Company

OPINION AND ORDER

BY THE COMMISSION:

Before the Pennsylvania Public Utility Commission (Commission) for consideration and disposition are the Exceptions of the Pittsburgh Water and Sewer Authority (PWSA), an intervening party, and Formal Complainant William B. Kazimer (Mr. Kazimer), filed on November 18, 2013, to the Recommended Decision (R.D.) of Administrative Law Judges (ALJs) Angela T. Jones and Darlene D. Heep, issued on November 8, 2013, in which the ALJs recommended approval of the Joint Petition for Settlement of Rate Investigation (Settlement).[1] On November 26, 2013, Pennsylvania-American Water Company (PAWC or the Company) filed Replies to Exceptions.

I. History of the Proceeding[2]

On April 30, 2013, the Company filed with the Commission Supplement No. 279 to Tariff Water – Pa. P.U.C. No. 4 and Original Tariff Wastewater Pa. P.U.C. No. 15 providing for an increase in water and wastewater rates based on a net operating revenue increase of $58.6 million or approximately 10.1% over the pro forma present annual rates of $578.6 million. The tariffs were to become effective on June 29, 2013.

By Order entered June 13, 2013, the Commission suspended the effective date of the tariffs until January 29, 2014, or until the Commission rules otherwise. In

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[1] Mr. Kazimer's Exceptions did not contain a Certificate of Service. Therefore, on November 19, 2013, the Commission's Secretary's Bureau forwarded a copy Mr. Kazimer's Exceptions to the Parties of record and extended the time for filing Replies to Exceptions to November 27, 2013.

[2] For a full and complete history, please refer to the Recommended Decision at 1-7.

addition, the Commission instituted a formal investigation to determine the lawfulness, justness and reasonableness of PAWC's existing and proposed rates, rules and regulations.

The case was assigned to ALJs Jones and Heep for the prompt scheduling of hearings and for the issuance of a Recommended Decision. The Commission received seventeen Formal Complaints. On June 27, 2013, ALJ Jones convened a Prehearing Conference. The following Parties were present and/or participated telephonically in the Prehearing Conference: PAWC; the Commission's Bureau of Investigation and Enforcement (I&E); the Office of Consumer Advocate (OCA); the Office of Small Business Advocate (OSBA); United States Steel Corporation (US Steel); the Commission on Economic Opportunity (CEO); PWSA; Doris Miller, *pro se* Complainant; and Jane Neufeld, *pro se* Complainant.[3] The above listed Parties were active participants. All the other Complainants were inactive participants as defined in Prehearing Conference Order #3 dated July 2, 2013.

During the Prehearing Conference, a schedule was set for public input hearings and formal testimony by the Parties. The first public input hearing was held on July 22, 2013, in Pittsburgh at the Shaler Vista Volunteer Fire Department. On July 23, 2013, a second public input hearing was held in Washington, Pennsylvania at the Washington County Fair and Expo Center. The third public input hearing was held on July 31, 2013, in Camp Hill, Pennsylvania at the Camp Hill Borough Building. The fourth public input hearing was held on August 6, 2013, in Scranton, Pennsylvania at the Scranton State Office Building. The fifth public input hearing was held at the Stroudsburg Area School District Auditorium in Stroudsburg, Pennsylvania. On August 7, 2013, a sixth public input hearing was held in the Exeter Community Library

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[3] On July 9, 2013, the Pennsylvania American Water Large Users Group (PAWLUG) filed a Petition to Intervene, which was unopposed. PAWLUG requested active participant status in the proceeding.

in Reading, Pennsylvania. The seventh and final public input hearing was held on August 8, 2013, in the East Fallowfield Township Building in West Chester, Pennsylvania.

On September 16, 2013, the Parties represented by counsel notified the ALJs that a settlement in principle had been reached. On October 18, 2013, the following Parties filed the Settlement: PAWC, I&E, OCA, OSBA, CEO and PAWLUG (Joint Petitioners). Also on October 18, 2013, PWSA and *pro se* Complainants Neufeld and Miller submitted statements of non-opposition to the Settlement. On October 24, 2013, US Steel filed a letter of non-opposition to the Settlement.

The non-signatory, inactive Parties were also notified of the proposed Settlement by a letter from the OCA. In that letter, the Parties were notified that access to the Joint Settlement was available through an internet website. The letter also provided a form through which the Parties could indicate whether they accepted the Settlement, opposed the Settlement or had no position.

Dawn Spielvogel, an inactive participant, supported the Settlement. The following parties chose to oppose the Settlement: S. Stockton Alloway, Mr. Kazimer, and Thad Shirey.

The record was closed on October 28, 2013.

In their Recommended Decision, issued on November 8, 2013, the ALJs found, *inter alia*, that the Settlement submitted by the Joint Parties is just and reasonable and should be approved. The ALJs further found that, upon the Commission's approval of the Settlement, the Company will receive a stipulated increase in annual revenues of $26 million, in lieu of the Company's original base rate increase request of $58.6 million, which will produce approximately $604.6 million in total annual combined water and wastewater revenue. R.D. at 48-49.

Exceptions to the Recommended Decision were filed as above noted. For the reasons stated below, we shall deny PWSA's Exceptions, in part, and grant them in part; deny Mr. Kazimer's Exceptions; approve the Settlement; and adopt the ALJs' Recommended Decision, as modified, consistent with this Opinion and Order.

II. Description of the Company

PAWC is an investor-owned company and a subsidiary of American Water Works Company, Inc.

The Company provides water service to over 641,000 customers. It serves all or portions of the following thirty-six counties: Adams, Allegheny, Armstrong, Beaver, Berks, Bucks, Butler, Centre, Chester, Clarion, Clearfield, Clinton, Columbia, Cumberland, Dauphin, Fayette, Indiana, Jefferson, Lackawanna, Lancaster, Lawrence, Lebanon, Luzerne, McKean, Monroe, Montgomery, Northampton, Northumberland, Pike, Schuylkill, Susquehanna, Union, Washington, Warren, Wayne and York. In addition, PAWC provides wastewater service to the following counties totaling over 17,000 customers: Chester, Clarion, Monroe, Pike and Washington.

III. Discussion

A. Public Input Hearings

The dates and locations of the public input hearings have been described above. A sampling of the testimony is provided below.[4]

Some testimony concerned requests for PAWC to extend water service to various communities. For example, Ms. Elizabeth Cowden, a supervisor in Cecil Township in Washington County, testified that her community is growing fast and many areas are without water service but would like to receive public water service. She also testified that many private wells are contaminated. Tr. at 80-85.

In addition, some witnesses challenged the rate increase, particularly the shifting of a portion of the wastewater cost of service to the entire customer base. For example, Mr. Phillip B. Volmer explained that the Borough of Camp Hill operates the sewer system in his community and PAWC is not involved with such service. He objected to paying for a sewer system for others while continuing to pay a sewer bill to his borough. Tr. at 220-221.

Representatives Kevin Haggerty of the 112th District in Pennsylvania and Martin Flynn of the 113th District expressed concerns about the impact on families which have some of the lowest incomes in the state and are least able to afford the proposed rate increase. Furthermore, Representative Flynn noted that, based on public reports of the Company's profits, PAWC could pay for necessary infrastructure improvements using

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4 For a more detailed discussion of the public input hearings, see pages 9-19 of the Recommended Decision.

other capital methods such as utilizing the increased profits of the Company. Tr. at 248-254.[5]

Mr. Thomas Gombar, District Director for State Senator Judy Schwank, introduced written remarks on behalf of Senator Schwank. In her written comments, Senator Schwank stated that PAWC was granted a rate increase only two years ago and expressed concerns about the impact of the requested increase on senior citizens and persons on fixed incomes. She also asserted that the increase will put small businesses at a competitive disadvantage. Tr. at 351-352.

Additional testimony pertained to requests for clarification of the increase. Formal Complainant Jane Neufeld acknowledged that PAWC had purchased the previous water supplier and made improvements to the prior system and that a rate increase was to be expected. However, she noted that one rate is not appropriate for all communities, explaining that the consolidation of different areas of Pennsylvania into fewer payment zones would cause some people to experience significant monthly rate increases. Tr. at 318-328.

Some witnesses spoke of civic organizations' support for the Company, while others expressed concerns about odor, discolored water, and customer and communications problems. For example, State Senator Andrew Dinniman testified that there are problems with odor from PAWC facilities and the water provided is often discolored. Tr. at 421-423.

[5] Thom Welby, Representative Flynn's Chief of Staff, also testified that PAWC currently offers subscriptions for maintenance contracts on work outside of customer homes. According to Mr. Welby, only three percent of the Company's customer base subscribes to the service and expanding this base would be preferable to raising revenue through a rate increase. Tr. at 274-275.

In addition, Senator Dinniman asserted that residents in his district have already paid significant increases in their water rates, maintaining that PAWC is seeking a rate sixty-two percent higher than the rate charged rate in 2007. Furthermore, Senator Dinniman asked for assurance that a $9.9 million low-interest loan PAWC received form the Pennsylvania Infrastructure Investment Authority to upgrade the Rock Run water treatment center is taken into consideration when determining the rate. Finally, Senator Dinniman stated that he considered the eleven percent overall rate of return to be too high and maintained that an expected or traditional rate of return is about 8.68%. Accordingly, he calculated that the difference in the expected and traditional rates is equal to $47 million, which could be used to reduce water and wastewater bills. Tr. 419-421.

B. Terms and Conditions of the Joint Settlement

The Joint Petitioners agree to the following pertinent terms and conditions regarding PAWC's proposed rate increase as reflected in Paragraph No. 8 of the Settlement:

> a) Upon the Commission's approval of this Settlement, but no earlier than January 1, 2014 (see 8.d. below), PAWC will be permitted to charge the rates for water service set forth in the proposed Tariff Supplement annexed hereto as Appendix A and the rates for wastewater service set forth in the proposed Original Tariff annexed hereto as Appendix B (hereafter, the Settlement Rates).[6] The Settlement Rates are designed to produce additional annual operating revenue of $26 million, as shown on the proof of revenues annexed hereto as Appendix C. The Water Tariff Supplement set forth in Appendix A and the Wastewater

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[6] Although the Joint Petitioners refer to the rates for the wastewater service in Appendix B as an "Original Tariff," the Parties have modified the wastewater tariff as originally filed with the Commission on April 30, 2013.

Original Tariff set forth in Appendix B have been reviewed by the Joint Petitioners and comply with the terms of the Settlement. The Settlement Rates are designed to produce approximately $604.6 million in total annual combined water and wastewater revenue (including Other Revenue) as shown in Appendix C, Schedule A, column 8.

b) The Joint Petitioners agree that the Company's originally filed pro forma present rate revenue level has been used to establish the Settlement Rates. The Joint Petitioners specifically agree that this provision is for the purposes of settlement for this case only and is not determinative of any party's position in future cases.

c) The Commission previously approved wastewater rate increases to become effective on January 1, 2011, 2012, 2013, and 2014 for the Company's Coatesville wastewater operations (Docket No. R-2010-2166212), Claysville wastewater operations (Docket No. R-2010-2166210) and Northeast wastewater operations (Docket No. R-2010-2166214), as part of a rate phase-in. The rates to become effective on January 1, 2014 were to remain in effect through the years 2014, 2015, and 2016. On January 1, 2017, the aforementioned wastewater rates were to be reduced to those in effect on January 1, 2013. As a result of the combination of the water and wastewater revenue requirements reflected in the Settlement, water customers will be allocated $7.8 million of the deferred increases to the Coatesville, Claysville and Northeast wastewater customers, to be recovered by an increase in the water revenue requirement of $2.6 million per year in each of the years 2014, 2015, and 2016. On January 1, 2017, Zone 1 water rates will be reduced by the following amounts to remove that $2.6 million from rates: (i) $0.0073 per 100 gallons for the Residential customer class; (2) $0.0035 per 100 gallons for the Commercial customer class; and (3) $0.0054 per 100 gallons for the Other Public Authority customer class. Additionally, as part of this Settlement, the previously-approved wastewater rate increases noted in this subsection scheduled to take effect on January 1, 2014 for Coatesville, Claysville and Northeast will not occur.

d) The Joint Petitioners agree to exercise their best efforts to obtain approval of this Settlement by the Commission on or before December 19, 2013, and the implementation of the Settlement Rates on January 1, 2014. Upon the entry of a Commission Order approving this [Settlement], the Company will be permitted to file a tariff supplement for water service, in the form attached hereto as Appendix A, and a tariff for wastewater service, in the form attached hereto as Appendix B, to become effective upon less than statutory notice on January 1, 2014.

e) PAWC will not file for another general rate increase under Section 1308(d) of the Public Utility Code for its water operations, Pocono wastewater operations, Clarion wastewater operations or Clean Treatment wastewater operations prior to March 31, 2016.[7] However, if a legislative body or administrative agency, including the Commission, orders or enacts fundamental changes in policy or statutes which directly and substantially affect the Company's rates, this Settlement shall not prevent the Company from filing tariffs or tariff supplements to the extent necessitated by such action.

f) The Joint Petitioners acknowledge and agree that the Company will use the depreciation rates set forth in PAWC Exhibit Nos. 10-C, 10-F and 10-I to calculate the depreciation expense it records on its regulated books of account. This provision is included solely for the purpose of recording annual and accrued depreciation in PAWC's regulated books of account and is not determinative of depreciation rates or depreciation expense for future ratemaking purposes.

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[7] "As a result of settlements in previous proceedings, PAWC already is prohibited from requesting an increase in base rates prior to March 31, 2016, for its wastewater operations in Claysville (Docket No. R-2010-2166210), Coatesville (Docket No. R-2010-2166212), and Northeast (Docket No. R-2010-2166214), except under extraordinary circumstances." Settlement at 7.

g) The Joint Petitioners agree that the Settlement Rates reflect the amortizations set forth in Appendix D to the [Settlement], which includes amortizations of the acquisition adjustments that PAWC recorded in connection with its acquisition of the water utility assets of the Lake Spangenberg Water Company, Ha Ra Corporation (Fernwood Community Water System), Olwen Heights Water Service Company, Inc., North Fayette County Municipal Authority, Wildcat Park Corporation and Indian Rocks Property Owners Association, Inc. The parties agree that a ten (10) year amortization period shall be employed for settlement purposes. All parties retain their right to review and make recommendations regarding ratemaking treatment to be accorded the Company's pending acquisition of the Paint Township Municipal Water Authority in PAWC's next base rate proceeding.

h) As part of the comprehensive Settlement of this case, the Joint Petitioners agree that, for purposes of determining the revenue requirement in this case, all capitalized repairs deductions claimed on a tax return have been normalized for ratemaking purposes and the appropriate related amount of tax effect of those deductions has been reflected as Accumulated Deferred Income Taxes as a reduction to PAWC's rate base.

i) The low income customer charge discount for water customers will be increased from 65% to 80%, as reflected in the Settlement Rates.

j) The Company's annual contribution to its hardship grant program will be increased from its current level of $250,000 to $300,000 and, in accordance with current practice, such contribution will be recorded as a "below the line" expense and will not be claimed by PAWC for recovery in its rates. This term of the Settlement is set forth for information purposes, and the Commission's approval of this term is not requested.

k) With regard to service-related issues and concerns expressed at the public input hearings held in Exeter

Township (Reading) and East Fallowfield Township (Coatesville):

(1) The Company has already taken the action summarized in Appendix E-1 annexed hereto with respect to the single service-related concern expressed at the Exeter Township (Reading) public input hearing;

(2) The Company has already taken the action summarized in Appendix E-2 annexed hereto with respect to service-related issues and concerns expressed at the East Fallowfield Township (Coatesville) public input hearing and agrees to take such appropriate further action as summarized in Appendix E-3;

(3) The Company agrees to conduct semi-annual information sessions for customers of its Coatesville water and wastewater operations, in the manner more fully set forth in Appendix E-3 annexed hereto.

l) The Company agrees to invest $10 million to construct water main extensions under and pursuant to Rule 27.1(F) of its water tariff, which authorizes main extensions to be installed without customer contributions subject to Commission approval in order to address health and safety concerns. The Company's investment will be used to install the water main extensions identified in Appendix F annexed hereto. If the $10 million investment to which the Company is committing is not fully expended on the aforementioned main extensions, the Company will work with the OCA and other interested parties to identify such additional main extensions in Washington County that satisfy the criteria of Tariff Rule 27.1(F) and will use such remaining committed investment to construct such main extensions under and pursuant to Tariff Rule 27.1. With respect to the foregoing commitments, the following terms and conditions also apply:

(1) The Company and the OCA will work together to establish a reasonable timeframe for the

completion of the projects that are within the scope of the Company’s committed investment once the specifications for such projects are known;

(2) The Company shall apply least-cost principles in designing and constructing the main extensions that are within the scope of its commitments in this Settlement;

(3) The Commission’s approval of this [Settlement] Petition will constitute the approval required under Tariff Rule 27.1(F) to construct the projects identified in Appendix F. Based upon the Commission’s approval of the construction of the main extensions identified in Appendix F, the Joint Petitioners agree not to contest the inclusion in rate base of the capital costs associated with the construction of those extensions.

(4) PAWC agrees to continue to use its best efforts to apply for grants from applicable local municipalities and to receive contributions from other sources, such as from Marcellus Shale drilling companies, in order to mitigate the cost for the main extension projects identified in Appendix F. To the extent any grants are received, they will not diminish the Company’s commitment to invest $10 million for main extensions that meet the criteria of Tariff Rule 27.1(F) but, instead, will enable the Company to fund additional projects under Tariff Rule 27.1(F).

(5) The Joint Petitioners agree that the provisions set forth in this subparagraph l. and Appendix F are not precedential as to conditions that might validate the application of Tariff Rule 27.1(F) in the future and shall not be cited as such in any subsequent proceeding.

m) The Company agrees to work with I&E, OCA and OSBA to refine its existing process for systematic evaluation of main extension requests to ameliorate, by the application of Tariff Rule 27.1(F), documented health and safety problems that exist within its service territory because of the inadequate quantity or quality of property owners' individual well water supplies.

n) As part of this Settlement, the Company has agreed to provide the Commission's Bureau of Technical Utility Services ("TUS"), the I&E, OCA and OSBA, on or before April 30, 2014, an update to PAWC Exhibit No. 3-C, pages 3-10, which will include actual plant additions and retirements by month for the twelve months ending December 31, 2013. On or before October 31, 2014, PAWC will update Exhibit No. 3-C, page 3-10 for the twelve months ending June 30, 2014. In PAWC's next base rate proceeding, the Company will prepare and submit a comparison of its actual expenses and rate base additions for the twelve months ended December 31, 2014 to its projections in this case. However, it is recognized by the Joint Petitioners that this is a black box settlement that is a compromise of the Joint Petitioners' positions on various issues.

o) The Company will not implement a Distribution System Improvement Charge (DSIC) during the calendar year ending December 31, 2014. The first DSIC in 2015 will be effective no earlier than April 1, 2015 based on DSIC-eligible expenditures during January and February 2015. In any event, the Company will not begin to impose a DSIC until the balances of DSIC-eligible accounts, net of plant funded with customer advances and customer contributions, exceed the December 31, 2014 levels of investment in plant additions projected by PAWC in this case. This provision relates solely to the calculation of DSIC during the time that the Settlement Rates are in effect and is not determinative for future ratemaking purposes of the projected plant additions to be included in rate base in a fully projected future test year filing.

p) The Settlement Rates set forth in Appendix A reflect the Joint Petitioners' agreement with regard to water rate structure, rate design and the distribution of the increase in revenues in this case, as follows:[8]

(1) The Rate Zone 1 5/8-inch customer charge for all customer classes except Industrial and Other Water Utilities will be $15.00 per month. The same percentage increase as that for 5/8 inch meters will be applied to the customer charges for all other meter sizes and classes of customers in Rate Zone 1.

(2) Rate Zones 36, 43, 45, 48 and 49 are being consolidated with Rate Zone 1 under the Settlement Rates.

(3) For Rate Zone 40, the OCA's proposal as set forth in OCA Statement No. 3 (page 34) has been adopted with one modification, which establishes a consumption charge of $0.5350 per hundred gallons.

(4) For Rate Zone 41, the customer charges have been equalized with Rate Zone 1 and the residential usage charge will be $0.7100 per 100 gallons.

(5) For Rate Zone 44, the OCA's proposal as set forth in OCA Statement No. 3 (pages 36-37) has been adopted.

(6) For Rate Zone 46 Winter, the I&E's proposal as set forth in I&E Statement No. 4 (pages 53-55) has been adopted with one modification, which establishes a

8 "Subparagraphs (1)-(8) provide a general description of the water rate structure and water rate design incorporated in the Settlement Rates. While every effort has been made to ensure that the description is accurate, if any inconsistency exists between such description and the rates set forth in Appendix A to the Joint Settlement, the latter shall take precedence." Settlement at 12.

consumption charge of $0.7100 per hundred gallons after meters are installed.

(7) For Rate Zone 46 Summer, the I&E's proposal as set forth in I&E Statement No. 4 (pages 53-55) has been adopted with one modification, which establishes a consumption charge of $0.7100 per hundred gallons after meters are installed.

(8) For Rate Zone 47, the customer charges have been equalized with Rate Zone 1. The residential usage charge for the first usage block will be $0.6200 per 100 gallons. The residential usage charge for the second usage block will be $0.5000 per 100 gallons.

q) The Settlement Rates set forth in Appendix B reflect the Joint Petitioners' agreement with regard to wastewater rate structure, rate design and the distribution of the increase in revenues in this case. A description of the impact of the Settlement Rates on an average Residential class customer in each of the Company's wastewater operations is set forth below.[9]

(1) **Coatesville**: Under the Settlement Rates, an average residential customer's monthly bill will decrease by 13.3% to $58.50. There will be no change in the existing rates for the Commercial, Industrial and Municipal customer classes.[10]

(2) **Claysville**: Under the Settlement Rates, an average residential customer's monthly bill will decrease

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[9] "If any inconsistency exists between the information provided in subparagraphs (1)-(7) and the rates set forth in Appendix B to the [Settlement], the latter shall take precedence." Settlement at 13.

[10] "As explained in paragraph 8.c., *supra*, under the terms of the [Settlement], the scheduled January 1, 2014 increase in the rates of all customers of the Coatesville, Claysville and Northeast wastewater operations will not occur." Settlement at 13.

by 36.0% to $58.50. The rates for the Commercial and Municipal customer classes will be the same as the existing Coatesville wastewater operation's rates for those classes. (There are no Industrial customers on the Claysville wastewater system.)

(3) **Northeast**: Under the Settlement Rates, an average residential customer's monthly bill will remain at $58.50 because the Settlement Rates are the same as the existing rates for Northeast.

(4) **Clarion**: The Company's proposed rates as set forth on PAWC Exhibit No. 11-B, Schedule 14, are the Settlement Rates. The Settlement Rates will result in an average residential customer monthly bill of $47.63, or an increase over existing rates of 36.9%.

(5) **Pocono**: Customers will be converted from flat rates to metered rates. The Settlement Rates for Pocono are the same as the Settlement Rates for Clarion. An average residential customer's monthly bill will decrease by 6.6% to $47.63.

(6) **Clean Treatment**: An average residential customer's monthly bill will decrease by 13.97% to $58.50. The rates for the Commercial customer class will be the same as the existing Coatesville wastewater operation's rates for that class. (There are no Municipal or Industrial customers on the Clean Treatment wastewater system.)

(7) **Combined Water and Wastewater Revenue Requirement**: Pursuant to Section 1311(c) of the Public Utility Code and the Commission's Implementation Order in Docket No. R-2013-23565276, under the Settlement Rates a portion of the wastewater revenue requirement totaling $5,411,134 is being allocated to water customers, as shown in Appendix G (*see* column 10, line 34).

We note that Paragraph No. 8 of the Settlement does not provide an average increase in the water rates for each zone of service. Upon review of the revenue schedules attached to the Settlement, we provide the following summary of the possible impact on residential water service customers:

Comparison of Monthly Residential Bills at Present and Settlement Rates
5/8 Inch Meter

Zone	Typical Consumption	Present Rates	Settlement Rates	Increase	
				Amount	Percent
Zone 1 - PWAC*	3,960	$52.52	$55.45	$2.93	5.58%
Zone 40 - Nittany	3,960	$23.84	$32.69	$8.85	37.12%
Zone 41 - Sutton Hills*	3,960	$31.21	$43.12	$11.91	38.16%
Zone 43 - Acquisitions*	3,960	$46.66	$55.45	$8.79	18.84%
Zone 44 - Wildcat	3,960	$45.94	$49.79	$3.85	8.38%
Zone 45 - Lake Spangenberg	3,960	$47.07	$55.45	$8.38	17.80%
Zone 47 - Balsinger	3,960	$28.40	$39.55	$11.15	39.26%
Zone 48 - All Seasons (Winter)	3,960	$27.50	$41.87	$14.37	52.25%
Zone 48 - All Seasons (Summer)	3,960	$18.33	$41.87	$23.54	128.42%
Zone 48 - Springfield	3,960	$46.22	$55.45	$9.23	19.97%
Zone 49 - Olwen Heights	3,960	$44.10	$55.45	$11.35	25.74%

* Present Rates include 5.82% DSIC and -0.15% State Tax Assessment Surcharge.

Settlement, Appendix C, Schedule 9, at 1-11.

C. Applicable Law

The purpose of this investigation is to establish rates for PAWC customers which are "just and reasonable" pursuant to Section 1301 of the Public Utility Code (Code), 66 Pa. C.S. § 1301. This Commission possesses a great deal of flexibility in the ratemaking function.

> In determining just and reasonable rates, the [Commission] has discretion to determine the proper balance between interests of ratepayers and utilities. *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*, 522 Pa. 338, 342-43, 561 A.2d 1224, 1226 (1989). As this Court stated in *Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Co.*, 492 Pa. 326, 337, 424 A.2d 1213, 1219 (1980), cert. denied, 454 U.S. 824, 102 S.Ct. 112, 70 L.Ed.2d 97 (1981),
>
>> There is ample authority for the proposition that the power to fix "just and reasonable" rates imports a flexibility in the exercise of a complicated regulatory function by a specialized decision-making body and that the term "just and reasonable" was not intended to confine the ambit of regulatory discretion to an absolute or mathematical formulation but rather to confer upon the regulatory body the power to make and apply policy concerning the appropriate balance between prices charged to utility customers and returns on capital to utility investors consonant with constitutional protections applicable to both.

Popowsky v. Pa. PUC, 542 Pa. 99, 108, 665 A.2d 808, 812 (1995).

Commission policy promotes settlements, 52 Pa. Code §§ 5.231 and 69.401. Settlements lessen the time and expense the parties must expend litigating a case and at the same time conserve administrative hearing resources. The Commission has indicated that settlement results are often preferable to those achieved at the conclusion of a fully litigated proceeding. 52 Pa. Code § 69.401. Rate cases are expensive to litigate and the cost of such litigation at a reasonable level is an operating expense recovered in the rates approved by the Commission. This means that a settlement, which allows the parties to avoid the substantial costs of preparing and serving testimony and the cross-examination of witnesses in lengthy hearings, the preparation and service of briefs, reply briefs, exceptions and reply exceptions, together with the briefs and reply briefs necessitated by any appeal of the Commission's decision, yields significant savings for the company's customers. That is one reason why settlements are encouraged by long-standing Commission policy.

In order to accept a settlement, the Commission must determine that the proposed terms and conditions are in the public interest. *Pa. PUC v. Philadelphia Gas Works*, Docket No. M-00031768 (Order entered January 7, 2004).

Section 315(a) of the Code reads as follows:

> § 315. Burden of proof
>
> (a) Reasonableness of rates.--In any proceeding upon the motion of the commission, involving any proposed or existing rate of any public utility, or in any proceedings upon complaint involving any proposed increase in rates, the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility. The commission shall give to the hearing and decision of any such proceeding preference over all other proceedings, and decide the same as speedily as possible.

66 Pa. C.S. § 315(a). Consequently in this proceeding, PAWC has the burden to prove that the rate increase it has proposed through the Settlement is just and reasonable. The Joint Petitioners have reached an accord on the issues and claims that arose in this proceeding and submitted a Settlement for Commission review. In reviewing the

Settlement, the question which must be answered is whether it is in the public interest. The Joint Petitioners have the burden to prove that the Settlement is in the public interest.

Before addressing the Exceptions, we note that any issue or Exception that we do not specifically address shall be deemed to have been duly considered and denied without further discussion. The Commission is not required to consider expressly or at length each contention or argument raised by the parties. *Consolidated Rail Corp. v. Pa. PUC,* 625 A.2d 741 (Pa. Cmwlth. 1993); *also see, generally, University of Pennsylvania v. Pa. PUC*, 485 A.2d 1217 (Pa. Cmwlth. 1984).

D. Public Interest Considerations

The Joint Petitioners attached Statements of Support to the Settlement setting forth the bases upon which they believe that the Settlement is fair, just, reasonable, non-discriminatory, lawful and in the public interest. Settlement at 15. In particular, the Joint Petitioners argue that the Settlement is in the public interest for the following four reasons. First, the Settlement provides for an increase in annual operating revenue of $26 million, or 4.5%, which is lower than the originally requested increase of $58.6 million, or 10.1%. Second, approval of the Settlement will avoid the need for further administrative proceedings and possibly appellate proceedings at significant cost to the Joint Petitioners, other parties, and the Company's customers. Third, the Settlement Rates will allocate the agreed-upon combined water and wastewater revenue requirement to each rate zone and customer class in a reasonable manner considering the positions of the Parties regarding rate structure and cost. Fourth, the Settlement implements Section 1311(c) of the Code, 66 Pa. C.S. § 1311(c), in a fair manner to all customers.[11] According to the Joint Petitioners, the Settlement avoids wastewater increases scheduled for January 1, 2014, and results in wastewater rates that are substantially lower than they would have been under stand-alone wastewater requirement calculations.[12] Settlement at 15.

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[11] Relevant to this proceeding, Act 11 of 2012 made two substantive changes to Chapter 13 of the Code at Sections 1311(c) and (e). Specifically, these sections now state:

> § 1311. Valuation of and return on the property of a public utility.
>
> ….
>
> (c) *Segregation of property.* **--**When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utility as a unit in determining the value of the rate base of such public utility for the purpose of fixing base rates. **A utility that provides water and wastewater service shall be exempt from this subsection upon petition of a utility to combine water and wastewater revenue requirements. The commission when setting base rates, after notice and an opportunity to be heard, may allocate a portion of the wastewater revenue requirement to the combined water and wastewater customer base if in the public interest.**
>
> ….
>
> **(e) *Definition.* --As used in this section, the term "utility that provides both water and wastewater service" shall include separate companies that individually provide water or wastewater service so long as the companies are wholly owned by a common parent company.**

66 Pa. C.S. § 1311(c) and (e) (emphasis added to show changes made through Act 11 of 2012).

[12] The total unrecovered wastewater cost of service which will be transferred to the water cost of service under the Settlement is $5,410,115. This transfer represents less than 1% of the total proposed water revenue of $588,251,723. Settlement, Appendix C, Schedule 1, and Appendix G.

With regard to Section 1311(c), PAWC, I&E, and OCA each argue that it is in the public interest to allocate a portion of the wastewater revenue requirement to the combined water and wastewater customer base. According to PAWC, the effect of this allocation would be to moderate the rates of wastewater customers while only having a negligible impact on the rates of customers. PAWC Statement in Support of the Settlement at 2.

I&E notes that, without the Settlement, customers in the Coatesville, Claysville, and Northeast wastewater service territories are going to experience significant rate increases in 2014-2016. I&E Statement in Support of Settlement at 9. For example, the average residential customer in the Coatesville territory, currently paying $67.50 per month for wastewater service, will pay $81.27 on January 1, 2014, for the same service. *Id.* I&E supports the Settlement, which will eliminate the January 2014 rate increases for the Coatesville, Claysville, and Northeast wastewater divisions by adding the deferred wastewater catch-up revenue to the water revenue requirement. According to I&E, the Settlement is in the public interest as mandated by Act 11 because it significantly moderates the rate impact of the investments needed in the wastewater divisions in a way that is reasonable for PAWC water customers. *Id.* at 9-10, 19-22.

OCA also agrees that the combination of the water and wastewater rate base in the Settlement is in the public interest as required under Act 11. OCA Statement in Support of Settlement at 6-7.

E. Exceptions, Replies and Disposition

1. Exceptions of PWSA

As noted above, PWSA filed a statement of non-opposition to the Joint

Settlement on October 18, 2013. PWSA's statement provided, in part, that it "does not oppose the proposed allocation of $5.4 million of wastewater revenue to water customers as identified [in the Settlement]." PWSA Statement of Non-Opposition (PWSA Statement) at 2-3. In their Recommended Decision, the ALJs considered the PWSA Statement to be "compelling" and concluded that PWSA found the resolution to pay a portion of wastewater service costs in water service rates as "palatable." R.D. at 41.[13]

In its first Exception, PWSA stated that it was incorrect for the ALJs to characterize its non-opposition as "compelling" in support of the Settlement or for any other purpose. Further, PWSA argues that it was incorrect to view the PWSA Statement as a finding that PWSA considers the payment of wastewater service costs through water rates to be "palatable." According to PWSA, its position in regard to the settlement revenue terms and the allocation of wastewater costs to water rates is simply one of non-opposition and it objects to any other characterization of its position. PWSA Exc. at 2-3.

In its Replies to the Exceptions, PAWC considers PWSA's first Exception to be limited in nature and, if granted, will have no effect on the PWSA. R. Exc. at 5-6.

We do not believe the ALJs committed error by concluding that the PWSA Statement was compelling in terms of the disposition of the Settlement. First, PWSA does not provide a rationale for its objections. Second, as properly noted by the ALJs, many customers in the public input hearings testified that it was improper and not in the public interest to require water-only customers to pay for part of the wastewater service supplied to others. R.D. at 43. However, active participants in the proceeding, which

[13] "We find the non-opposition of PWSA *compelling*. PWSA is allocated costs of the wastewater service as part of the rate increase that it is knowingly not opposing. This revelation alone is evidence that an industrial customer of PAWC that receives only water service from the Company finds the resolution to pay a portion of the wastewater service *palatable* considering the totality of the resolution for this proceeding through the Joint Settlement." *Id.* (emphasis added).

included organizations representing the public interest, had the opportunity to raise similar concerns or objections but declined to do so. Accordingly, we agree that the PWSA Statement as to this issue was influential for purposes of evaluating whether the Settlement is in the public interest and the ALJs acted within their discretion by giving weight to PWSA's filing. Moreover, we find no error in the ALJs conclusion that PWSA considered the Settlement to be "palatable."[14] It is fair to conclude that, if PWSA considered the Settlement to be unacceptable, it would have refrained from submitting its statement of non-opposition. Therefore, we shall deny PWSA's first Exception.

In its second Exception, PWSA objects to being identified as an "industrial customer" of PAWC on page 41 of the Recommended Decision. PWSA avers that it intervened in the proceeding, not as a customer, but to minimize equalization payments made by PWSA for the benefit of PAWC water customers who reside in Pittsburgh's South Hills area. According to PWSA, it would be incorrect to identify PWSA as an industrial customer in any final order by the Commission. PWSA Exc. at 3.

In its Replies to the Exceptions, PAWC agrees that PWSA is not an industrial customer of PAWC. Further, PAWC notes that PWSA is correct in asserting that its pleadings, testimony and statement of non-opposition averred that its intervention was based on its claimed interest in PAWC's rates allegedly arising from equalization payments it makes on behalf of Pittsburgh residents who are PAWC customers. As such, PAWC believes the granting of PWSA's second Exception would create no barrier to the Commission's approval of the Settlement. R. Exc. at 6.

Upon review, we agree with PWSA and PAWC that the ALJs' characterization of PWSA as an industrial customer is inconsistent with PWSA's filing

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[14] "Palatable" is defined as: "1: agreeable to the palate or taste : savory; 2: agreeable to the mind : acceptable." Webster's Seventh New Collegiate Dictionary 606 (1963).

regarding the circumstances of PWSA's intervention in this proceeding. In order to clarify the record, we shall grant PWSA's second Exception. Accordingly, we shall modify the Recommended Decision to remove reference to PWSA as an industrial customer of PAWC.

2. Exceptions of Mr. Kazimer

Mr. Kazimer raises two objections in his Exceptions to the Recommended Decision.[15] First, he argues that "Act 11, 66 Pa. C.S. § 1311(c)" is unconstitutional, unfair, discriminatory and unreasonable. He claims that he already pays his township for wastewater and sewage disposal and that PAWC is not entitled to the Settlement.[16] Second, Mr. Kazimer asserts that the ALJs did not include information related to his testimony at the public input hearing in Reading. He argues that his testimony pertaining to the approval of PAWC's prior rate increases was not included in the Recommended Decision. Kazimer Exc. at 1.[17]

In its Replies to Exceptions, PAWC argues that the Commission is not the forum in which to challenge the legality or the constitutionality of a duly enacted statute

[15] We acknowledge that the format of Mr. Kazimer's Exceptions does not strictly comply with Section 5.533(b) of our Regulations, 52 Pa. Code § 5.533(b), which requires that exceptions be numbered, identify the finding of fact and conclusion of law to which exception is taken, and cite to the relevant pages of the Recommended Decision. Nevertheless, particularly because Mr. Kazimer is appearing *pro se*, we will accept the Exceptions as filed pursuant to Section 1.2(a) of our Regulations, 52 Pa. Code § 1.2(a), in order to secure a just, speedy, and inexpensive determination of this matter.

[16] Although not entirely clear from the Exceptions, it appears that Mr. Kazimer is also challenging the application of Section 1311(c) and the conclusions of the ALJs that it is in the public interest to require water-only customers to pay for part of the wastewater service supplied to others.

[17] In his Exceptions, Mr. Kazimer states that the Commission granted an average increase in rates of 57% in years 2001, 2003, 2007, 2009 and 2011 and asks: "too generous or not generous enough?" *Id.*

such as Act 11. Further, PAWC claims that Section 1311(c) of the Code reflects the legislative judgment that it is fair, reasonable and non-discriminatory to allocate a portion of wastewater revenue requirement to the combined water and wastewater customer base of a utility which furnishes water and wastewater service. R. Exc. at 7-8.

In response to Mr. Kazimer's second objection, PAWC argues that the increases approved at the conclusion of the Company's base rate cases in 2001, 2003, 2007, 2009, and 2011 have no bearing on the reasonableness of PAWC's claims in this case or the Settlement. In addition, PAWC argues, the increases in revenue requirements since 2001 reflect the Company's need to invest capital to replace and rehabilitate aging infrastructure, to respond to increasingly stringent environmental and drinking water standards, and to help address the problems created by troubled and non-viable water systems in the state. Moreover, PAWC asserts that the details and supporting data for the requested increase in revenue are adequately set forth in the Settlement. R. Exc. at 9-12.

With regard to the first objection, we agree with PAWC that the Commission is without the authority to entertain Mr. Kazimer's objections to the Code. Administrative agencies are creatures of the legislature and have only those powers which have been conferred by statute. *Western Pennsylvania Water Company v. Pa. PUC*, 471 Pa. 347, 370 A.2d 337, 339-340 (1977). Further, the Commonwealth Court has made clear that an administrative agency does not have power to determine the constitutionality of a statute it is charged to implement. *Cutler v. State Civil Service Comm'n (Office of Admin.),* 924 A.2d 706, 716-17 (Pa. Cmwlth. 2007). Here, Mr. Kazimer is objecting to the legality and the constitutionality of Section 1311(c) of the Code and the Commission is not permitted to entertain this challenge.

Furthermore, to the extent that Mr. Kazimer is also objecting to the application of Section 1311(c) and the ALJs' determination that it is in the public interest to allocate a portion of the wastewater requirement to the combined water and wastewater customer base, we shall deny the Exception. As the Commission has previously acknowledged, one benefit of Section 1311(c) is that the costs of necessary upgrades to wastewater systems to maintain safe and reliable service, which can be substantial on a stand-alone basis, can be spread among the common customer base of the water and wastewater utilities.[18]

Here, the ALJs acknowledged that, during the public input hearings, many customers disputed that it was in the public interest to combine the water and wastewater customer base to help pay for the wastewater service. However, the ALJs gave weight to the active party participants who supported the Settlement and asserted that it is in the public interest to pass moderate increases to water-only customers for the greater public good of reasonable wastewater rates and wastewater improvements. R.D. at 43.

Upon review of the record, we find that the ALJs properly concluded that it is in the public interest to allow the combination of the water and wastewater customer base under Section 1311(c). We agree that the Settlement avoids significant wastewater increases scheduled for January 1, 2014, while allowing for moderate increases in water rates.[19]

In addition, we find that Mr. Kazimer's second objection, claiming the ALJs did not address his testimony pertaining to prior approved rate increases, to be without merit. As an initial matter, Mr. Kazimer introduced an exhibit during his

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[18] *Petition of York Water Company for Authorization to Present a Combined Filing for a General Rate Increase Under 66 Pa. C.S. § 1308(d) Covering Both its Water and Wastewater Revenue Requirements Pursuant to 66 Pa. C.S. § 1311(c)*, Docket No. P-2012-2340409 (Order entered February 28, 2013) at 3.

[19] For example, the average residential increase in water rates for Zone 1 PAWC customers with 5/8 inch meters is expected to be 5.58%. *See* B. Terms and Conditions of the Settlement, *supra.*

testimony titled "PAWC Rate Case History" which was admitted into the record. Tr. at 393; Kazimer Exh. 1. This Exhibit was also referenced in the Recommended Decision. R.D. at 16. Furthermore, the Exhibit is identical to the chart attached to Mr. Kazimer's Exceptions upon which he based his calculations of prior rate increases. Thus, we find no basis in the record or in the Recommended Decision which suggests the ALJs disregarded Mr. Kazimer's testimony. Furthermore, Mr. Kazimer's objection is essentially a statement of dissatisfaction with the ALJs' Recommended Decision. We are of the opinion that the ALJs correctly determined that PAWC has sustained its burden of proof in demonstrating that the increase in rates as proposed in the Settlement is warranted. Accordingly, we shall deny Mr. Kazimer's Exceptions.

E. Additional Consideration

During the public input hearings, Amity Township Manager Charles Lyon questioned PAWC's apparent practice of requiring the payment of public fire hydrant fees and the filing of indemnification documents when there is a use of the hydrants. Tr. at 356-358; R.D. at 44. The ALJs concluded that these issues were beyond the scope of the Settlement and did not appear to be a service or safety issue that required immediate attention. R.D. at 44. Because the record is incomplete on this issue, the ALJs recommended that a formal complaint form be sent to Amity Township in order for the Township to formally pursue its concerns in a separate proceeding if it chooses to do so. *Id.* We agree and will direct the Commission's Secretary's Bureau to mail a formal complaint form to Amity Township.

III. Conclusion

We have reviewed the record as developed in this proceeding, including the ALJs' Recommended Decision and the Exceptions filed thereto. Initially, the Company requested an overall revenue increase of $58.6 million, or 10.1%. Thereafter, the Company, I&E, OCA, OSBA, CEO and PAWLUG submitted a Settlement for the Commission's approval. The ALJs recommended that the Commission adopt the Settlement, which would result in the Company receiving a stipulated increase in annual revenues of $26 million, or 4.5%. The Settlement would produce approximately $604.6 million in total annual combined water and wastewater revenue as shown in Appendix C, Schedule A, column 8 of the Settlement. The ALJs further recommended that the Company be authorized to file the Tariff Supplement for water service attached to the Settlement as Appendix A and the Original Tariff for wastewater service attached to the Settlement as Appendix B to become effective on January 1, 2014.

Based on our review, evaluation and analysis of the record evidence, we find that the Settlement is in the public interest. Consequently, we shall adopt the ALJs' recommendations, to the extent consistent with this Opinion and Order, and the resulting allowable revenue increase is $26 million, or 4.5%, increase in revenues. The Exceptions of PWSA will be granted, in part, and denied, in part, and the Exceptions of Mr. Kazimer will be denied, consistent with this Opinion and Order; **THEREFORE,**

IT IS ORDERED:

1. That the Exceptions filed by the Pittsburgh Water and Sewer Authority on November 18, 2013, to the Recommended Decision of Administrative Law Judges Angela T. Jones and Darlene D. Heep are denied, in part, and granted, in part.

2. That the Exceptions filed by William B. Kazimer on November 18, 2013, to the Recommended Decision of Administrative Law Judges Angela T. Jones and Darlene D. Heep are denied.

3. That the Recommended Decision of Administrative Law Judges Angela T. Jones and Darlene D. Heep, issued on November 8, 2013, is adopted, as modified, to the extent consistent with this Opinion and Order.

4. That Pennsylvania-American Water Company shall not place into effect the rates, rules, and regulations contained in Supplement No. 279 to Tariff Water – Pa. P.U.C. No. 4 and Original Tariff Wastewater Pa. P.U.C. No. 15 as filed on April 30, 2013, the same having been found to be unjust, unreasonable, and therefore, unlawful.

5. That the rates, terms and conditions contained in the Joint Settlement Petition filed by Pennsylvania-American Water Company, the Bureau of Investigation & Enforcement , the Office of Consumer Advocate, the Office of Small Business Advocate, the Commission on Economic Opportunity, and the Pennsylvania American Water Large Users Group on October 18, 2013, is approved.

6. That Pennsylvania-American Water Company is hereby authorized to file tariffs, tariff supplements or tariff revisions containing rates, rules and regulations for water service consistent with Appendix A of the Joint Settlement Petition filed by Pennsylvania-American Water Company, the Bureau of Investigation & Enforcement , the Office of Consumer Advocate, the Office of Small Business Advocate, the Commission on Economic Opportunity, and the Pennsylvania American Water Large Users Group on October 18, 2013, that become effective upon less than statutory notice on January 1, 2014, and are designed to produce total annual operating revenue not to exceed $588,251,723.

7. That Pennsylvania-American Water Company is hereby authorized to file tariffs, tariff supplements or tariff revisions containing rates, rules and regulations for wastewater service, consistent with Appendix B the Joint Settlement Petition filed by Pennsylvania-American Water Company, the Bureau of Investigation & Enforcement, the Office of Consumer Advocate, the Office of Small Business Advocate, the Commission on Economic Opportunity, and the Pennsylvania American Water Large Users Group on October 18, 2013, that become effective upon less than statutory notice on January 1, 2014, and are designed to produce total annual operating revenue not to exceed $16,324,282.

8. That, upon acceptance of the appropriate compliance filing, the investigation at Docket No. R-2013-2355276 shall be marked closed.

9. That the Formal Complaint filed at Docket No. C-2013-2362470, by the Office of Consumer Advocate, is dismissed.

10. That the Formal Complaint, filed at Docket No. C-2013-2364641, by the Office of Small Business Advocate is dismissed.

11. That the Formal Complaint, filed at Docket No. C-2013-2364664, by Brian L. Casper is dismissed.

12. That the Formal Complaint, filed at Docket No. C-2013-2364692, by Dawn B. Spielvogel is dismissed.

13. That the Formal Complaint, filed at Docket No. C-2013-2364773, by Robert Redinger is dismissed.

14. That the Formal Complaint, filed at Docket No. C-2013-2366095, by Rita Sherman is dismissed.

15. That the Formal Complaint, filed at Docket No. C-2013-2367036, by Guy & Nedra Visconti is dismissed.

16. That the Formal Complaint, filed at Docket No. C-2013-2367041, by Russell Vankoughnet is dismissed.

17. That the Formal Complaint, filed at Docket No. C-2013-2369063, by Doris Miller is dismissed.

18. That the Formal Complaint, filed at Docket No. C-2013-2369095, by Jon & Dorothy Pichelman is dismissed.

19. That the Formal Complaint, filed at Docket No. C-2013-2369464, by Jane Neufeld is dismissed.

20. That the Formal Complaint, filed at Docket No. C-2013-2369925, by Georgia L. Dicko is dismissed.

21. That the Formal Complaint, filed at Docket No. C-2013-2370649 by Carly J. Dunn, is dismissed.

22. That the Formal Complaint, filed at Docket No. C-2013-2372396, by William B. Kazimer is dismissed.

23. That the Formal Complaint, filed at Docket No. C-2013-2366239, by S. Stockton Alloway is dismissed.

24. That the Formal Complaint, filed at Docket No. C-2013-2372641, by Thad Shirey is dismissed.

25. That the Formal Complaint filed at Docket No. C-2013-2379466 by Paul Trizonis is dismissed.

26. That the Secretary's Bureau shall mail a Formal Complaint form to the Amity Township Board of Supervisors:

Attention: Mr. Charles Lyon, Township Manager
Amity Township Municipal Offices
2004 Weavertown Road
Douglassville, PA 19518

27. That the Secretary's Bureau shall mark the following Dockets closed: No. C-2013-2362470; No. C-2013-2364641; No. C-2013-2364664; No. C-2013-2364692; No. C-2013-2364773; No. C-2013-2366095; No. C-2013-2367036; No. C-2013-2367041; No. C-2013-2369063; No. C-2013-2369095; No. C-2013-2369464; No. C-2013-2369925; No. C-2013-2370649; No. C-2013-2372396; No. C-2013-2366239; No. C-2013-2372641; and No. C-2013-2379466.

BY THE COMMISSION,

Rosemary Chiavetta
Secretary

(SEAL)

ORDER ADOPTED: December 19, 2013

ORDER ENTERED: December 19, 2013

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, DECEMBER 12, 2012

APPLICATION OF

VIRGINIA-AMERICAN WATER COMPANY

CASE NO. PUE-2011-00127

For a general increase in rates

FINAL ORDER

On February 6, 2012, Virginia-American Water Company ("Virginia-American" or "Company") filed an application with the State Corporation Commission ("Commission") for an increase in water rates ("Application").[1] In its Application, the Company requests authority to increase rates for water service to produce an increase in water revenues of $5.723 million.[2] The proposed increase would constitute a 15.93% increase in the Company's water revenues and is based on an 11.3% return on common equity.[3] The increase in metered water sales revenue is divided between Virginia-American's Alexandria District - $1,660,831 (a 12.2% increase); Hopewell District - $1,650,119 (a 12.50% increase); Prince William District - $1,841,276 (a 24.81% increase); and Eastern District $570,294 (a 33.82% increase).[4]

By Order for Notice and Hearing entered on March 2, 2012, the Commission docketed the Application; established a procedural schedule; directed the Company to provide public notice of its Application; scheduled a public hearing on the Application for September 25, 2012; and assigned the case to a hearing examiner to conduct all further proceedings on behalf of the Commission and file a report with her findings and recommendations.

[1] The Application was accepted as "complete" on February 13, 2012.

[2] Application at 2.

[3] *Id.*

[4] *Id.*

The Division of Consumer Counsel of the Office of the Attorney General ("Consumer Counsel"); the Hopewell Committee for Fair Water Rates ("Hopewell Committee"); the City of Hopewell ("Hopewell"); and Concerned Ratepayers in the Eastern District ("Eastern Ratepayers") filed Notices of Participation (collectively, "Respondents").

The public hearing was convened as scheduled on September 25, 2012. The testimony of three public witnesses, each of whom has a residence in the Company's Eastern District, offered testimony in opposition to the proposed increase. At the conclusion of the public hearing, the Company, the Staff, and the Respondents ("Stipulating Participants") advised the Chief Hearing Examiner, Deborah V. Ellenberg, that they had entered into settlement discussions, and they requested that the hearing be reconvened at 2 p.m. on October 4, 2012.

On October 4, 2012, the hearing was reconvened and the Stipulating Participants presented a stipulation ("Stipulation") for the Commission's consideration.[5] Pursuant to the terms of the Stipulation, the Application and supporting attachments and schedules, the testimony and exhibits of the Stipulating Participants' witnesses, and the Stipulation were admitted into the evidentiary record. The Stipulation, in part, provides for an additional total revenue requirement of $2,287,107,[6] based upon a return on equity of 9.75% within a recommended authorized range of 9.0% - 10.0%.

On October 18, 2012, the Chief Hearing Examiner issued her report ("Report"). After summarizing the evidence and the Stipulation, the Chief Hearing Examiner found the Stipulation to be fair, reasonable, and in the public interest.

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[5] Attachment A.

[6] The revenue requirement increase is apportioned among the Company's districts as follows: Alexandria District - $929,970; Hopewell District - $0; Prince William District - $1,128,710; and Eastern District - $228,427.

The Chief Hearing Examiner recommended that the Commission enter an order that adopts the Stipulation and the findings contained in the Report; approves a total annual revenue requirement increase as recommended in the Stipulation of $2,287,107; directs the Company to refund with interest the difference between the interim rates effective July 12, 2012, and the rates approved in the Final Order; and passes the papers herein to the file for ended causes.[7]

NOW THE COMMISSION, having considered this matter, is of the opinion and finds that the Report and the Stipulation should be adopted and that the total annual revenue requirement increase represented in the Stipulation should be approved. Further, the Company should refund with interest the difference between the interim rates effective July 12, 2012, and the rates approved herein, as directed below.

Accordingly, IT IS ORDERED THAT:

(1) The findings and recommendations of the October 18, 2012 Report are hereby adopted.

(2) The Stipulation is hereby adopted and made part of this Final Order.

(3) The rates and charges approved herein are fixed and substituted for the rates and charges and terms and conditions that took effect on an interim basis on July 12, 2012. The Company shall forthwith file revised tariff sheets incorporating the findings herein on rates and charges and terms and conditions of service with the Clerk of the Commission and the Commission's Division of Energy Regulation in accordance with this Final Order. The Clerk of the Commission shall retain such filing for public inspection in person and on the Commission's website: http://www.scc.virginia.gov/case. Refunds of interim rates shall be made as required below.

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[7] Report at 29.

(4) The Company shall recalculate, using the rates and charges approved herein, each bill it rendered that used, in whole or in part, the rates and charges that took effect on an interim basis and subject to refund on and after July 12, 2012, and, where application of the new rates results in a reduced bill, refund the difference with interest as set out below within ninety (90) days of the issuance of this Final Order.

(5) Interest upon the ordered refunds shall be computed from the date payments of monthly bills were due to the date each refund is made at the average prime rate for each calendar quarter, compounded quarterly. The average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin or in the Federal Reserve's Selected Interest Rates (Statistical Release H. 15) for the three (3) months of the preceding calendar quarter.

(6) The refunds ordered herein may be credited to the current customers' accounts. Refunds to former customers shall be made by check mailed to the last known address of such customers when the refund amount is $1 or more. The Company may offset the credit or refund to the extent of any undisputed outstanding balance for the current or former customer. No offset shall be permitted against any disputed portion of an outstanding balance. The Company may retain refunds to former customers when such refund is less than $1, and such refunds shall be promptly made upon request. All unclaimed refunds shall be subject to § 55-210.6:2 of the Code.

(7) Within sixty (60) days of completing the refunds ordered herein, the Company shall deliver to the Commission's Divisions of Energy Regulation and Utility Accounting and Finance a report showing that all refunds have been made pursuant to this Final Order and detailing the costs incurred in effecting such refunds and the accounts charged.

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(8) The Company shall bear all costs incurred in effecting the refunds ordered herein.

(9) This matter is dismissed.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to: Richard D. Gary, Esquire, Hunton & Williams LLP, 951 East Byrd Street, Richmond, Virginia 23219-4074; Brian R. Greene, Esquire, GreeneHurlocker, PLC, Eighth & Main, 707 East Main Street, Suite 1025, Richmond, Virginia 23218; David C. Fratarcangelo, City Attorney, City of Hopewell, 300 North Main Street, Hopewell, Virginia 23860; Louis R. Monacell, Esquire, and Cliona M. Robb, Esquire, Christian & Barton, LLP, 909 East Main Street, Suite 1200, Richmond, Virginia 23219; and C. Meade Browder, Jr., Esquire, and Kiva B. Pierce, Esquire, Division of Consumer Counsel, Office of the Attorney General, 900 East Main Street, Second Floor, Richmond, Virginia 23219; and a copy shall be delivered to the Commission's Office of General Counsel and Divisions of Energy Regulation and Utility Accounting and Finance.

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Attachment A

COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

APPLICATION OF	)	
	)	
VIRGINIA-AMERICAN WATER COMPANY	)	Case No. PUE-2011-00127
	)	
For a general increase in rates	)	

STIPULATION

This Stipulation represents the agreement between Virginia American Water Company ("Virginia American" or "Company"), the Staff of the State Corporation Commission ("Staff"), the Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"), Concerned Ratepayers of the Eastern District ("CRED"), Hopewell Committee for Fair Water Rates ("Committee"), and the City of Hopewell (collectively, "Stipulating Participants") resolving all issues raised by the Stipulating Participants relating to the Application filed on February 6, 2012 by Virginia American for a general increase in rates ("Application").

1. The Application, its pre-filed direct testimony, its rebuttal testimony (the "Rebuttal Testimony") and their exhibits shall be made a part of the record without cross-examination.

2. The testimonies and exhibits filed by Staff, Consumer Counsel, CRED, Committee and City of Hopewell shall be made a part of the record without cross-examination.

3. To resolve all issues raised by the Stipulating Participants concerning the Application and to establish the Company's rates, the Stipulating Participants accept the positions of Staff set out in its pre-filed testimony on the Application filed August 23, 2012 (the "Staff Testimony") with the modifications below.

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4. The amount of $41,657 will be used in the rate year for Sewer and Billing revenue in the Alexandria District.

5. A three-year operations and maintenance ("O&M") expense percentage for each district (as calculated in the Rebuttal Testimony) will be used. The Company will continue to use a 3-year O&M expense percentage for each district in all Annual Informational Filings filed by the Company until the Company's next base rate case, at which time the use of a three-year average on an ongoing basis will be reviewed.

6. The Company's Rate Case Expense will be normalized over five years.

7. The Cost of Service will include $256,570 of the projected Service Company Business Transformation expense. This includes $120,473 for the Alexandria District, $41,206 for the Hopewell District, and $94,891 for the Prince William District.

8. The Cost of Service for the Eastern District will include $100,000 of management fees. In each subsequent rate case, the Company will be allowed to include an additional $75,000 of management fees, if prudently incurred, for the Eastern District until the full level of prudently incurred management fees is included in rates.

9. The Cash Working Capital changes in the Rebuttal Testimony will be adopted, with the exception that a $0 cash working capital impact will be used for Utility Tax Collection. In addition, the Company agrees that in any future lead/lag study, it will use Staff's methodology for Utility Tax Collection, which will set the net lead/lag days equal to the maximum allowable payment time under the applicable municipal codes.

10. The Return on Equity ("ROE") of 9.75% will be used to establish rates in this proceeding.

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11. The ROE range in this proceeding will be 9.0% - 10.0%. This ROE range, until changed by the Commission, will be used for future earnings tests.

12. With these modifications to Staff's pre-filed testimony, the additional revenue requirements for each District, for service rendered on and after July 12, 2012, will be:

a. Alexandria $929,970
b. Hopewell $0
c. Prince William $1,128,710
d. Eastern $228,427
Total $2,287,107

In addition, the Stipulating Participants agree to the following provisions:

13. The Company will maintain bi-monthly billings in the Eastern District until at least the next rate case and will provide notice to the customers in the Eastern District at least six months before changing to monthly billings.

14. The Company will not implement its proposed DSM program for the Hopewell District at this time. The Company will work with the District's industrial customers and other rate classes to further refine the parameters and timing of implementation of a DSM program for the Hopewell District if it is needed in the future.

15. The Company will file tariffs with the Commission for its review and approval prepared in conformance with this Stipulation and the rate design proposed by Staff in the Staff Testimony. For the Hopewell District, the rates, as they existed prior to the interim rate increase resulting from the Application, will remain unchanged.

16. Any necessary refunds of interim rates will be determined and completed as ordered by the Commission.

17. This Stipulation represents a settlement in this case only and shall not be regarded as a precedent or any other principle in any future case, except as specifically provided for in

paragraphs 5, 8, and 9 above. The Stipulating Participants agree that the resolution of the issues in the Stipulation, taken as a whole, and the disposition of all other matters set forth in the Stipulation are in the public interest. This Stipulation is conditioned on and subject to acceptance by the Commission and is non-severable and of no force or effect and may not be used for any other purpose unless accepted in its entirety by the Commission, except that this paragraph shall remain in effect in any event.

18. In the event that the Commission does not accept the Stipulation in its entirety, including the issuance of a recommendation to approve the Stipulation, the Stipulating Participants retain the right to withdraw support for the Stipulation. In the event of such action by the Commission, any of the signatories to the Stipulation will be entitled to give notice exercising its right to withdraw support for the Stipulation; provided that the Stipulating Participants may, by unanimous consent, elect to modify the Stipulation to address any modifications required, or issues raised, by the Commission. Should the Stipulation not be approved, it will be considered void and have no precedential effect, and the Stipulating Participants reserve their rights to participate in all relevant proceedings in the captioned case notwithstanding their agreement to the terms of the Stipulation. If the Commission chooses to reject the Stipulation, the Stipulating Participants may request that an *ore tenus* hearing be convened at which time testimony and evidence may be presented by the case participants and cross-examination may occur on any issues arising in this proceeding.

Respectfully submitted,
VIRGINIA AMERICAN WATER COMPANY

October 4, 2012

By: ______________________
Counsel

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Richard D. Gary
Noelle J. Coates
HUNTON & WILLIAMS LLP
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074

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STAFF OF THE STATE CORPORATION
COMMISSION

By: ________________
Counsel

Frederick D. Ochsenhirt
Mary Beth Adams
Office of General Counsel
State Corporation Commission
P.O. Box 1197
Richmond, Virginia 23218

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OFFICE OF THE ATTORNEY GENERAL
DIVISION OF CONSUMER COUNSEL

By: Kiva Pierce
Counsel

Kiva Bland Pierce, Esq.
Division of Consumer Counsel
Office of the Attorney General
900 East Main Street
Richmond, Virginia 23219

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CONCERNED RATEPAYERS IN THE
EASTERN DISTRICT

By: ____________________
Counsel

Brian R. Greene, Esq.
GreeneHurlocker, PLC
707 E. Main Street, Suite 1025
Richmond, Virginia 23219

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HOPEWELL COMMITTEE FOR FAIR WATER RATES

By: Cliona Mary Robb
Counsel

Cliona M. Robb, Esq.
Christian & Barton, LLP
909 E. Main Street, Suite 1200
Richmond, Virginia 23219-3095

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CITY OF HOPEWELL

By:____________________
Counsel

David C. Fratarcangelo, Esq.
City Attorney, City of Hopewell
300 N. Main Street
Hopewell, Virginia 23860

**PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA
CHARLESTON**

CASE NO. 15-0675-S-42T
WEST VIRGINIA-AMERICAN WATER COMPANY
Rule 42T tariff filing to increase sewer rates and charges.

and

CASE NO. 15-0676-W-42T
WEST VIRGINIA-AMERICAN WATER COMPANY
Rule 42T tariff filing to increase water rates and charges.

February 24, 2016

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**PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA
CHARLESTON**

At a session of the PUBLIC SERVICE COMMISSION OF WEST VIRGINIA in the City of Charleston on the 24th day of February 2016.

CASE NO. 15-0675-S-42T
WEST VIRGINIA-AMERICAN WATER COMPANY
Rule 42T tariff filing to increase sewer rates and charges.

and

CASE NO. 15-0676-W-42T
WEST VIRGINIA-AMERICAN WATER COMPANY
Rule 42T tariff filing to increase water rates and charges.

COMMISSION ORDER

This Commission grants rate relief to West Virginia-American Water Company (WVAWC) in general base rate cases for its water and sewer operations in West Virginia (2015 Rate Case) and in a separate case, West Virginia-American Water Company, Case No. 15-0674-WS-D (2015 Depreciation Case), approves a request to change depreciation rates.[1] The 2015 Depreciation Case was decided by separate order issued today in that proceeding but the changed depreciation rates are reflected in the water rates approved by the Commission in the 2015 Rate Case.[2] WVAWC originally filed for a $35.472 million base rate increase (later reduced to $32.075 million) in water rates and a $0.177 million increase in sewer rates. The Commission grants an $18.170 million increase in water rates and $0.151 million in sewer rates and cancels the use of an Allowance for Funds After Construction (AFFAC).

1 For this Order, the parties to this proceeding will be referred to as: "Staff" (Staff of the Commission); "CAD" (Consumer Advocate Division of the Commission); "KCC/RDA" (the Kanawha County Commission and the Kanawha County Regional Development Authority), "ASWS" (Advocates for a Safe Water System); "WVEUG and SWVA" (West Virginia Energy Users Group and SWVA, Inc.); and "Charleston" (the City of Charleston).

2 The record in this proceeding consists of over 1,008 pages of live testimony and 2,179 pages of prefiled testimony and exhibits, plus exhibits admitted at the hearing. In addition, the parties tendered 306 pages of briefs.

I. INTRODUCTION

Although the general regulatory bromide is that there is nothing easier than regulating a state water utility, the rate cases for West Virginia-American Water Company (WVAWC) belie that common perception. WVAWC is by far the State's largest water utility and is one of the State's larger public utilities by almost any measure.[3] The regulatory issues for WVAWC in a general rate case are just as technically complex, diverse and difficult as the issues the Commission confronts in regulating the State's major electric and natural gas utilities.

The difficulty of WVAWC cases springs not only from the regulatory issues faced by the Commission but also because those cases, particularly more recent cases, are shaded by public perceptions and (it would appear) a level of ambivalence about WVAWC. These public perceptions, as expressed to the Commission at public comment and protest hearings or in prior Commission Orders over time, include that:

- Unlike some states, West Virginia is blessed with abundant raw water. As a consequence, the common perception that water "flows free" in many areas of the State, leads some water customers to believe that water service from WVAWC should be readily, easily and inexpensively available regardless of the difficulty of delivering water service over the extensive transmission and distribution system of WVAWC in the often mountainous, difficult and sparsely populated service territories of the State. West Virginia-American Water Company, Case No. 08-0900-42T (WVAWC 2008 Rate Case), March 25, 2009 Order (WVAWC 2008 Rate Case Order) at 5.

- Although water service is generally reported elsewhere as one of the lowest cost utility services, the water service provided by WVAWC is generally perceived as higher in cost than the cost of water service provided out of State or by other State water utilities.[4]

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3 According to the records of the Commission, the State's largest seven utilities by customer count as of the end of 2014 are:

UTILITY	NO. OF CUSTOMERS
Appalachian Power Company	433,388
Monongahela Power Company	386,901
Frontier	319,191
Mountaineer Gas Company	217,632
West Virginia American Water Company	169,117
Potomac Edison Company	137,484
Dominion Hope Gas Company	113,236

There are no other West Virginia utilities with over 100,000 customers; the second largest water utility in the State, Beckley Water Company, has 22,728 customers.

4 Despite WVAWC efforts in past rate cases to convince the public that the cost of water in densely populated, less geographically dispersed service areas in other states would, and should, be lower than the cost for WVAWC to distribute its potable water within its geographically spread service territories, that argument seems to fall on deaf ears. West Virginia-American Water Co., Case No. 03-0353-W-42T, January 2, 2004 Order at 24-30; CAD 2016 Annual Report (Table 3). Further,

- Water utilities are frequently perceived as the stepchild of the utility industry, but water is a unique utility product and is the only utility product designed to be ingested. As a consequence, the absence, or inadequacy, of water service presents critical public concerns – in addition to the adverse impact on economic growth and vitality, there are other serious concerns about public health and safety, fire protection and sanitary problems.[5] As a consequence, it appears that the customers of WVAWC tend to be less tolerant of the State's largest water utility providing anything other than top quality service than customers of smaller water utilities might be.

- Raw water supplies in most of the service areas of WVAWC, by and large, are surface water sources and do not require expensive exploration, drilling and extraction. As a consequence, there also appears to be a lack of public appreciation for the extensive production, operation and maintenance costs to produce clean, clear potable water for a large and geographically disbursed customer base on a 24/7/365 basis. WVAWC 2008 Rate Case Order at 4, 5.

- Because most water utility transmission and distribution plant is buried, not visible, not readily or easily accessible, and not easily examined or inspected, the customers do not necessarily appreciate that maintenance and replacement of aged and deteriorated plant and water lines is difficult, costly and unfortunately is often done in response to ruptures, leaks or breaks.

Although it is axiomatic that no customers are enthusiastic about rate increases, there was a fairly significant period of time when many entities (municipalities, public service districts, and other small public and private systems) viewed WVAWC as a viable solution for their troubled water systems and as the means to obtain reliable potable water service in difficult terrain and sparsely populated areas, as demonstrated by the growth WVAWC experienced over the years (growth generated primarily from acquisitions, mergers, and public-private partnerships (PPPs)).[6]

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although there is considerable comment about the impact of WVAWC rates on fixed income or on low volume (not necessarily the same thing) users under WVAWC's tariff, minimum users receive up to 1,500 gallons of water while many smaller systems' minimum bills require a minimum bill based on 3,000 gallons. A study of rate comparisons showing that difference has not been presented to the Commission and might be instructive on the relative cost of residential water service to low-use customers.

5 Witness (i) the current torrent of adverse publicity about the presence of lead in the water in the City of Flint, Michigan, and (ii) closer to home, the national attention around the Spill near the WVAWC intake discussed in this Order at 8 infra.

6 See Appendix A for a partial list of WVAWC projects related in part to plant and customer additions previously approved by the Commission.

The limitations, barriers and problems associated with providing widespread quality water service in this State were touched on in the testimony of WVAWC witnesses[7] in this case and have been mentioned by the Commission in prior cases, including the 2008 Rate Case. WVAWC 2008 Rate Case Order at 4-5, 32.

It is interesting that a substantial quote from the same WVAWC 2008 Rate Case serves as a lengthy footnote in the introductory portion of Commission Staff's Initial Brief (Staff Init. Br. at 5, footnote 10).[8] That part of the 2008 Rate Case Order was intended to instruct and encourage WVAWC, during the difficult economic times of 2008-2009, to take steps to examine its operations and to operate in a prudent and fiscally conservative manner.

WVAWC apparently took note of the Commission directive in the 2008 Rate Case Order to make efforts to reduce O&M expense. A review of the activities and financial records of WVAWC over the past eight years, as reflected in the records of WVAWC in its Annual Reports to the Commission and from the records in this case or other WVAWC rate case orders after that time, reflects that the WVAWC level of O&M expense has remained at or below the rate of inflation. In fact, the level of O&M expenses sought by WVAWC in the instant case is actually $1.1 million lower than the level of O&M expenses awarded in the last WVAWC rate case and at the lowest level since 2010. WVAWC Ex. JST-D at 12.

The limitations, barriers and problems that bedeviled the Commission in 2008 continue today. We said in 2008:

> West Virginia-American Water Company is the largest water public utility in West Virginia. It serves nearly 40% of the residents of this State with potable water that meets every water quality standard imposed by State and Federal authorities. It has been a pioneer in developing cooperative efforts for extending water service into and throughout some of the most difficult service areas within the State. It has been a good corporate citizen, frequently supporting small town and large city activities and encouraging its executives and professionals to participate in government and nonprofit charitable activities within the State.
>
> WVAWC stepped forward in the early to late 1990s, at a time when the State was trying desperately to expand safe drinking water service and infrastructure to its citizens and indicated its willingness to expend $200 to $300 million in private capital for that purpose, an enormous commitment for a private water utility in this State, to spur the development of quality water service into unserved or underserved areas and to leverage the spending of public sector funds for the same purpose.

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[7] WVAWC Witness Sean T. Graves Direct, WVAWC Ex. STG-D at 4-7; Jeffrey L. McIntyre Direct, WVAWC Ex. JLM-D at 21-24. References to prefilled testimony will be by party, exhibit identification and page number, such as "WVAWC Ex. JLM-D at ___."

[8] The briefs of the parties will be referenced by party identification, nature of brief, and page number, such as "Staff Init. Br. at ___" or "Staff Reply Br. at ___."

During the time of that expansion, the Company sought, and in some instances received, regulatory treatments that recognized the investments that were being made by WVAWC and its commitment to improving the quality of service for customers throughout the State. These regulatory treatments were often more favorable to WVAWC than traditional regulatory policy that the Commission applied to utilities that were operating under different circumstances from WVAWC. That treatment was frequently extended to the Company in either annual rate filings or during "rate filing moratoria" that spanned several years, but that allowed periodic step rate increases or other types of rate adjustments to the Company, even during those moratoria periods. The Company frequently cited its good public work on behalf of providing water service to the "unserved" or "underserved" citizens of West Virginia as the basis for those rate filings and those frequent rate increases.

As a part of its capital commitment, WVAWC undertook the renovation or replacement of many small treatment plants that served some of the smaller customer distribution systems in south-central and southern West Virginia and upgraded its primary or flagship treatment plants in Kanawha, Cabell, Fayette, Lewis and Mercer/Summer Counties. Incident to public/private partnerships entered into by the Company, frequently involving the construction or renovation of these plants, the Company extended transmission and distribution mains into areas that could be served from these larger treatment plants. As a result, WVAWC has wide-spread service areas, often marked by long transmission and distribution runs and a large number of boosters, tanks and related facilities that frequently serve pockets of customers or areas with relatively low customer density.

All of these factors, and the willingness of the Company to take on unserved, poorly-served or underserved areas or to acquire troubled systems contiguous to its service areas, have caused, at least in part, the escalating rates of the Company and to some extent help to explain the Company's relatively high unaccounted for water losses.

Because of all of this, over the last fifteen years, the Company has experienced (i) an increase in the frequency and size of rate requests and allowances, and (ii) an increase (for the lack of a better term) in the "absolute" level of the Company's rates, both of which have drawn the negative attention of the public. During that same time, the American Water Works Company ("AWWC"), the parent of the Company, was the subject of an acquisition of, and subsequent partial sale of, its common stock in a transaction that was not generally warmly received by its customers in this State.

WVAWC 2008 Rate Case Order at 4-5.

In the last twenty years or so, with the consent and approval of the Commission, WVAWC has extended water service to more than 40,000 customers, or approximately 120,000 State residents. Much of the system improvements and customer growth, however, came from investments in extension projects, with public private partnerships (PPPs) and other asset acquisitions, with little organic customer growth occurring in historical service areas. Over that same timeframe, WVAWC has seen its investment in utility plant increase from approximately $183 million in 1993 to over $748 million at year end 2014 based on the filing in this case. WVAWC Ex. 2 (Rule 42 (Statement B)). That number does not include the investment by the public partners in those PPPs financed by the PPPs.

While many state residents received enhanced water service, as reflected in Appendix A, much of the growth in utility plant and facilities, and the capital expenditures related to that growth, came after the WVAWC 1994 Rate Case. West Virginia-American Water Co., Case No. 94-0138-W-42T. Because of (i) the significant growth of utility plant and the related costs and expense incident to the addition of that utility plant to serve its customers, (ii) the increase in operation and maintenance (O&M) expenses in the cost of service, (iii) the (unfortunate) lack of significant additional or incremental revenues from the number of customers added during that time, and (iv) the systematic and regular decline in water sales experienced by WVAWC over the past twenty years, WVAWC sought rate relief on a regular basis in order to recover increased O&M costs and a return on plant investment.[9]

Those relatively frequent requests for rate relief have been based on the position of WVAWC that it has been unable to achieve the level of revenue expected or rate of return allowed by the Commission. The principal assertions by WVAWC about the level of revenue have related to regulatory lag, declining sales, low rate of return and what WVAWC has viewed as non-mainstream regulatory approaches involving historical test year limitations and consolidated income tax savings used by the Commission in developing the cost of service. WVAWC Init. Br. at 9.

Because of the factors discussed in the preamble to this Order and in prior WVAWC cases, many of the key issues in these cases involve specifically how utility plant is recognized in rate base for ratemaking purposes for WVAWC.

The genesis of WVAWC's effort to expand its utility plant program and serve unserved, under-served and ill-served areas of the State was nurtured to some extent by the approval by the Commission in 1981 of the concept of Single Tariff Pricing (STP). West Virginia-American Water Co., Case No. 81-126-W-42A (STP Case). STP allowed WVAWC to develop and implement one company-wide tariff based on a total company cost of service instead of on the basis of a separate cost of service calculations for each operating district. STP encouraged the significant capital commitment of between

[9] Since 1993, WVAWC has filed eleven general rate cases including the current case, with four of those cases being fully litigated (including the current case.) WVAWC received rate case orders more recently in 2010, 2013 and this Order (2016).

$200 million to $300 million, by WVAWC and its parent company, American Water Works Company, made from the witness stand to extend and improve service to customers in 1994 in the WVAWC 1994 Rate Case.

After that commitment, the Commission approved numerous filings and projects undertaken by WVAWC. As indicated, those filings involved petitions and applications to construct state-of-the-art regional treatment plants capable of meeting increased water quality standards and supporting customer growth. Those filings included PPP certificate projects approved by the Commission and undertaken by the WVAWC with its public partners to extend service to unserved, underserved and ill-served areas near WVAWC service areas. The projects undertaken included acquisitions, mergers and many of the other customer related transactions approved by this Commission over the years mentioned in Appendix A to this Order.

Those transactions have facilitated extensions of service to WVAWC's current service areas. In its current operating configuration brought about by these projects, WVAWC has over 4,100 miles of transmission and distribution mains, 190 water storage tanks, and 325 booster/pressure reducing stations serving approximately 170,000 customers spread across parts of nineteen counties throughout south central and southern West Virginia. WVAWC Ex. STG-D at 2-7.

By and large, even during periods of frequent rate requests, WVAWC did not experience large numbers of public protests and relatively few protestants appeared at public comment hearings in this rate request. The level of rate increase in this case, however, coupled with the fallout from the Spill, has brought focus on rates driven by that investment but strangely enough a Janus-like reaction to those rates by Staff, CAD and WVEUG. WVAWC Init. Brief at 7; CAD Ex. RCS-D at 9; Staff Ex. DLK-D at 12; and WVEUG Ex. RAB-D at 5-6. On the one hand, WVAWC has been criticized for the magnitude of the rate case it filed by most of the parties, while at the same time being castigated for failing to spend sufficient capital on the system. WVAWC characterized this dichotomy in its reply brief:

> CAD, WVEUG, ASWS, and the City/County claim to want additional main replacement, to the point of assailing any other investment as needless and incorrectly contending that the Company has not maintained its system. Yet when it comes to supporting infrastructure investment in this case, these same parties stridently oppose ***any*** means to align new investment with timely cost recovery: not only FTY-based ratemaking, a DSIC, or any other mechanism for prospective investment recovery, but even recovery for investments already devoted to serving customers. But instead of acknowledging the disconnect between their investment goals and their ratemaking recommendations, these parties disparage the Company's need for a timely return to equity investors and question its GAAP-based presentation of achieved ROEs for not incorporating regulatory "disallowances."

WVAWC Reply Br. at 2, 3 (emphasis in WVAWC Reply Br.).

While the rate increase sought in this case is not a particularly large increase for a major electric utility, it is a large request for any water utility. The original rate increase sought in the filing in this case of $35.5 million (later amended to $32.1 million) is, we believe, the largest base rate case for a water utility ever filed in West Virginia. According to WVAWC, however, the size of the increase results primarily because past regulation has not allowed realistic, timely or effective recognition of utility plant or other ratemaking treatments (some of which WVAWC concedes the Commission addressed in the recent APCo Rate Case).[10]

In addition to the public concern about the absolute size of the rate increase, the filing of this rate case unfortunately comes at a time when WVAWC is the subject of intense scrutiny as a result of the chemical spill (Spill) by Freedom Industries, Inc. As virtually everyone in this State is aware, because of the Spill by Freedom Industries, Inc., that allowed an unpermitted discharge of crude 4-methylcyclohexane methanol into the Elk River about one mile above the water intake structure of WVAWC, WVAWC entered a "do not use" notice for customers on January 9, 2014, that impacted most of the 100,000 customers served from WVAWC's Charleston treatment plant. That "do not use" notice was lifted, sequentially, by zones throughout the Kanawha Valley System beginning January 13, 2014. Regardless of WVAWC's efforts to address the fallout from the Spill, the long-term adverse publicity resulting from the Spill is still being confronted by WVAWC.

When WVAWC filed this rate case, it did so in the face of considerable public concern about the Spill and with knowledge of other cases pending before the Commission resulting from allegations related to the Spill[11] and a class action civil action pending in the Federal District Court for the Southern District of West Virginia[12] and various suits pending in state circuit court (all of which seek to take WVAWC to task for the Spill).

Those Spill cases have been pending during this rate case and have to some extent clouded the issues raised by some parties in this case. WVAWC, in order to allow itself the opportunity to move forward with this rate case, states that it has attempted to eliminate from the rate case any Spill-related costs or expenses. WVAWC Ex. JLM-D at 11-13. The Commission is not factoring any incurred costs or expected costs related to the Spill into this case.

Utility plant is the predominant issue in this case. The appropriate test-year and its impact on the determination of the level of rate base and utility plant are the principal

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[10] 2014 APCo Order (Appalachian Power Co./Wheeling Power Co., Case No. 14-1152-E-42T, Order issued May 26, 2015). According to WVAWC, the Commission showed a willingness "to adapt by addressing a number of RoE-eroding ratemaking approaches – a return to the 'parent company loss adjustment' for consolidated tax savings was most prominent among them." WVAWC Init. Br. at 10.

[11] West Virginia-American Water Co., Case No. 14-0872-W-GI and twenty-eight separate customer complaint cases.

[12] Good v. American Water Works Co., Inc., C.A. No. 2:14-cv-01374, 310 F.R.D. 274 (S.D. W. Va. 2015).

revenue impact issues. By a rough estimate, nearly sixty-six percent of the original requested rate increase in this case (seventy-one percent based on the amended filing) can be attributed to the rate impact of utility plant additions or proposed utility plant additions to be placed in service above the level on which current rates were determined. WVAWC Ex. JLM-D at 11.

While utility plant and test year are the driving force of the filing, other factors certainly impact and complicate the Commission analyses of this rate case. The Commission has received conflicting positions and arguments from the parties on several other major issues and a host of minor issues, all discussed in this Order.

These issues and others raised by the parties in this case are complex. They have a significant impact on both WVAWC and its customers. If the magnitude of the rate increase was not enough to inspire vigorous examination by the parties and the Commission, the ongoing circumstances regarding the Spill have raised the level of concern by some intervening parties.

As we indicated, WVAWC states that the costs of the Spill have been excluded from the rate relief requested in this case, and the Commission has been vigilant to separate the cost of service impact of the Spill from this case. The Commission, the Federal District Court for the Southern District of West Virginia and the State Circuit Court have before them other proceedings addressing the circumstances surrounding the Spill. The Intervenors and others are attempting to resolve the issues in those proceedings. Some of the issues surrounding the Spill have begun to be addressed by the Legislature by passage in 2015 of Senate Bill 373 that requires WVAWC to develop detailed plans and recommendations that address numerous aspects of its operations going forward.

Each party that put forth an overall cost of service recommendation in this case has recommended some level of rate increase. While all of the intervenors to the case take exception to the magnitude of rate increase, no party disputed that WVAWC needs to increase its level of distribution system replacement investment to spur the replacement rate for distribution system mains. WVAWC asserts that additional capital investment, in the face of inadequate revenues or flat or declining water sales levels, is a recipe for further increased rates. WVAWC Ex. JST-D at 8-10; WVAWC Ex. JLM-D at 9, 10.

That leaves the Commission with the difficult statutory obligation to review the record positions of WVAWC, Staff and Intervenors to determine if WVAWC has met its burden of proof under W.Va. Code §24-2-4a to show the justness and reasonableness of the requested rates. The Commission has attempted to place WVAWC in the position to adequately maintain and replace its facilities, maintain and improve its level of service, and attract the external capital necessary to carry out public service mission. While it is never easy for the customers to accept any rate increase, the Commission has determined that a rate increase of $18.2 million for water customers is warranted based on the thorough review of the extensive record in this case discussed in this Order.

II. PROCEDURAL BACKGROUND

The following is a summary of the procedural background of the case. Additional procedural background can be found at Appendix B of this Order.

On April 30, 2015, WVAWC tendered for filing revised tariff sheets reflecting increased water rates and charges of approximately $35,472,154 annually (a 28.18 percent increase) for furnishing potable water to approximately 170,000 customers in Boone, Braxton, Cabell, Clay, Fayette, Harrison, Jackson, Kanawha, Lewis, Lincoln, Logan, Mason, Mercer, Putnam, Raleigh, Roane, Summers, Wayne and Webster Counties, to become effective on May 30, 2015. WVAWC also filed revised tariff sheets reflecting increased sewer rates and charges of $176,895 annually (a 22.3 percent increase) for furnishing sewer utility service to 1,050 customers in Fayette County, to become effective on May 30, 2015.

On the same date, WVAWC filed an application to increase depreciation rates effective on the same date that its revised water and sewer rates go into effect, Case No. 15-0674-WS-D, the 2015 Depreciation Case mentioned earlier.

By Order issued May 27, 2015, the Commission (i) made WVAWC a respondent in these proceedings, (ii) consolidated the three cases for initial processing,[13] (iii) suspended the proposed increased rates and charges through Wednesday, February 24, 2016, (iv) granted a waiver to allow WVAWC additional time to provide individual notice, (v) established the completion date for individual customer notice; (vi) set an intervention date of July 29, 2015, and (vii) granted a request to intervene from CAD.

By Order issued October 21, 2015, the Commission indicated that Chairman Albert is recused from the Depreciation Case and required the parties to file an agreed order of witness presentation at the October 27, 2015 evidentiary hearing.

By Order issued November 5, 2015, the Commission deconsolidated the Depreciation Case from these cases and set the filing date for initial and reply briefs.

Intervenors in the cases include the Commission Consumer Advocate Division (CAD), the Kanawha County Commission and the Kanawha County Regional Development Authority (KCC/RDA), Advocates for a Safe Water System (ASWS), West Virginia Energy Users Group (WVEUG) and SWVA, Inc. (SWVA), and the City of Charleston. Commission Orders issued May 27, 2015, June 26, 2015, June 29, 2015, July 22, 2015, and August 5, 2015.

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[13] The Depreciation Case, Case No. 15-0674-WS-D, was originally consolidated with Case Nos. 15-0675-W-42T and 15-0676-S-42T, but was deconsolidated from the two rate cases by Commission Order issued November 5, 2015.

III. FULLY FORECASTED TEST YEAR

As further described in the Order, our decision in this case is not predicated on the use of a forecasted or fully forecasted future test year approach.

WVAWC, Staff and Intervenor Parties are on occasion vague in their use of the terms future test year (FTY), fully forecasted test year (FFTY) or even fully forecasted future test year (FFFTY). That has not made our task any easier.

WVAWC for instance in its Initial Brief, refers to its filing as a three-volume Rule 42 presentation which essentially reflected:

> [T]he standard Rule 42 presentation; the "bridge year" presentation (usually referred to as the "addendum"), which forecasted terminal rate base, depreciation expense and other costs of service elements through February 29, 2016; and the future test year ("FTY") presentation, which reflected a forecasted average rate base for the "rate year," the first full year rates will be in effect (ending February 28, 2017). In the FTY filing, **all revenue and expense adjustments** are also projected to that date, and rate base and accumulated depreciation balances reflect a rate-year thirteen-month average. Co. Ex. JST-D (Tomac direct) at 1-3. Based on the FTY presentation, the initial filing of April 30, 2015 would produce additional annual revenues of $35.5 million per year, amounting to a 28.2% increase, or approximately $11.63 per month for an average residential customer.

WVAWC Init. Brief at 2 (emphasis added).

The WVAWC description of its FTY filing could give the impression that the Rule 42 Addenda contained adjustments other than those related to rate base for the first full year rates from this case are effective. That is not the case. The inclusion of the word **all** in describing Mr. Tomac's testimony seems to add to the confusion about the filing by WVAWC. In the Rule 42 Rate Year Addendum, WVAWC included only limited revenue and expense adjustments. The actual direct testimony of Mr. Tomac provided:

> Also included in the FTY volume are adjustments for incremental revenues and other operating expenses and taxes associated with those incremental revenues through February 28, 2017.

WVAWC Ex. JST-D at 3.

The Commission could conclude from the language in the WVAWC Initial Brief that all revenue and expenses are projected to February 28, 2017 [a fully projected test year]. A review of the WVAWC bridge year or addendum, however, shows that the only incremental revenue adjustment is the additional proforma rate increase related to the FTY rate base adjustment, and the only incremental expenses are uncollectible accounts expense and general tax expense associated with that additional rate increase increment. The WVAWC FTY addendum actually reflects only a projected Rate Year rate base and does not constitute a fully projected test year filing as normally defined.

Both Staff and CAD refer to the WVAWC filing as being based on a fully forecasted future test year, which, as pointed out above, it is not. Staff, in the Introduction to its Initial Brief, argued that WVAWC is "requesting that the Commission abandon its well-established preference for the use of a historical test year in favor of using a "fully forecasted future test year." Staff Init. Br. at 1-2.

In its Initial Brief, CAD characterized the WVAWC filing as a request to set rates based upon a Fully Forecasted Future Test Year (FFFTY) that includes projected costs through 2017. CAD Init. Br. at 2-3.

Commission Tariff Rule 19.4 (Tariff Rule 19.4) requires the filing of an Historical Test Year (HTY) with adjustments to per unit revenues and expenses for known and measurable changes. There were a number of rate cases in the 1980's, however, in which the Commission specifically permitted the use of a projected test year, including inflation adjustments for Rate Year expenses. Appalachian Power Co., Case No. 81-538-E-PC (1981 APCo Case), November 30, 1981 Order (1981 APCo Order) at 2; West Virginia Water Co., Case No. 84-008-W-42T, October 19, 1984 Recommended Decision at 38, Final Order November 19, 1984.

The 1981 APCo Order authorized the use of a projected test year approach, an approach that included forecasts or budgeted information through the rate year for **all** cost of service elements, including revenues, operating expenses, capital costs and rate base items. The 1980's were a time of extreme inflation, and the projected test year approach was used by the Commission to address the unusual circumstances present in that period.

In Contel of West Virginia, Inc., Case No. 89-206-T-42T (1989 Contel Rate Case), a case referenced several times in the CAD and WVEUG/SWVA testimony and briefs, the Commission denied a projected test year approach proposed by Contel based on a lack of evidence from Contel supporting the need to depart from the HTY approach. Contrary to the implications given in the instant proceeding, the 1989 Contel Rate Order did not preclude the use of a projected test year approach; instead, it described certain conditions that justified a future test year:

> Departures from the historic (sic) test year approach must be based on some determination by the Commission that the traditional approach does not fairly represent the conditions that will occur in the future, as noted in Appalachian Power Company, Case No. 81-538-E-PC, as follows: "Indeed, such Rule (42) authorizes the Commission to grant a departure from its provisions because of unusual circumstances." (Order of February 26, 1982). When the use of a projected test year is challenged, the party proposing the projected test year must prove that the historic revenue and expense units, matched to historic rate base, are not representative of

> the relationships that will exist in the future. Thus, it is the relationship between investment, revenue units and expense units that is most important when considering whether rates established based on any test period are fair and reasonable.

1989 Contel Rate Case, May 18, 1990 Order at 9 (emphasis added)

The Commission changed its earlier position allowing a projected test year approach and addressed this issue in a filing for WVAWC in West Virginia-American Water Co., Case No. 92-0113-W-PC. The March 23, 1992 Order in that case denied WVAWC's request to include an inflation adjustment in the upcoming rate case and scheduled a hearing on the issue of using a projected 1993 test year. The May 19, 1992 Order in a fairly summary fashion denied the WVAWC request to use a fully projected test year approach. In that Order, however, in place of a fully projected test year as had been allowed for APCo in 1982, the Commission addressed expanding the use of "known and measurable" adjustments to revenues and expenses that the Commission had historically allowed, to also allow known and measurable adjustments to HTY rate base.

> The Commission believes that a reasonable regulatory approach, when faced with escalating rate base concerns as expressed by WVAWC in its arguments herein, is to allow going level rate base adjustments for known and measurable changes. The Commission will not reject a filing that contains such adjustments and will reserve judgment as to the reasonableness of such adjustments pending the development of a full record. The record must be sufficiently developed for the Commission to determine that such rate base adjustments are known and measurable, are not related to growth, and would not be expected to reduce expenses.

West Virginia-American Water Co., Case No. 92-0113-W-PC, May 19, 1992 Order at 2.

Based on the May 19, 1992 Order in that case, WVAWC amended its projected test year filing in West Virginia-American Water Co., Case No. 92-0250-W-42T (WVAWC 1992 Rate Case), to include known and measurable adjustments to the WVAWC HTY Rule 42 filing, including post-HTY rate base additions that were non-revenue producing/non-expense reducing. The WVAWC 1992 Rate Case subsequently settled with a specific recognition of a rate base substantially higher than the HTY thirteen-month average rate base proposed by CAD. WVAWC 1992 Rate Case, November 5, 1993 Recommended Decision at 5 (Commission Final Order December 28, 1992).

The Commission addressed the issue of post-HTY rate base in numerous WVAWC rate cases after issuing the May 19, 1992 Order in Case No. 92-0113-W-PC. The historical review of the Commission decisions regarding post-HTY rate base treatment in contested WVAWC rate cases is addressed below in the Rate Base section of this Order.

Staff, CAD and WVEUG/SWVA all took exception to the projected post HTY rate base approach provided in the Company Addenda (called FTY, FFTY or FFFTY approaches by Staff, CAD and WVEUG/SWVA), arguing that the Commission has historically regulated utilities using the historical test year (HTY) approach and adjusted HTY information only for known and measurable changes. As explained above, the Commission has never limited filings to a "pure" historical test year approach. The Commission has always allowed adjustments to historical revenues and expenses for known and measurable changes, and beginning with the WVAWC 1992 Rate Case, known and measurable changes to post-HTY rate base.

As we indicated, the term "forecasted test year" "fully forecasted test year" or "fully forecasted future test year," as used by various parties in this proceeding, is a little confusing and does not accurately describe what was included in the post-HTY Addenda. The WVAWC Rule 42 Addenda in this case included only post-HTY adjustments related to rate base items and the related adjustments for depreciation expense, uncollectible accounts expense, general taxes and income taxes. All other Statement G adjustments were included in the WVAWC HTY Rule 42 and appear similar to the types of adjustments historically allowed by the Commission and proposed in past WVAWC general rate case filings.

In addition to the rate base adjustments included in the WVAWC Rule 42 Addenda, there are certain revenue and expense adjustments included in the HTY filing that seek recognition for what WVAWC claimed were known and measurable changes that are expected to occur in the Rate Year. The declining residential usage adjustment and wage increases fall in this category, and those adjustments were requested in the WVAWC 2008 and 2012 Rate Cases as well. No party to the 2008 and 2012 WVAWC Rate Cases, however, claimed those cases were a FFTY or FFFTY filing because adjustments were proposed by WVAWC to reflect declining residential usage and wage adjustments through the Rate Year. The Commission, for instance, has routinely recognized wage increases for the Rate Year if there are union contracts in place to support those adjustments. WVAWC did not attempt to include budgeted projections for the majority of its expenses and did not project new customers and other elements that would be present in a projected test year as historically recognized by the Commission.

It is the projection of rate base into the first full year that the rates from this case will be in effect (Rate Year) that is different in this case, and that has created the objections of Staff and the Intervenors about WVAWC's rate base approach. The Commission does not view the WVAWC filing as a request for a projected test year approach; instead, the Commission views the filing as a request for post-HTY rate base extended with an average additional rate base through the Rate Year, an approach similar in scope to many past WVAWC rate cases.

The Commission has allowed a projected test year (APCo, Case No. 81-538-E-PC) and has refused to allow a projected test year (WVAWC, Case No. 92-0113-W-PC) in the past. We do not feel that we need to make a ruling about the use of a fully projected test year in this case because it is not incorporated in the adjustments to the HTY revenue requirements requested by WVAWC. The use of a fully projected test year may be appropriate at some later date and may be an appropriate regulatory tool for the Commission to consider, but we do not consider that appropriate or necessary here because we do not believe this is a projected test year filing. The Commission will, however, address the specific issues raised in this case concerning post-HTY rate base treatment.

IV. RATE BASE

A. Overview

As indicated earlier, utility plant and the appropriate level of rate base is by far the largest revenue requirement issue in this case. WVAWC Ex. JST-R at 4. WVAWC requested that the Commission determine rate base using a projected thirteen-month average rate base for the Rate Year. The WVAWC filing included a requested increase in rate base of slightly more than $90 million, or twenty percent above the rate base level embedded in current rates. Staff, CAD and WVEUG, on the other hand, have recommended that a projected thirteen-month average rate base for the Rate Year be denied. Staff and CAD instead determined rate base using the HTY thirteen-month average rate base, adjusted for terminal year-end treatment for certain transmission and distribution (T&D) utility plant additions and corresponding rate base offset elements. Because of the magnitude of the impact on the revenue requirement related to the competing positions on rate base, the Commission has conducted a further analysis of this issue.

B. Definition

As described in almost every investor-owned utility rate case order, rate base is a utility's net investment in utility plant and working capital necessary to provide utility service to its customers. Rate base is financed by the capital structure of the utility, and consists of numerous elements, including utility plant in service; certain regulatory assets authorized by the Commission; and working capital components. The sum of those three rate base elements are then adjusted by accumulated depreciation; depletion and amortization; contributions in aid of construction (CIACs); customer advances for construction (CACs); certain regulatory liabilities authorized by the Commission; deferred state and federal income taxes (ADITs), and other items specific to each utility.

The net rate base represents the amount against which the overall rate of return authorized by a utility regulatory commission is applied to generate the return component included in utility rates. This return component includes an allowance for interest costs, preferred stock dividends, and return on equity.

For utility plant to be included in rate base, it must be (i) used (in service) and (ii) useful (used by the utility to provide service to its customers). Various state utility commissions, however, determine rate base using different points in time. Some state commissions use only HTY information (HTY Approach), other state commissions permit post-HTY changes in rate base elements up to the time new rates are effective

(Committed Construction), and some state commissions permit a rate base determined on the average Rate Year rate base elements (Forecasted Rate Year).

C. Commission Rules for Rate Base Determination

Under Tariff Rule 19.4, the Commission requires utility rate filings and Tariff Rule 42 Financial Exhibits (Rule 42) to use HTY thirteen-month average rate base components as of the beginning of the test year and as of the end of each month of a test year.

The Commission has not, however, limited rate base to the thirteen-month average HTY balance. In fact, Tariff Rule 19.4 specifically permits utilities to depart from the thirteen-month average HTY rate base filing requirement. The utility must show the departure in supplemental schedules filed in a separate addendum to the required HTY Rule 42. The supplemental schedules included in the addendum must provide a complete description of the proposed departure from the required thirteen-month average HTY rate base calculation and an explanation of the underlying reasons and justifications for the proposed departure.

The Commission has generally recognized HTY information as a proper determinant, but not necessarily <u>the</u> exclusive determinant, of rate base. The Commission has on numerous occasions moved beyond or departed from the HTY average rate base approach to determine just and reasonable rates. As noted above in the 1989 Contel Order and Tariff Rule 19.4, those departures are granted when a utility has justified and adequately supported that departure.

For those departures to be limited to rate base and not require projections of associated revenue growth or expense reductions, the Commission traditionally limits the adjustments to rate base that is non-revenue producing/ non-expense reducing, or that provides service to ill-served areas. The Commission has on occasion allowed these departures to apply to terminal treatment for utility plant investments that occur in the HTY and for utility plant investments that are forecasted to be placed in service after the HTY, including forecasted investments through the end of the Rate Year.

D. Positions of the Parties

1. WVAWC Direct

WVAWC President Jeffrey McIntyre testified that the major driver for the requested rate increase of \$35.5 million (later amended to \$32.704 million) related to the increased capital investment (rate base) above the authorized rate base level embedded in current rates. Mr. McIntyre testified that the total O&M expenses included in this case were actually lower than the level of O&M expenses requested in <u>West Virginia-American Water Co.</u>, Case No. 12-1649-W-42T (WVAWC 2012 Rate Case). He testified that the revenue requirement related to increased rate base is approximately sixty-six percent of the total requested rate increase. WVAWC Ex. JLM-D at 9-11.

Mr. McIntyre testified that chronic erosion of the authorized return levels continues to plague WVAWC and places WVAWC at a substantial disadvantage in attracting the capital it needs to maintain and replace its aging infrastructure. He claimed that the use of an HTY approach for determining rate base might have been appropriate when growth in usage and customers counterbalanced the growth in (capital) investment, but that situation no longer exists (and has not for many years). Mr. McIntyre asserted that today, when there is a need to increase infrastructure replacement investment amid falling customer usage, the forecasted Rate Year rate base approach used by WVAWC is required if WVAWC is to have a fair opportunity to achieve its authorized rate of return. Id. at 15-17.

WVAWC witness Tomac addressed the actual earnings performance of WVAWC for the years 2011-2014, and testified that achieved returns on equity of between 4.39 percent and 5.39 percent are 400 to 500 basis points below the return authorized by the Commission. According to Mr. Tomac, these low returns are consistently below the cost of long-term debt, are contrary to fundamental financial tenets, are not sustainable for WVAWC, and make it difficult for WVAWC to attract the capital necessary to adequately maintain and replace its aging infrastructure. WVAWC Ex. JST-D at 6-8.

Mr. Tomac supported using a forecasted (projected) Rate Year rate base approach. He provided several references to other state utility commissions that use a FFTY approach and several NARUC pronouncements supporting the use a FFTY approach to regulate water utilities. Mr. Tomac asserted that when a utility, such as WVAWC, is faced with declining residential revenues and the need to increase capital investment substantially, the regulatory lag associated with an HTY rate base approach does not provide an investor-owned utility with a reasonable opportunity to achieve (i) a rate of return commensurate with investments in companies of similar risk, (ii) a return that provides sound financial results, or (iii) a return that permits the attraction of capital at reasonable rates. Id. at 13-24.

WVAWC witness Brett Morgan provided testimony supporting the WVAWC (i) Comprehensive Planning Study (CPS) process, (ii) capital investment projects completed since the 2012 Rate Case, (iii) capital projects completed during the 2014 HTY, (iv) capital projects to be completed in the Transition Period, (v) capital projects to be completed in the Rate Year, (vi) tank painting program, and (vii) potential additional capital investments that may be needed to satisfy Senate Bill 373 requirements. WVAWC Ex. BWM-D.

2. Staff Direct and Cross-Examination

Staff proposed a rate base of \$490.5 million, or \$46.9 million lower than WVAWC. Staff limited its rate base determination to the HTY. Staff accepted the WVAWC adjustments to utility plant for terminal treatment of AFFAC eligible HTY utility plant additions completed in the HTY, over capitalization of OPEBs and removal of Spill related replacement costs for GAC. Staff accepted the WVAWC requested terminal HTY treatment for ADITs and deferred AFFAC, but proposed to utilize only the average HTY balances for Accumulated Depreciation, materials and supplies, deferred

ITC and the Coal River/Van acquisition costs. Staff supported its position to limit materials and supplies, deferred ITC, and Coal River/Van acquisition costs to HTY average balances because WVAWC had not provided an analysis or explanation about why those costs should receive terminal HTY treatment. Staff did not provide an explanation for limiting accumulated depreciation to the average HTY balance, or the reason the corresponding depreciation expense, retirements and cost of removal related to the terminal HTY utility plant additions were denied HTY terminal rate base treatment. Staff corrected the HTY Retirement Work In Progress (RWIP) balance provided in the WVAWC Rule 42 that WVAWC had mistakenly shown as a negative number. Staff Ex. 1 (Staff Rule 42), Statement B; Staff Ex. DLK-D at 9-12.

Although Staff did not support the forecasted Rate Year rate base approach proposed by WVAWC, Staff witness, Mr. Eads, did address the Commission decisions in past WVAWC rate cases regarding post-HTY rate base and the impact of regulatory lag. Mr. Eads indicated that the Commission has historically recognized terminal rate base for HTY non-revenue producing utility plant additions and, beginning with the 2010 Rate Case, the authorization of AFFAC for post-HTY replacement of mains, service lines, meters and hydrants. West Virginia-American Water Co., Case No. 10-0920-W-42T, April 18, 2011 Order (WVAWC 2010 Rate Case Order) at 4-8. Mr. Eads also testified that he did not believe that AFFAC adequately insulates WVAWC from the impact of earnings erosion from post-HTY utility plant investments. Staff Ex. TRE-D at 8-11; Tr. 11/2 at 124-126.

As an alternative to AFFAC, Mr. Eads proposed that WVAWC develop an Infrastructure Replacement Plan (IRP), including an IRP Surcharge mechanism to recover the cost of post-HTY infrastructure replacement investments between rate cases. Mr. Eads described the proposed IRP Surcharge mechanism and said it would be similar to the IRP program authorized by the legislature for gas utilities in 2015 by Senate Bill 390. Mr. Eads recommended WVAWC be authorized to implement the IRP Surcharge on March 1, 2016, for investments in non-revenue producing replacement of T&D mains and service lines installed in the Rate Year.

The IRP Surcharge proposed by Mr. Eads would be calculated by applying the overall return and depreciation rates approved in this case to the IRP eligible replacements of mains and service lines, net of the level of depreciation expense related to mains and service lines included in base rates in this proceeding. The IRP would then be subject to a true-up at the end of each subsequent review period. The true-up mechanism would adjust the IRP surcharge rate recovery initially based on forecasted investment to the actual IRP eligible capital expenditures completed by WVAWC in each review period. This true-up process would continue annually until WVAWC s next base rate case filing. Mr. Eads proposed that AFFAC cease with the effective date of new rates from this case if the Commission approved the IRP Surcharge mechanism. Mr. Eads did not address capital investments made during the Transition Period. Staff Ex. TRE-D at 11-19, Tr. 11/2 at 124-136, 148-173.

3. CAD Direct and Cross-Examination

CAD proposed rate base of $479.6 million, or $57.7 million below the WVAWC rate base request. CAD, like Staff, limited its rate base determination to HTY activity, and accepted the WVAWC adjustments to reflect terminal HTY treatment for AFFAC eligible utility plant, to correct over-capitalization of OPEBs, and to remove the costs for GAC related to the Spill. The CAD also accepted the WVAWC adjustments for terminal HTY treatment of material and supplies, ADITs, Deferred ITC, and Other Deferred Debits. CAD, like Staff, also utilized the thirteen-month average balance for accumulated depreciation, but did not explain CAD's rejection of terminal treatment to determine accumulated depreciation for HTY depreciation expense, retirements and cost of removal related to the HTY T&D utility plant additions given terminal treatment. CAD did not correct the WVAWC error for RWIP (Staff did). CAD Ex. RCS–D at 14-24.

On cross-examination by WVAWC, Mr. Smith was asked about his statement that customer growth would offset post-HTY rate base and that the post-HTY offset was a reason to deny the forecasted rate base requested by WVAWC. In response, he indicated that WVAWC's recent historical growth had been minimal and the vast majority of the WVAWC capital investment had not been directed to customer growth or revenue producing capital investment projects. Tr. 11/29 at 21-22. Mr. Smith also responded to WVAWC questions about the IRP Surcharge mechanism. Mr. Smith responded that while CAD opposes an IRP from a legal perspective, as a conceptual matter (with proper underlying statutory authorization and proper notice), CAD is not categorically opposed to the concept of some type of infrastructure recovery mechanism that would allow for surcharge-based, cost-based recovery in the period that occurs between base rate cases. Id. at 25-32.

4. WVEUG/SWVA Direct and Cross-Examination

WVEUG/SWVA witness Baudino opposed the use of a forecasted Rate Year rate base approach. In several instances, Mr. Baudino described the HTY approach as consistent with past practice and the historical approach used by the Commission to determine rate base. He urged the Commission to continue to employ an HTY to determine the revenue requirement in this proceeding, arguing that post-HTY rate base investments are not known and measurable and recognition of post-HTY rate base would violate the matching principle for revenues, expenses and rate base present in the HTY approach. Mr. Baudino addressed the use of AFFAC authorized by the Commission in the 2010 Rate Case and argued that, for regulatory purposes, the continuation of AFFAC sufficiently offsets any regulatory lag impact resulting from the HTY rate base approach. WVEUG Ex. RAB-D.

On cross-examination by WVAWC about the IRP surcharge mechanism, Mr. Baudino recommended that the Commission not implement the IRP Surcharge mechanism for water utilities unless a similar statute to that recently passed for gas utilities is adopted. Mr. Baudino stated that there is no statute requiring the Commission to limit rate cases to HTY data, but he believes that has been the Commission past practice. He also stated that the Commission could depart from past practice and adopt a future test year approach. Tr. 10/28 at 211.

In response to the Staff cross-examination, Mr. Baudino recommended that if the Commission authorized an IRP Surcharge mechanism in this case additional customer protection provisions should be added to the Staff recommended methodology. He expressed his opinion that an IRP Surcharge mechanism should not be authorized in this case because the parties did not have adequate time to explore the mechanism and address alternatives. If an IRP is to be considered, it should be addressed in a separate case where all parties have adequate time to formulate their position. Id. at 220-226.

5. Advocates for a Safe Water System Direct

Advocates for a Safe Water System (AFSWS) witness Stottlemyer stated his opinion that WVAWC lacks (i) appropriate prioritization and sufficient investment in main replacements and (ii) appropriate accounting treatment (maintenance vs. capitalization) for unscheduled main replacements. Mr. Stottlemyer also testified that WVAWC has an excessively long main replacement rate and has problems with cement/cast iron reinforced pipelines in the Dunbar area. Although Mr. Stottlemyer acknowledged WVAWC has a high degree of competence in the comprehensive planning area, he stated that in his opinion WVAWC planners placed more emphasis on IT projects, meter replacements and regionalization projects than on the major main replacement projects included in the CPS. AFSWS Ex. FDS-D.

6. **City of Charleston Direct**

City of Charleston witness Mayor Danny Jones provided testimony about the adverse impact that a large rate increase would have on the City of Charleston and its residents. Mayor Jones also offered his opinion that WVAWC has not adequately maintained or improved its infrastructure and that its efforts consist primarily of fixing problems when they appear. Mayor Jones also expressed his belief that the WVAWC responses to service outages have been slow. City of Charleston Ex. DJ-D.

7. WVAWC Rebuttal

Mr. McIntyre addressed the testimony of the other parties regarding the appropriate level of rate base in his rebuttal testimony. He recounted statements from customers appearing at the public comment hearings about the need to increase the level of investment in infrastructure replacement. Mr. McIntyre testified that he sensed a public "tipping point" has been reached in recognizing the need for infrastructure replacement. Mr. McIntyre asserted that a thirteen-month average Rate Year rate base approach is the best solution for the chronic earnings erosion experienced by WVAWC from regulatory lag. WVAWC Ex. JLM-R at 1-2.

Mr. McIntyre criticized both Staff and CAD for failing to analyze or address the impact of regulatory lag that results from strict adherence to an HTY rate base approach. He claimed that the HTY rate base approach is not a reasonable proxy for the relationship of revenue, expenses and rate base for the Rate Year when a utility is making major investments for capital improvements at a time when customer usage is declining. Mr. McIntyre testified that he is not alone in criticizing Staff and CAD for ignoring the erosion of earnings related to regulatory lag. He referred to the testimony from several recent rate cases of WVAWC, APCo, Mountaineer Gas, Monongahela Power, and Hope Gas that addressed the problems inherent with the HTY approach. Id. at 5-7, 12-13. Mr. McIntyre also expressed appreciation for the Staff recognition of the impact of regulatory lag in this case and the Staff proposal to address that lag through an IRP Surcharge for Rate Year T&D main and service line replacements. He stressed, however, that the Staff proposal did not address the impact of regulatory lag created by failing to recognize the Transition Period capital investment. Id. at 13-15.

In response to the Staff IRP Surcharge proposal, Mr. Nevirauskas called the Staff IRP Surcharge proposal promising, but testified that it was inferior to the forecasted Rate Year rate base approach because the Staff proposal does not address rate recovery of the additional Transition Period rate base investment included in the WVAWC Rule 42. He pointed out that ignoring approximately $87 million of utility plant investments included in the Transition Period Addendum (above the HTY average utility plant balance) that will be paid for and in service at the time new rates from this case become effective will do little to mitigate the regulatory lag problem. Mr. Nevirauskas testified that the loss of the Transition Period rate base in this case will result in WVAWC absorbing the cost of that investment until WVAWC's next general rate case, a period of more than three years. He argued that if the Commission authorized the IRP Surcharge in this case, the Commission should also recognize the additional rate base included in the Transition Period Addendum. WVAWC Ex. RPN-R at 1-3.

E. Historical Rate Base Treatment for WVAWC

Other than WVAWC, the parties to this proceeding have argued against the use of a forecasted Rate Year approach for determining rate base. The WVEUG/SWVA witness indicated that it is Commission policy to use only an HTY approach. The CAD witness referenced the Contel order as support for adherence to an HTY approach and referenced several previous WVAWC rate cases to support the HTY approach. CAD Ex. RCS-D at 15-23.

In fact, every contested WVAWC rate case since 1990 has authorized some modification to the thirteen-month average HTY rate base approach, including various combinations of rate recognition for terminal HTY treatment, projected Rate Year rate base treatment, and the use of AFFAC.

While the Commission has stated its preference for the HTY approach to establish utility rates, it has not precluded utilities from requesting modification to the HTY rate base approach if circumstances warrant and the modification is included in an addendum to the WVAWC HTY Rule 42, along with appropriate explanations to support the need for the departure as described in Tariff Rule 19.4.

After the decision in Contel, the Commission addressed recognition of post-HTY rate base treatment in the WVAWC 1994 Rate Case, December 22, 1994 Order (WVAWC 1994 Rate Case Order) at 55-58. In the 1994 Rate Case the Commission accepted the Staff rate base calculation based on terminal treatment for post-HTY non-revenue producing, non-expense reducing additions to plant, including those budgeted for the Rate Year. The Commission placed WVAWC on notice that the Commission would not grant the same treatment in the next rate case unless WVAWC demonstrated the need, prudence, and reasonable certainty of construction expenditures, including the special treatment for investments in ill-served areas. The Order language explaining the Commission justification for departing from the HTY rate base approach is instructive:

> The Commission is concerned with the difficulties that the Company apparently suffers in actually achieving its rate of return authorized by the Commission. The Commission is also sensitive to the fact that the Company is having an ever increasing rate base needed to service its customers but has a very slow increase in sales. The Commission is also sensitive to the large unmet water needs in West Virginia, in which the Company may be a key player in providing service. We are therefore willing to consider alternative treatments to rate base in the future. One possibility that the parties should review and examine in the next rate case is a possibility of a special experimental allowance for West Virginia Water Company of an Allowance for Funds After Construction (AFFAC). A possible AFFAC adjustment might allow the Company to accrue the dollars spent after construction on non-revenue producing, non-expense reducing plant that could be recovered in rates in later rate cases. The Commission is willing to consider an AFFAC mechanism but only on the plant that is truly non-revenue producing, non-expense reducing. The Commission is concerned that the Company or other advocates of special rate treatment actually prove that any qualifying rate base be actually non-revenue producing, non-expense reducing. The Commission is willing to consider other experimental innovative ratemaking treatments to address the special problems West Virginia Water has regarding rate base.

WVAWC 1994 Rate Case Order at 56-57.

The Commission also addressed post-HTY rate base in West Virginia-American Water Co., Case No. 03-0353-W-42T, January 2, 2004 Order (WVAWC 2003 Rate Case Order) at 96-98. The WVAWC 2003 Rate Case Order rejected the CAD proposal to return to a strict adherence to the HTY approach.

> Clearly, the Commission has set parameters for terminal treatment of certain rate base items for the Company and we believe those have been met in this case for the rate base adjustments advocated by Staff. The Commission does not believe that the CAD has provided any reason for us to reject the Staff's recommended adjustments that conform to the Commission's past practice of allowing non-revenue producing and

> non-expense reducing plant additions during and even after the end of the test year to be given terminal rate base treatment.

WVAWC 2003 Rate Case Order at 98.[14]

In the 2008 Rate Case, the Commission included terminal HTY rate base for T&D system replacements of mains, services, meters, and hydrants. WVAWC 2008 Rate Case Order at 24-33. The Commission stated:

> The age of that plant, and the necessity to replace aging T&D delivery plant regardless of customer growth, or lack thereof, is a major problem for WVAWC if it must face a lag of two rate cases before the full revenue requirement of such plant replacement is reflected in rates.

WVAWC 2008 Rate Case Order at 29.

The Commission Order in the 2008 Rate Case also addressed post-HTY rate base. WVAWC claimed that it must increase investment for T&D plant replacements if it was to address the recommendations contained in a "Water Loss Study" prepared by WVAWC as required by the Settlement Agreement in West Virginia-American Water Co., Case No. 07-0998-W-42T, (WVAWC 2007 Rate Case) March 18, 2008 Order. WVAWC stated that the current replacement rate for mains and services was over 400 years, a timeframe that far exceeded the expected useful life of those facilities. WVAWC claimed that without additional investment in T&D replacements it could not address the increasing level of unaccounted for water (UFW). The Commission Order did not recognize the requested post-HTY investment as rate base, but said,

> Given the lack of record on these items, the Commission will not establish a procedure as described above for a $4 million rate base adjustment nor will the Commission in this case make an adjustment to reduce expenses to reflect a lower level of UFW. The Commission looks for improvement in this number and urges the Company to redouble its efforts to control UFW. The Company should discuss with Staff and CAD the pros and cons of a surcharge or accounting approach that could be the subject of a separate filing by the Company. The Commission will consider a filing by the Company to be an allowable extension of this decision and would consider the implementation of a surcharge or accounting procedure in a separate proceeding without waiting for a future full rate case before implementing such a procedure. Whether the parties come to full agreement, partial agreement or no agreement at all, the Commission will not indicate in advance that it will approve a filing, but it will fully consider and rule on a mechanism to protect the Company against an erosion of earnings related to identifiable, quantifiable and

[14] The Staff adjustments referenced by the Commission included Staff calculations of average non-revenue producing, non-expense reducing plant additions through the Rate Year.

> verifiable incremental investment in main replacement as described in the Water Loss Study.

WVAWC 2008 Rate Case Order at 33.

On December 21, 2009, WVAWC petitioned in a reopening of the 2008 Rate Case and for consent to institute a periodic Distribution System Improvement Charge (DSIC). Shortly thereafter, WVAWC filed its 2010 Rate Case and the petition to initiate a DSIC surcharge was ultimately decided in the 2010 Rate Case. The Commission decision reflects the continuation of terminal HTY treatment for T&D plant replacements, the denial of a Surcharge mechanism and authorization of AFFAC for post HTY replacement of transmission and distribution facilities.

> The Commission is charged to investigate and consider alternative concepts in utility regulation and management. W. Va. Code §24-1-1(c). Although we do not at this time believe that the benefits of implementing a DSIC are outweighed by the detriments we perceive, we are willing to authorize WVAWC to use AFFAC as an alternative under the circumstances we have discussed above. The AFFAC may be booked until further Order of the Commission. The Commission places the Company on notice that it may modify or require cessation of the AFFAC procedure in future rate cases, after reviewing its effectiveness, or lack thereof.

WVAWC 2010 Rate Case Order at 8.

F. Commission Decision

These past Commission decisions support that, for years and in numerous WVAWC rate cases, the Commission has recognized that the unique circumstances of WVAWC (flat growth and large capital investment) warranted some deviation from the thirteen-month average HTY rate base approach. As early as the 1989 Contel Order, the Commission recognized that an HTY approach only worked properly when the matching relationship of revenues, expenses and rate base present in the HTY was expected to continue into the year that new rates would be effective. The Commission has fairly routinely authorized exceptions for WVAWC to the HTY rate base approach, including post-HTY rate base recognition, because the combination of declining customer usage and increasing non-revenue producing capital investment distorted the HTY matching relationship from the matching relationship of revenues, expenses and rate base for the Rate Year.

The decision faced by the Commission in this case is not whether it can and should depart from the preferred HTY rate base approach (clearly W.Va. Code §24-1-1(c) and the Commission Tariff Rules permit the use of alternative ratemaking approaches); rather, the questions are (i) whether the HTY year reflects a proper matching of revenue, expenses and rate base in the Rate Year, and (ii) whether WVAWC adequately supported its proposed departure from the HTY rate base approach.

1. Post-HTY Rate Base

The last Commission ruling regarding terminal rate base was the WVAWC 2010 Rate Case Order that authorized terminal HTY rate base for AFFAC eligible T&D replacement projects. WVAWC 2010 Rate Case Order at 21-23. That Order also authorized the recording of AFFAC for post-HTY T&D replacement projects until those projects are recognized as rate base in the next general rate case of WVAWC.

The Commission indicated in the 2010 Rate Case Order that it may modify or require cessation of AFFAC in a future rate case after determining whether it was effective. WVAWC presented evidence in this case that AFFAC (i) has not worked as well as anticipated in minimizing regulatory lag, (ii) does not provide a cash return on capital investment between rate cases, (iii) does not provide for additional depreciation expense related to AFFAC eligible property, and (iv) is not effective in offsetting the impact of earnings erosion due to GAAP accounting requirements regarding the equity portion of AFFAC. WVAWC Ex. JST-D at 24-25.

Staff witness Eads also testified that AFFAC, particularly in the early life of the AFFAC eligible T&D plant replacements, has not been successful in addressing the erosion of earnings caused by regulatory lag and at best provides only a small marginal positive impact on earnings. Mr. Eads recommended that the Commission consider an alternative to AFFAC. Staff Ex. TRE-D at 9-11; Tr. 11/2 at 124-136.

WVAWC proposed a forecasted Rate Year rate base approach as an alternative to the HTY rate base approach and the continuance of AFFAC for post-HTY T&D projects as authorized in the 2010 Rate Case. Staff proposed HTY rate base, adjusted for terminal T&D projects, and an IRP Surcharge for Rate Year main and service line replacements to replace AFFAC. Staff, however, did not address the Transition Period rate base investment included in the WVAWC filing at $33.1 million. CAD and WVEUG/SWVA advocate for strict adherence to the HTY approach. Although all the intervenors express dissatisfaction with the rate increase request, no party suggested that a main replacement rate in excess of 400 years is acceptable or sustainable on a long-term basis. The AFSWS and City of Charleston witnesses particularly, criticized WVAWC for not significantly increasing the investment level for main and service line replacements to-date.

The Commission has reviewed the historical record of the WVAWC rate cases and the record presented in this case. Nothing much has changed. As first addressed in the 1992 and 1994 Rate Case Orders, and in each contested WVAWC rate case thereafter, WVAWC continues to face the combination of earnings erosion due, in large part, to regulatory lag for a post-HTY rate base growth, declining residential revenue, and a need to increase its historical investment level for T&D system replacements. Despite the efforts of the Commission to address these issues through numerous innovative ratemaking approaches in prior WVAWC rate cases, those same issues remain an issue in this proceeding.

The Commission is at a crossroads regarding the rate base treatment that will provide WVAWC a reasonable opportunity to meet these challenges and at the same time moderate the impact on customer rates. WVAWC has met its burden of proof regarding the inadequacy of the thirteen-month average HTY rate base approach in this case. The combination of declining per residential customer usage, little if any customer growth, and increased costly system replacements described in WVAWC and Staff testimony are unique to WVAWC and lead to the inescapable conclusion that the HTY approach, under current circumstances and operations for WVAWC, does not properly match revenues, expenses and rate base in the Rate Year. Further, the experimental AFFAC approach has provided minimal relief to WVAWC from regulatory lag and is not working as well as intended. The Commission believes it is time to cease the AFFAC approach and consider other alternatives.

The projected Rate Year rate base proposed by WVAWC would help address regulatory lag and would not be a significantly different rate base approach from that authorized by the Commission for WVAWC beginning in the 1992 Rate Case.

The Commission is not prepared to authorize a fully projected Rate Year rate base in this proceeding. The Rate Year utility plant additions included in the Rate Year Addendum are only estimates at this point and the accuracy of the cost of Rate Year plant additions was not fully developed in the record of this case.

The Commission will instead consider a determination of rate base at the beginning of the Rate Year that includes terminal rate base for all non-revenue producing additions in the Transition Period and some additional adjustments based on the Staff and CAD rate base recommendations as more fully described below.

Based on the evidence presented in this case, establishing rate base at the beginning of the Rate Year is reasonable because inclusion of additional investment in rate base elements for the Transition Period (i) will provide a reasonable level of known and measurable rate base that will be used and useful and in service at the time the new rates authorized in this proceeding become effective, (ii) will provide a better matching of revenues, expenses and rate base present in the Rate Year than would adherence to a non-representative HTY approach, and (iii) will better mitigate the impact of regulatory lag than would AFFAC. WVAWC should cease recording AFFAC on the effective date of new rates authorized in this case.

2. IRP Surcharge Mechanism

The Staff recommendation of an IRP Surcharge mechanism has merit and should be explored further. An IRP Surcharge mechanism would also be effective in reducing regulatory lag and would limit rates customers pay to the actual cost of distribution system replacement costs net of depreciation and deferred income tax expenses currently recovered in rates. WVAWC, unfortunately, did not propose (or provide notice of) an IRP type surcharge in its filing.

While we compliment Staff on its willingness on occasion to advance or initiate new rate making approaches, Staff first mentioned an IRP Surcharge in this case in the testimony filed on September 25, 2015, about five months after the original case filing and only one month prior to the beginning of the evidentiary hearing. CAD and WVEUG took exception to the IRP proposal on the grounds that the Staff had not adequately supported the IRP Surcharge, provided meaningful investigation of comparable plans in other states, nor proposed appropriate customer protections. SWVA/WVEUG Initial Brief at 19-21.

SWVA/WVEUG also argued that approval of the IRP Surcharge in this case would violate the notice provision of W.Va. Code §24-2-4a. SWVA/WVEUG recommended that if the Commission wanted to explore an IRP Surcharge mechanism it should do so in a separate proceeding pursuant to proper notice and where all parties would have adequate time to investigate and be heard on this issue. Id. at 21-22.

WVAWC circumstances giving rise to the IRP Surcharge proposal in this case are similar to the circumstances addressed by the Commission in WVAWC's 2008 Rate Case. In that case, WVAWC proposed a $4 million per year post-HTY adjustment (through the Rate Year) in order to increase the level of main replacement as recommended in the Water Loss Study. The Commission declined to include that adjustment, instead directing WVAWC to discuss the pros and cons of a surcharge mechanism or accounting approach in a separate proceeding without waiting for a future rate case to implement such a procedure. That process resulted in Commission authorization of AFFAC in the WVAWC 2010 Rate Case Order.

Arguably, requesting a rate base adjustment into the Rate Year would have the same potential impact on rates as the Staff alternative to begin an IRP Surcharge mechanism; however, the Commission will not approve the IRP Surcharge mechanism for WVAWC proposed by Staff at this time. We believe that the Commission has the statutory authority to implement an IRP mechanism after notice that such a mechanism is under consideration, but the lack of notice of a potential IRP Surcharge and the fact that Staff proposed the IRP Surcharge approximately five months after the original case filing, did not permit a fully developed record in this case. Rather than approving an IRP Surcharge mechanism, the Commission will direct WVAWC to seek authorization for an IRP Surcharge mechanism, if it chooses to do so, in a separate proceeding outside a general rate case filing. The separate proceeding will allow the IRP Surcharge mechanism to be noticed and will allow each party ample opportunity to investigate and develop its position.

3. Rate Base Elements Other Than Cash Working Capital

A rate base of $526,617,437 is reasonable based on the record in this case and the discussion above, and reflects the appropriate level of known and measurable rate base that will be used and useful and in service at the beginning of the Rate Year. The Commission is attaching Appendix F to this Order. Appendix F is a schedule that summarizes each individual rate base component of the total rate base approved for rate recovery in this proceeding. The discussion below addresses each of those individual adjustments other than the adjustments related to cash working capital.

The Commission recognizes the following adjustments to the per books HTY thirteen-month average utility plant balance as reasonable for the determination of rate base in this proceeding:

- The Commission accepts the non-disputed adjustments to reflect terminal rate base for HTY AFFAC eligible utility plant additions. Statement G Adjustments: WVAWC Adj. 66, Staff Adj. 60, and CAD Schedule B.

- The Commission accepts the non-disputed adjustment to eliminate Spill related GAC costs. WVAWC Statement G, WVAWC Adj. 67, Staff Adj. 62, and CAD Schedule B.

- WVAWC, Staff and CAD each proposed an adjustment to recognize the over capitalization of OPEB expense on WVAWC's books when compared to the level of OPEB expense recognized for rate recovery under the modified accrual method.

- The Staff adjustment reflects the calculation of that overcapitalization in accordance with past Commission decisions and the Commission recognizes the Staff adjustment. Staff Statement G, Adj. 70.

- Based on the Commission decision to recognize post-HTY rate base in this proceeding, the Commission accepts the WVAWC adjustment to reflect net utility plant additions through the Transition Period. WVAWC Statement G, Adj. B1.

The Commission also recognizes the following adjustments to the per books HTY thirteen-month accumulated depreciation balance as reasonable for the determination of rate base in this proceeding:

- Terminal treatment for HTY depreciation expense, utility plant retirements and cost of removal costs. WVAWC Rule 42, Statement B, Schedule 7. While both Staff and CAD recognized terminal treatment for HTY non-revenue producing replacements of mains, service lines, meters and hydrants, they failed to give similar terminal treatment to corresponding elements of accumulated depreciation. The utility plant recognized for rate base in the HTY should be utilized to determine the impact on accumulated depreciation.

- The impact of additional depreciation expense at existing depreciation rates (depreciation rates prior to the change in depreciation rates authorized in the February 24, 2016 Order in the 2015 Depreciation Case), plant retirements and cost of removal should be applied to the Transition Period utility plant recognized in this case to determine the accumulated depreciation balance at the beginning of the Rate Year. WVAWC Statement G, Adj. B1 adjusted to existing depreciation rates.

WVAWC erred in presenting its HTY RWIP balance by subtracting the balance from rate base. WVAWC corrected this error in response to a CAD data request, and the error was also corrected by Staff in Statement G, Adj. 71. The Commission accepts the Staff adjustment as reasonable for the determination of rate base in this proceeding.

The Commission recognizes the following adjustments to the per books HTY thirteen-month average CIAC balance as reasonable for the determination of rate base in this case:

- In past WVAWC rate cases, the Staff has proposed, and the Commission has accepted, the reinstatement of negative acquisition costs that were written off by WVAWC. Staff Statement G, Adj. 67 reinstates those same negative acquisition costs for rate recovery in this case and no party rebutted that position.

- Based on the Commission decision to recognize post-HTY rate base through the beginning of the Rate Year, the Commission also recognizes the WVAWC adjustment to CIACs for Transition Period activity. WVAWC Statement G, Adj. B10.

Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes the WVAWC adjustment to customer advances for construction for terminal treatment of HTY activity as reasonable for the determination of rate base in this proceeding. Statement G, Adj. B11 and CAD Schedule B.

Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes the adjustment to material and supplies for HTY activity as reasonable for the determination of rate base in this proceeding. WVAWC Statement G, Adj. 69 and CAD Schedule B.

The Commission recognizes the following adjustments to the per books HTY thirteen-month average ADIT balance as reasonable for the determination of rate base in this case:

- The Commission accepts the non-disputed adjustment to reflect terminal HTY ADITS. Statement G Adjustments: WVAWC Adj. 72, Staff Adj. 64 and CAD Schedule 2.

- Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes additional Transition Period ADITs related to accelerated over book depreciation expense (calculated at existing depreciation rates). WVAWC Statement G, Adj. B13.

- The Commission lowered WVAWC's proposed adjustment to ($6.133) million to synchronize the adjustment to the accelerated depreciation deduction included in the Commission income tax calculation that reflects the impact of the post-HTY utility plant.

Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes the adjustment to accumulated deferred ITC for HTY activity as reasonable for the determination of rate base in this proceeding. WVAWC Statement G, Adj. 73 and CAD Schedule B.

The Commission recognizes the following adjustments to the per books HTY thirteen-month average Other Deferred Debits balance as reasonable for the determination of rate base in this case:

- Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes the adjustment to the Coal River/Van PSD acquisition costs for HTY activity. WVAWC Statement G, Adj. 74 and CAD Schedule B.

- Consistent with Commission decisions in prior WVAWC rate cases, Staff proposed the removal of the Parkersburg acquisition costs. No other party provided rebuttal to the Staff position. The Commission recognizes the Staff adjustment to eliminate the deferred Parkersburg acquisition costs:

- The Commission accepts the non-disputed adjustment to reflect terminal rate base for HTY AFFAC recorded since the 2012 Rate Case. Statement G, Adj. 75; Staff Adj. 75, and CAD Schedule B.

- Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes additional Transition Period AFFAC. WVAWC Statement G, Adj. B16.

4. Cash Working Capital

The Commission addressed in Appalachian Power Co./Wheeling Power Co., Case No. 14-1152-E-42T (2014 APCo Case), May 26, 2015 Order (2014 APCo Order) at 26-32, various elements of the cash working capital calculation. Based on the record in this case, and considering our rationale in the 2014 APCo Order, we think the same treatments would apply to cash working capital issues raised in this case. The Commission may not repeat all of the discussion included in the 2014 APCo Order here, and will refer to that decision where appropriate and address the other specific areas in which the parties disagree.

WVAWC proposed a cash working capital allowance of $11 million based on a lead/lag study prepared by Harold Walker, III. Several items of WVAWC cash working capital calculation are different from the Commission determination of cash working capital in the 2014 APCo Order. WVAWC proposed a negative 36.3 day lead for property tax payments, an indication that property tax bills are prepaid, based on a review of the applicable dates shown on the property tax bills themselves. WVAWC included a revenue lag for all operating income, deferred income tax expense and depreciation expense. WVAWC Ex. HW-D; Schedules HW-1 through HW-29.

Staff proposed a cash working capital allowance of negative $1.8 million. Staff calculated the average lead days for O&M expense of 11.2 days, or 4.6 days fewer than WVAWC, by applying the WVAWC O&M expense lead days to Staff pro-forma O&M expenses. Staff did not apply a revenue lag calculation to deferred income taxes or operating income, but did do so for depreciation expense. The Staff used 609 lead days for property tax expense, the same number used in the 2014 APCo Order. Staff Ex. 1, Statement B, Schedule 7.

CAD proposed a cash working capital allowance of negative $6.0 million. CAD calculated the lead days for O&M expense cf 14.6 days using the WVAWC expense lead days applied to CAD's pro-forma expenses. CAD did not apply a revenue lag calculation to deferred income taxes, depreciation expense or net income. Unlike WVAWC or Staff, CAD proposed the inclusion of interest expense in the cash working capital calculation by using both the revenue lag days and the lead days for long-term and short-term interest expense payments. The CAD calculation, using the methodology described in the 2014 APCo Order, determined 511 lead days for property tax expense based on the actual payment dates and 517 lead days using the scheduled payment dates. CAD Ex. RCS-D at 24-37. 2014 APCo Order at 28-30.

The Commission based the cash working capital calculation on the level of cost of service elements in Appendix C to this Order. WVAWC, Staff and CAD arrived at different expense lead days for O&M. The Staff O&M expense lead days of 11.2 days is reasonable in this case because the Staff O&M expense best matches the O&M expense used by the Commission in its cost of service determination.

WVAWC applied a revenue lag to depreciation expense and deferred income tax expense; Staff applied a revenue lag to depreciation expense but not deferred income tax expense; and CAD did not apply a revenue lag to either expense. Neither Staff nor CAD provided any compelling argument that a revenue lag should not apply to these two expenses. The Commission held to the contrary in the 2014 APCo Rate Case, 2014 APCo Order at 31. The Commission will, therefore, allow the revenue lag to apply to both depreciation expense and deferred income tax expense for the same reason as we stated in the 2014 APCo Order. We held in APCo that the revenue lag applies to all billed customer revenue (the entire cost of service) and that while neither of these expenses requires an immediate cash outlay, those funds are immediately reinvested in the business and reduce rate base. As a result, those funds are subject to the revenue lag in determining the cash working capital allowance.

WVAWC proposed a revenue lag for operating income, including the portion of operating income used to pay interest expense. Staff did not include a revenue lag for operating income. CAD did not include a revenue lag for the net income portion of operating income, but did include both a revenue lag and expense lead to reflect the payment of interest expense. The Commission agrees with the CAD position on this issue. Both the revenue lag and expense lead days should be used to determine the level of cash working capital allowance related to interest expense. The Commission will not recognize the revenue lag for net income. In the 2014 APCo Order the Commission determined that a revenue lag should only apply to net income if the utility considered the payment lead for dividend payments that are made from that net income. WVAWC did not provide any evidence about this in the cash working capital calculation and did not present any supportable basis for changing the Commission position regarding inclusion of net income in the revenue lag as described in the 2014 APCo Order. 2014 APCo Order at 31-32.

The Commission dedicated a significant amount of attention to the property tax payment lag issue in the 2014 APCo Order. 2014 APCo Order at 28-30. There we held that the service period should be the mid-point of the assessment year (the year when the property tax return is filed and the property assessment is rendered by the Board of Public Works) as defined in W.Va. Code §11-5-3. That calculation lowered the lag days by one year from what Staff proposed in the 2014 APCo Case (a service period determined by the mid-point of the year on which property values were based). In this case, WVAWC proposed that the service period for property taxes should be based on the applicable periods shown on the tax bills themselves, a calculation that would indicate that property taxes are paid in advance.

The Commission is not persuaded by WVAWC testimony that the service period for determining property tax lead days should not be the mid-point of the assessment year as determined in the 2014 APCo Order. Mr. Walker did not point out any West Virginia law or regulation to support his position, or provide any testimony addressing the Commission decision in the 2014 APCo Order that supported the proposition that the service period for property tax payments is the assessment year under W.Va. Code §11-5-3. The Commission believes that property taxes will not be payable until some future period after the applicable property base has been in service. It is not, therefore, logical to argue that property taxes are prepaid.

Staff used the same 609 days for property tax expense lead days recognized in the 2014 APCo Order, but did not perform a distinct calculation in this case. CAD witness Smith did do a distinct calculation of the property tax payment lead days based on the calculation method described in the 2014 APCo Order using both the actual payment dates for property tax payments and the scheduled September 1 and March 1 payment dates. The result of his analysis determined 511 and 517 property tax lead days, respectively. The Commission determines that 517 lead days for property tax payments is reasonable for establishing the cash working capital calculation applicable to property tax payments in this case.

Based on the record in this case and the discussion above, the appropriate and reasonable level of cash working capital for WVAWC is a negative $2,138,157 and that has been included in WVAWC's authorized rate base level.

V. Operating Income and Operation and Maintenance Expenses

A. Operating Income

1. Annualize HTY Rate Increase to Lincoln Public Service District

WVAWC witness Tomac testified that the HTY sale-for-resale revenues were adjusted to annualize a rate increase and adjust usage for Lincoln Public Service District (Lincoln PSD). Mr. Tomac explained that a going level adjustment of $59,176 reflected a rate increase that became effective for WVAWC January 6, 2014, and increased HTY usage. During 2014, Lincoln PSD significantly reduced its water take from WVAWC and was billed a total of only 793,999 gallons for 2014. The HTY sales were less than the average amount of 35,614,400 gallons billed in 2012 and 2013. WVAWC increased sales on a going level basis to the higher 2012/2013 average usage level and combined this with annualization of the rate increase. This resulted in a going level adjustment of $59,176 for WVAWC. WVAWC Ex. JST-D at 39, WVAWC Rule 42, Statement G, Adj. 9.

Ms. Kellmeyer disagreed with WVAWC's Statement G, Adj. 9 because 2015 usage by Lincoln was greater than the 2012/2013 average. Although the Lincoln PSD usage for the first three months of 2015 appears to be unusually high, the next five months are level. Staff annualized usage for that five-month period and increased revenue by $88,438. Staff Ex. DLK-D at 3, Staff Rule 42, Statement G, Adj. 9. In rebuttal testimony, WVAWC witness Tomac agreed with the Staff adjustment. WVAWC Ex. JST-R at 5, attached WVAWC Ex. JST-2 R at 1.

The Commission will adopt the Staff position as reasonable because the Staff adjustment reflects the latest known and measurable information about the level of sales to Lincoln PSD.

2. Annualize HTY Rate Increase to Clendenin Customers

Mr. Tomac testified that WVAWC increased HTY revenues by $73,650 to annualize the rate increase for WVAWC that took effect on October 9, 2014, and to reflect the final phase-in of rates to WVAWC rates for customers formerly served by Clendenin. Ex. JST-D at 41, WVAWC Rule 42, Statement G, Adj. 17.

Because of a difference in correction factors, Staff reduced the WVAWC adjustment by $1,653. Staff Rule 42, Statement G, Adj. 16. The Commission will adopt the Staff position as a reasonable adjustment to the HTY revenue generated by the rate increase implemented during the HTY for the former customers of the Town of Clendenin.

3. Annualize Rate Increase to Upper Kanawha Valley Public Service District

Mr. Tomac testified that WVAWC increased HTY revenues by $6,178 based on a March 5, 2015 rate increase to reflect the fourth of five annual rate adjustments to phase-in the rates for customers formerly served by Upper Kanawha Valley Public Service District (Upper Kanawha Valley PSD) to WVAWC rates. Mr. Tomac stated that because the last phase-in is scheduled to take place on or around the time new rates go into effect, WVAWC requests that the rates of the Upper Kanawha Valley PSD customers be set equal to the rates authorized in this case for all other customers. WVAWC Ex. JST-D at 41, WVAWC Rule 42, Statement G, Adj. 18.

Because of a difference in correction factors, Staff increased the WVAWC proposed adjustment by $3,434. Staff Rule 42, Statement G, Adj. 17. The Commission will adopt the Staff position as a reasonable adjustment to the HTY revenues generated by the rate increase implemented during the HTY for the former customers of the Upper Kanawha Valley PSD. WVAWC will, however, be entitled to file tariffs to reflect the final rate adjustment for the Upper Kanawha Valley PSD customers on March 15, 2016, as outlined in the original phase-in schedule.

4. Declining Residential Usage Trend Adjustment

a. Overview

As described above, over the last twenty years WVAWC has added approximately 40,000 customers with nearly all that customer growth coming from acquisitions and PPPs that extended WVAWC's historical service territories. Those extension projects and related treatment plant construction projects were authorized by the Commission and supported by Staff and CAD in certificate and rate cases that in large part were resolved by Settlement among the parties to the cases. After WVAWC completed those major extensions in the early part of the twenty-first century, WVAWC experienced little, if any, customer growth.

After the growth activity from acquisitions and PPPs was completed, the issue of declining residential usage per customer was raised in several past rate cases filed by WVAWC. In those rate cases, WVAWC asked the Commission to address a persistent and continuing decline in the average usage per residential customer. WVAWC attributed the usage decline to a combination of an aging population, fewer people per household, and water-saving plumbing fixtures and devices. The declining usage per residential customer caused actual revenue in the rate year for those cases to be consistently lower than the revenue level authorized by the Commission for determining the revenue allowance. WVAWC claimed that post-HTY revenue shortages consistently deprived WVAWC of a reasonable opportunity to achieve its authorized earnings level.[15] Over a long period of time the Commission denied that adjustment and simply required

[15] 2003 Rate Case, WVAWC Ex. CKM-D and CKM-R; West Virginia-American Water Co., Case No. 12-1649-W-42T, Co Ex. GAN-R and WVAWC Ex. ELS-R.

WVAWC to absorb the resulting loss of revenues. An adjustment for a declining residential usage per customer is again a major, contested issue in this case.

b. Positions of the Parties at Hearing

WVAWC witness McIntyre described the revenue loss from declining residential usage per customer as one of the major drivers for the need for rate relief in this case. WVAWC Ex. JLM-D at 9; Id. at 32.

At hearing, Mr. McIntyre conceded that total metered gallons sold to residential customers increased slightly from 2013 to 2014 although the number of customers during that same period fell. Mr. McIntyre explained that the increase in 2014 residential usage was attributable to customers letting water run to prevent freezing during the early winter of 2014, the "polar vortex." Tr. 10/27 at 75-77.

WVAWC witness Tomac testified that WVAWC revenues in 2014 of \$128.040 million were \$4.935 million lower than the expected \$133.025 million for the applicable rate year (2013) as shown on the revenue requirement schedules attached to the Joint Stipulation for the 2012 Rate Case. WVAWC 2012 Rate Case; September 26, 2013 Order, Joint Stipulation, Ex.1-A, Ex. 1-B and Ex. 1-C; WVAWC Ex. JST-D at 10-11. He stated that in order to help stabilize WVAWC's financial condition, WVAWC needs a regulatory mechanism to recognize the trend in declining residential usage per customer so that WVAWC has a reasonable opportunity to achieve the Commission-authorized revenue level. Id. at 10. Mr. Tomac stated that from 2011 through 2014, WVAWC revenues fell short of allowed amounts, solely by virtue of declining residential usage per customer, by more than \$14 million. He also testified that the deficiency will reach \$22.4 million by the time new rates go into effect and stated that without a post-HTY declining consumption adjustment, revenues will continue to fall significantly below the level upon which a fair rate of return has been calculated. Id. at 11.

Mr. Tomac cited the NARUC adoption of a resolution in November 2013 that specifically identified declining per-customer usage as a reason for its support of prospective test years for water and wastewater utilities. WVAWC Ex. JST-D at 18-21, attached WVAWC Ex. JST-2, "Resolution Endorsing Consideration of Alternative Regulation that Supports Capital Investment in the 21st Century for Water and Wastewater Utilities."

WVAWC characterized WVAWC Rule 42, Statement G, Adjustment 15, as a going-level reduction in revenues for two years beyond the HTY to reflect continued declining residential usage through the Rate Year. WVAWC computed the adjustment based on a ten-year analysis of consumption patterns prepared by WVAWC and supported by WVAWC witness Dr. Edward Spitznagel. The ten-year analysis shows an average decline in residential customer usage of 636 gallons per year. When that decline in consumption is multiplied by the number of customers at year end 2014 and multiplied by the current rate per 1,000 gallons, the resulting adjustment is a reduction of HTY revenues of \$2,042,031. WVAWC Ex. JST-D at 40.

Dr. Spitznagel provided testimony and exhibits that supported a trend of declining residential usage per customer. WVAWC Ex. ELS-D. Dr. Spitznagel testified that changes in weather from year to year impact water usage, particularly water usage by residential customers. He developed a model, attached as Appendix C to his testimony, to determine the impact of weather on monthly residential customer usage data from 1985 to 2014. Id. at 7. Dr. Spitznagel studied several drought indices published monthly by the National Oceanic and Atmospheric Administration (NOAA) and compared those drought indexes to determine their impact on corresponding monthly residential water usage results for the same period. Through that analysis, he determined that there are three primary indicators of the impact of weather on residential water usage: (1) the calendar year, (2) the month of the year and (3) the Palmer Modified Drought Index (PMDI). He placed the three indicators specific to the WVAWC service area into his model to determine the impact of weather on the WVAWC average residential usage per customer for the ten-year period 2005-2014. Dr. Spitznagel used the weather normalized usage results in a regression analysis to determine the weather normalized trend for residential water usage. The WVAWC regression analysis determined that weather normalized residential consumption has declined 1.64 gallons per residential customer per day. According to Dr. Spitznagel, the trend of declining residential customer usage per day, shown on Appendix D to his testimony, will continue through his projection period ending in 2018. Id. at 7.

WVAWC witness Roach testified that the decline in water consumption by residential customers is attributable to an increase of low flow (water efficient) plumbing fixtures and a growing water conservation ethic, prompted in part by conservation programs implemented by WVAWC and other water utilities. WVAWC Ex. GPR-D at 4. He described the impact of low flow toilets and stated that replacing an old toilet with a new one can save from two to nearly six gallons per flush. The United States Environmental Protection Agency estimates that there are more than 220 million toilets in the United States and that annually approximately 10 million new toilets are either installed in new homes and businesses or are installed to replace older models. Mr. Roach stated that the Energy Independence & Security Act of 2007 (Public Law 110-140) (EISA) will further reduce indoor water consumption because it established stringent efficiency standards for dishwashers and clothes washers. Dishwashers manufactured after 2009 and clothes washers manufactured after 2010 must use 54 percent and 30 percent less water, respectively. All other factors being equal, a typical residential household in a new home constructed in 2015, with water efficient toilets, clothes washers, dishwashers and other fixtures, will use approximately 35 percent less water for indoor purposes than a non-retrofitted home built prior to 1994. He stated that current per-person consumption is twelve percent less than the per-person consumption that was introduced into evidence during the WVAWC 2008 Rate Case. Id. at 5-6, attached WVAWC Ex. GPR-1.

Mr. Roach presented a ten-year linear regression analysis showing that residential usage per customer is declining at a rate of 636 gallons per customer per year, or 1.67 gallons per day. WVAWC Ex. GPR-D, attached WVAWC Ex. GPR-2 at 1-3. The trends of residential usage per customer for other American Water utility subsidiaries are similar to the WVAWC trend. On average, the states served by American Water operating companies have experienced a decline averaging 1.50 percent per year over the last ten-year period analyzed (2004-2013). Id. at attached WVAWC Ex. GPR-3. Mr. Roach recounted that a 2010 Water Research Foundation report stated that water utilities across the country are experiencing declining water usage. He cited Coomes, Paul et al., North America Residential Water Usage trends since 1992 - Project # 4031 (Water Research Foundation, 2010). Mr. Roach predicted that the trend will continue for up to seventy more years. Id. at 8-10, 15.

Mr. Roach also described the negative impacts of conservation. The disconnect between the decline in revenues and the increase in utility costs and capital needs has been labeled the "conservation conundrum" and is now recognized by utilities, policy makers, and academics. Mr. Roach explained that under current ratemaking policies, WVAWC has an economic disincentive to encourage conservation and sell less water in its service territory. According to the Water Research Foundation Report:

> [W]hile water conservation is normally seen as positive, this gradual erosion in residential consumption may force utilities to raise rates to provide sufficient revenues for expanding service and replacing old water mains and equipment. (WRF Report page xxi.)

WVAWC Ex. GPR-D at 12-13.

Staff witness Jonathan M. Fowler does not believe the WVAWC analysis of residential customer consumption reflects the most current trend. He reviewed WVAWC annual reports for the past ten years, data compiled by WVAWC witness Roach, and additional data points to bring the data current through August 2015. He observed that residential consumption "bottomed-out" in 2013 and increased in 2014. Staff Ex. JMF-D at 2-3, attached Staff Ex. JMF-1. Mr. Fowler concluded that an upward trend in consumption occurred during the past two years and that the decline in residential consumption has ceased. Id. at 4-5. Mr. Fowler recommended that the Commission reject the WVAWC adjustment for declining residential usage. Id. at 5-6; Staff Init. Br. at 34-36.

CAD witness Smith testified that the WVAWC adjustment to reduce residential revenues for projected declining usage has no precedent in West Virginia and is not known and measurable. He also noted that from 2010 to 2014 residential revenues increased for WVAWC, and he presented a chart to reflect that increase. CAD Ex. RCS-D at 39-42; CAD Init. Br. at 5-6. Mr. Smith stated that the WVAWC adjustment would penalize residential customers for their conservation of water and that the water usage data used by Mr. Roach was not consistent with WVAWC annual reports filed for the same years. Mr. Smith opposed the WVAWC adjustment in part because any decline in usage could be offset by other factors, including weather, construction, and acquisitions of other utility systems. Id. at 41-43. Mr. Smith stated that the WVAWC adjustment, if accepted by the Commission would result in customers paying for water they would not use, rather than for water they are actually using. He believes that allowing the adjustment to reflect post-HTY declining residential usage per customer could be offset by increased water consumption related to weather or customer growth and would, therefore, violate the HTY matching principle. Id. at 45; CAD Init. Br. at 14-16.

In his rebuttal testimony, Mr. Tomac testified that Mr. Smith's chart showed residential revenues increased from 2010 through 2014, and stated that Mr. Smith failed to consider the two rate increases that WVAWC implemented during that time frame. The rate increases, and not increased consumption, accounted for the increase in residential revenues during the period. WVAWC Ex. JST-R at 16-17.

Mr. Roach stated in his rebuttal testimony that WVAWC adjusted its declining residential usage regression trend analysis for weather effects. The weather normalization process used by Mr. Roach analyzed the twelve-month annual average residential usage per customer values over a decade-long period. This analysis included a bifurcated look at both Base (non-weather sensitive) and non-Base (weather sensitive) data. Base usage is not related to, or impacted by, changes in outdoor, weather-related residential water usage. Mr. Roach provided a table showing weather normalized declining residential usage for the time periods 2000-2015, 2005-2014 and 2006-2015. The table concluded that the trend of declining usage per residential customer is between -1.69 and -1.21 gallons per day.

Mr. Fowler, by comparison, only analyzed total residential monthly usage per customer with no consideration for the impacts of weather. When Mr. Roach recalculated Mr. Fowler's analysis applying time and weather variables, the 2000-2015 data indicated a continuing declining usage trend of between -1.64 and -1.8 gallons per customer per day. Mr. Roach argued that his recalculation of Mr. Fowler's analysis for the impact of weather disproved Mr. Fowler's suggestion that residential usage has begun to increase and supported the WVAWC recommendations of declining residential usage by Dr. Spitznagel of -1.64 and Mr. Roach's companion analysis of -1.7 gallons per customer per day. WVAWC Ex. GPR-R at 2-7; WVAWC Init. Br. at 14-16; WVAWC Reply Br. at 17-19.

In response to Mr. Smith's assertion that increases in residential revenues indicate that declining residential usage is not a major factor in WVAWC's inability to earn its authorized rate of return, Mr. Roach also stated that rate increases, not usage, caused the increase in revenues. WVAWC Ex. GPR-R at 8, 10. Mr. Tomac similarly criticized Mr. Smith's assertions regarding residential revenues at the hearing. Tr. 10/27 at 224-25.

Mr. Roach testified that Mr. Smith's statements that the WVAWC data is unreliable was incorrect and said that Mr. Smith was attempting to assign significance and substance to an insignificant variation of 0.09 percent between the Staff Audit set of data and the WVAWC Annual Report data. WVAWC Ex. GPR-R at 11, 13. At hearing, Mr. Smith conceded that 0.09 percent difference was not significant, but also stated that his chart contradicted the WVAWC assumption that residential consumption will decline every year. Tr. 10/29 at 19-20. Mr. Smith agreed that the two WVAWC rate increases that occurred during the 2010-2014 time period would be at least part of the reason that residential customer revenues increased. Tr. 10/29 at 12. Mr. Smith stated that CAD does not object to using test year data on this issue, but would object to forecasting declining residential usage beyond a known and measureable timeframe. Id. at 13.

Mr. Fowler stated that if the most current trend reflected declining residential usage, Staff would not object to the declining residential usage adjustment of WVAWC. Tr. 11/2 at 94. Mr. Fowler also stated that he did not complete a specific weather normalization in his analysis, but he does not believe that it would have made a significant impact on the data had he applied weather normalization. Id. at 99-100.

c. Commission Decision

We are troubled by the loss of residential revenues from the decline in the average residential usage per customer. Clearly, over time, the decline in residential consumption has been real, significant and damaging to WVAWC. WVAWC has again advanced a request for an adjustment for lost revenue and has provided data showing the significant decline over time and the likelihood that the decline will continue. WVAWC Ex. ELS-D at 1-7; WVAWC Ex. JST-D at 10-11; WVAWC Ex. GPR-D at 1-15.

The decline in residential consumption is not peculiar to WVAWC, but has occurred over the entire water industry. Tr. 11/2 at 110-116. It is a decline that seems to begin with, and be attributable to, low flow devices in showers, commodes and other water-using devices. In 1993, an average WVAWC residential customer used 53.168 thousand gallons (TG) per year (1993 Annual Report). In the WVAWC 2014 HTY a residential customer used an average of 39.072 TG per year. WVAWC Rule 42, Statement D, 2 of 20. This is a decline of 19.076 TG per year, or 48.9 percent. Over that twenty-one year period, the average annual decline has been 2.3 percent per year. We cannot continue to ignore the fact the WVAWC and most other water utilities have experienced a dramatic decline in residential usage per customer.

The Commission must decide in this case whether that decline has continued in 2015 and will continue in the Rate Year. Stated in a different way, we must decide if HTY residential usage levels are representative of the likely residential usage levels for the first year in which the rates authorized in this case will be effective. The Commission stated in the 1989 Contel Order that departures from the HTY approach must be based on some determination by the Commission that the traditional approach does not fairly represent the conditions that will occur in the future. Thus, it is the relationship between investment, revenue units and expense units that is most important when considering whether rates established based on any test period are fair and reasonable.

WVAWC provided an analysis that normalized the impacts of weather and indicated that through the 2014 HTY, residential usage per customer continued to decline. Both Dr. Spitznagel and Mr. Roach asserted that the decline will continue because conservation impacts described above have not reached a saturation point on water-using devices. Staff, on the other hand, provided an analysis showing that residential usage per customer did not decline in 2014 and that 2014 residential usage per customer actually increased slightly from 2013 levels. Staff did not, however, adjust its analysis for the impact of weather. Staff witness Fowler, on cross examination by the

WVAWC attorney, indicated that he would have recommended approval of the declining residential usage adjustment if the current trend indicated declining usage per customer. He also indicated that the residential per customer usage declined after a spike in the 2007 average residential usage per customer. Tr. 11/2 at 94-104.

We have the utmost respect for Mr. Fowler, but given the persistent and consistent decline in water consumption over the past twenty years, we are not persuaded that a slight uptick in the 2014 residential usage per customer signals an end to the trend of declining residential usage experienced by WVAWC over the last twenty years. The development of water and energy conserving plumbing fixtures and appliances has not stopped. In fact, given the emphasis on energy efficiency measures in the power industry, conservation efforts are likely to increase and intensify. History has shown us that, for water utilities, electric energy conservation applications also typically save significant amounts of water. APCo, Case No. 10-0261-E-GI, October 5, 2010 Order at 3 (approval of EE/DR Program).

CAD claimed that the WVAWC regression analysis developed to support the WVAWC claim as presented in the testimonies of Mr. Roach and Dr. Spitznagel is not "scientific evidence." While the decline in usage appears to be consistent with WVAWC witnesses' theory about national trends during the early 2000's, this theory has not been tested, and is not "scientific evidence." CAD Reply Br. at 4-6. The Commission does not agree with the CAD position.

The Commission has normalized several elements of the cost of service on a routine basis. It is common in rate cases to normalize uncollectible expense and rate case expense when trends indicate HTY information is not reflective of future rate year expected expense levels. WVAWC 2010 Rate Case Order at 31-32. In gas utility cases, the Commission has routinely authorized adjustments to HTY consumption units to normalize the impact of weather. Bluefield Gas Company, Case No. 11-0410-W-42T, Recommended Decision at 2, 5. We believe that the WVAWC ten-year analysis adjusted for the impacts of weather demonstrates that the HTY residential usage per customer is not reflective of the likely residential usage levels in the Rate Year, particularly given the long-term nature of that decline. The Commission believes the WVAWC trend analysis is more reflective of future residential per customer usage trends than the three-year trend offered by Staff.

The declining residential usage adjustment is not a "throw away" item for WVAWC in its cost of service adjustment. According to the testimony of Mr. Tomac, WVAWC has lost $14 million just in the last three years from that declining residential usage trend. WVAWC Ex. JST-D at 11. This Commission and many other regulatory commissions recognize the validity of normalization of abnormal revenues and expenses in a test year. The Commission concludes that to be meaningful, a declining residential water usage analysis should be normalized for the impact of weather and an adjustment should be made until the data suggests otherwise.

The Commission will move cautiously, however, and only reflect the declining residential usage per customer adjustment up to the beginning of the Rate Year, an approach consistent with the post-HTY rate base determination above. The Commission determines that a declining residential usage per customer adjustment reducing HTY residential revenues at present rates by $1.021 million is supported by evidence in this case, is representative of the likely and measurable decline in residential usage per customer for the Rate Year, and is reasonable for the determination of fair and reasonable rates in this case.

WVAWC should note that the Commission is not authorizing declining residential usage adjustments as a "regular" and "routine" cost of service adjustment in all future rate cases. Unless the adjustment is supported by the record in those cases, we will not consider that adjustment.

B. Operation and Maintenance Expenses

Operation and Maintenance (O&M) expense levels are not a major driver of the WVAWC requested rate increase in this case. According to Mr. Tomac, the WVAWC requested O&M in this case is $1.1 million less than proposed in the last WVAWC rate case (2012 Rate Case). WVAWC Ex. JST-D at 12. There are, however, differences in the positions of the parties in this case about the level of certain O&M expenses.

1. Purchased Power Accrual

Mr. Tomac explained that WVAWC adjusted HTY power usage for known and measurable going-level base electric usage changes and re-priced that usage level using the most current electric rates. As originally filed, the calculation resulted in a reduction of power costs on a going level basis of $275,660. Mr. Tomac corrected the adjustment in response to a CAD data request and indicated that HTY purchased power costs should have been reduced by only $50,692. WVAWC Ex. JST-D at 43, WVAWC Rule 42, Statement G, Adj. 24.

Staff witness Kellmeyer stated in her direct testimony that Staff accepted Mr. Tomac's correction of the HTY purchased power accrual and included that correction in its going level adjustment. Staff Ex. DLK-D at 3-4, Staff Rule 42, Statement G, Adj. 22. Although the CAD data request prompted the WVAWC correction, CAD failed to include the correction to the HTY power accrual in its adjustments.

The Commission will adopt the amended WVAWC HTY power accrual restated at current electric rates as agreed to by the Staff as a reasonable resolution of this issue.

2. Reduced Purchased Power, Chemicals and Waste Disposal for Declining Residential Usage

In the WVAWC Rule 42, WVAWC proposed to reduce its HTY fuel and power, chemicals, and waste disposal expenses (production costs) to reflect the lower going-level water revenues attributable to the declining residential usage trend forecasted through the Rate Year. WVAWC reflected corresponding lower production costs related to the lower customer usage. WVAWC Ex. JST-D at 40, WVAWC Rule 42, Schedule G, Adjs. 25, 28, and 30. Staff and CAD did not recognize the adjustment for declining residential usage in their filings and did not include the corresponding production cost reductions.

As discussed earlier, the Commission recognized one-half of the lower residential consumption related to declining residential usage from the level proposed by WVAWC. Likewise the Commission will recognize only one-half of WVAWC's corresponding reduction to production costs.

3. **Employee Count, Salary and Wage Increases, Overtime, and Annual Incentive Compensation Plan Costs**

WVAWC, Staff and CAD presented differing recommendations for employee count, wage and salary increases, overtime hours and the Annual Incentive Plan (AIP) costs. WVAWC proposed to increase HTY expense levels by $1,837,561 for this category of expenses; Staff recommended an increase of $507,045 and CAD recommended an increase of $755,022.

a. Positions of the Parties

WVAWC, in its required Utility Management Report (W.Va. Code §24-2-4a) included as a part of its rate filing, stated that it has markedly improved its efficiencies with respect to employees. The Utility Management Report included with the rate filing stated that in 1993 WVAWC had 377 employees to serve 108,000 customers, or 286 customers per employee. WVAWC currently has 300 employees serving over 170,000 customers, or 560 customers per authorized employee. This reflects a ninety-seven percent increase in this particular measure of productivity over that twenty-two year period. According to WVAWC, at current pay levels, that equates to more than $6.2 million in annual savings for payroll and benefit costs for which customers do not have to pay. WVAWC Ex. 1, "Utility Management Report" at 2, attached as a part of WVAWC's original filing.

Mr. Tomac described the WVAWC payroll calculation as based on 300 full-time employees with a full 2,080 regular pay base hours and the overtime hours present in the HTY. WVAWC priced regular and overtime hours for each union employee at current pay rates and then adjusted the rates to reflect 2015/2016 actual contract wage increases and 2016 projected wage increases. WVAWC priced non-union hourly and exempt hours at current pay rates and then adjusted for projected 2015/2016 wage increases. WVAWC's payroll adjustment included an increase to HTY AIP expense by $429,957 to reflect 100 percent of the AIP targeted pay, even though the HTY AIP was significantly less than 100 percent of the targeted AIP payout. Mr. Tomac testified that the total going-level payroll adjustments increased HTY payroll expense by $1,837,561. WVAWC Ex. JST-D at 44-45; WVAWC Rule 42, Statement G, Adj. 31.

WVAWC witness Carolyn Mount testified that WVAWC currently has 298 employees (295 water and 3 wastewater) compared to 272 employees embedded in the cost of service for the 2012 Rate Case, was in the process of hiring two additional employees, and expected to complete that process in the near future. WVAWC Ex. CM-D at 2. Ms. Mount testified that the three current employee classifications for WVAWC are exempt, non-union hourly and union hourly employees. Three unions represent union employees and WVAWC operates with five collective bargaining agreements. Utility Workers of America represents hourly employees in the Huntington and Northern Districts under two separate contracts. The Laborers International Union of America represents union employees in Charleston. WVAWC also has two collective bargaining agreements with the Plumbers and Pipefitters Industry of the United States and Canada, one in Oak Hill and another in Princeton/Bluefield. Id. at 3.

Ms. Mount testified that the Utility Workers of America have a ratified agreement that expires April 15, 2017. In 2014, the Oak Hill District agreement was ratified for a term that will expire August 31, 2016. In 2013, the Princeton/Bluefield agreement was negotiated for a term that will expire September 1, 2016. The Northern District agreement with the Utility Workers of America will expire April 14, 2016, and the Charleston agreement with the Laborers International Union will expire April 26, 2016. Ms. Mount stated that under WVAWC's National Benefits settlement, unions have the option to extend an expiring contract on the same terms for a period of one additional year, subject to a 2.25 percent base wage increase. WVAWC expects that a number of the unions will make that election. Id. at 4-5.

Ms. Mount explained the WVAWC employee compensation and benefits package. The compensation consists of base salary and variable or incentive compensation portion, also known as AIP. Id. at 5. She claimed WVAWC's compensation levels are in line with general industry compensation levels in surrounding regions and nationally, and with companies against which WVAWC competes to attract employees. Employees who excel in their performance can earn higher compensation than the "norm," and employees who do not excel may earn less than the "norm." Id. at 5. WVAWC evaluated the reasonableness of its level of compensation through a review of the compensation program conducted by Towers Watson for American Water. WVAWC targets the mid-point of the reasonable compensation range for similar positions in the area. Id. at 6.

Staff witness Kellmeyer did not agree with several of WVAWC's going level payroll expense adjustments. Ms. Kellmeyer stated that WVAWC computed its payroll expense based on 300 employees and that this WVAWC adjustment added 26,080.7 hours to the HTY work hours. She claimed that WVAWC will not have 300 employees continuously throughout the Rate Year. Staff used HTY labor hours to compute the going level expenses. According to Ms. Kellmeyer, using the HTY payroll hours will properly account for vacancy rates inherent in the hiring process to replace employees who retire or are otherwise terminated because it normally takes a few months to fill the open position. Ms. Kellmeyer stated that WVAWC computed the capitalized portion of labor to be 35.65 percent and the expense portion of labor to be 64.35 percent based on total HTY labor of $21,191,103. Ms. Kellmeyer also observed that WVAWC's going level adjustment No. 31 showed that the Spill-related overtime labor expense of $225,686 is included in expensed labor of $13,637,425, although WVAWC stated that it removed all costs of the Spill from this case. Removal of the cost of Spill from labor would result in total labor of $20,965,327 and expensed labor of $13,411,739 resulting in

63.97 percent of labor charged to expense. Accordingly, Staff used 63.97 percent allocation ratio for the expense portion in its labor and labor related adjustments. Staff Ex. DLK-D at 4.

Staff applied the latest 2015 union contract wage rates to HTY labor hours for all union employees, except for the Huntington union contract that expires in 2017 because the other union contracts expire in 2016. Staff computed going-level non-union and salaried wages by applying the current 2015 wage rates to HTY hours instead of using projected wage increases through the Rate Year (the approach taken by WVAWC). Staff also included only HTY AIP compensation instead of projecting a fifty-nine percent increase as WVAWC did. Staff recommended a going-level payroll adjustment of $507,045 to increase the HTY payroll expense levels for all employee groups. Staff Ex. at 5, Staff Rule 42, Statement G, Adj. 27.

CAD witness Suzanne Akers proposed labor expense of $14,392,447, an increase of $755,022 from the HTY O&M payroll expense. The CAD labor adjustment is $1,082,539 less than the amount proposed by WVAWC. CAD Ex. SOA-D at 2-3, attached Ex. SOA-2. Ms. Akers stated that WVAWC annualized salaries from the HTY by including some known and some estimated wage increases through the end of the Rate Year. CAD regards the 2014 and 2015 pay raises as known and measureable because WVAWC's three groups of employees (union, non-union hourly and non-union salary) received pay raises in 2014 and 2015. CAD regards the 2016 pay raises, however, as speculative, except those for Huntington District (Local 537) because that contract was signed in March 2015 and will be in effect through calendar year 2016. Id. at 4-6.

CAD disagreed with the WVAWC $225,686 adjustment in overtime payroll expense on grounds that removing the Spill-related overtime expenses from the HTY resulted in artificially lowering HTY expenses and, correspondingly, raising the going-level adjustment for overtime expense. Ms. Akers stated that WVAWC is requesting increased overtime payroll expense of $735,267, consisting of a $509,581 difference between WVAWC's requested going forward overtime amount of $2,273,728 and the HTY recorded overtime expense of $1,764,147 and an amount of $225,686 for 2014 overtime payroll expense associated with the Spill. Ms. Akers asserted that WVAWC's agreement to defer Spill-related costs to another proceeding should not allow it to inflate labor costs in this proceeding. CAD argued that increasing the amount of the payroll expense adjustment by $225,686 for 2014 Spill-related overtime costs effectively charges ratepayers for that amount of Spill-related overtime payroll expense. CAD recommended, therefore, that the Commission reject WVAWC's request for increased payroll expense in the amount of $225,686. Id. at 6-9.

CAD witnesses Smith and Akers did not agree with the WVAWC calculation of going-level AIP expense. Ms. Akers objected to WVAWC's use of an increase of AIP above the actual HTY level to reflect an expense based on the AIP targeted payment level. WVAWC's AIP includes a formula for determining incentive awards and the formula consists of distinctions between the financial (55 percent) and non-financial performance of WVAWC (45 percent). The financial portion is related to earnings per share, which benefit shareholders more than ratepayers. The non-financial portion is related to safety, customer satisfaction, environmental compliance, and customer service issues, which benefits ratepayers. CAD removed fifty-five percent of the WVAWC HTY AIP expense and all of the Long-term Incentive Plan (LTIP), a reduction of $596,531 from the WVAWC requested amount. CAD Ex. RCS-D at 74-78; attached Ex. LA-1, Schedule C-6 at page 2 of 2; CAD Ex. SOA-D at 10-12. CAD also applied the same methodology to the HTY expense for the AIP embedded in the charges to WVAWC from American Water Works Service Co., Inc. (AWWSC) and eliminated fifty-five percent of the AIP for AWWSC and all LTIP charges. CAD Ex. RCS-D, attached Ex. LA-1, Schedules C-16 and C-17.

In rebuttal testimony, Mr. McIntyre stated that WVAWC needs an employee count of 300 to operate the business with the increased efficiencies that WVAWC has developed. He stated that the achieved efficiencies have reduced WVAWC O&M expense over time. WVAWC Ex. JLM-R at 17.

Mr. Tomac, in his rebuttal testimony, stated that although it was unknown at the time of the rate filing, it is likely that WVAWC will have even more than 300 employees in the Rate Year. Under Mr. McIntyre's leadership, WVAWC has increased headcount to meet the needs of the business, with a particular focus on customer-related services. WVAWC had 296 employees at the end of the 2014 HTY, with four open positions. The open positions were filled. WVAWC indicated that it is comfortable using a 300 employee count for the rate case, but because it expects to operate with a higher number, WVAWC cannot accept a reduction below the 300-employee level included in the filing. WVAWC Ex. JST-R at 7.

Mr. Tomac objected to the Staff and CAD failure to recognize a union wage increase for four of the five union contracts that expire in the 2016 Transition Period. Mr. Tomac indicated that WVAWC calculated the wage increase for the four union agreements that expire in 2016 by averaging the wage increases that occurred in each union contract during the three-year terms of those contracts and filed a wage level based on a prorated factor carried to the end of the Rate Year. Subsequent to the WVAWC filing, WVAWC entered into a settlement under which each of the unions may elect an automatic 2.25 percent wage increase on expiration of its contract, and argued that the Commission should include at least this 2.25 percent wage increase in its determination of Rate Year payroll expense. Mr. Tomac stated that its projected non-union and salaried employee wage increase of 2.7 percent is reasonable based on historical practice. WVAWC Ex. JST-R at 8.

In response to Ms. Kellmeyer's use of HTY variable AIP compensation of $252,794 and rejection of the WVAWC calculated amount of $682,751, Mr. Tomac noted that Ms. Kellmeyer did not give any reason for her recommendation and asserted that the HTY test year amount is inappropriate because WVAWC experienced abnormally low AIP payout ratios in 2014 because of poor financial performance. WVAWC Ex. JST-R at 9.

In response to Ms. Akers' assessment of WVAWC's overtime expense, Mr. Tomac explained that by removing Spill-related overtime (and for that matter, all other Spill-related costs) from HTY expenses, going-level utility operating income increased, thus increasing present pro forma utility operating income and lowering the needed rate increase amount. Mr. Tomac stated that Ms. Akers incorrectly removed the Spill-related overtime a second time. WVAWC Ex. JST-R. at 12-13.

At the hearing, Mr. McIntyre stated that the future WVAWC employee headcount is 308. Tr. 10/27 at 49. As of the hearing, WVAWC had a headcount of 294. Id. at 196; Tr. 10/30 at 70-71 (WVAWC witness Mount). When asked whether the headcount might go down, Mr. McIntyre stated that although its need for meter readers should diminish before the end of 2015, WVAWC will hire six additional distribution workers in the Kanawha area to staff evening crews that will more quickly respond to main breaks and other customer-related issues. Tr. 10/27 at 49-51, 160-162.

Mr. McIntyre also testified at hearing that he did not believe that there are any incremental costs of overtime or other expense attributable to the 2014 Spill beyond what was already in the WVAWC rate case. Tr. 10/27 at 97.

Mr. Tomac stated at the hearing that if the Commission adopts Ms. Kellmeyer's use of labor hours to compute the going level wage expense, then WVAWC will start the Rate Year with totally outdated numbers. Tr. 10/28 at 33. He also stated that it would be unfair to impute test year labor hours to the Rate Year when it is certain that WVAWC will hire employees to result in a higher head count than during the test year. Id. at 36.

When questioned about whether the increase in employees to 308 would reduce overtime pay, Mr. Tomac testified that the added positions would not significantly reduce overtime or contract labor costs because the additional employee levels expected in the Rate Year will be providing new services. Tr. 10/28 at 40-46.

At hearing, WVAWC witness Mount stated that AIP funding is not paid to employees unless the utility achieves threshold financial performance goals. According to Ms. Mount, that is true even if the utility meets all of the non-financial goals such as customer satisfaction, customer service quality, environmental compliance and safety. Tr. 10/30 at 74-75. If the utility meets its financial goals, it is possible for employees to earn fifty-five percent of their AIP, even if non-financial goals are not reached. Id. at 75. She also stated that failure to meet non-financial goals can negatively impact the ability of the utility to meet its financial goals. Id. at 83-84.

b. Commission Decision

In the last several WVAWC rate cases employee count has been a significant issue. The Commission has attempted to address this issue and, in fact, included the full complement of employees as requested by WVAWC because WVAWC demonstrated that it filled those vacancies at the time of hearing. WVAWC 2010 Rate Order at 36-37. Shortly after completion of the 2010 Rate Case, the Commission was faced with a formal complaint filed by the Utility Workers of America claiming that WVAWC substantially reduced its workforce from the level provided for in current rates and that the reduced employee count had a negative impact on the service provided by WVAWC. The outcome of that case required WVAWC to provide quarterly metric reports on employee and service levels. West Virginia-American Water Co., Case No. 11-0740-W-GI, October 13, 2011 Order at 15-23.

In this case, WVAWC is again seeking adjustment of the HTY employee levels, and Staff and CAD are advocating for adherence to the payroll hours present in the HTY. The Commission understands that the WVAWC employee count at any particular point in time is a moving target. Employees retire or leave WVAWC, and the replacement hiring process may take several months. In some instances WVAWC may decide not to replace a position and instead to use the vacancy to fill a more pressing need or elect not to replace a position to save costs and operate more efficiently. The Commission expects utilities under its regulation to make every effort to improve efficiency and to thoroughly review every position on a regular basis in order to assure the lowest possible cost to the ratepayer. At the same time, the Commission expects utilities to have a sufficient number of employees to maintain adequate service levels and fulfill its public service obligation. The Commission believes utilities need that type of management flexibility to manage employees effectively.

Staff and CAD indicated that the HTY payroll hours included significant overtime hours, even after eliminating overtime hours related to the Spill. To the extent the HTY overtime level was used to offset employee vacancies, inclusion of full year replacement employees for rate recovery would require a reduction of HTY overtime hours. Although WVAWC included full year replacement employees for HTY vacancies in its proposed labor adjustment, it did not propose a corresponding reduction to HTY overtime hours or contract labor used to offset vacancies. On cross examination, Mr. Tomac conceded that filling the six evening positions could reduce overtime and contract labor "a little." Tr. 10/28 at 40-46.

The Commission believes that the level of payroll hours embedded in the HTY is the place to start the determination of an appropriate employee level and payroll expense. The Commission is not convinced, however, that the HTY overtime hours experienced to cover vacancies will not be reduced by the hiring of additional employees as claimed by WVAWC. The Commission will, therefore, price payroll using the HTY hours included in the Staff payroll adjustment, with a recognition for the six additional employees discussed below. The HTY approach used by Staff properly accounts for the elimination of Spill-related overtime from rate recovery in this case as addressed in the testimony of CAD witness Akers.

The Commission has historically recognized known and measurable post HTY pay increases that are included in union contracts. In this case, only the Huntington union contract pay rates are known for 2017. All other union contracts will expire in 2016 and are not known at this time. The Commission does not find it reasonable to recognize union and non-union pay increases that are not known and measurable at this time and will not be known until the later part of 2016.

Criticisms of WVAWC raised by both AFSWS and the City of Charleston are directly or indirectly related to the employee count. The AFSWS and City of Charleston witnesses claimed that (i) more priority should be given to replacement and maintenance of the distribution system, (ii) the response times to main breaks and other customer service issues should be improved, and (iii) the level of UFW should be reduced. Staff has also recommended that WVAWC accelerate its main replacement rate to address the current main replacement rate of nearly 400 years. Staff Ex. JMF-D at 6-12; Tr. 10/28 at 40-46. The Commission believes that both adequate capital investment and employee levels are required if WVAWC is to lower its main replacement rate, improve response time to leaks, make more cost-effective leak repairs, and meet the goals of making the distribution system more reliable and reducing UFW. Unfortunately, additional investment and more employees normally result in higher rates, a result that both AFSWS and the City of Charleston strongly oppose.

WVAWC claimed it will hire or has hired six additional employees for evening and weekend duty to (i) address main breaks and leak detection in a more expeditious manner, (ii) improve response times, and (iii) lower the level of lost water. The Commission is persuaded that hiring six additional distribution employees in the Kanawha Valley system will improve WVAWC's ability to address the distribution system improvements, main repair, and response time issues raised by Staff, AFSWS and the City of Charleston. The addition of six employees to the HTY payroll hours used in the Staff determination of labor expense is reasonable for the determination of Rate Year payroll expense in this proceeding. The Commission has increased the overall Staff payroll recommendation by approximately $450,000 to reflect the average Kanawha Valley distribution system employee payroll expense plus benefit costs for the six additional employees dedicated to the evening and weekend shifts.

Staff recommended that the Commission limit AIP expense to the actual HTY level for both WVAWC and AWWSC employees. CAD recommended the Commission eliminate fifty-five percent of the HTY AIP expense because that percentage of the AIP payments is tied to financial goals that CAD claimed benefit the stockholder, not the customer. CAD cites the sharing of AIP cost addressed in the APCo and WVAWC 2010 Rate Cases as justification for continuing the sharing approach. The Commission addressed the issue of AIP in the 2014 APCo Order at 73-77.

The Commission has reviewed the WVAWC AIP plan provided with the testimony of CAD witness Smith. CAD Ex. RCS-D, attached Ex. LA-3 at 34 (2013 American Water Annual Incentive Plan). The American Water Works Company (AWW) AIP is remarkably similar to the AEP AIP. In the 2010 APCo Rate Case, the Commission took the step of disallowing significant portions of the HTY levels of incentive compensation for both APCo and AEPSC employees, expressing concern about the levels of executive compensation and incentive plan payments made during the extremely difficult economic times brought on by the Great Recession of 2008. The Commission took a similar position in the WVAWC 2010 rate case regarding AIP.

Subsequent to the 2010 APCo and WVAWC Rate Cases, APCo and other utilities have presented the Commission with evidence that AIPs that tie some portion of an employee's compensation to an employee's actual performance are prevalent in the compensation packages for larger businesses and has become the "norm" for major utility companies. WVAWC Ex. CM-R at 2.

The WVAWC testimony in this case supports that the AIP is an integral part of the overall compensation plan of WVAWC and that the total compensation (the combination of base pay and incentive pay) to eligible employees is intended to place that total compensation at or near the market rate for each particular job or salary band. WVAWC Init. Br. at 49-51.

Mr. McIntyre testified that AWWSC provides a significant percentage of WVAWC's workforce, particularly in areas of the business that can benefit from the economies of scale available through sharing professional employees with other subsidiaries as opposed to hiring that professional expertise at each subsidiary. No party to this case has argued that the services provided by AEPSC are imprudent or not cost effective. WVAWC presented evidence of savings for AWWSC costs compared to the level in the 2014 HTY and substantially lower than AWWSC costs presented in the 2012 Rate Case because of continuing efforts to operate more efficiently through process and technology improvements. WVAWC Ex. JST-D at 48-49; WVAWC Rule 42, Statement G, Adj. 39; WVAWC Ex. JLM-D at 7-8, 11, 25-26, 29-30; WVAWC Ex. PLB-D.

Based on the record in this case, the Commission will allow the annual incentive plan costs for the HTY as proposed by Staff for both the WVAWC employees and employees of AWWSC. The Commission will not recognize the higher level of AIP proposed by WVAWC based on achievement of 100 percent of the targeted AIP levels. WVAWC could experience higher or lower AIP expense in the Rate Year than the level paid in the HTY. WVAWC has not, however, demonstrated that the target level of AIP payments is sufficiently known and measurable at this time for inclusion in this case. WVAWC in future rate cases should provide analysis that demonstrates that the total compensation to its employees (both direct and AWWSC employees) is in line with the market salary for each type of job classification. The analysis should address how the market value for each job classification is determined and provide examples that show how the actual salaries for various job classifications compare to the market-determined salaries.

4. Long-Term Incentive Plan Costs

WVAWC's total employee compensation plan includes elements of base salary, variable pay (at risk incentive based pay), and various employee benefit plans. AWW, the parent company of WVAWC, established a uniform compensation package for use by its subsidiaries that includes salary bands (ranges for each non-hourly position), incentive compensation plans, and employee benefit plans. The AWW compensation plan is based on market studies of comparable market pay ranges, incentive pay plans and employee benefit plans of companies similar to AWW and its subsidiaries so that AWW and the subsidiaries are able to compete for employees with the qualifications, experience and expertise needed to operate a large investor-owned water utility. The incentive compensation package is comprised of two types of incentive pay: (i) Annual Incentive

Pay (AIP) compensation available to all non-union employees and (ii) Long-term Incentive Plan (LTIP) compensation available to a select group or level of management employees. The LTIP is comprised of stock options, restricted stock units and performance stock units. Before awards under the LTIP plan are made to eligible employees, the AWW stock performance must meet a minimum threshold as established by the AWW Board of Directors. WVAWC Ex. CM-D at 5-6; CAD Ex. RCS-D, Attached Ex. LA-3 at 83-99.

In her direct testimony Staff witness Ms. Kellmeyer removed one-half of LTIP compensation for WVAWC and AWW employees. Ms. Kellmeyer explained that the WVAWC LTIP compensation award is based on the long-term success of AWW and the increase in the value of AWW stock. Staff based its adjustment on the Commission decision in the 2014 APCo Case in which the Commission recognized that a financially strong utility is important to customers and stockholders and authorized APCo and WPCo to recover one-half of the LTIP costs for the HTY. Staff Ex. DLK-D at 8; Staff Statement G, Adj. 69.

CAD witness Smith recommended that the Commission eliminate 100 percent of HTY LTIP costs for both WVAWC employees and AWWSC employees from rate recovery. CAD asserted that because the LTIP is based on stock performance, the cost of the LTIP should be the burden of stockholders who benefit from the LTIP, not ratepayers. Mr. Smith stated that valuation of the stock options and the restricted stock units (RSUs) is driven by changes in the stock price of AWW. Mr. Smith believes that ratepayers should not pay compensation that is based on the stock price of a utility or its parent, or that has the primary purpose of benefitting the parent company stockholders and aligning the interests of participants with those of the stockholders. CAD Ex. RCS-D at 80-81; attached Ex. LA-1, Schedule C-6 and Schedule C-16.

WVAWC witness Mount, in her rebuttal testimony, explained that the stock-based compensation plan has three components. Twenty percent of stock-based compensation consists of stock options, another twenty percent consists of RSUs, and the remaining sixty percent consists of performance stock units (PSUs). An eligible recipient receives one share of AWW stock for each PSU he or she earns if certain goals are achieved. All of these components vest on a phased basis in three installments over a prospective three-year period. Ms. Mount stated that the three components are parts of a total compensation package and substitute for a portion of cash-based compensation. WVAWC Ex. CM-R at 7-8.

Ms. Mount argued that Mr. Smith was incorrect in stating that ratepayers do not benefit from the stock-based compensation awarded based on earnings per share. She testified that ratepayers benefit because strong financial performance can reduce the amount of base rate increases and is associated with productivity and management efficiency. Ms. Mount stated that CAD overlooked the fact that stock-based compensation helps to reduce attrition. Ms. Mount stated that ratepayers benefit when WVAWC satisfies financial objectives and is able to maintain credit ratings that provide access to capital at reasonable rates and to use internally generated funds as a low-cost source of capital. She further testified that improved access to capital enables the utility to provide safe and reliable service and to maintain the technological expertise necessary to operate WVAWC and to comply with increasing water quality standards. Furthermore, Ms. Mount stated that CAD did not refute the reasonableness of the overall compensation levels of WVAWC. Id. at 8-10.

In Mr. Tomac's rebuttal testimony, he stated that WVAWC proposed to decrease its request for LTIP compensation by fifty percent in recognition that the Commission took a balanced approach regarding "at risk" LTIP compensation in the 2014 APCo Case. WVAWC Ex. JST-R at 13. WVAWC repeated its request for fifty percent of its stock-based program expenses in its initial brief. WVAWC Init. Br. at 51.

CAD in its Initial Brief argued that stock-based compensation provides no benefit to ratepayers, only benefits shareholders, and the expense related to stock-based compensation should be completely removed from rate recovery in this case. CAD Init. Br. at 13.

Staff argued in its Initial Brief that its recommendation to remove one-half of long-term incentive compensation is consistent with the Commission decision in the 2014 APCo Case. Staff Init. Br. at 43.

WVAWC argued in its Reply Brief that it had shown in this case that financial performance offers a benefit to ratepayers because a financially health utility attracts capital at more reasonable rates, is able to invest in beneficial technology that reduces operating costs, and is then able to reduce its base rate increases. Further, increased employee productivity can help drive financial performance and produce ratepayer benefits. WVAWC Reply Br. at 23.

The goals for the LTIP are largely tied to the overall financial performance of AWW stock. A financially strong utility is important to customers. In the case of the LTIP goals, however, while those goals may result in favorable cost of capital and other favorable impacts for customers, they also benefit the shareholders. Because achievement of the LTIP plan goals benefit both customers and shareholders, the Commission will authorize WVAWC to recover one-half of the LTIP costs recorded in the HTY as we did in the 2014 APCo Order.

5. Payroll Related Adjustments for 401(k), Pension, Retiree Medical, Active Employee Medical Expenses and Payroll Taxes

A number of adjustments included in the WVAWC filing related to, or are a function of, changes in payroll expense identified in the WVAWC Rule 42, Statement A, Schedule 2 (Operating Expense) and Schedule 4 (General Tax Expense). The Commission usually refers to these adjustments as payroll related adjustments. WVAWC made payroll related adjustments that impacted: 401(k) expense (Statement G, Adj. 32); defined contribution pension expense (new employees) (Statement G, Adj. 33); defined contribution retiree medical expense (Statement G, Adj. 34); Employee stock participation plan expense (Statement G, Adj. 35); active employee medical costs (Statement G, Adj. 36); and various payroll taxes (Statement G, Adjs. 57, 58, and 59).

Staff and CAD made similar payroll related adjustments to synchronize the impacted expenses with the payroll adjustments.

As described above, the Commission accepted the Staff and CAD position to limit the payroll determination to HTY hours and wage and salary levels to the known 2015/2016 increases. The Commission also accepted the Staff position to limit AIP costs to the actual HTY level. The Commission will accept the Staff payroll related adjustments identified in the Staff Ex. 1, Staff Rule 42 Statement G, Adjs. 28, 29, 30, 31, 32, 53, 54 and 55.

The Commission decision recognizes the WVAWC position to add six additional employees to the Staff position. The payroll related adjustments related to the six additional employees are included in the $450,000 Commission adjustment described above.

6. Defined Benefit Pension Valuation Costs

WVAWC proposed a reduction of the HTY pension expense of $236,584 based on the latest available information on the pension valuation report from the WVAWC actuary. Mr. Tomac stated that the WVAWC actuary calculated total pension contributions in the same manner as prior rate cases. WVAWC Ex. JST-D at 47; Tr. 10/28 at 25. Mr. Tomac indicated that the going-level pension expense was $1,015,531, a reduction of $236,584 from the HTY level, and $1,531,477 lower than the amount proposed in the 2012 Rate Case. WVAWC Ex. JST-D at 47.

Mr. Nevirauskas testified that WVAWC based its ERISA pension expense on the expected 2015 contributions, as shown on WVAWC Ex. RPN-D at attached Ex. RPN-2, titled the American Water Allocation of Pension Cost as provided by its actuary, Towers Watson. WVAWC used the total American Water contribution multiplied by the WVAWC allocation percentage, and then adjusted for the capitalization ratio, to arrive at the ERISA pension expense of $922,590. Also included in the WVAWC adjustment is the amortization of the timing difference between Service Company ERISA and FAS 87 pension costs of $92,941 (WVAWC 2008 Rate Case Order) to arrive at total pro forma pension cost of $1,015,531. WVAWC Ex. RPN-D at 6.

Staff witness Kellmeyer recommended a further downward adjustment to the WVAWC filed pension expense of $5,516 to reflect Staff's higher labor capitalization rate as described above. Staff Ex. DLK-D at 5, Staff Rule 42, Statement G, Adj. 33.

Mr. Tomac stated in his rebuttal testimony that because the Staff reduction in the WVAWC payroll expense is inappropriate, the corresponding Staff reduction in pension costs should be rejected. WVAWC Ex. JST-R at 9; WVAWC Init. Br. at 47.

Consistent with the Commission discussion and decision regarding payroll, the Commission adopts the Staff pension expense as reasonable for the determination of pension expense for rate recovery in this proceeding.

7. Miscellaneous Expenses Charged by American Water Works Service Company

Mr. Tomac summarized WVAWC's going-level American Water Works Service Company (AWWSC) charges (Statement G, Adj. 39). He stated that the adjustment is a reduction of HTY AWWSC charges of $648,055 and that the reduction demonstrates the American Water strategy to reduce Service Company costs across the business. He claimed that the going-level AWWSC fees of $12,420,461 are $1,070,587 less than the amount proposed in the WVAWC 2012 Rate Case. WVAWC Ex. JST-D at 47-48.

Mr. Baryenbruch testified that AWWSC fees do not include any profit markup and only include the actual cost of those services. WVAWC Ex. PLB-D at 6; attached WVAWC Ex. PLB-1 "Market to Cost Comparison of Service Company Charges to West Virginia American Water Company, 12 Months Ended December 31, 2014" dated April 30, 2015, at 2.

CAD witness Smith testified that the Commission should remove $128,490 of HTY AWWSC charges that he claimed do not benefit WVAWC ratepayers and are not necessary for the provision of safe, reliable water service. Mr. Smith summarized CAD adjustment C-14 that included removal of HTY AWWWC expenses for (1) Supplemental Executive Retirement Plan (SERP) and 401(k) restoration costs, (2) employee stock purchase plan expense, (3) employee award expense, (4) advertising expense, (5) community relations expense, (6) dues/membership expense, (7) relocation expense, and (8) income tax expense. CAD Ex. RCS-D at 69-73, attached Ex LA-1, Schedule C-14. He stated that the CAD adjustment removed SERP and 401(k) restoration expenses because SERPs provide supplemental retirement benefits for select executives and are generally intended to provide retirement benefits that exceed amounts otherwise limited in qualified pension and 401(k) plans by Internal Revenue Service regulations. Id. at 71-72.

Mr. Smith testified that CAD adjustment C-14 eliminated employee awards and costs for an AWWSC employee stock purchase plan. He eliminated advertising costs of AWWSC because WVAWC incurs its own advertising costs and did not justify charging West Virginia ratepayers for affiliated service company advertising. Mr. Smith eliminated community relations charges from AWWSC and AWWSC dues and membership charges because those are in the nature of corporate image building expenditures of the affiliate and are not necessary for the provision of water utility service. Mr. Smith eliminated affiliate relocation charges to WVAWC because WVAWC did not demonstrate any benefit to West Virginia ratepayers from relocating AWWSC employees. He removed income tax charged by AWWSC to WVAWC because WVAWC has its own income tax expense for ratemaking purposes and include adjustments for expenses outside the test year. He eliminated losses incurred by AWWSC on disposal of other non-operating property. CAD Ex. RCS-D at 71-73.

Staff accepted the WVAWC adjustment to reduce HTY AWWSC charges by $648,055 (Staff Statement G, Adj. 35) and an additional adjustment of $441 to reduce AWWSC advertising expense (Statement G, Adj. 68).

Mr. Tomac testified on rebuttal that many of the expenses that Mr. Smith removed from his Schedule C-14 occur in WVAWC's general course of business and are common throughout all industries. WVAWC Ex. JST-R at 18.

WVAWC argued that expenses for membership dues and community relations allow WVAWC to stay connected with the communities it serves and that employee awards and relocation expenses allow AWWSC to attract and retain talented employees. WVAWC asked that the Commission carefully evaluate the CAD adjustments. WVAWC Init. Br. at 53.

It is commendable that WVAWC has been able to reduce HTY AWWSC charges in its filing. It is also encouraging that the AWWSC charges requested in this case are substantially lower than the level requested in the 2012 Rate Case. The Commission will remind WVAWC, however, that it has the statutory burden of proof to support cost of service elements for rate recovery. CAD in this case has proposed adjustments that reduce HTY AWWSC charges that, in some cases, were not adequately addressed in WVAWC rebuttal testimony or Briefs.

The Commission has reviewed the CAD proposed adjustments to HTY AWWSC charges and will accept the following CAD adjustments that reduce AWWSC charges from the level recommended by WVAWC and Staff:

a. Eliminate $5,087 of SERP expenses. WVAWC has not demonstrated that SERP expenses that provide supplemental pension benefits to highly compensated executives are reasonable for rate recovery.

b. Eliminate $2,465 of 401(k) expenses. WVAWC has not demonstrated that 401(k) restoration costs related to supplemental benefits to highly compensated executives are reasonable for rate recovery.

c. Eliminate $12,115 of employee stock purchase plan expense. WVAWC has not demonstrated that employee stock purchase expenses for AWWSC employees are reasonable for rate recovery.

d. Eliminate $441 of advertising expense. WVAWC has not demonstrated that advertising expenses for AWWSC are reasonable for rate recovery.

e. Eliminate $32,707 of dues/membership expenses. WVAWC has not demonstrated that dues/membership expenses for AWWSC are reasonable for rate recovery. Some dues/membership expenses for AWWSC employees may normally be appropriate for rate recovery, such as dues/membership expense related to professional certification; however, WVAWC did not provide support for that consideration by the Commission.

The Commission declines to accept CAD's recommended adjustments to eliminate employee awards expense, community relation expenses, relocation expenses, gains and losses, and income tax expense. The Commission agrees with the WVAWC position that a reasonable level for employee awards expense is customary in recognition of career milestones and acceptable for rate recovery. Some reasonable level of ongoing relocation expenses for an organization as large as AWWSC is appropriate, and the Commission does not believe $14,363 is extraordinary or unreasonable. The Commission would also expect some ongoing support for community involvement programs from AWWSC employees and does not find the $1,773 amount unreasonable. The Commission does not agree with CAD that income tax expense for AWWSC should be excluded from rate recovery. AWWSC is part of the AWW consolidated tax filing and the tax liability specific to AWWSC is not embedded in the WVAWC specific income tax calculation.

8. Defined Benefit OPEB Valuation Costs

Mr. Tomac stated that WVAWC Rule 42, Statement G, Adj. 38, was determined in a similar manner as its proposed adjustment to pension expense. WVAWC seeks $1,572,921 of Other Post-retirement Employee Benefits (other than pensions) (OPEB), an increase of $1,062,272 above the HTY level. The OPEB expense level was based on the 2015 AWW valuation report expense determination prepared by the actuary firm Towers Watson. WVAWC determined its allocated portion of that expense and then adjusted that result by the capitalization ratio and WVAWC specific retiree contributions to determine the going-level OPEB expense requested by WVAWC. The WVAWC adjustment increased the HTY amount by $1,062,272, an amount that is $395,932 less than the amount proposed in the 2012 Rate Case. WVAWC Ex. JST-D at 47, WVAWC Rule 42, Statement G, Adj. 38.

Staff witness Kellmeyer recommended a downward adjustment of $9,416 to the WVAWC requested OPEB expense to reflect the Staff capitalization ratio. Staff Ex. DLK-D at 5; Staff Rule 42, Statement G, Adj. 34.

CAD witness Smith testified that the WVAWC response to data request CAD 5-E-40 stated that the total AWW OPEB expense was determined by its actuary Towers Watson and shown on Attachment 1 (2015 Towers Watson August 2015 Valuation Report-Comparison of Postretirement Benefit Cost and Cash Flows). Mr. Smith stated that the total amount was broken out between expected employer contributions and expected retiree participant contributions. CAD Ex. RCS-D at 66-67. Mr. Smith stated that the inclusion of the participant contribution amount should be disallowed because ratepayers should not be responsible for these costs. They are paid by the PBOP (OPEB) participants and not incurred by WVAWC. Mr. Smith recommended that the Commission use the employer contributions amount as the starting point to determine the WVAWC going-level PBOP expense. Mr. Smith recommended a going-level OPEB expense of $1.457 million. Id. at 67; attached Ex. LA-1; Schedule C-10 at 1.

Mr. Tomac stated in rebuttal that the OPEB expense level requested by WVAWC was correct and that the CAD adjustment had effectively eliminated the WVAWC retiree contributions twice. According to Mr. Tomac, WVAWC first determined the amount of the total 2015 OPEB expense allocated to WVAWC and then reduced that amount by the specific WVAWC retiree contributions. He explained that CAD had determined its OPEB allocation to WVAWC by starting with the total AWW OPEB expense net of retiree contributions, and then again adjusted the result by the retiree contribution specific to WVAWC, thereby effectively reducing the WVAWC expense twice for the WVAWC retiree contributions. He also disagreed with the Staff adjustment to OPEB expense to reflect the higher Staff capitalization rate. WVAWC Ex. JST-R at 9, 17-18.

The Commission will accept the Staff recommendation for Defined Benefit OPEB Valuation costs as reasonable for the determination of the cost of service in this proceeding. The Commission discussion on payroll above indicates acceptance of the Staff payroll capitalization rate. The Commission agrees with the WVAWC position that the CAD OPEB recommendation incorrectly reduces the WVAWC allocated OPEB expense twice for the same WVAWC retiree contributions and will deny the CAD adjustment (thus reducing the OPEB expense once).

9. Advertising Expense

WVAWC eliminated $2,021 of promotional advertising expense included in the HTY expense level that has historically been excluded from rate recovery. WVAWC Ex. JST-D at 48; WVAWC Rule 42, Statement G, Adj. 43. CAD did not contest the WVAWC adjustment. Staff proposed an adjustment to eliminate $8,901 of promotional advertising expense from the HTY expense. Staff Rule 42, Statement G, Adj. 39. WVAWC indicated in a post-hearing exhibit that WVAWC did not contest the Staff adjustment for promotional advertising expense. WVAWC Commission Post Hearing Ex. No. 2.

The Commission will accept the Staff adjustment to eliminate $8,901 of promotional advertising from the HTY expense as reasonable for the determination of the cost of service in this proceeding.

10. Rate Case Expense

WVAWC estimated that its rate case expense associated with this proceeding would be $861,850. Mr. Tomac testified that this amount is higher than in past cases, and includes the cost of the Depreciation Study in the amount of $70,000. The estimate assumed that the case would be fully litigated rather than resolved by settlement. WVAWC normalized the expense by adding the costs of this rate application to the costs of the two previous applications and dividing by a five-year normalization period. This resulted in a going level adjustment of $254,241. WVAWC Ex. JST-D at 49-50; WVAWC Rule 42, Statement G, Adj. 46.

Staff agreed with the WVAWC adjustment. Staff Rule 42, Statement G, Adj. 42.

CAD witness Smith testified that the WVAWC estimate of rate case expense for this proceeding was too high. He stated that the WVAWC 2012 Rate Case was resolved by settlement and, although the parties litigated the 2010 Rate Case, the costs associated with the litigated proceeding were less than half of what WVAWC proposed for rate case costs in this case. Mr. Smith provided Exhibit LA-1, Schedule C-5, showing the CAD-recommended adjustments including exclusion of $150,000 for affiliated Service Company charges, and reduction of legal expense by $48,000. In support of these adjustments, Mr. Smith stated that WVAWC had not demonstrated that the HTY AWWSC charges did not already reflect AWWSC charges for rate case preparation. Mr. Smith claimed the inclusion of the AWWSC charges in rate case expense would result in double counting of that expense. Mr. Smith used the WVAWC estimate of legal fees from its last rate case as a reference for his legal fee adjustment in this case. Mr. Smith's adjustments would reduce WVAWC's requested Rate Case expense by $39,355. CAD Ex. RCS-D at 63-64, attached Ex. LA-1, Schedule C-5.

In his rebuttal testimony, Mr. Tomac stated that the HTY AWW charges did not include any expense for rate case preparation because WVAWC did not file or prepare a rate case in the 2014 HTY. Mr. Tomac claimed that rate case preparation charges are not charged in the normal reoccurring AWW charges, but are segregated and charged only to subsidiaries that have rate case activity for that year. WVAWC Ex. JST-R at 17.

In its initial brief, Advocates for a Safe Water System (AFSWS) touched on rate case expenses by arguing that one reason WVAWC resisted disclosure of planning materials during discovery was that it could afford to litigate discovery disputes because of its ability to pass rate case expenses on to ratepayers. ASWS Init. Br. at 17, footnote 10.

WVAWC stated in its initial brief that WVAWC was correct to assume this case would be fully litigated and that Mr. Smith's use of a legal fee estimate based on a rate case filed in 2012 had no legitimate basis for rates going into effect in 2016. WVAWC Init. Br. at 52-53.

The Commission adopts the WVAWC and Staff recommendation concerning an appropriate normalized level of rate case expense for rate recovery in this proceeding. The Commission will not base the legal fees in this case on the legal fees expended in the 2012 Rate Case, a case that was completed by Settlement Agreement among the parties. This case has been fully litigated with considerable discovery, hearing and briefing. The Commission has determined that the legal fees included in rate case expense for this case are reasonable given the level of litigation required to prosecute the case. The Commission, likewise, will not eliminate the $150,000 of AWW fees charged to rate case expense. It is reasonable to expect the AWW rate personnel to assist regulated subsidiaries in the preparation of rate filings given the cyclical nature of base rate cases. The sharing of rate case expertise among the regulated subsidiaries is a common practice in large investor-owned utility organizations and avoids unnecessary and costly duplication of that expertise at each regulated utility. The Commission has determined that the $339,848 of normalized rate case expense proposed by WVAWC and Staff is reasonable and is approved in this case.

11. Uncollectible Expense

Mr. Tomac testified that WVAWC calculated a normalized uncollectible expense of $1,932,168 based on the three-year average of net write-offs to billed revenues for the period 2011 through 2013. WVAWC applied the resulting normalized ratio to going-level billed revenues at present rates to determine the $2,258,434 adjustment reducing HTY uncollectible expense. Mr. Tomac stated that WVAWC did not use write-offs to billed revenues for 2014 in the computation because uncollectible expense was abnormally high in 2014 and would have skewed the results to the detriment of customers. WVAWC Ex. JST-D at 50; WVAWC Rule 42, Statement G, Adj. 47.

Staff recommended a reduction in HTY uncollectible expense of $2,233,123. Staff accepted WVAWC's ratio of net write-offs to billed revenue, and attributed the $25,311 difference between the WVAWC and Staff adjustments to the difference in going-level revenue at present rates. Staff Ex. DLK-D at 6, Staff Rule 42, Statement G, Adj. 43.

CAD did not contest the WVAWC adjustment to HTY uncollectible expense.

In its initial brief Staff stated that WVAWC had adopted the Staff adjustment to going-level revenues for the sales to Lincoln County Public Service District and that WVAWC and Staff now agree on this adjustment to HTY uncollectible expense in the amount of $2,233,123. Staff Init. Br. at 41.

The Staff adjustment to HTY uncollectible expense is not contested and will be adopted by the Commission as reasonable for the determination of uncollectible expense in this case.

12. Tank Painting Amortization

Mr. Tomac testified that the WVAWC adjustment to amortize tank painting and inspection costs was determined consistent with tank painting and inspection cost determination in prior rate cases. WVAWC calculated the tank painting amortization expense cost by including all HTY tank painting amortization for tanks painted between 2005-2014 and including a fourteen-year amortization of three tanks and tank inspection costs that are scheduled for completion in 2015. The adjustment results in an increase to HTY tank painting amortization expense of $210,947. WVAWC Ex. JST-D at 51; WVAWC Rule 42, Statement G, Adj. 51.

WVAWC witness Brett W. Morgan described the WVAWC tank painting program in his direct testimony. He stated that WVAWC must maintain 190 above-ground water storage tanks that are critical to WVAWC operations and the safe delivery of water and fire protection. WVAWC and third parties inspect tanks in order to prioritize tank painting. Tank expenses of approximately $1.2 million annually are in addition to a significant capital spending plan. Mr. Morgan provided a list of the tanks that were painted or rehabilitated after the 2012 Rate Case and a list of the tanks that will be rehabilitated or painted in 2015 through 2017. WVAWC Ex. BWM-D at 21-24.

Staff witness Kellmeyer disagreed with Mr. Tomac's portrayal of the WVAWC tank painting adjustment (Schedule G Adj. 51) as being consistent with the methodology utilized in prior Commission Orders to determine tank painting expense. Ms. Kellmeyer claimed that, historically, the Commission has recognized a normalized tank painting expense by adjusting the last fourteen years of tank painting costs, inflating those expenditures to current values and then recognizing one-fourteenth of the normalized cost for rate recovery. Ms. Kellmeyer claimed that the method utilized by the Staff is consistent with past Commission decisions, citing the Commission decisions in the 2012 and 2010 rate cases. Ms. Kellmeyer also attached the Staff workpapers from Case Nos. 12-1649-W-42T, 10-0920-W-42T, 08-0900-W-42T, 07-0998-W-42T and 04-0373-W-42T, in support of her position that neither Staff nor WVAWC has applied an amortization methodology in prior cases in the manner proposed by WVAWC in this case. Ms. Kellmeyer recommended that the Commission use the previously-approved methodology and not include 2015 tank painting costs. Staff Ex. DLK-D at 6-7; attached Ex. DLK-3. The Staff adjustment increased the HTY tank painting expense by $118,863. Staff Rule 42, Statement G, Adj. 47.

In his rebuttal testimony, Mr. Tomac stated that the 2015 tank painting costs are known and measureable and that the only purpose of Ms. Kellmeyer's recommendation to remove 2015 tank painting costs from WVAWC's amortization schedule was to reduce the revenue requirement. WVAWC Ex. JST-R at 5. Mr. Tomac stated that removal of 2015 costs would be an outdated ratemaking treatment, contrary to NARUC best practices, and require WVAWC to operate with outdated numbers. Id. at 10. Mr. Tomac also stated that WVAWC did not capitalize tank painting costs and that Statement G, Adj. 51 reflects the same methodology as prior cases because the unrecovered tank painting expense of $11,424,211 divided by fourteen years results in a yearly amortization of $816,015. The same result comes from multiplying the monthly amortization of $68,001 times twelve. Id. at 9-10.

At hearing, Mr. Tomac stated that his calculation included the 2015 painting costs whereas Ms. Kellmeyer took the unamortized cost of tank painting over the fourteen-year historical period and inflated those costs to 2014 values. Tr. 10/28 at 46-49. Mr. Tomac did not include the projected costs for 2016, although he believes they should be included as well. Id. at 49. Mr. Tomac believes that removal of 2015 costs would delay recovery for three to four years and contribute to the inability of WVAWC to earn its authorized rate of return. Id. at 50. Mr. Tomac agreed that Ms. Kellmeyer's methodology is consistent with prior Commission Orders regarding tank painting costs, but he believes that the Commission should revise the policy to move WVAWC away from filing double-digit rate increases every two years. Id. at 51-52.

The WVAWC initial brief explained that WVAWC used the same methodology as in past cases, except that WVAWC did not inflate the unamortized deferred balances. WVAWC denied that it capitalized tank painting costs or included them in rate base, and argued that 2015 tank painting costs should be included because they are known and measurable today. WVAWC argued that its approach is consistent with past practice and includes known costs in the calculation, rather than waiting until the next rate case to recognize them. WVAWC Init. Br. at 52.

The Staff initial brief stated that Staff properly used the methodology historically recognized by the Commission as first addressed in the WVAWC 1984 Rate Case Order and consistently used through the WVAWC 2010 Rate Case. The historically recognized methodology requires a rolling fourteen-year average of tank painting expenses. Staff criticized the WVAWC argument that its 2012 rate case used post-HTY methodology on grounds that the case was settled and, therefore, should not be cited as establishing a regulatory principle. Staff Init. Br. at 39-41.

The Commission has historically recognized tank painting expense in the manner described by Staff. The Commission inflates the latest fourteen-year actual costs to current values and recognizes one-fourteenth of the adjusted costs as the normalized tank painting expense for rate recovery. WVAWC refers to the historical method as an amortization methodology, a portrayal with which Staff disagreed. WVAWC may amortize actual unadjusted tank painting costs for financial presentation under U. S. GAAP accounting. This is not, however, the method historically recognized by the Commission. The intent of the historical Commission tank painting recovery methodology is to provide WVAWC with a normalized level of tank painting based on the actual fourteen-year historical cost (adjusted to present value) and the fourteen-year tank painting cycle presented by WVAWC in numerous rate cases.

The Commission is not persuaded that we should discard this long-standing methodology. If WVAWC is painting its tanks over a fourteen-year cycle and those actual costs are inflated to present value, then historical normalization methodology will adequately compensate WVAWC for future tank painting costs. WVAWC has not provided adequate evidence that the historical normalization method is unreasonable or unfair. The Commission determines that the normalized tank painting expense recommended by Staff is reasonable and will be adopted to determine the cost of service in this proceeding.

13. Miscellaneous Expenses of WVAWC

CAD witness Smith proposed to reduce O&M expense by $19,363 by removing certain expenses for an annual water festival, a WVAWC-sponsored baseball game and costs related to television advertisements for community education on water issues that were listed in the response to CAD 7-E-058. CAD Ex. RCS-D at 82, Ex. LA-1, Schedule C-17.

In his rebuttal testimony Mr. Tomac claimed that WVAWC incurred the expenses identified by Mr. Smith to develop and support employee and community relations. He stated that the employee support and community relations activities were important to foster an engaged and productive workforce and to support local communities. Mr. Tomac described payments to West Virginia Power Baseball for an employee appreciation night. Mr. Tomac also described expenses for the WVAWC annual water festival in Charleston, an event open to all customers and the general public and that offered activities and tours at the WVAWC treatment facility. Mr. Tomac stated that television advertising educates customers on important water-related issues. WVAWC believes these expenses were for activities critical to operating the water utility business and benefitted all stakeholders. WVAWC Ex. JST-D at 18-19.

WVAWC argued in its initial brief that employee and community relations expenses are common throughout all industries and allow WVAWC to stay connected with communities it serves and to retain and attract talented employees. WVAWC Init. Br. at 53.

The Commission appreciates the WVAWC position that sponsoring activities to develop and support employee relations, community involvement and community education are worthwhile endeavors. The Commission has never said the utilities it regulates should not undertake such activities. The questions the Commission must answer, however, are whether these activities benefit customers and whether customers should pay for them. A fine line exists between WVAWC promotional activities and customer information activities. The Commission has the duty to draw the fine line and determine whether an expense should be included for rate recovery.

The Commission determines WVAWC has not met its burden of proof to show that WVAWC customers benefitted from those activities. A cursory statement that those expenses are important to employee and customer relations does not meet the test the Commission has historically placed on the utility to justify expenses for rate recovery. In future rate cases, WVAWC should explain how these types of expenses benefit customers if it wishes to recover the expenses in rates. The Commission will recognize the CAD adjustment to reduce miscellaneous expenses by $19,363, based on the record in this case as reasonable for the determination of the cost of service for rate recovery in this proceeding.

VI. CAPITAL STRUCTURE AND COST OF CAPITAL

A. Overview

The capital structure of a utility is comprised of all the sources of capital used by the utility and consists of various types of capital supporting its net utility assets (rate base). A utility capital structure will normally reflect the amount of capital acquired through borrowing (debt), the issuance of stock (common and preferred), retained earnings and other paid in capital contributions from stockholders. Other sources of utility capital, such as customer contributions, customer advances, and some deferred credits, are normally treated as a rate base offset, and are not considered a part of, or supported by the total capitalization of the utility.

A review of the capital structure for purposes of determining the cost of capital calculations normally involves examining the component parts, such as short-term and long-term debt, and both common equity and preferred equity of WVAWC's capital structure. The measurement of the ratio of individual capital components to the total capital establishes the relationship among the various capital sources for use in determining a composite weighted average cost of capital (WACC). WVAWC 2010 Rate Order at 10.

In determining the cost of capital, a regulatory commission typically uses the weighted cost of capital that it calculates using the percentage of each component of the capital structure in relationship to the total capital. The cost rates for long-term debt, short-term debt, preferred equity, and common equity are then multiplied by each component's percentage of the total capital to derive the weighted cost of capital of each component. The weighted cost for each capital component is then combined to reach a composite WACC that the regulator uses as a guide to assist in determining what a utility can earn on the cost of its investment.

The Commission uses the WACC approach, a variety of other techniques and its judgment and experience to determine a reasonable capital structure. The Commission may review historic, projected and hypothetical capital structures. The Commission determines a capital structure that (i) is reasonable, (ii) fairly balances the interests of current and future customers, the general interests of the State's economy and the interests of the utilities, and (iii) produces the lowest reasonable overall revenue requirement that maintains the financial integrity and flexibility of the utility. Mountaineer Gas Company, Case No. 11-1627-G-42T, October 31, 2012 Order at 3; W.Va. Code §24-1-1.

B. Capital Structure

Five witnesses presented evidence about the capital structure and the cost of capital: Dr. James Vander Weide and Mr. Nevirauskas for WVAWC, Mr. Smith for CAD; and Mr. Josh Allen for Staff. SWVA/WVEUG witness, Mr. Richard A. Baudino, presented testimony commenting on the Staff-recommended return on equity (RoE), but did not perform an independent analysis of RoE. Those parties advocated the following capital structures and cost rates for the various components of the capital structure:

Type of Capital	WVAWC % of Total	WVAWC % Cost Rate	CAD % of Total	CAD % Cost Rate	Staff % of Total	Staff % Cost Rate
Common Equity	46.552	10.750	42.989	9.0 or 10.0	43.300	9.490
Pref. Stock	0.181	8.930	0.282	8.920	0.243	8.930
Long-Term Debt	48.296	5.860	51.425	5.870	51.180	5.870
Short-Term Debt	4.971	1.482	5.304	0.310	5.277	0.560

Source: WVAWC Ex. RPN-D at 2-6, WVAWC Rule 42, Statement C (Rate Year), Staff; Ex. JA-D at 2-4, Appendix JA-1, Schedule 1; CAD Ex. RCS-D, Ex. LA-1, Schedule D.

WVAWC used a capital structure for the twelve months ending December 31, 2014, adjusted for permanent financing activity to be completed by March 1, 2016. That proposed permanent financing included an equity infusion of $30 million to be provided by AWW by March 1, 2016. WVAWC Ex. RPN-D at 3. The proceeds from the new common equity financing will be used to pay down the short-term debt balance that WVAWC has accumulated to fund its operations, including replacement of existing infrastructure and other capital investment expenditures through the gap period (referred to in this Order as "Transition Period") that ends at the beginning of the Rate Year, the first full year the rates will be in effect. Mr. Nevirauskas testified that after reflecting the additional $30 million of equity financing in the capital structure, the debt to equity ratio is 53.3 percent debt and 46.7 percent equity. According to Mr. Nevirauskas, this debt to equity ratio is generally consistent with the debt to equity ratios of other regulated water companies. He indicated that a capital structure with an appropriate mix of debt and equity is important in maintaining key financial ratios within ranges that will permit WVAWC to attract capital at optimum rates. WVAWC Ex. RPN-D at 2-3.

Mr. Nevirauskas testified that the debt component of WVAWC's capital structure included $25.609 million of short-term debt, or 4.971 percent of total capital, and was calculated using the thirteen-month average short-term debt balance for the HTY. WVAWC long-term debt consisted of 48.30 percent of the capital structure, with an effective cost rate of 5.860 percent. Id. at 3-5; WVAWC Rule 42, Statement C (Rate Year).

Staff used the actual capital structure at December 31, 2014, as the starting point for the determination of the capital structure. Staff Ex. JA-D at 2. Mr. Allen testified that, as of December 31, 2014, WVAWC had 1) a long-term debt balance, net of unamortized debt costs and sinking funds balance, of $248,336,769; 2) a preferred stock net of unamortized issue expense and sinking funds balance of $1,177,400; and 3) a common equity balance of $210,105,179. WVAWC average daily balance of short-term debt for the HTY ending December 31, 2014, was $25,607,420. Mr. Allen proposed a capital structure that would consist of 5.28 percent short-term debt, 51.18 percent long-term debt, 0.24 percent preferred stock and 43.30 percent equity. Id. at 3; Ex. JA-D, Appendix JA-1, Schedule 1.

CAD witness Smith used the actual capital structure of WVAWC as of December 31, 2014, with the same long-term debt and preferred stock cost rates proposed by WVAWC. He recommended a short-term debt rate of 0.31 percent. He provided two presentations of the WACC, one using 9.0 percent RoE and the other using 10.0 percent RoE, but admitted that he had not prepared or provided any specific testimony in support of those RoEs. Mr. Smith proposed a 6.95 percent overall WACC for the 9.0 percent RoE presentation and a 7.36 percent overall WACC for the 10.0 percent RoE presentation. CAD Ex. RCS-D attached Ex. LA-1 at Sch. D, p. 11 of 36.

The Staff and CAD capital structure recommendations did not consider the WVAWC Transition Period or Rate Year adjustments to the capital structures, including the $30 million equity infusion from AWW.

In rebuttal testimony, Mr. Nevirauskas argued that the Staff-recommended 43.3 percent equity ratio did not reflect the level of equity that will be in place to support the

Transition Period or Rate Year capital investment included in the WVAWC Rule 42 Addenda. According to Mr. Nevirauskas, WVAWC invested $87 million for utility plant additions after the end of the HTY, and a 43.3 percent equity capital structure would give no value to this investment. WVAWC Ex. RPN-R at 4.

Capital structures can and do change from time to time, and at any point in time a single snapshot of capital structure may not represent a reasonable expectation of the capital structure over an extended period of time. As the Commission has stated in other decisions, the capital structure utilized by the Commission to establish rates in any case should closely approximate the ratios of the capital structure components that will be in place during the first year the rates will be in effect in order to finance the rate base that the Commission authorizes in this case. 2014 APCo Order at 15. As explained below, the Commission has determined an appropriate rate base using the post HTY capital investment through the beginning of the Rate Year. The Commission is adopting an approach to rate base in this case that is slightly different from the approach used in the last contested rate case of WVAWC, the 2010 Rate Case. The Commission does not believe that the capital structures proposed by WVAWC, Staff and CAD reasonably reflect the capital structure components that will be in place to fund that level of post HTY rate base recognized in this case. The Commission has determined a different capital structure that better matches that rate base approach.

The Commission started with the WVAWC actual capital structure at December 31, 2014. The Commission adjusted the December 31, 2014 actual capital structure short-term balance by adding $28.457 million of short-term debt that matches the additional net rate base for the Transition Period included in the Commission determination of rate base at the beginning of the Rate Year. These adjustments resulted in total capital that closely approximates the level of rate base authorized for rate recovery in this Order. The Commission made a final adjustment to reflect the $30 million of additional equity financing and a corresponding reduction to the resulting short-term debt balance.

After reflecting these adjustments, the resulting capital structure is 6.470 percent short-term debt, 47.503 percent long-term debt, 0.19 percent preferred stock, and 45.838 percent common equity. That capital structure is attached to this Order at Appendix E, and is a reasonable capital structure for determining the appropriate cost of capital in this case and provides a proper matching of the capital component ratios that will fund the rate base authorized in this case.

C. Cost of Short-Term Debt

Mr. Nevirauskas testified that the AWWSC treasury department projections support the WVAWC interest rate of 1.482 percent for short-term debt. WVAWC Ex. RPN-D, Ex. RPN-1.

The Staff-recommended cost rate for short-term debt was 0.56 percent. Mr. Allen based his short-term debt cost rate on the average of the April, May and June 2015 short-term interest rates, the most recent available information for witness Allen's calculation. Staff Ex. JA-D at 4 and Appendix JA-1, Sch. 1, Sheet 3 of 4. Mr. Allen stated that the use of the most recent cost information available allows an adjustment to HTY short-term debt expense for post HTY known and measurable changes.

The CAD recommended cost rate for short-term debt was 0.310 percent, but Mr. Smith did not explain the determination of his cost rate.

The Commission adopts the Staff recommendation of a 0.56 percent short-term interest because it is based on the latest information available at the time of the evidentiary hearing and results in a reasonable short-term debt rate for determining the appropriate cost of capital in this case.

D. Cost of Long-Term Debt

The Staff- and CAD-recommended long-term debt cost rates were nearly identical to WVAWC's (5.87 percent respectively as compared with 5.86 percent). WVAWC Ex. JST-D at 8, WVAWC Statement C Rate Year at 2; Staff Ex. JA-D at 4; CAD Ex. RCS-D, attached Ex. LA-1, Schedule D. Mr. Allen agreed with WVAWC that the long-term debt cost rate calculation should also include the amortization of the long-term debt issuance cost of $228,370 per year. Based on his calculation, Mr. Allen recommended that the Commission fix the weighted cost of long-term debt at 5.87 percent. Staff Ex. JA-D at 4.

The long-term interest rates recommended by the parties in this case are nearly identical, separated by only one hundredth of one percent. The Commission, therefore, adopts the Staff and CAD recommendation for a 5.87 percent long-term debt interest rate for determining the appropriate cost of capital in this case.

E. Cost of Preferred Stock

Because the cost of preferred stock is largely a contractual commitment, it is not surprising that WVAWC, Staff and CAD recommended nearly identical preferred stock cost rates. Each preferred stock cost rate calculation included the preferred dividends paid by WVAWC and the amortization of issuance cost in determining the cost rate. WVAWC proposed a preferred stock cost rate of 8.93 percent; Staff proposed a cost rate of 8.93 percent; and CAD proposed a cost rate of 8.92 percent. WVAWC Rule 42 (Transition Period), Statement C, Staff Rule 42, Statement C, and CAD Ex. RCS-D, Ex. LA-1, Schedule C-3. The Commission adopts the WVAWC and Staff recommendation of 8.93 percent as the appropriate preferred stock cost rate for determining the appropriate cost of capital in this case.

F. Return on Equity

Both the United States Supreme Court and the West Virginia Supreme Court of Appeals adhere to the regulatory maxim that utility rates should allow a public utility the opportunity to earn a level of revenue sufficient to attract capital in the competitive capital market, balanced with the interests of the consuming public in receiving fair and reasonable rates. Bluefield Water Works v. Public Service Commission, 320 U.S. 679

(1923); Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S. Ct. 281 (1944); Permian Basin Area Rate Cases, 390 U.S. 747, 88 S. Ct. 1344 (1968); Monongahela Power Company v. Public Service Commission, 276 S.E.2d 179 (W.Va. 1981). The Commission has said that it uses that guidance and its best judgment to assess the record to determine a reasonable RoE that allows the utility a level of revenue sufficient to attract capital in the competitive market, while balancing the interests of ratepayers in receiving fair and reasonable rates. Black Diamond Power Company, Case No. 12-0064-E-42T, Order at 5 (August 10, 2012); WVAWC 2010 Rate Order at 15.

Although the goal of utility ratemaking is easy to state, calculation of the appropriate cost of common equity is not as easy to derive, and is frequently based on informed judgment. Witnesses presenting testimony on the cost of common equity capital frequently use the same or similar methodologies but end at significantly different results. The Commission has noted in the past that

> [A]ll of these methods represent artful analyses rather than exact science and none of them can be said to produce a finite 'correct' answer to the exclusion of the others. These studies are useful in providing data that is susceptible to interpretation, but the ultimate answer regarding investor expectations must rely heavily on the judgment of the Commission.

Appalachian Power Company, Case No. 91-026-E-42T, November 1, 1991 Order at 4.

We recently stated that the data that underlie the recommendations of RoE witnesses must be evaluated and judged carefully and practically, based on our judgment of the methods used by expert witnesses, the data presented by those witnesses and the current market conditions. There is no absolute, correct answer for RoE, even though the determination of a reasonable RoE involves calculations on a mass of data presented by expert witnesses. The fair RoE result lies within a zone of reasonableness that is framed by the evidence, including the testimony and exhibits of various witnesses. The final determination of RoE, however, rests with the Commission based on our judgment and the application of regulatory principles and policies that have been used by this Commission. WVAWC 2010 Rate Order at 18.

WVAWC filed its case seeking an RoE of 10.75 percent. WVAWC witness on RoE, Dr. Vander Weide, provided fundamental analyses of the economic and legal principles regarding the determination of RoE and the business and financial risks applicable to WVAWC as part of the water utility industry. WVAWC Ex. JVW-D at 5-16. He then estimated the RoE by applying the Discounted Cash Flow (DCF), the Capital Asset Pricing Model (CAPM), and the Risk Premium (RP) approach, to groups of comparable risk, publicly-traded water and natural gas companies. Id. at 17-47. Dr. Vander Weide's RoE range was 9.8 percent to 11.1 percent. Id. at 48.

Staff was the only other party to perform a cost of equity analysis. Mr. Allen recommended an RoE based on the application of the DCF and CAPM to a sample group of nine water utilities that have actively traded stock and are reflected in the Value Line Water Utility Industry section. Staff Ex. JA-D at 6. The Staff analysis produced an average RoE of 9.04 percent using the DCF methodology and 9.95 percent using the CAPM methodology. Staff then calculated an average of those two measures to arrive at the Staff RoE recommendation for RoE of 9.49 percent. Mr. Allen also produced an analysis using the Staff cost of service elements and his recommended capital structure and cost of capital to produce interest coverage ratios that he says test the reasonableness of his RoE recommendation. Staff Ex. JA-D at 12, Appendix JA-1, Schedules 2, 3, 4, 5, and 6.

The DCF model is based on the dividend discount model of financial theory that holds that the value (price) of any security is the discounted present value of all future cash flows. This financial theory assumes that an investor buys a share of stock to receive a string of dividend payments plus capital appreciation when that stock is sold and the market price of the stock is adjusted to the required return that compensates investors for the level of risk associated with that investment. The discount rate that makes the future anticipated dividends and future anticipated selling price equal to the current market price is the cost of equity. The purpose of the DCF model is to capture that cost of equity based on the market data inputs used in the model. WVAWC Ex. JVW-D at 18-21; Staff Ex. JA-D at 6.

Dr. Vander Weide's DCF analysis incorporated a variety of projected earnings growth estimates added to the current yield for each of the companies in his water and natural gas sample groups. He relied primarily on analyst projected earnings as reported by I/B/E/S because of considerable empirical evidence that investors use widely available forecasts by analysts to estimate future earnings growth. Because of the generally small market capitalization of the investor-owned water utility sector and the limited number of analysts following that industry, Dr. Vander Weide also used Value Line future earnings projections in his analysis (WVAWC Ex. JVW-D at 23-25) and the latest available information to determine a quarterly average of stock prices. He also allowed a five percent flotation cost. Id. at 26-28.

Dr. Vander Weide's water sample group consisted of nine publicly traded water utilities that: (i) pay dividends, (ii) did not change dividend policy in the last two years, (iii) have an analyst's long-term growth forecast, (iv) are not the subject of a merger, and (v) have a Value Line safety rank of three or better. He also selected a sample group of local distribution company (LDC) gas utilities for application of the DCF calculation because (i) of his concern for the small sample of investor-owned water utilities and the large variance in market capitalization for the water sample group, (ii) the gas LCDs are a conservative proxy for the risk of investing in an investor-owned water utility, and (iii) it is useful to examine the cost of equity of companies with similar risk to test the reasonableness of the water sample group DCF result. The results of his DCF calculations produced a market weighted average RoE for both the water and gas LDC sample groups of 9.8 percent. Id. at 28-33.

The CAPM is a risk premium (RP) approach to cost of equity analysis where a premium is added to the risk-free rate to estimate the cost of equity capital. The premium is the difference between the market return, estimated on either an historical basis, *ex poste*, or on a projected basis, *ex ante*, and the risk free rate. The CAPM model requires a determination of the risk for each sample company, called the "beta," that is a measurement of the relative movement (and relative risk) between a particular stock and the movement of the entire market. A company that experiences an exact correlation to the volatility of the market has a beta of 1.0, while a company that only changes by half of the market volatility has a beta of 0.5. Multiplying the market return premium by the company specific beta and adding it to the risk-free rate produces a CAPM estimate of the RoE. Dr. Vander Weide, Tr. 10/28 at 140-142.

Dr. Vander Weide determined the market premium for one of his CAPM analysis using the total return on the S&P 500 index from 1926 to 2014 (12.05 percent) less the income return on 20-year U.S. Treasury bonds over the same period (5.08 percent), arriving at a risk premium of 6.97 percent, rounded to 7.0 percent (12.05-5.08). He then added the current projection for 20-year Treasury bond rates (4.4 percent) to the beta adjusted risk premium (5.1 percent) and a 0.15 percent flotation cost to arrive at a CAPM result of 9.7 percent. Dr. Vander Weide also performed a CAPM analysis using a DCF calculation for the S&P 500 companies to arrive at the market return (12.4) and a risk premium of 8.0 percent. The beta adjusted risk premium of 5.85 percent was then added to the current projection for 20-year Treasury bond rates (4.4 percent) and a 0.15 percent flotation cost to determine an RoE of 10.4 percent. Id. at 41-46. Dr. Vander Weide stated that he gives little weight to the results of the CAPM analysis when the beta of the sample group is significantly less than 1.0 and the market capitalization of the sample group is small because financial research provides strong support to conclude that the CAPM underestimates the cost of equity for companies meeting those criteria. Ex. JVW-D at 47.

For his third cost of equity calculation, Dr. Vander Weide presented an RP approach that determined the additional risk that investors require to forgo the relative safety of bonds in order to bear the greater risks associated with owning common stock. He presented both *ex poste* and *ex ante* risk premium calculations. Dr. Vander Weide used a sample group of gas LDCs with similar or lower risk than the water sample group for his RP calculations because there are few water utilities with sufficient data extending back for a reasonably long study period. His *ex ante* approach determined risk premium for the difference between the monthly DCF expected returns and A-rated utility bonds for the LDCs from 1998 to January 2015 (5.0 percent) and added the current projected A-rated utility bond rate (6.1 percent) to determine an RoE of 11.1 percent. His *ex poste* approach determined risk premium for the difference between both the S&P index return and S&P gas LDC index from 1937 and 2014 (4.7 percent and 3.9 percent respectively) and added the projected A-rated utility bond rate (6.1 percent) to the average market premium of 4.3 percent to determine a RoE of 10.6 percent. Id. at 34-41.

The Staff DCF analysis examined a sample group of nine investor-owned water utilities. The projected dividends were determined for each sample company based on the forecast of dividends for the next twelve months as shown in the Value Line Investment Survey of September 18, 2015. The stock price for each sample company was determined based on the average daily closing prices for the thirteen-week period ending September 18, 2015. The projected annual dividend was divided by the average price to determine the dividend yield used in the DCF calculation. To estimate the appropriate growth rate, Staff examined various measures of growth, on both an historical and projected basis, for dividends per share and earnings per share. The projected and historical dividend growth rates for each sample group company was obtained from the July 17, 2015 Value Line, and the analysts projected earnings per share growth rates for each sample company was obtained from the September 19, 2015 Value Line. Staff added the individual growth rates to the individual dividend yields of the sample companies. Those steps produced multiple DCF results. In order to remove outliers, Staff applied a first screening test and eliminated any DCF result lower than the 3.85 percent cost for the 2013 long-term debt issued by WVAWC. Additionally, Staff eliminated any results that exceeded 300 basis points above or below the average DCF RoE result. The Staff outlier removal process eliminated fourteen growth outliers. Staff Ex. JA-D at 8. After outlier adjustment, Staff calculated the average growth rate as 6.20 percent that, when added to the average dividend yield of 2.64 percent, produced a DCF cost of equity of 9.04 percent. Staff Ex. JA-D at 5 8, Appendix JA-1, Schedule 2.

Staff also produced an analysis of RoE based on the CAPM methodology. Mr. Allen explained that he used the historical short-term Treasury bill rate as the risk-free rate because the Commission has stated its preference for using the short-term Treasury bill in the application of the CAPM. Mountaineer Gas Co., Case No. 11-1627-G-42T, October 2, 2012 Order at 12-13 (2011 Mountaineer Gas Case). However, because the current short-term Treasury bill is so low and more influenced by the Federal Reserve policy than market conditions, he relied on only the average historical short-term Treasury bill rate as determined for the period 1926-2014 and as published in Stocks, Bonds, Bills and Inflations Evaluation 2015 Yearbook as the risk-free rate in the CAPM. He also determined a market premium for the same 1926-2014 historical period and adjusted that by the beta for each sample group company. The result of this CAPM approach produced an RoE of 9.95 percent for the sample group. Mr. Allen presented no rebuttal testimony to the RoE testimony of Dr. Vander Weide.

Although WVEUG witness Baudino did not provide a cost of equity analysis or address RoE in his direct testimony, he criticized the Staff RoE recommendation as too high. He took exception to the Staff reliance on a CAPM based only on historical risk free rates. Mr. Baudino recognized, as did Dr. Vander Weide, that controversy surrounds the use of the CAPM methodology in estimating RoE, particularly regarding the relationship of market beta verses the actual risk of a company in relation to the total market. He also pointed out that substantial judgment is required to estimate the required broad based market returns.

Mr. Baudino did not support determining market returns by relying only on S&P and Value Line stock market return information. WVEUG/SWVA Ex. RAB-R at 7-10. Mr. Baudino criticized the Staff DCF calculation and recommended that historical growth rates not be considered because return on equity analysis is founded on a forward looking process. He recommended that the Staff DCF, adjusted as he suggested, would result in an 8.88 percent RoE and a $2.16 million reduction to the Staff recommended rate increase.

In his rebuttal testimony, Dr. Vander Weide criticized the inclusion of historical growth factors in the Staff DCF because the fundamental theory behind the DCF methodology is based on future, not past, earnings. He criticized the use of projected dividend growth for the water sample companies. DCF theory is based on a constant growth factor where, over time, earnings per share, dividends per share and book value per share all grow at a constant rate. Dr. Vander Weide pointed out that the current projected earnings for water utilities is 6.94 percent while projected dividends are expected to grow at 5.94 percent, a 100 basis point difference. He claimed this variance relates to the expectation that dividend payout ratios will decline, thus distorting the constant growth relationship between earnings and dividend growth estimates as described above. The distortion created by changes in dividend policies is the reason that substantial levels of research literature support earnings growth as the best proxy for investor growth expectations to be used in the DCF model. He also criticized the Staff analysis for not including flotation costs and for not weighting the DCF results based on the market capitalization for each individual company in the water sample.

Dr. Vander Weide criticized Staff for giving equal weight in the average RoE determination to the six water utilities with market capitalization under $1 billion (and that only included 15 percent of the total sample market capitalization of the water sample) as it gave to the three largest water utilities (that include 85 percent of the market capitalization). Dr. Vander Weide stated that giving equal consideration to each company's RoE result, regardless of market capitalization, created a significant downward bias that should not occur in the portfolio DCF approach. Although Dr. Vander Weide did not take exception to the historical CAPM approach used by Staff, he did emphasize that the downward bias in the CAPM for betas lower than one and the recommended premium for smaller capitalization, like WVAWC, would apply to the Staff CAPM calculation. Dr. Vander Weide's final criticism of the Staff RoE recommendation related to the lack of recognition of the additional financial risk of WVAWC presented by the low equity ratio (43.3 percent) included in the capital structure recommended by Staff in relation to the equity ratio (57.39 percent) for the sample water utilities. WVAWC Ex. JVW-R at 1-18

During the hearing, Mr. Allen was asked if the his DCF results would have been higher if he had not performed the second outlier elimination process that eliminated the average growth rates from the DCF average for results that produced results 300 basis points over or under the average DCF RoE result. Mr. Allen agreed with the calculus presented in WVAWC Cross Ex. 1 and 2. He also agreed that the Commission Order in the 2011 Mountaineer Case did not include a finding of fact or conclusion of law that the Commission had accepted the Staff approach of eliminating outlier results in the DCF calculation for individual sample group results above or below the average DCF based RoE result. Tr. 11/2 at 26-37.

At the hearing, the Commission requested that Mr. Allen file a post-hearing exhibit showing a recalculated market-weighted average DCF result. Mr. Allen filed that exhibit and, with the qualification that Staff did not agree with the WVAWC methodology, the exhibit reflected a market weighted average DCF result of 10 percent. Mr. Allen explained that if the DCF results had been presented to the nearest hundredth, as done in Staff Ex. Appendix JA-I, Schedule 2, Staff would have calculated a market-weighted average DCF of 10.06 percent. Using the market capitalization numbers found in Dr. Vander Weide's direct testimony, a market-weighted average DCF of 10.05 percent would have been calculated using Staff's DCF results rounded to the nearest hundredth. Mr. Allen also verified in the post-hearing exhibit that no mathematical errors were made on Dr. Vander Weide's Schedule 2. However, a market-weighted average DCF with a flotation cost allowance of 10.16 percent would have been calculated if the DCF results were presented to the nearest hundredth, as done in Staff Ex. Appendix JA-1, Schedule 2. Using the market capitalization figures from Dr. Vander Weide's direct testimony, Staff calculated a market-weighted average DCF of 10.15 percent rounded to the nearest hundredth. Staff post-hearing Exhibit 1.

The DCF method has long been one of the methods relied on by the Commission when determining a reasonable RoE. Both of the cost of equity witnesses presented various DCF analyses. WVAWC DCF results for both the water and gas LDC sample groups were 9.8 percent. Staff produced an average DCF result of 9.04 percent, and WVEUG/SWVA, in rebuttal to Staff, recommended a DCF equity cost estimate of 8.8 percent.

The Commission is curious about the Staff outlier elimination process and the failure to weight for market capitalization (discussed above). We understand the bottom of the range as described above, but Staff has not adequately explained why 300 basis points above the average RoE should be accepted as the top of the acceptable RoE range. The basic tenets of finance dictate that equity capital carries more risk than long-term debt. The Commission agrees that eliminating any result of an RoE estimate that is below the current cost of long-term debt, plus the minimum risk premium for common equity capital, is reasonable and in full compliance with financial theory. The Commission, however, does not appreciate the basis or analysis for the elimination of RoE results that are 300 basis points above or below the average RoE for the sample group in a portfolio approach. We expect the sample group to include some results near the lower end of the acceptable RoE range and others at the high end of the acceptable range. The average, therefore, could be argued to be the reasonable result. In the next rate case in which Staff presents a cost of equity capital analysis and recommendation, we hope Staff will explain why 300 basis points above the sample group average RoE result is the top of the acceptable range for RoE to be included in the sample group result.

The Commission considers CAPM a valuable tool in evaluating the range from which to determine a reasonable RoE. The CAPM compares the risk adjusted RoE result to alternative utility investments, and provides the Commission with a basis to compare the reasonableness of the DCF results. Both rate of return witnesses presented CAPM RoE estimates. Dr. Vander Weide produced both an Historical CAPM and a DCF Based CAPM that resulted in RoE recommendations of 9.7 percent and 10.4 percent, respectively. Dr. Vander Weide indicated, however, that he relied little, if any, on the CAPM results because of the perceived downward bias resulting from reliance on low beta risk for the sample group and the small capitalization of the water sample group.

The Staff CAPM analysis produced an average CAPM RoE estimate of 9.95 percent utilizing an *ex poste* approach that incorporated historical market premiums and the average historical risk-free rate for U.S. Treasury bills. In light of the actions by the Federal Reserve to keep short-term interest rates at record lows to stimulate the economy, it is not realistic to rely on current short-term treasury rates as the risk-free rate. We think that the current treasury market is driven more by government intervention than market bidding, and we find the Staff *ex poste* approach reasonable.

The Commission has reviewed all of the evidence, testimony, arguments, and briefs and has considered cases cited by the parties, and past decisions of the Commission. The recommendations of expert witnesses on cost of common equity are useful as guides, but the determination of an appropriate cost of common equity must rest principally with the best judgment of the Commission.

Based on our review of the record presented in this case, and applying the Commission judgment and expertise in this area, the Commission determines that an RoE of 9.75 percent is reasonable, falls within the range of reasonable RoEs presented by the parties, fairly balances the interests of WVAWC and its customers and meets the standards set forth by the United States Supreme Court and the Supreme Court of Appeal of West Virginia.

G. Summary of Capital Structure and Cost of Capital

Based on the discussion and determinations described above concerning the capital structure, cost of debt, preferred stock and RoE, the Commission determines that an overall weighted cost of capital of 7.311 percent is reasonable for establishing rates in this proceeding and fairly balances the interests of WVAWC and its customers. A schedule showing the capital structure and cost of capital determinations of the Commission is provided in Appendix E attached to this Order.

VII. FEDERAL INCOME TAX EXPENSE

In the 2014 APCo Order, the Commission addressed a change in the application of a consolidated income tax adjustment (CTA) for determining current federal income tax (FIT) expense for utility subsidiaries that are part of a consolidated federal income tax return arrangement. In that case, the Commission abandoned its more recent CTA methodology based on an effective FIT rate that embedded all taxable losses for subsidiaries with taxable losses in a consolidated filing group to arrive at an effective FIT rate. 2014 APCo Order at 66-68.

The CTS effective FIT rate used by the Commission prior to the 2014 APCo Order was calculated by dividing consolidated FIT payments made to the IRS by the total positive taxable income of the consolidated tax filing group. The effective FIT rate methodology has historically been referred to as the consolidated tax savings (CTS) approach. The CTS approach resulted in an effective FIT rate that was lower than the thirty-five percent statutory FIT rate. The lower CTS FIT rate was then applied to the taxable income of the regulated West Virginia utility to determine current FIT expense.

Prior to Monongahela Power Co/Potomac Edison Co, Case No. 06-0960-E-42T, Order dated May 22, 2007 (2007 Mon Power Order), the Commission had limited the taxable losses included in the CTS effective FIT rate calculation to only the parent company losses included in the consolidated federal income tax return. This CTS methodology was referred to as the parent company loss adjustment (PCLA) CTS approach. In the 2014 APCo Order, the Commission decided to discard the CTS approach that included all taxable loss subsidiaries in the CTS calculation and returned to a CTA that only included the PCLA. The Commission also determined that it would no longer apply the CTA through and effective FIT rate, but instead would apply the CTA though reduction to the regulated West Virginia utility taxable income for its allocated share of the PCLA and determine the resulting current FIT expense using the statutory thirty-five percent FIT rate. 2014 APCo Order at 66-68.

Based on the record in this case, WVAWC and Staff have followed in this case the PCLA approach authorized in the 2014 APCo Order. CAD recommended that the Commission return to the CTS effective FIT rate approach used prior to the determination in the 2014 APCo Order. The Commission will address the issues concerning the appropriate method for determining federal income tax expense raised by the Parties to this case. The Commission will not, however, repeat here the lengthy discussion included in the 2014 APCo Order, but may refer to that Order where appropriate.

WVAWC filed this case prior to the issuance of the 2014 APCo Order, and in its original filing in this case, WVAWC determined current FIT expense using the CTS approach used by the Commission prior to the method authorized in the 2014 APCo Order. WVAWC later amended its case to reflect the PCLA approach authorized in that Order. WVAWC Ex. RPN-R at 5.

1. WVAWC Direct Testimony

Mr. Nevirauskas filed direct testimony addressing the level of federal income tax (FIT) and state income tax expense included in the WVAWC rate filing. He stated that the statutory FIT rate for corporations is thirty-five percent, but that the application of a consolidated tax adjustment (CTA) used by the Commission in prior WVAWC rate cases, reduced the WVAWC effective tax rate to 32.03 percent. WVAWC focused on its likely taxpayer position in the Rate Year and utilized a "trending" analysis, first used by the Commission in the 2010 Rate Case, to derive an effective tax rate. Mr. Nevirauskas expressed concern about using a CTA adjustment that limits full recovery of FIT expense. WVAWC Ex. RPN-D at 8. WVAWC continued to advocate for restoration of the parent company loss adjustment (PCLA) approach instead of continuing the CTS approach. Id. at 9-11.

Mr. Nevirauskas stated that WVAWC is a member of the AWW consolidated federal income tax filing group (Consolidated Group). Members record FIT expense, make payments of FIT liabilities to the Consolidated Group, and receive refunds when applicable, at the thirty-five percent statutory tax rate, as if they were a stand-alone federal income tax entity. He explained that utility holding companies and other multi-subsidiary corporations typically file consolidated returns. The benefits of doing so include administrative savings and the immediate receipt of refunds when a company has a taxable loss. Absent the use of a consolidated return, a standalone company with a taxable loss must await the conclusion of a loss carry back/forward process before receiving a refund. WVAWC Ex. RPN-D at 9-10.

Although Mr. Nevirauskas advocated the PCLA approach, he stated that to present a fair picture of the Rate Year FIT expense under the trending approach, WVAWC made three adjustments to the historical period income tax data , (i) elimination of the impact of excess tax over book depreciation in order to eliminate a possible violation of IRS normalization regulations; (ii) normalization of the impact of American Water's election to take advantage of tax deductions arising from a tax accounting change relating to the capitalization of certain repairs (Capitalized Repairs Deduction); and (iii) removal of the impact of losses of other AWW regulated companies. WVAWC arrived at a 32.03 percent FIT rate utilizing the calculations and the prospective trending analysis shown in WVAWC Ex. RPN-3 at 1. WVAWC Ex. at 8-9, 13-14, attached Exhibit RPN 3.

Mr. Nevirauskas explained that WVAWC normalized the impacts of current tax deductions for excess tax over book depreciation and capitalized repairs as historically recognized by the Commission. Through normalization accounting a current deferred FIT expense is recognized for rate recovery at the statutory thirty-five percent FIT rate in the income tax expense provision and a corresponding adjustment is reflected for the current deferred income tax as shown on Statement B, Schedule 13, of the HTY Rule 42 exhibit, the Addendum, and the Rate Year Filing for the water case. WVAWC reflected \$4.7 million, \$7.1 million, and \$5.2 million, respectively, as a reduction to rate base (credit to ADITs) for those deferred federal and state income tax impacts. WVAWC Ex. RPN-D at 14.

Mr. Nevirauskas stated that WVAWC incorporated into its revenue requirement the 6.5 percent state income tax rate that was effective January 1, 2014. WVAWC Ex. RPN-D at 15.

2. Staff Direct Testimony

Staff witness Kellmeyer stated that the Staff had several differences from the CTS effective FIT rate approach included in the WVAWC original filing. Staff followed the Commission PCLA approach discussed in the 2014 APCo Order and determined its current FIT expense using the PCLA approach. Application of the PCLA approach resulted in an increase to the WVAWC standalone taxable loss by its pro rata share (\$953,335) of the parent company taxable loss. Staff then applied the statutory tax rates of thirty-five percent for federal income tax and 6.5 percent for state income tax. The second difference between the WVAWC and Staff income tax calculation related to WVAWC's failure to include the statutory deduction for ADR cost of removal (\$8,873,464) in the determination of going-level taxable income. Ms. Kellmeyer stated that WVAWC Statement G, Adj. 62 reduced bonus depreciation by \$7,527,379 that should have resulted in (and in fact did result in) a decrease in statutory deductions and an increase in current taxes and a decrease in deferred taxes for excess depreciation. Staff Ex. DLK-D at 8.

3. CAD Direct Testimony

CAD witness Smith utilized a CTS effective FIT Rate approach to determine the current FIT expense included in his overall revenue requirement recommendation. Mr. Smith testified that consolidated returns lower income tax liabilities through the netting of gains, losses and credits for all subsidiaries prior to calculating the income tax owed for the consolidated tax filing entity. He also stated that tax losses generated by subsidiaries are offset against the income of other subsidiaries and parent company debt generates tax deductible interest that lowers the tax liability of the group as a whole. Profits of the subsidiaries provide the source of funds for the payment of taxes. Therefore, the goal is to determine WVAWC's proportionate share of the consolidated tax based upon its positive taxable income. CAD Ex. RCS-D at 49.

In determining the CTS effective FIT rate, Mr. Smith included the adjustments to eliminate excess tax over book depreciation and capitalized repairs to avoid normalization issues, but did not exclude the taxable losses of other AWW regulated subsidiaries in the CTS calculation citing the Commission decision in the WVAWC 2010 Rate Case Order. He also did not include the trending adjustment of historical effective FIT rates as addressed in the WVAWC 2008 Rate Case Order as proposed in the WVAWC FIT rate of 32.03 percent included in its original filing. As shown on Exhibit LA-1, Schedule C-3, CAD recommended an effective FIT rate of a 28.91 percent based on the average of the 2010-2014 AWW tax return data. CAD Ex. RCS-D at 47-48, 55-57.

Mr. Smith acknowledged that he was aware of the recent Commission decision to modify the CTS effective FIT rate approach in the 2014 APCo Order, but decided not to use the modified PCLA approach. Mr. Smith testified that the WVAWC situation in this case is different from the APCo/WPCo situation. Mr. Smith claimed that, notwithstanding the 2014 APCo Order modification to the historical CTS approach, the CTS effective FIT rate approach should be continued for WVAWC to counteract the AWW decisions not to allow WVAWC to claim bonus tax depreciation in years 2011 and 2013. CAD Ex. RCS-D at 48. Specifically, Mr. Smith claimed that APCo/WPCo utilized all available tax deductions each year, including bonus tax depreciation, while WVAWC opted out of bonus depreciation in 2011 and 2013. Mr. Smith stated that AWW opted out of bonus depreciation to avoid losing the ability to claim net operating loss carry-forward deductions and charitable contribution carry-over deductions. Mr. Smith claimed that as a consequence of the AWW decision, the WVAWC ADIT balance is lower and its net rate base is higher than if bonus depreciation had been utilized in 2011 and 2013, and, therefore, the AWW decision is detrimental to ratepayers. Id. at 54-55.

4. WVAWC Rebuttal Testimony and Cross-Examination

Mr. Tomac's testified that if the Commission had issued its Order in the 2014 APCo Case prior to the date that WVAWC filed its direct testimony, WVAWC would have used the Commission modified PCLA methodology to calculate its current FIT expense. He claimed the current FIT expense calculated using the PCLA approach is, ironically, close to the current FIT expense calculated using the 32.03 percent effective FIT rate proposed in the original WVAWC filing. WVAWC Ex. JST-R at 15.

Carl R. Meyers, Director of Tax for AWWSC, addressed the Staff and CAD positions on income taxes. He described the 2014 APCo Order as a Commission directive to calculate tax savings for federal income tax expense purposes using a PCLA approach instead of a trended calculation incorporating the losses of other affiliates. Mr. Meyers prepared a new calculation of FIT expense of $8.4 million based on the PCLA approach. WVAWC Ex. CRM-R at 1, attached WVAWC Ex. CRM-1.

Mr. Meyers stated that the Staff and WVAWC calculation differed because the WVAWC PCLA calculation of its pro rata share of the parent company losses was $718,618, rather than the $953,335 calculated by Staff, a difference of $234,717. WVAWC Ex. CRM-R at 1, attached WVAWC Ex. CRM-1 at line 55. In addition, Mr. Meyers incorporated actual 2014 tax return results for the three years included in his average. Mr. Meyers stated that WVAWC agreed with errors pointed out by Staff that in the WVAWC federal and state tax expense schedules. Mr. Tomac provided corrected calculations in Exhibit JST-2 attached to his rebuttal testimony. WVAWC Ex. CRM-R at 2.

Mr. Meyers also stated that another difference between the WVAWC and Staff tax calculations was that Staff did not calculate a current state income tax loss but only calculated the related deferred tax expense. Mr. Meyers calculated a state tax loss of $527,294. WVAWC Ex. CRM-R at 2, attached Ex. CRM-1 at line 79. In addition, Mr. Meyers noted differences between the WVAWC revised calculation of Deferred FIT Capitalized Repairs and the Staff calculation. Mr. Meyers testified that the Staff deferred FIT tax expense was incorrect because the Staff calculation in determining the Deferred FIT-Capitalized Repairs for line 62 contained an error. The Deferred FIT-Capitalized Repairs line is different by $563,323 ($4,051,592 at Company line 62, compared with the Staff number of $4,614,915 found at Staff Rule 42 Statement A, Schedule 5, page 1 of 2).

In response to Mr. Smith's testimony that the PCLA should not apply to WVWAC because AWW opted out of bonus depreciation in 2011 and 2013, Mr. Meyers stated that Mr. Smith did not offer any regulatory or case support for his recommendation. Furthermore, Mr. Smith did not calculate the negative impact of the AWW decision on ratepayers, nor did he provide any support or justification for his claim that the decision to forego bonus depreciation deductions was inappropriate, improperly motivated or taken without legitimate tax planning concerns. WVAWC Ex. CRM-R at 2-3.

Mr. Meyers suggested that Mr. Smith chose to use a five-year average in his effective tax rate calculations so that he could include year 2011, one of the years for which AWW elected not to claim bonus depreciation. Mr. Meyers argued that Mr. Smith did not make a valid argument that the desire of AWW to preserve its ability to fully use its charitable contribution carry-forward was inappropriate or improperly motivated. WVAWC Ex. CRM-R at 3.

Under cross-examination at hearing, Mr. Meyers reviewed Ms. Kellmeyer's testimony and realized that she did calculate a state income tax loss, contrary to his statement in his rebuttal testimony. Tr. 10/28 at 231-232. Mr. Meyers also testified that the decision to opt out of the bonus depreciation tax deduction in 2011 and 2013 would not impact rate base (as claimed by Mr. Smith) because any impact on the Accumulated Deferred Income Tax (ADITs) rate base deduction would have been offset by recording a corresponding ADITs asset for the NOL generated by the bonus depreciation deduction had it been recorded. Mr. Meyers claimed that contrary to the claim by CAD of a higher rate base because of the decision to forgo the bonus depreciation in 2011 and 2013, there would have been no impact on rate base. Id. at 232-234.

5. CAD and Staff Cross-Examination

Under cross-examination, Mr. Smith again stressed the difference between WVAWC and the APCo/WPCo tax situations and the decision to forego bonus depreciation deductions in 2011 and 2013 that could have generated additional ADITs to offset the impact of rate base growth driven by plant additions. Mr. Smith also acknowledged that he did not calculate the financial impact of the parent company decision. Tr. 10/29 at 41-44.

Mr. Smith also referenced two competing IRS private letter rulings in 2014 and 2015 that he said addressed the ratemaking impact of a company taking bonus tax depreciation deductions that result in net operating losses. One set of private letter rulings would require a company to record the ADIT asset related to NOL's driven by bonus depreciation because they would not yet have received a benefit from claiming that tax deduction. The other set of private letter rulings indicated that deferred income tax expense is collected through a utility's revenue requirement and is paid for by ratepayers and, therefore, excluding the deferred income tax asset for NOL's related to bonus depreciation would not be a normalization violation. He stated that the second set of private letter rulings is consistent with this Commission's treatment of the issue in the recent Mountaineer rate case. Mr. Smith claimed that continuing a CTA would protect ratepayers from the negative impacts of the parent decision to require the utility to forego tax deductions. Tr. 10/29 at 47-49. In response to cross-examination, Mr. Smith indicated that he did not consider an adjustment to deferred income tax expense of about $3.5 million that was in error in the WVAWC filing, and was subsequently corrected by WVAWC and Staff. Id. at 86-92.

At hearing, Ms. Kellmeyer presented a revised revenue requirement marked as Staff Ex. DLK-1 revised. This document reflected the parent company loss adjustment calculation using the 2104 actual parent company tax return instead of the estimate of parent company loss included in the Staff original filing. The exhibit also corrected her calculation of deferred income tax on capitalized repairs to result in an increase in rate base of $313,460. Tr. 11/2 at 59.

6. Briefs of the Parties

In its initial brief, WVAWC criticized Mr. Smith for recommending that the Commission continue to impose a CTA in order to punish WVAWC for the AWW election not to claim bonus tax depreciation. WVAWC also pointed out that Mr. Smith did not attempt to calculate the negative impact of the bonus depreciation decision in 2011 and 2013, or to establish a connection between a calculation of the impact and the revenue requirement impact of using a full CTA instead of a PCLA. WVAWC argued the AWW tax decisions were based on the AWW substantial net operating loss carry-forwards during those tax years. WVAWC argued that there could have been no impact on rates arising from the AWW decisions regarding bonus depreciation and that taking those deductions would have generated a significant amount of additional loss for those years and offset any deferred tax liability generated by the bonus depreciation. WVAWC Init. Br. at 39-41.

CAD argued in its initial brief that the Commission should not allow a parent company desire to preserve charitable deductions to result in a failure by a regulated utility to take 2011 and 2013 bonus tax depreciation. CAD claimed that in the 2014 APCo Case, the utility showed that it claimed all available tax deductions in each year including bonus tax depreciation. In this case, CAD argued that because of tax normalization concerns, the decision of AWW to opt-out of bonus depreciation deductions for 2011 and 2013 cannot be imputed to WVAWC, but one remedy that is available to the Commission would be to protect WVAWC ratepayers in this case by continuing to use the CTA (CTS effective FIT rate), similar to past WVAWC rate cases. CAD Init. Br. at 10 (emphasis added).

7. Commission Decision

The Commission will not accept the CAD CTS calculation using the CTS effective FIT rate of 28.91 percent. The CAD argues that the Commission should not use the PCLA approach authorized in the 2014 APCo Order because the circumstances of APCo/WPCo are different from those of WVAWC. CAD primarily bases this difference on a decision by the consolidated tax group, of which WVAWC is a member, to elect not to claim bonus depreciation on its 2011 and 2013 consolidated federal income tax return.

The Commission views the CTS issue and the CAD claim of overstated rate base related to the bonus depreciation deduction decision as two distinct issues. The CAD was free to recommend any approach of its choosing to calculate current FIT expense in this case and chose to recommend a CTS effective income tax rate approach. Given the Commission decision in the 2014 APCo case, CAD was also free to provide the Commission whatever evidence it chose to support a continuation of a CTS effective income tax rate. The CAD has based its support for the CTS effective income tax rate approach on a tax normalization issue that is entirely unrelated to any CTS approach.

The CAD may have raised a relevant issue regarding the decision to opt-out of bonus depreciation for the AWW consolidated federal income tax return for 2011 and 2013, but the CAD failed to provide any estimate of the potential impact of the bonus depreciation decision on the ADITs balance in this case, the potential impact on other rate base or expense items, or the potential impact on the revenue requirement. The CAD recommendation suggests WVAWC should be punished for the decision to forego bonus depreciation deductions in 2011 and 2013, instead of providing properly substantiated adjustments for two distinct federal income tax issues.

The CAD raised the private letter ruling regarding the recording of a deferred income tax asset for the amount of NOL attributable to the recording of bonus depreciation, an issue that arose out of the Commission decision in Mountaineer Gas, Case No. 11-1627-G-42T. The IRS ruled that the exclusion of an ADIT tax asset recorded on the books of Mountaineer Gas related to NOL's generated by recording bonus depreciation was not a normalization violation. The critical issue in the IRS decision was not that Mountaineer had not realized the NOL's related to bonus depreciation through its federal income tax returns, but rather that the entire tax over book depreciation difference, including bonus depreciation had been normalized and built into customer rates.

CAD made no showing that the bonus depreciation foregone in 2011 and 2013 was ever built into WVAWC rates. In reviewing the record of this case, both WVAWC and Staff eliminated bonus depreciation recorded in 2014 from the going-level federal income tax calculation because Congress had not renewed that deduction for 2015 and beyond. The WVAWC 2012 Rate Case ended in settlement. In reviewing the tax calculations of WVAWC and Staff it is not clear whether bonus depreciation was normalized for rate recovery. There has been no evidence presented in this case that would permit the Commission to determine if the CAD position on bonus depreciation deductions has merit.

The Commission will not revert to a CTS effective income tax rate approach as proposed by CAD. The Commission will place WVAWC and other Parties to this case on notice that the issue of bonus depreciation opt-out has not been decided on the merits of the CAD position in this case and may be raised, to the extent it is relevant, as an issue in a future WVAWC rate case.

The Staff and WVAWC (after becoming aware of the Commission decision to modify its CTS approach to reflect the PCLA approach in the 2014 APCo Order), presented the Commission with recommendations for current federal income tax expense based on the modified PCLA approach. After both WVAWC and Staff reviewed the calculations of the PCLA based on the final 2014 AWW tax return, they appear to agree that the PCLA is approximately $718,000.

The Commission will adopt the PCLA approach in the determination of current state and federal tax expenses in this case as proposed by WVAWC and Staff. The Commission determined the excess tax over book depreciation deduction for current income taxes based on the final rate base determination. The result of the Commission income tax calculation produced current FIT expense of $2.738 million and current deferred FIT expense of $7.037 million. The current SIT expense was determined to be $0.599 million and deferred SIT expense of $0.787 million.

The total federal and state income tax expense of $11.160 million is reasonable and will be used to establish the cost of service in this proceeding.

VIII. DEPRECIATION EXPENSE

The Commission, in its Order in the 2015 Depreciation Case issued today, authorized new depreciation rates for WVAWC to calculate the depreciation expense included in the cost of service in this case. As indicated in that case, Chairman Michael A. Albert is recused from participation in the 2015 Depreciation Case and took no part in deliberations or the Commission decision in that case. The results of that case were applied by the Commission in this case.

IX. OVERALL REVENUE REQUIREMENT

The Commission determines that the overall revenue requirement determined in this case supports an increase in rates of $18.170 million, or 15.1 percent, to current water service tariffs. The Commission determines the rate increase of $18.170 million provided in Appendix C is just and reasonable based on the record presented in this case as discussed above.

X. RATE DESIGN

WVAWC provided a cost of service allocation for its water and sewer operations based on a Cost of Service Study prepared by Paul Herbert of the firm Gannet Fleming Valuation and Rate Consultants, LLC. WVAWC Ex. PRH-D, attached WVAWC Ex. PRH-1 and PRH-2. Mr. Herbert prepared the Cost of Service Study using the base-extra capacity method. Id. at 4-9. Based on Mr. Herbert's Cost of Service Study, he recommended a rate design that adjusted the rates of the former Upper Kanawha Valley PSD and Cumberland PSD customers to the uniform WVAWC rate, and spread the increased rates across the board to the existing tariff structure. WVAWC Rule 42, Statement E at 8-9. Other than the Staff objection to combining the water and sewer rates in the next WVAWC base rate case, no party objected to the cost of service allocation and rate design recommendation of Mr. Herbert in this proceeding.

The rate design recommended by Mr. Herbert will be adopted in this proceeding. The resulting water tariff designed to produce the revenue requirement authorized in this case are attached to this Order in Appendix G.

XI. SEWER RATE CASE

WVAWC requested an overall increase of $176,895, or 22.3 percent in sewer service revenues. WVAWC Ex. 3 (WVAWC Rule 42). WVAWC proposed, as it did in the water rate case described above, that the Commission determine rate base on a forecasted Rate Year basis. The WVAWC Rule 42 included the required HTY filing, an addendum to reflect rate base and associated costs to the beginning of the Rate Year (Transition Period Addendum), and a separate addendum for the Rate Year rate base adjustments (Rate Year Addendum). WVAWC proposed to base the sewer revenue requirement on the same total WVAWC capital structure proposed in the water rate case. WVAWC Ex. JST-D at 60-61. The Transition Period Addendum decreased the HTY rate base by $67,548 and the Rate Year Addendum increased the Transition Period rate base by $53,348, a net decrease of $14,200. WVAWC Rule 42, Statement B.

WVAWC directly tracks certain expenses related to its sewer operations, but does not separately track other corporate expenses for water and sewer operations. In the rate filing, WVAWC allocated applicable corporate expenses to the sewer operation based on an allocation study performed by WVAWC witness Paul Herbert as required by the Commission Order in the 2012 Rate Case. WVAWC Ex. PRH-D at 3, attached WVAWC Ex. PRH-2. WVAWC included the results of the allocation study in WVAWC Rule 42, Statement E.

WVAWC determined revenues at going-level using a bill analysis for the HTY and priced those billing units at current rates. WVAWC proposed three adjustments to the HTY revenues: (i) eliminated unbilled revenue, (ii) eliminated a customer discount and (iii) adjusted local B&O taxes. The net of those three adjustments reduced HTY revenues at present rates by $442. WVAWC proposed several adjustments that reduced HTY operating expenses by $53,473. WVAWC Ex. JST-D at 61-62, WVAWC Rule 42, Statement A, Schedules 2, 3, 4.

Staff recommended an increase of $119,443, or 15.0 percent, in sewer service revenues. Staff Ex. TRE-D at 3; Staff Ex. JSA-D at 2, attached Ex. JSA-1. Staff witness Arboleda reflected the same three adjustments to HTY revenues that WVAWC proposed and eliminated unbilled revenue, adjusted local B&O taxes and eliminated discounts, but his net adjustment was $17 less than the WVAWC adjustment. Staff also included the same adjustments to O&M expenses that WVAWC proposed; however, the Staff purchased power expense adjustment was $1,022 more than WVAWC requested. Mr. Arboleda also used the depreciation rates recommended by Staff witness Pauley, resulting in a depreciation expense reduction of $20,010 more than the reduction proposed by WVAWC. Mr. Arbodela also adjusted HTY local and state B&O taxes as recommended by Staff witness Kellmeyer to reduce general tax expense by $331 from the level proposed by WVAWC.

Ms. Kellmeyer testified about the Staff position on other income adjustments for the sewer case (Staff did not remove other income at going level and proforma, while WVAWC did (Staff Ex. DLK-D at 9)). Staff did not adjust HTY materials and supplies (Staff objects to year end rate base treatment (Id.)) and adjusted retirement work in progress (Staff corrected an error in the WVAWC Rule 42 that reflected RWIP as a reduction to rate base (Id. at 4)) for the sewer case. Staff did not recognize the Transition Period and Rate Year (net) rate base reduction of $14,200 included in the WVAWC Rule 42 Addenda. Staff Ex. TRE-D at 6.

Ms. Kellmeyer opposed combining water and sewer operations in the next rate case. She pointed out that in the 2012 Rate Case the Commission rejected the allocation of a portion of the sewer revenue increase to the water customers to mitigate the rate impact on the sewer customers. The Commission stated in Conclusion of Law No. 1:

> An arbitrary revenue shift between the agreed to cost of service for water and sewer service because of a belief that the sewer increase may constitute rate shock is not a valid and reasonable basis for imposing a sewer revenue requirement on water service customers.

Staff Ex. DLK-D at 13, citing 2012 Rate Case Order at 7.

In the 2012 Rate Case, the Commission required WVAWC to provide in its next rate filing a study supporting its allocation factors applicable to joint water and sewer expenses and to provide distinct calculations of the general tax expenses, depreciation expense, and income tax expenses. 2012 Rate Case Order at 8, 14. Ms. Kellmeyer does not believe this indicated that the Commission would support combining the water and sewer operations for ratemaking purposes. Ms. Kellmeyer stated that the WVAWC water and sewer rates have been similar since the 2012 Rate Case but that does not mean they will remain similar. For example, in the event a need arises for alternate water sources in the future, rates could move apart. Staff would oppose a rate scenario under which sewer customers were required to pay costs of improvements that only benefitted water customers. Staff Ex. DLK-D at 13.

Mr. Tomac testified at the hearing that WVAWC proposed to combine its water and sewer operations in its next rate case. He stated that the rates are approximately seven or eight cents apart. Mr. Tomac commented at the hearing, however, that once Staff opposed combining the operations in its direct testimony, WVAWC decided to focus on other issues in the rate cases. 10/8 Tr. at 17-19.

Mr. Nevirauskas stated in his rebuttal testimony that he did not agree with the Staff revenue requirement because he believes the overall rate of return applied to the sewer rate base should reflect the 10.75 percent RoE recommended by Dr. Vander Weide. This approach supported an overall rate of return of 7.92 percent instead of the Staff recommended 7.16 percent. Mr. Nevirauskas also testified that the sewer system Federal Income Tax (FIT) calculation should reflect the methodology ordered by the Commission in the 2014 APCo Order, as described in more detail in WVAWC witness Meyer's testimony. WVAWC Ex. RPN-R at 4-5; WVAWC Ex. CRM-R.

In the WVAWC initial brief, WVAWC asked the Commission to authorize combining the water and sewer operations for ratemaking purposes. In response to the concern expressed by Ms. Kellmeyer that the potential need for alternative water sources in the future could be expensive, and that wastewater customers should not bear any portion of that cost, WVAWC argued that the same observation could be made about any plant investment that serves one group of water customers but not others. WVAWC argued that single tariff pricing is beneficial and not detrimental to all customers, and that wastewater customers may ultimately benefit from the combination. WVAWC suggested that if, in the future, the Commission wished to restrict recovery of a major investment to sewer customers only, it could accomplish that through other means, such as a surcharge. WVAWC asserted that the administrative benefits of combining the water and wastewater operations for ratemaking purposes outweigh any potential drawbacks. WVAWC Init. Br. at 57-58.

In the Staff reply brief, Staff continued to object to combining water and sewer operations for ratemaking purposes on grounds of possible resulting subsidization. Staff Reply Br. at 11-12.

The differences between the WVAWC and Staff positions on revenues at present rates, O&M expenses, and general taxes are minimal. The Staff position on these areas of the cost of service are based on more current data and will be adopted as reasonable for the determination of the cost of service in this proceeding. As discussed in the 2015 Depreciation Case Order issued today, the Commission adopts the WVAWC recommended depreciation rates.

The Commission adopts the Staff HTY rate base recommendation as a starting point for the determination of rate base because the Staff rate base correctly reflects the correction to RWIP. Consistent with the determination of rate base for the water case as described above, the Commission has also reflected the terminal year end material and supply balance as proposed by WVAWC, and the Transition Period rate base reduction of $67,548 proposed by WVAWC. The Commission determines that the resulting rate base of $2,594,132 is reasonable for the determination of the cost of service in this proceeding. The Commission will also use the capital structure and resulting overall cost of capital of 7.311 percent discussed above as reasonable for determining the cost of service in this proceeding.

The Commission will not approve the WVAWC request to merge the separate cost of service calculations for its water and sewer operations at this time. The Commission will not merge the tariffs for two distinct services, water and sewer service. WVAWC must continue to separate cost of service calculations for water and sewer service as it has in this case, until such time that WVAWC can demonstrate that a combining of the water and sewer tariffs will not result in a cross-subsidization between water and sewer customers.

The Commission concludes that an overall rate increase of $151,324 for the sewer operations of WVAWC is reasonable and will be authorized. No party took exception to the WVAWC proposal to spread the rate increase equally to all tariff elements. The tariff authorized by the Commission for WVAWC sewer operations is attached and identified as Appendix H.

XII. PROTECTIVE TREATMENT

On April 30, 2015, WVAWC filed a Motion for Protective Order seeking protective treatment for information derived from AWW's consolidated tax returns provided as a component of (i) the water rate case workpapers, in response to the requirements of Statement A, Schedule 5 Supplemental Information under Tariff Rule 19.3.e; and (ii) Exhibit RPN-3 attached to Mr. Nevirauskas' direct testimony (Tax Return Data). The Motion also sought protective treatment for portions of Exhibit RPN-2 of Mr. Nevirauskas' direct testimony, that include data on the pension and OPEB actuarial calculations prepared by AWW's actuary (Pension/OPEB Data). The confidential exhibits to Mr. Nevirauskas' testimony were entered into the record at hearing as attachments to WVAWC Ex. RPN-D.

By Order issued June 29, 2015, the Commission granted permanent protective treatment for the Tax Return Data. The Order granted interim protective treatment for the redacted portion of Ex. RPN-2 attached to Mr. Nevirauskas' direct testimony, WVAWC Ex. RPN-D.

On October 23, 2015, WVAWC filed a First Amendment to Motion for Protective Order seeking to protect materials produced in response to data requests and included in testimony filed after WVAWC filed its April 30, 2015 Motion. WVAWC stated the newer materials could be classified with, and share the same bases for protection, as the data categorized as Tax Return Data and Pension/OPEB Data in the Motion filed on April 30, 2015. WVAWC also sought to protect six new categories of confidential information not initially addressed in the April 30, 2015, Motion: Compensation Data, Business Transformation Data, Accounting Data and Procedures, Contractor and Supplier Information, Organizational Structure Information, and Highly Sensitive Confidential Information, First Amendment Confidential Data.

WVAWC identified as confidential additional tax information in the WVAWC responses to CAD 2-C-009 (repair deduction data), CAD 2-C-012 (tax net operating loss data), and CAD 7-C-015 (trended effective tax rate and tax savings data), as well as confidential references in the direct testimony of CAD witness Ralph C. Smith at Ex. LA-4, entered into the record at hearing as CAD Ex. RCS-D confidential. WVAWC also identified as business sensitive certain staffing and compensation information provided with its responses to CAD 1-E-007 (Change of incumbent information), CAD 2-E-025 (compensation study and policy), and CAD 5-E-052 (additional change of incumbent information). WVAWC listed as confidential its Business Transformation data including the WVAWC responses to CAD 2-F-009 (AWW board meeting minutes regarding the BT program), CAD 2-J-020 (BT program update presentation), and CAD 2-J-025 (BT program cost savings data and projected benefits). WVAWC listed as confidential its accounting data and procedures included with the responses to ASWS 2-022 (analysis regarding investment in automatic meter reading technology) entered into the record at hearing as ASWS Cross Ex. 6C, CAD 1-J-004 (service company cost distribution information), and CAD DEP 1-015 (capitalization procedures) entered into the record at hearing as CAD Cross Ex. 5C.

WVAWC further listed as confidential its contractor and supplier information contained in responses to CAD 1-F-006 (agreement with supplier to perform a cost of equity study) and CAD 5-E-035 (bidding, expense and supplier information related to chemical procurement). WVAWC listed as confidential its organizational structure information in the WVAWC response to CAD 1-J-001 (American Water corporate organization charts).

WVAWC listed as Highly Sensitive Confidential Information concerning its Kanawha Valley System Comprehensive Planning Study (CPS), all or portions of which were discussed or requested in data requests ASWS 1-002, ASWS 3-001 entered into the record at hearing as ASWS Cross Ex. 9 confidential, ASWS-3-003, ASWS 4-013, and ASWS 4-024. The CPS or portions thereof were entered into the record at hearing as confidential ASWS Ex. Cross 7, ASWS Cross Ex. 9, ASWS Cross Ex. 11, ASWS Ex. FDS-D confidential (witness Stottlemyer direct testimony). WVAWC made the CPS available for review to the parties pursuant to protective agreements, but did not file any part of the CPS with the Commission or the parties.

By Order issued October 26, 2015, the Commission granted interim protective treatment to the information that was the subject of the Company First Amendment to Motion for Protective Treatment, and took under advisement whether to grant permanent protective treatment.

The CPS was the subject of a discovery dispute between WVAWC and ASWS and an *in camera* hearing on an ASWS motion to compel. The hearing was held on October 26, 2016. By bench ruling memorialized in an Order issued October 26, 2015, the Commission required WVAWC to make the whole of the CPS reasonably available to ASWS for review in advance of the evidentiary hearing.

In both the original Motion and the First Amendment, WVAWC asserted that the information it filed under seal is exempt from the West Virginia Freedom of Information Act and meets the criteria adopted by the Supreme Court of Appeals of West Virginia in State ex rel. Johnson v. Tsapis, 187 W.Va. 337,419 S.E. 2d 1 (1992), for determining the need for permanent protective treatment. The parties have not opposed permanent protective treatment for the subject information.

At hearing, WVAWC moved into evidence a confidential exhibit attached to the rebuttal testimony of WVAWC witness Brett W. Morgan as WVAWC Ex. BWM-1 (PCCP Pipe Summary).

The Commission concludes that it is not necessary to resolve the issue of permanent protective treatment for the various documents designated as confidential by WVAWC at this time. With the exception of the ASWS Motion to Compel that was ruled on by the Commission, no entity has requested that the Commission provide copies of any information designated as confidential and/or subject to interim protective treatment. The Commission will continue to segregate and maintain the documents described in the Company Motion for Protective Order, First Amendment to Motion for Protective Order, and Exhibit BWM-1 under seal until the future time, if any, that the Commission receives a Freedom of Information Act request for them. On receipt of that filing, the Commission will notify WVAWC and provide it with an opportunity to argue whether the documents are entitled to permanent protective treatment, consistent with our handling of similar requests for protective treatment in recent cases. Mountaineer Gas

Company, Case No. 15-0003-G-42T, Commission Order October 13, 2015 at 9; WVAWC 2010 Rate Order at 48, 66.

FINDINGS OF FACT
WVAWC 15-0676-W-42T & 15-0675-S-42T

WATER RATE CASE[16]

1. This rate filing originally proposed a rate increase of $35,472,154 for water utility customers and $176,895 for sewer utility customers. WVAWC adjusted and lowered its rate request for water customers to $32,074,000. WVAWC Ex. JST-R at 4.

2. The WVAWC Rule 42 filed in this case included a standard HTY presentation, and two separate addenda defined in this Order as the Transition Period Addendum and the Rate Year Addendum that projected rate base from the historical test year through the Rate Year.

Forecasted Test Year

3. The WVAWC Rule 42 Rate Year Addendum filing reflected a projected Rate Year rate base, and not a fully projected test year filing.

4. The WVAWC Rule 42 Addenda in this case included only post-HTY adjustments related to rate base items and the related adjustments for depreciation expense, uncollectible expense, general taxes and income taxes. All other Statement G adjustments were included in the WVAWC HTY Rule 42.

RATE BASE

5. Every contested WVAWC rate case since 1990 has authorized some modification to the thirteen-month average HTY rate base approach, including various combinations of rate recognition for terminal HTY treatment, projected Rate Year rate base treatment, and the use of AFFAC. Order at 21.

Post-HTY Rate Base

6. WVAWC and Staff presented evidence in this case that AFFAC (i) has not worked as well as anticipated in minimizing regulatory lag, (ii) does not provide a cash return on capital investment between rate cases, (iii) does not provide for additional depreciation expense related to AFFAC eligible property, and (iv) is not effective in offsetting the impact of earnings erosion. WVAWC Ex. JST-D at 24-25; Staff Ex. TRE-D at 9-11; Tr. 11/2 at 124-136.

[16] References to earlier portions of this Order, and supporting discussion or authority, for Findings of Fact and Conclusions of Law, will be by page number, such as "Order at ___."

IRP Surcharge Mechanism

7. WVAWC did not propose, or provide notice of, an IRP type surcharge in this rate filing.

8. Staff testimony on IRP Surcharge was first filed on September 25, 2015, about five months after the original case filing and only one month prior to the beginning of the evidentiary hearing.

Rate Base Elements other than Cash Working Capital

9. Certain adjustments to rate base were undisputed among the parties including Statement G Adjustments: WVAWC Adj. 66, Staff Adj. 60, and CAD Schedule B (terminal HTY AFFAC eligible utility plant additions). Statement G Adjustments: WVAWC Adj. 67, Staff Adj. 62, and CAD Schedule B (eliminate Spill related GAC costs); Statement G Adjustments: WVAWC Adj. 72, Staff Adj. 64 and CAD Schedule 2 (terminal HTY ADITS); Statement G Adjustments: WVAWC Adj. 75, Staff Adj. 75, and CAD Schedule B; (terminal rate base for HTY AFFAC recorded since the 2012 Rate Case).

Cash Working Capital

10. WVAWC presented a lead/lag study that supports a proposed cash working capital allowance of $10.998 million. WVAWC Ex. HW-D; Schedules HW-1 through HW-29.

11. WVAWC, Staff and CAD disagreed on average lead days for O&M expense and lead days for property tax expense. WVAWC proposed a revenue lag for the entire cost of service while Staff did not provide a revenue lag for deferred income tax and operating income. CAD proposed the inclusion of interest expense in the cash working capital calculation but did not provide for a revenue lag for deferred income tax, depreciation or net income. WVAWC Ex. HW-D; Schedules HW-1 through HW-29; Staff Ex. 1, Statement B, Schedule 7; CAD Ex. RCS-D at 24-37.

OPERATING INCOME AND OPERATION AND MAINTENANCE EXPENSES

Operating Income

12. Staff and WVAWC agreed on an $88,438 positive adjustment for Lincoln Public Service District water usage. Staff Ex. DLK-D at 3, Staff Rule 42, Statement G, Adj. 9; WVAWC Ex. JST-R at 5, attached WVAWC Ex. JST-2 R at 1.

13. The WVAWC rate filing reflects adjustments to annualize the effect of HTY rate increases for Clendenin and Upper Kanawha Valley Public Service District customers. WVAWC Ex. JST-D at 41, WVAWC HTY Rule 42, Statement G, Adjs. 17 and 18.

14. In past rate cases, the Commission denied WVAWC requested adjustments for declining residential water usage.

15. After 1993, WVAWC experienced, and continues to experience, declining residential customer water usage. WVAWC Ex. JST-D at 10-11; WVAWC Ex. ELS-D at 1-7, Appendix D; WVAWC Ex. GPR-D at 1-15 attached WVAWC Exs. GPR-1, GPR-2 at 1-3.

16. WVAWC lost $14 million over the last three years from loss of revenues attributable to a declining residential usage per customer on average at a rate of 636 gallons per year, or approximately 1.64 gallons per day. WVAWC Ex. JST-D at 11; WVAWC Ex. GPR-D at 4, attached WVAWC Ex. GPR-2 at 1-3.

17. Declining residential usage is caused by water conservation among customers and an increase in the prevalence and use of low-flow plumbing fixtures and other water saving devices; data indicates that the water industry as a whole has experienced a similar declining usage trend. WVAWC Ex. GPR-D at 4.

18. All other things being equal, an on-going trend of declining residential customer usage after the HTY results in Rate Year revenues that fall below the level authorized by the Commission to determine fair and reasonable rates. WVAWC Ex. JLM-D at 9; WVAWC Ex. JST-D at 10-11.

Operation and Maintenance Expenses

19. WVAWC proposed an O&M expense recovery in this case in an amount that is $1.1 million less than proposed in the last WVAWC rate case (2012 Rate Case). WVAWC Ex. JST-D at 12.

20. The rate filing included proposed adjustments to increase purchase power accrual expense, reductions for production costs (fuel, power, chemicals and waste disposal), adjustments for payroll related items (for 401(k) plan, pension, retiree medical, active employee medical plan and payroll taxes), a reduction of AWWSC charges, increased post-retirement employee benefit costs, eliminated advertising expenses, increased rate case expense, reduced uncollectible expense, increased tank painting and inspection costs, and increased miscellaneous community and employee relations expenses. WVAWC Rule 42, Statement A, Schedule 2.

Purchased Power Accrual

21. WVAWC and Staff agreed to reduce purchased power accrual expense by $50,692. Order at 41. WVAWC Ex. JST-D at 43; Staff Ex. DLK-D at 3-4, Staff Rule 42, Statement G, Adj. 22.

Reduced Purchased Power, Chemicals and Waste Disposal Costs as a Result of Declining Residential Usage

22. WVAWC proposed to reduce its HTY fuel and power, chemicals, and waste disposal expenses (production costs) to reflect the lower going-level water consumption attributable to the declining residential usage trend forecasted through the Rate Year. Order at 41-42.

Employee Count, Salary and Wage Increases, Overtime, and Annual Incentive Compensation Plan Costs

23. In 1993, WVAWC had 377 employees to serve 108,000 customers, or 286 customers per employee. WVAWC is now authorized to have 300 employees serving over 170,000 customers, or 560 customers per authorized employee, a ninety percent increase over that twenty-two year period. WVAWC Ex. 1, "Utility Management Report" at 2, attached to WVAWC Ex. 1.

24. When WVAWC filed this rate case, WVAWC had 298 employees (295 water and 3 wastewater) compared to 272 employees embedded in the 2012 Rate Case, and expected to hire two additional employees. WVAWC Ex. CM-D at 2.

25. As of the hearing, WVAWC had a headcount of 294 employees, but WVAWC plans to hire six additional employees to staff evening crews to respond to main breaks and customer service issues. Tr. 10/27 at 196; Tr. 10/30 at 70-71.

26. Three unions represent WVAWC employees and WVAWC operates with five collective bargaining agreements. WVAWC Ex. CM-D at 3.

27. WVAWC employee compensation and benefits package includes base salary and benefits plus variable or incentive compensation, also known as AIP. Id. at 5.

28. AIP compensation is part of the overall compensation package and is not paid to employees unless the utility achieves threshold financial performance goals. This is true even if the utility meets all non-financial goals such as customer satisfaction, customer service quality, environmental compliance and safety. WVAWC witness Mount, Tr. 10/30 at 74-75.

29. WVAWC included full year replacement employees for HTY vacancies in its proposed labor adjustment, but did not propose a corresponding reduction to HTY overtime hours or contract labor used to offset vacancies.

30. AIPs tie a portion of an employee's compensation to an employee's actual performance, are prevalent in the compensation packages for larger businesses, and have become the "norm" for major utility companies. WVAWC Ex. CM-R at 2.

31. AWW established a uniform compensation package for use by its subsidiaries that includes salary bands (ranges for each non-hourly position), incentive

compensation plans, and employee benefit plans. WVAWC Ex. CM-D at 5-6; CAD Ex. RCS-D, Attached Ex. LA-3 at 83-99.

32. AWW based its compensation plan on market studies of comparable market pay ranges, incentive pay plans and employee benefit plans of companies similar to AWW and its subsidiaries. Id.

Long-Term Incentive Plan Costs

33. The AWW incentive compensation package is comprised of two types of incentive pay: (i) AIP compensation available to all non-union employees; and (ii) LTIP compensation available to a select group or level of management employees. Id.

34. The LTIP is comprised of stock options, restricted stock units and performance stock units. Before awards under the LTIP plan are made to certain eligible upper-level management employees, the AWW stock performance must meet a minimum threshold as established by the AWW Board of Directors. Id.

35. WVAWC reduced by 50% its request to recover all of its LTIP costs based on the 2014 APCo Rate Case Order. WVAWC Ex. JST-R at 13; WVAWC Init. Br. at 51.

Payroll Related Adjustments for 401(k), Pension, Retiree Medical, Active Employee Medical Expenses and Payroll Taxes

36. Certain adjustments are directly related to the level of payroll in this case and include: 401(k) expense (WVAWC HTY Rule 42 Statement G, Adj. 32); defined contribution pension expense (new employees) (Id. at Adj. 33); defined contribution retiree medical expense (Id. at Adj. 34); employee stock participation plan expense (Id. at Adj. 35); active employee medical costs (Id. at Adj. 36); and various payroll taxes (Id. at Adjs. 57, 58, 59).

Defined Benefit Pension Valuation Costs

37. The difference between the WVAWC and Staff adjustments to pension contribution costs is attributable to Staff's use of a higher labor capitalization rate. WVAWC Ex. RPN-D at attached Ex. RPN-2, Confidential Ex. RPN-D at 6; WVAWC Ex. JST-D at 47; Staff Ex. DLK-D at 5, Staff Rule 42, Statement G, Adj. 33.

Miscellaneous Expenses Charged by AWWSC

38. This rate filing included a reduction of HTY AWWSC charges of $648,055, and going-level Service Company fees of $12,420,461 that are $1,070,587 less than the amount proposed in the WVAWC 2012 Rate Case. WVAWC Ex. JST-D at 47-48.

Defined Benefit OPEB Valuation Costs

39. The difference between the WVAWC and Staff adjustments to defined benefit OPEB valuation costs is attributable to Staff's use of a higher labor capitalization rate. Staff Ex. DLK-D at 5; Staff Rule 42, Statement G, Adj. 34.

40. The CAD adjustment to defined benefit OPEB valuation costs was miscalculated and eliminated the WVAWC retiree contributions two times. WVAWC Ex. JST-R at 9, 17-18; CAD Ex. RCS-D at 66-67, attached Ex. LA-1; Schedule C-10 at 1.

Advertising Expense

41. WVAWC and Staff agree to eliminate $8,901 of promotional advertising expense from HTY expense. Staff Rule 42, Statement G, Adj. 39; WVAWC Commission Post Hearing Ex. No. 2.

Rate Case Expense

42. WVAWC estimated rate case expense is $861,850, and is higher than prior rate cases because WVAWC correctly assumed this case would be fully litigated and not resolved by settlement. WVAWC normalized the expense by adding the costs of two prior rate cases and dividing by a five-year normalization period, for a going level adjustment of $254,241. WVAWC Ex. JST-D at 49-50; WVAWC Rule 42, Statement G, Adj. 46.

43. Rate case preparation charges are not included in the AWWSC charges to WVAWC for years in which the utility does not file a rate case. WVAWC Ex. JST-R at 17.

Uncollectible Expense

44. WVAWC and Staff agreed on the appropriate level of uncollectible expense. Staff Ex. DLK-D at 6, Staff Rule 42, Statement G, Adj. 43; Staff Init. Br. at 41.

Tank Painting Amortization

45. WVAWC maintains 190 above-ground water storage tanks as part of its water and fire safety operations. Expenses related to tank maintenance total approximately $1.2 million annually. WVAWC Ex. BWM-D at 21-24.

46. WVAWC and third parties inspect tanks in order to prioritize tank painting. Id.

47. The Commission has historically calculated normalized tank painting expense by adjusting the last fourteen years of tank painting costs to current values and then recognizing one-fourteenth of the normalized cost for rate recovery.

Miscellaneous Expenses of WVAWC

48. CAD eliminated certain public relations and employee-related activity expenses that WVAWC proposed for rate recovery. CAD Ex. RCS-D at 82, Exhibit LA-1, Schedule C-17.

49. The Commission determines in a rate case whether certain utility employee, community and public relations expenses should be included in rate recovery on grounds of whether the expense benefits utility customers.

CAPITAL STRUCTURE AND COST OF CAPITAL

50. AWW will complete a $30 million equity infusion on or before by March 1, 2016. WVAWC Ex. RPN-D at 3.

51. Adjusting the actual capital structure of WVAWC as of December 31, 2014, (i) to add $28.457 million of short-term debt matching the additional net rate base for the Transition Period, and (ii) to reflect the $30 million of additional equity financing from AWW, results in total capital that closely approximates the level of rate base authorized for rate recovery in this Order. Order at 64.

Cost of Short-Term Debt

52. The WVAWC short-term debt interest rate was 1.482 percent based on AWWSC projections. The Staff rate was 0.56 percent based on an average of April, May and June 2015 short-term interest rates. The CAD rate was 0.310 percent. WVAWC Ex. RPN-D, Ex. RPN-1; Staff Ex. JA-D at 4, Appendix JA-1, Sch. 1, Sheet 3 of 4; CAD Ex. RCS-D, attached Ex. LA-1, Schedule D.

Cost of Long-Term Debt

53. The Staff and CAD-recommended long-term debt cost rates that were nearly identical to WVAWC's (5.87 percent respectively as compared with 5.86 percent). WVAWC Ex. JST-D at 8, WVAWC Statement C Rate Year at 2; Staff Ex. JA-D at 4; CAD Ex. RCS-D, attached Ex. LA-1, Schedule D.

Cost of Preferred Stock

54. WVAWC, Staff and CAD preferred stock cost rates were nearly identical, and each of the calculations included the preferred dividends paid by WVAWC and the amortization of issuance cost in determining the cost rate. WVAWC Rule 42 (Transition Period), Statement C; Staff Rule 42, Statement C; Staff Ex. TRE-2; and CAD Ex. RCS-D, Ex. LA-1, Schedule C-3.

Return on Equity

55. Dr. Vander Weide provided analyses of WVAWC as part of the water utility industry and he estimated capital market information in his DCF, CAPM and RP models to groups of comparable risk, publicly-traded water and natural gas companies. WVAWC Ex. JVW-D at 5-16, 17-47. Dr. Vander Weide's RoE range was 9.8 percent to 11.1 percent, and his recommended RoE was 10.75 percent. Id. at 48.

56. Staff recommended an RoE based on the application of the DCF and CAPM to a sample group of nine water utilities. Staff Ex. JA-D at 6. The Staff analysis produced an average RoE of 9.04 percent based on the DCF methodology and 9.95 percent based on the CAPM methodology. The average of those two measures is the Staff-recommended RoE of 9.49 percent. Staff Ex. JA-D at 12, Appendix JA-1, Schedules 2, 3, 4, 5, and 6.

57. In his DCF analysis, Staff witness Allen applied a screening test and eliminated any DCF result lower than the 3.85 percent cost for the 2013 long-term debt issued by WVAWC. Additionally, Staff eliminated any results that exceeded 300 basis points above or below the average DCF RoE result. The Staff outlier removal process eliminated fourteen growth outliers. Staff Ex. JA-D at 8.

FEDERAL INCOME TAX EXPENSE

58. Prior to the 2014 APCo Rate Case, the Commission used a CTS effective FIT rate approach that the Commission calculated by dividing consolidated FIT payments made to the IRS by the total positive taxable income of the consolidated tax filing group.

59. Prior to its decision in the 2007 Mon Power Order, the Commission used the parent company loss adjustment (PCLA) CTS approach which limited the taxable losses included in the CTS effective FIT rate calculation to only the parent company losses included in the consolidated federal income tax return.

60. In the 2014 APCo Order, the Commission abandoned the CTS approach that included all taxable loss subsidiaries in the CTS calculation and returned to a CTA that only included the PCLA.

61. In the 2014 APCo Order, the Commission determined that it would no longer apply the CTA through an effective FIT rate, but instead would apply the CTA though a reduction to the regulated West Virginia utility taxable income for its allocated share of the PCLA and determine the resulting current FIT expense using the statutory thirty-five percent FIT rate. 2014 APCo Order at 66-68.

62. Staff and WVAWC presented the Commission with recommendations for current federal income tax expense based on the modified PCLA approach and agreed that the PCLA is approximately $718,000. WVAWC Ex. CRM-R at 1, attached Ex. CRM-1; Staff Exhibit DLK-D at 8, Staff Rule 42, Statement G, Adj. 75.

63. CAD did not provide an estimate of the potential impact of the bonus depreciation decisions of the Consolidated Group on the ADITs balance in this case, the potential impact on other rate base or expense items, or the potential impact on the revenue requirement.

64. There is no evidence that the bonus depreciation foregone in 2011 and 2013 was ever built into WVAWC rates.

65. The WVAWC and Staff tax calculations do not indicate whether bonus depreciation was normalized for rate recovery in the 2012 Rate Case.

DEPRECIATION EXPENSE

66. The Commission issued its Order today in WVAWC Case No. 15-06074-WS-D authorizing revised depreciation rates.

67. In this proceeding, the Commission used the depreciation rates formulated and approved in Case No. 15-0674-WS-D (Depreciation Case) to determine depreciation expense included in the cost of service.

RATE DESIGN

68. WVAWC was the only party to file a cost of service study. WVAWC Ex. PRH-D, attached WVAWC Ex. PRH-1 and PRH-2.

69. Other than the Staff objection to combining the water and sewer rates in the next WVAWC base rate case, no other party objected to the WVAWC cost of service study.

SEWER RATE CASE

70. This rate filing originally proposed a rate increase of approximately $176,895 for sewer utility customers.

71. The WVAWC Rule 42 filed in this case included a standard HTY presentation and two Addenda for the Transition Period and the Rate Year.

72. The WVAWC Rule 42 Transition Period Addendum decreased the HTY rate base by $67,548 and the Rate Year Addendum increased the Transition Period rate base by $53,348, a net decrease of $14,200. WVAWC Rule 42, Statement B.

73. The differences between the WVAWC and Staff positions on revenues at present rates, O&M expenses, and general taxes are minimal. WVAWC HTY Rule 42, Statement A, Schedule A1, Schedule A2, Schedule A4; Staff Rule 42, Statement A, Schedule 1, Schedule 2, Schedule 4.

74. Although there may be an argument for the consolidation of the cost of service of WVAWC's water and sewer operations, the water service and sewer service operations of WVAWC are currently distinct from one another and have separate costs of service that can be calculated independently.

PROTECTIVE TREATMENT

75. WVAWC requested permanent protective treatment of the information filed under seal in this proceeding including material produced in discovery, testimony, and hearing exhibits. WVAWC Motion for Protective Order filed April 30, 2015, WVAWC First Amendment to Motion for Protective Order filed October 23, 2015, WVAWC Ex. BWM-1 confidential.

CONCLUSIONS OF LAW
WVAWC 15-0676-W-42T & 15-0675-S-42T

1. This WVAWC rate filing is a request for Rate Year rate base and is similar in scope to Commission rate base determinations in past WVAWC rate cases. WVAWC 1994 Rate Case; WVAWC 2003 Rate Case. The rate filing does not request a fully projected test year approach.

RATE BASE

2. Although the Commission has stated its general preference for the HTY approach to establish utility rates, it has not precluded utilities from requesting modification to the HTY rate base approach if circumstances warrant and the modification is included in an addendum to the WVAWC HTY Rule 42, along with appropriate explanations to support the need for the departure as described in Tariff Rule 19.4.

3. The Commission in prior rate cases authorized exceptions for WVAWC to the HTY rate base approach, including post-HTY rate base recognition, based on the combination of a declining customer usage and increasing non-revenue producing capital investment that distort the matching relationship of revenues, expenses and rate base for the Rate Year from the matching relationship present in the HTY. Order at 21-24.

Post-HTY Rate Base

4. WVAWC has met its burden of proof regarding the inadequacy of the thirteen-month average HTY rate base approach in this case.

5. The HTY approach, under current circumstances and operations for WVAWC, would result in a severe mismatch of revenues, expenses and rate base in the Rate Year.

6. The experimental AFFAC previously approved by the Commission is not working as intended and should be terminated.

7. The projected Rate Year rate base proposed by WVAWC could help address regulatory lag and would not be a significantly different rate base approach from that authorized by the Commission for WVAWC beginning in the 1992 Rate Case.

8. The Commission will not authorize a fully projected Rate Year rate base in this proceeding because the accuracy of the utility plant additions included in the Rate Year addendum was not fully developed in the record of this case.

9. It is just and reasonable to establish rate base at the beginning of the Rate Year because inclusion of additional investment in rate base elements for the Transition Period (i) will provide a reasonable level of known and measurable rate base that will be used and useful and in service at the time the new rates authorized in this proceeding become effective, (ii) will provide a better matching of revenues, expenses and rate base present in the Rate Year than would adherence to a non-representative HTY approach, and (iii) will better mitigate the impact of regulatory lag than would AFFAC.

IRP Surcharge Mechanism

10. The Staff recommendation of an IRP Surcharge mechanism has merit and should be explored further because an IRP Surcharge mechanism, in certain circumstances, could reduce regulatory lag and limit customer rates to the actual cost of distribution system replacements net of depreciation and deferred income tax expenses that are currently recovered in rates.

11. The Staff-proposed IRP Surcharge mechanism for WVAWC will not be approved at this time because of the combination of the lack of notice of a potential IRP Surcharge and the lack of a fully developed record on the proposal.

12. Rather than approving an IRP Surcharge mechanism, the Commission will direct WVAWC to seek authorization for an IRP Surcharge mechanism, if it chooses to do so, in a separate proceeding outside a general rate case filing. The separate proceeding would allow the IRP Surcharge mechanism to be adequately noticed and will allow each party ample opportunity to investigate and develop its position.

Rate Base Elements other than Cash Working Capital

13. The WVAWC adjustments to Rate Base that were undisputed among the parties are just and reasonable and include Statement G Adjustments: WVAWC Adj. 66, Staff Adj. 60, and CAD Schedule B (terminal HTY AFFAC eligible utility plant additions). Statement G Adjustments: WVAWC Adj. 67, Staff Adj. 62, and CAD Schedule B (eliminate Spill related GAC costs); Statement G Adjustments: WVAWC Adj. 72, Staff Adj. 64 and CAD Schedule 2 (terminal HTY ADITS); Statement G Adjustments: WVAWC Adj. 75, Staff Adj. 75, and CAD Schedule B; (terminal rate base for HTY AFFAC recorded since the 2012 Rate Case).

14. The Staff adjustment to recognize the over capitalization of OPEB expense on WVAWC's books when compared to the level of OPEB expense recognized for rate recovery under the modified accrual method is just and reasonable in this case because Staff reflects the calculation of that overcapitalization in accordance with past Commission decisions. Staff Statement G, Adj. 70.

15. The terminal treatment for HTY depreciation expense, utility plant retirements and cost of removal costs related to HTY terminal utility plant additions should be utilized to determine the impact on accumulated depreciation.

16. The existing depreciation rates (the depreciation rates in place prior to the change in depreciation rates authorized in the February 24, 2016 Order in the 2015 Depreciation Case) should be applied to the Transition Period utility plant recognized in this case to determine the accumulated depreciation balance. WVAWC Statement G, Adj. B1 adjusted to reflect the existing depreciation rates.

17. The Staff adjustment to the HTY RWIP balance is reasonable for the determination of rate base in this proceeding after Staff corrected an error to the WVAWC adjustment. Statement G, Adj. 71.

18. The Staff proposal to reinstate negative acquisition costs for rate recovery is in accordance with prior Commission decisions and will be utilized in this case. Staff Statement G, Adj. 67.

19. Based on the just and reasonable Commission decision in this case to recognize post-HTY rate base through the beginning of the Rate Year, the Commission also recognizes the WVAWC adjustments to reflect: net utility plant additions through the Transition Period, WVAWC Statement G, Adj. B1; the WVAWC adjustment to CIACs for Transition Period activity, WVAWC Statement G, Adj. B10; the WVAWC adjustment to material and supplies for HTY activity, WVAWC Statement G, Adj. 69 and CAD Schedule B; and the WVAWC adjustment to Transition Period ADITs related to accelerated depreciation, WVAWC Statement G, Adj. B13 as further adjusted downward by this Commission ($6.133 million) to synchronize to the accelerated depreciation deduction included in the Commission income tax calculation that reflects the impact of the post-HTY utility plant.

20. Based on the Commission decision to recognize post-HTY rate base, the Commission recognizes as reasonable for the determination of rate base in this proceeding: the WVAWC adjustment to accumulated deferred ITC for HTY activity, WVAWC Statement G, Adj. 73 and CAD Schedule B; the WVAWC adjustment to the Coal River/Van PSD acquisition costs for HTY activity, WVAWC Statement G, Adj. 74 and CAD Schedule B; and the WVAWC adjustment for Transition Period AFFAC, WVAWC Statement G, Adj. B16.

21. The Staff proposal to remove Parkersburg acquisition costs from rate base in accordance with prior Commission decisions is just and reasonable.

22. A rate base of $526,617,437 is just and reasonable based on the record in this case to reflect the appropriate level of known and measurable rate base that will be used and useful and in service at the beginning of the Rate Year.

Cash Working Capital

23. The Staff O&M expense lead days of 11.2 days is reasonable in this case and best matches the O&M expense used by the Commission in its cost of service determination.

24. It is just and reasonable to allow the revenue lag to apply to both depreciation expense and deferred income tax expense because the revenue lag applies to all billed customer revenue (the entire cost of service), and, while neither of these expenses requires an immediate cash outlay, the funds are immediately reinvested in the business and reduce rate base. See, 2015 APCo Rate Order at 31.

25. The Commission should use both the revenue lag and expense lead days to determine the level of cash working capital allowance related to interest expense. The Commission will not recognize the revenue lag for net income because revenue lag should only apply to net income if the utility considered the payment lead for dividend payments that are made from that net income. 2014 APCo Order at 31.

26. The service period for determination of West Virginia property tax payments should be the mid-point of the assessment year (the year when the property tax return is filed and the property assessment is rendered by the Board of Public Works) as defined in W.Va. Code §11-5-3. 2014 APCo Order at 28-30.

27. The Commission adopts 517 property tax lead days as just and reasonable for purposes of the cash working capital calculation applicable to property tax payments in this case. CAD Ex. RCS-D at 24-37.

28. The just and reasonable level of cash working capital for WVAWC based on the record in this case is a negative $2,138,157.

OPERATING INCOME AND OPERATION AND MAINTENANCE EXPENSES

Operating Income

29. The Staff positive adjustment in the amount of $88,438 for Lincoln Public Service District water usage is just and reasonable and reflects the latest known and measurable sales information. Staff Ex. DLK-D at 3, Staff Rule 42, Statement G, Adj. 9.

30. The Staff adjustment to reflect the effect of a rate increase to former Clendenin customers is just and reasonable. Staff Rule 42, Statement G, Adj. 16.

31. The Staff adjustment to reflect phased-in rate increases to customers formerly served by Upper Kanawha Valley PSD is just and reasonable and allows

WVAWC to file revised tariffs on March 15, 2016, to reflect the final of five phased rate increases to those customers.

32. The WVAWC ten-year analysis adjusted for the impacts of weather presented by Dr. Spitznagel demonstrates that the HTY residential usage per customer is not reflective of the likely residential consumption levels during the Rate Year. WVAWC Ex. ELS-D, Appendix D.

33. The WVAWC residential customer usage trend analysis is more reflective of future residential per customer usage trends than the three-year trend offered by Staff. WVAWC Ex. GPR-D, attached Ex. GPR-2; WVAWC Ex. ELS-D, Appendix D.

34. To be meaningful, a declining residential water usage analysis should be normalized for the impact of weather.

35. Because WVAWC has shown that (i) HTY information is not reflective of expected residential usage and (ii) the associated loss of residential revenue adjustment is consistent with prior Commission decisions to normalize certain elements of the cost of service, the Commission will reflect the declining residential usage per customer adjustment up to the beginning of the Rate Year. WVAWC 2010 Rate Case Order at 31-32; Bluefield Gas Co., Case No. 11-0410-W-42T, Recommended Decision at 2, 5.

36. The declining residential usage per customer adjustment reducing HTY residential revenues at present rates by $1.021 million is supported by evidence in this case, is representative of the likely and measurable decline in residential usage per customer for the Rate Year, and is just and reasonable for purposes of determining rates in this case.

37. The Commission is not authorizing a declining residential usage adjustment as a regular cost of service adjustment for WVAWC in all future rate cases. The adjustment will not be continued in a future case unless it is supported by the record in that future case.

Operation and Maintenance Expenses
Purchased Power Accrual

38. The amended WVAWC HTY power accrual restated at current electric rates as agreed to by the Staff is a just and reasonable resolution of this issue. WVAWC Ex. JST-D at 43; Staff Ex. DLK-D at 3-4, Staff Rule 42, Statement G, Adj 22.

Reduced Purchased Power, Chemicals and Waste Disposal for Declining Residential Usage

39. Because the Commission recognized one-half of the lower revenue related to declining residential usage from the level proposed by WVAWC, it is just and reasonable to recognize only one-half of WVAWC's corresponding reduction to

production costs. WVAWC Ex. JST-D at 40, WVAWC Rule 42, Schedule G, Adjs. 25, 28, and 30.

Employee Count, Salary and Wage Increases, Overtime, and Annual Incentive Compensation Plan Costs

40. To the extent the HTY overtime level was used to offset employee vacancies, inclusion of full year replacement employees for rate recovery requires a reduction of HTY overtime hours.

41. The HTY hours included in the Staff payroll adjustment is the proper starting point to price payroll in this case and the Staff approach properly accounts for the elimination of Spill-related overtime from rate recovery.

42. The Huntington union contract pay rates are known and measurable. It is not reasonable to include as yet undetermined pay raises for other union contracts that expire in 2016 because those costs are not known and measurable at this time.

43. Adequate capital investment and employee levels are necessary if WVAWC is expected to lower its main replacement rate, improve response time to leaks, make more cost-effective leak repairs, meet the goals of making the distribution system more reliable and reduce UFW.

44. The inclusion of additional labor expense to the Staff labor determination to reflect the addition of six employees at the average Kanawha Valley distribution system employee payroll and benefit expense cost is just and reasonable and will be approved in this case.

45. The hiring of six additional distribution employees in the Kanawha Valley system will improve WVAWC's ability to address the distribution system improvements, main repair, and response time.

46. The Commission adopts the AIP costs for the HTY as proposed by Staff. The AIP costs are lower than the level proposed by WVAWC, for both WVAWC and AWWSC employees. The higher level of AIP proposed by WVAWC based on achievement of 100 percent of the targeted AIP level is not known or measurable at this time.

47. In future rate cases, it is reasonable to require WVAWC to provide analysis that supports that the total compensation to its employees (both direct and AWWSC employees) is in line with the market salary for each type of job classification. The analysis should address how the market value for each job classification is determined and provide examples that show how the actual salaries for various job classifications compare to the market-determined salaries.

Long-Term Incentive Plan Costs

48. The recovery of LTIP plan costs will be limited to one-half of HTY amounts for both WVAWC and AWWSC employees because the goals of the LTIP plan benefit both customers and shareholders.

Payroll Related Adjustments for 401(k), Pension, Retiree Medical, Active Employee Medical Expenses and Payroll Taxes

49. Because the Commission accepts the Staff and CAD position to limit the payroll determination to HTY hours and wage and salary levels to known 2015/2016 increases (with the addition of six employees), and because the Commission also accepts the Staff position to limit AIP costs to the actual HTY level, it is just and reasonable to accept the Staff payroll related adjustments identified in Staff Ex. 1, Staff Rule 42 Statement G, Adjs. 28, 29, 30, 31, 32, 53, 54 and 55.

Defined Benefit Pension Valuation Costs

50. Consistent with the Commission discussion and decision regarding payroll expense, the Commission adopts the Staff pension expense as just and reasonable for the determination of pension expense for rate recovery in this proceeding. Staff Ex. DLK-D at 5; Staff Rule 42, Statement G, Adj. 33.

Miscellaneous Expenses Charged by American Water Works Service Company

51. The Commission eliminates $5,087 of SERP expenses because WVAWC did not demonstrate that SERP expenses that provide supplemental pension benefits to highly compensated executives are just and reasonable for rate recovery.

52. The Commission eliminates $2,465 of AWWSC 401(k) expenses because WVAWC did not demonstrate that 401(k) restoration costs related to supplemental benefits to highly compensated executives are just and reasonable for rate recovery.

53. The Commission eliminates $12,115 of AWWSC employee stock purchase plan expense because WVAWC did not demonstrate that employee stock purchase expenses for AWWSC employees are just and reasonable for rate recovery.

54. The Commission eliminates $441 of AWWSC advertising expense because WVAWC did not demonstrate that the nature of the advertising expenses for AWWSC are just and reasonable for rate recovery.

55. The Commission eliminates $32,707 of AWWSC dues/membership expenses because WVAWC has not demonstrated that the nature of the dues/membership expenses for AWWSC made them fair for rate recovery. Although some dues/membership expenses for AWWSC employees may normally be appropriate for rate

recovery, such as dues/membership expense related to professional certification, WVAWC did not provide support for such consideration by the Commission.

56. The Commission will not eliminate a just and reasonable expense for AWWSC employee awards because a reasonable level of employee awards expense is customary in recognition of career milestones and is acceptable for rate recovery.

57. The Commission accepts $14,363 in AWWSC relocation expenses as a reasonable level of ongoing relocation expense for an organization as large as AWWSC.

58. The Commission accepts $1,773 as a just and reasonable amount for AWWSC ongoing support for community involvement programs.

59. The Commission does not exclude income tax expense for AWWSC from rate recovery because AWWSC is part of the AWW consolidated tax filing and the tax liability specific to AWWSC is not embedded in the WVAWC specific income tax calculation.

Defined Benefit OPEB Valuation Costs

60. Consistent with the Commission discussion and decision regarding payroll expense, the Commission adopts the Staff defined benefit OPEB valuation costs as just and reasonable for the determination of pension expense for rate recovery in this proceeding. Order at 55.

Advertising Expense

61. The Commission accepts the uncontested Staff adjustment to eliminate $8,901 of promotional advertising from the HTY expense as just and reasonable for the determination of the cost of service in this proceeding.

Rate Case Expense

62. The Commission adopts $339,848 of normalized rate case expense as just and reasonable for rate recovery in this proceeding.

63. The legal fees included in rate case expense for this case are just and reasonable given the level of litigation required to prosecute the case.

64. The AWW fees charged to rate case expense in the amount of $150,000 are just and reasonable because AWW personnel assist regulated subsidiaries in the preparation of rate filings. Furthermore, the sharing of rate case expertise among the regulated subsidiaries is a common practice in large investor-owned utility organizations and avoids unnecessary and costly duplication of that expertise at each regulated utility.

Uncollectible Expense

65. The Commission accepts the uncontested Staff adjustment to HTY uncollectible expense as just and reasonable for the determination of uncollectible expense in this case.

Tank Painting Amortization

66. The tank painting amortization adjustment historically approved by the Commission will be approved in this case because that approach normalizes tank painting expenses over a fourteen-year cycle at present value and adequately compensates WVAWC for future tank painting costs.

67. WVAWC has not provided adequate evidence that the historical normalization method is not just and reasonable, and the Commission determines that the normalized tank painting expense level recommended by Staff is reasonable and will be adopted to determine the cost of service in this proceeding.

Miscellaneous Expenses

68. WVAWC did not meet its burden of proof to show that WVAWC customers benefitted from money spent on the WVAWC annual water festival, employee attendance at a baseball game, and television advertisements. In future rate cases, WVAWC should explain how these types of expenses benefit customers if it wishes to recover the expenses in rates.

69. The CAD adjustment to reduce miscellaneous expenses by $19,363, based on the record in this case is just and reasonable for the determination of the cost of service for rate recovery in this proceeding.

CAPITAL STRUCTURE AND COST OF CAPITAL

70. A utility capital structure will normally reflect the amount of capital acquired through borrowing (debt), the issuance of stock (common and preferred), retained earnings and other paid in capital contributions from stockholders.

71. The measurement of the ratio of individual capital components to the total capital establishes the relationship among the various capital sources for use in determining a composite weighted average cost of capital (WACC). WVAWC 2010 Rate Case Order at 10.

72. The Commission uses the cost rates for long-term debt, short-term debt, preferred equity, and common equity, multiplied by its percentage of the total capital structure, to derive a weighted cost of capital of each component. The weighted cost for each capital component is then combined to reach a composite WACC that the regulator uses as a guide to assist in determining what a utility can earn on the cost of its investment.

73. The capital structure utilized by the Commission to establish rates in any case should closely approximate the ratios of the capital structure components that will be in place during the first year the rates will be in effect in order to finance the rate base that the Commission authorizes in this case. 2014 APCo Order at 15.

74. The Commission adjusts the short-term debt balance of the actual capital structure of WVAWC as of December 31, 2014, by adding $28.457 million of short-term debt that matches the additional net rate base for the Transition Period included in the Commission determination of rate base at the beginning of the Rate Year.

75. The Commission adjusts the resulting short-term debt balance to reflect the $30 million of additional equity financing.

76. The Commission adopts the capital structure shown at Appendix E to this Order that is 6.470 percent short-term debt, 47.503 percent long-term debt, 0.19 percent preferred stock, and 45.838 percent common equity. This capital structure is just and reasonable for determining the appropriate cost of capital in this case and provides a proper matching of the capital component ratios that will fund the rate base authorized in this case.

Cost of Short-Term Debt

77. The Commission adopts the Staff-recommended short-term interest rate of 0.56 percent because it is based on the latest information available at the time of the evidentiary hearing and results in a reasonable short-term debt rate for determining the appropriate cost of capital in this case.

Cost of Long-Term Debt

78. The Commission adopts the Staff and CAD recommendation for a 5.87 percent long-term debt interest rate for determining the appropriate cost of capital in this case.

Cost of Preferred Stock

79. The Commission adopts the WVAWC and Staff recommendation for an 8.93 percent preferred stock cost rate for determining the appropriate cost of capital in this case.

Return on Equity (RoE)

80. Utility rates should allow a public utility the opportunity to earn a level of revenue sufficient to attract capital in the competitive capital market balanced with the interests of the consuming public in receiving fair and reasonable rates. Bluefield Water Works v. Public Service Commission, 320 U.S. 679 (1923); Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S. Ct. 281 (1944); Permian Basin Area Rate

Cases, 390 U.S. 747, 88 S. Ct. 1344 (1968); Monongahela Power Company v. Public Service Commission, 276 S.E.2d 179 (W.Va. 1981).

81. This Commission determines a RoE based on empirical studies of returns in the capital markets while balancing the interests of ratepayers in receiving fair and reasonable rates. Black Diamond Power Company, Case No. 12-0064-E-42T, Order at 5 (August 10, 2012); WVAWC 2010 Rate Case Order at 15.

82. The DCF method has long been one of the methods relied on by the Commission for determining a reasonable RoE, but the Commission also considers CAPM as a valuable tool in evaluating the range from which to determine a reasonable RoE.

83. Because equity capital carries more risk than long-term debt, it is just and reasonable to eliminate any result of an RoE estimate that is below the current cost of long-term debt, plus the minimum risk premium for common equity capital.

84. The record does not provide the Commission with sufficient basis or analysis to support the elimination of RoE results that are 300 basis points above or below the average RoE for the sample group in a portfolio approach. A sample group would normally include some results near the lower end of the acceptable RoE range and others at the high end of the acceptable range. The average, therefore, could be argued to be the reasonable result.

85. The CAPM compares the risk adjusted RoE result to alternative utility investments, and provides the Commission with a basis to compare the justness and reasonableness of the DCF results.

86. It is not just and reasonable in this case to use current short-term interest rates as the risk-free rate in the CAPM calculation because of the ongoing actions of the Federal Reserve to keep short-term interest rates at record lows in order to stimulate the economy.

87. The Staff *ex poste* approach to the CAPM analysis is just and reasonable because it incorporates historical market premiums and the average historical risk-free rate for U.S. Treasury bills.

88. Based on our review of the record presented in this case, and applying the Commission judgment and expertise in this area, the Commission determines that an RoE of 9.75 percent is just and reasonable, falls within the range of reasonable RoEs presented by the parties, fairly balances the interests of WVAWC and its customers and meets the standards set forth by the United States Supreme Court and the Supreme Court of Appeal of West Virginia.

FEDERAL INCOME TAX EXPENSE

89. The CTA approach that uses only the PCLA is just, reasonable, necessary and appropriate because of (i) the nature of the tax losses at non-parent company subsidiaries in a utility holding company structure, (ii) the volatility on the CTS calculation resulting when those tax losses are included, and (iii) the uncertainty imposed on the utility because of that volatility. 2014 APCo Order at 140-41, Conclusion of Law 87.

90. The Commission will not revert to a CTS effective income tax rate approach as proposed by CAD and approves the PCLA approach in the determination of current state and federal tax expenses in this case.

91. WVAWC is a member of the AWW Consolidated Group, and the Consolidated Group made decisions in 2011 and 2013 that subsidiaries would elect not to claim bonus tax depreciation. WVAWC Ex. RPN-D at 9-10.

92. The CTS effective income tax approach advocated by the CAD is not related to the bonus depreciation issue raised by CAD.

93. The record in this case is not sufficient to permit the Commission to determine if the CAD position on bonus depreciation deductions has merit, or not.

94. This Order does not determine the issue of bonus depreciation opt-out on the merits of the CAD position for determining federal income tax expense, and, to the extent relevant, the parties are free to raise that issue in a future rate case.

95. Because the final rate base and depreciation rates approved in this case impact the excess tax over book depreciation deduction for current income taxes, the Commission has synchronized its excess tax over book depreciation deduction to its determination of rate base and depreciation rates authorized in this case. The Commission accepts a current FIT expense of $2.738 million, a current deferred FIT expense of $7.037 million, a current SIT expense of $0.599 million and a deferred SIT expense of $0.787 million.

96. The total federal and state income tax expense of $11.160 million is just and reasonable and will be used to establish the cost of service in this proceeding.

DEPRECIATION EXPENSE

97. The Commission incorporates the depreciation expense determined by applying the depreciation rate results of the Commission decision issued today in the WVAWC 2015 Depreciation Case into the cost of service determination in this case.

RATE DESIGN

98. The Commission adopts the rate design recommended by Mr. Herbert. WVAWC Ex. PRH-D, attached WVAWC Ex. PRH-1 and PRH-2. The Commission approves the resulting water tariff designed to produce the revenue requirement authorized in this case that is attached to this Order in Appendix G.

SEWER RATE CASE

99. The Commission accepts the Staff recommended revenue level, O&M expenses and general taxes because they are based on more current data than the WVAWC positions and are just and reasonable for the determination of the cost of service in this proceeding.

100. The Commission incorporates the new depreciation rates ordered today in the 2015 Depreciation Case, into the determination of depreciation expense in this proceeding.

101. The Commission adopts the Staff HTY rate base recommendation as a just and reasonable starting point for the determination of rate base because the Staff rate base appropriately reflects the correction to RWIP.

102. The Commission reflects the terminal year end material and supply balance as proposed by WVAWC, and the Transition Period rate base reduction of $67,548 proposed by WVAWC consistent with the determination of rate base for the water case. The resulting rate base of $2,594,767 is just and reasonable for the determination of the cost of service in this proceeding.

103. The Commission will use the capital structure and resulting overall cost of capital of 7.311 percent discussed above as just and reasonable for determining the cost of service in this proceeding.

104. The Commission will not authorize consolidation of the WVAWC water and sewer services for ratemaking purposes. WVAWC will continue to separate cost of service calculations for water and sewer service as it has in this case, until such time that WVAWC can demonstrate that combining the water and sewer tariffs will not result in a cross-subsidization between water and sewer customers.

105. The Commission authorizes an overall rate increase of $151,324 for the sewer operations of WVAWC that shall apply equally to all tariff elements as shown on the sewer tariff at Appendix H to this Order.

ORDER

IT IS THEREFORE ORDERED that the Commission authorizes an overall increase in water rates of $18,169,937 million, or 15.1 percent, as set out in the cost of service calculation, attached and incorporated herein as Appendix C, which Appendix C is hereby established as the cost of service and revenue requirement approved in these proceedings for WVAWC for providing water utility service to its customers in West Virginia.

IT IS FURTHER ORDERED that the Commission authorizes an overall increase in sewer rates of $151,324, or 19.8 percent, as set out in the cost of service calculation, attached and incorporated herein as Appendix D, which Appendix D is hereby established as the cost of service and revenue requirement approved in these proceedings for WVAWC for providing sewer utility service to its customers in West Virginia.

IT IS FURTHER ORDERED that no later than ten days from the date of this Order, WVAWC must prepare and file with the Commission revised tariff schedules that reflect the increase to base rates by tariff classification as shown on Appendices G (water) and H (sewer) and consistent with the Commission decisions contained in section IX. Rate Design of this Order.

IT IS FURTHER ORDERED that on or before 180 days after the date of this Order, WVAWC shall make a closed entry filing in this case stating the total number of employee positions authorized and filled and the number of additional evening shift employees that have been hired to provide service to the Kanawha district. If WVAWC has not hired six additional evening shift employees within 180 days, WVAWC shall explain their efforts to do so and provide the expected date each of those additional positions will be filled.

IT IS FURTHER ORDERED that all hearing transcript references indicating that attorney Paul R. Sheridan represented Legal Aid of West Virginia are corrected to indicate that Mr. Sheridan represented Advocates for a Safe Water System in this case.

IT IS FURTHER ORDERED that WVAWC cease recording AFFAC on the effective date of new rates authorized in this case.

IT IS FURTHER ORDERED in the next rate case in which Staff presents a cost of equity capital analysis and recommendation, Staff will explain why 300 basis points above the sample group average RoE result is the top of the acceptable range for RoE to be included in the sample group result.

IT IS FURTHER ORDERED that the WVAWC requests for permanent protective treatment of the material filed under seal in this proceeding is deferred pending a request for that information.

IT IS FURTHER ORDERED that on entry of this Order this case shall be removed from the Commission's docket of open cases.

IT IS FURTHER ORDERED that the Executive Secretary of the Commission serve a copy of this Order by electronic service on all parties of record who have filed an e-service agreement, and by United States First Class Mail on all parties of record who have not filed an e-service agreement, and on Commission Staff by hand delivery.

A True Copy, Teste,

Ingrid Ferrell

Ingrid Ferrell
Executive Secretary

JML/klm
150676co.docx

Partial List of WVAWC Projects Related in Part to Customer Additions

This list is not complete, but see for example these cases:

92-0605-W-CN	West Virginia-American Water Company and Kanawha County Commission
93-0252-PWD-CN	West Virginia-American Water Company and Danville Public Service District
94-0098-W-PWD-PC-CN	West Virginia-American Water Company, the County Commission of Mercer County; the County Commission of Summers County; the City of Hinton; & Oakvale Road Public Service District
94-0181-W-CN	West Virginia-American Water Company
94-0362-W-PC	West Virginia-American Water Company and Kanawha County Regional Development Authority
94-0510-W-PC	West Virginia-American Water Company and Town of Winfield
94-0528-PWD-CN	West Virginia-American Water Company and Guthrie Public Service District
94-0671-W-PC	West Virginia-American Water Company and Kanawha County Regional Development Authority
94-0765-PSD-CN	West Virginia-American Water Company and Danville Public Service District
94-0804-W-CN	West Virginia-American Water Company and Kanawha County Regional Development Authority
95-0228-W-42T	West Virginia-American Water Company
95-1068-W-PWD-PC	West Virginia-American Water Company and Mossy Public Service District
96-0195-W-PC	West Virginia-American Water Company and Town of Buffalo
96-0218-W-PWD-PC	West Virginia-American Water Company and Coal River Public Service District
96-0243-W-PC	West Virginia-American Water Company and Town of Ansted
96-0260-W-PWD-PC	West Virginia-American Water Company and Van Public Service District
96-0273-W-PC	West Virginia-American Water Company and Town of Bancroft
96-0317-W-PWD-PC	West Virginia-American Water Company and Salem-Gatewood Public Service District
96-0400-W-CN	West Virginia-American Water Company
96-0450-W-PWD-PC	West Virginia-American Water Company and Putnam Union Public Service District

96-0634-W-PC	West Virginia-American Water Company and Kanawha County Regional Development Authority
96-1000-W-PC	West Virginia-American Water Company and Elkem Metals Company, L.P. Hawks Nest Water Distribution System
96-1072-W-PC	West Virginia-American Water Company, Town of Fayetteville and Beckwith Public Service District
96-1195-W-PC	West Virginia-American Water Company and Kanawha County Regional Development Authority
96-1306-W-PWD-PC	West Virginia-American Water Company and Spruce Fork Public Fork Public Service Commission
96-1338-W-PWD-PC	West Virginia-American Water Company, Boone County Commission, and Danville Public Service District
96-1393-W-PC	West Virginia-American Water Company and Kanawha Water Company
96-1447-W-PWD-PC-CN	West Virginia-American Water Company, Fayette County Commission, and New Haven Public Service District
96-1484-W-CN	West Virginia-American Water Company and Lewis County Economic Development Authority
97-0688-W-PWD-PC	West Virginia-American Water Company and Lashmeet Public Service District
97-1436-W-PC	West Virginia-American Water Company and the Town of Eleanor
97-1482-W-PC-CN	West Virginia-American Water Company and Kanawha County Regional Development Authority
97-1627-W-PWD-PC	West Virginia-American Water Company and Jumping Branch-Nimitz Public Service District
98-0246-W-42T	West Virginia-American Water Company
98-0686-W-PC	West Virginia-American Water Company and Glade Springs Utility Limited Liability Company
98-0774-W-PWD-PC-CN	West Virginia-American Water Company, Salt Rock Water Public Service District and the County Commission of Cabell County
99-0124-W-PWD-PC-CN	West Virginia-American Water Company and Kanawha County Regional Development Authority
99-0674-W-PWD-PC-CN	West Virginia-American Water Company, Putnam County Commission, and Putnam County Building Authority
98-0774-W-PSD-CN	West Virginia-American Water Company, Salt Rock Water Public Service District and the County Commission of Cabell County

99-0124-W-PWD-PC-CN	West Virginia-American Water Company, Kanawha County Commission, the Kanawha County Regional Development Authority, Big Sandy Water Public Service District, Chelyan Public Service District, Elk Two Mile Public Service District, Guthrie Public Service District and Riverside Public Service District
01-0326-W-42T	West Virginia-American Water Company
01-1624-PWD-CN	West Virginia-American Water Company; Oakvale Road Public Service District; Mercer County Commission; Summers County Commission; the City of Hinton; and the City of Princeton
02-1764-W-CN	West Virginia-American Water Company
02-1993-W-CN	West Virginia-American Water Company and Lewis County Economic Development Authority
03-0610-W-CN	West Virginia-American Water Company Kanawha County Regional Development Authority
03-0631-W-PWD-CN	West Virginia-American Water Company and Salt Rock Water Public Service District
04-0449-W-CN	West Virginia-American Water Company and the Regional Development Authority of Charleston-Kanawha County
04-0596-W-CN	West Virginia-American Water Company and Lewis County Economic Development Authority
05-0687-W-PWD-PC	West Virginia-American Water Company and Logan County Public Service District

APPENDIX B

Procedural Background

On April 30, 2015, West Virginia American Water Company (WVAWC) tendered for filing revised tariff sheets reflecting increased water rates and charges of approximately $35,472,154 annually (a 28.18 percent increase) for furnishing potable water to approximately 168,000 customers in Boone, Braxton, Cabell, Clay, Fayette, Harrison, Jackson, Kanawha, Lewis, Lincoln, Logan, Mason, Mercer, Putnam, Raleigh, Roane, Summers, Wayne and Webster Counties, to become effective on May 30, 2015. WVAWC also filed revised tariff sheets reflecting increased sewer rates and charges of $176,895 annually (a 22.3 percent increase) for furnishing sewer utility service to 1,050 customers in Fayette County, to become effective on May 30, 2015.

On the same date, WVAWC filed an application to increase depreciation rates effective on the same date that its revised water and sewer rates go into effect, Case No. 15-0674-WS-D, the 2015 Depreciation Case mentioned earlier.

By Order issued May 27, 2015, the Commission (i) made WVAWC a respondent in these proceedings, (ii) consolidated the three cases for initial processing,[17] (iii) suspended the proposed increased rates and charges through Wednesday, February 24, 2016, (iv) granted a waiver to allow WVAWC additional time to provide individual notice, (v) established the completion date for individual customer notice; (vi) set an intervention date of July 29, 2015, and (vii) granted a request to intervene from CAD.

Intervenors in the cases include the Commission Consumer Advocate Division (CAD), the Kanawha County Commission and the Kanawha County Regional Development Authority (KCC/RDA), Advocates for a Safe Water System (ASWS), West Virginia Energy Users Group (WVEUG) and SWVA, Inc. (SWVA), and the City of Charleston. Commission Orders issued May 27, 2015, June 26, 2015, June 29, 2015, July 22, 2015, and August 5, 2015.

By Orders issued June 29, 2015, and July 1, 2015, the Commission set a procedural schedule in these rate cases, including an intervention deadline of July 29, 2015, and ordered WVAWC to publish notice of the scheduled hearings.

On June 30, 2015, WVAWC filed affidavits of publication of a Tariff Form No. 8 Notice of Filing in newspapers published and of circulation in the counties in which it provides service. The publications occurred between May 7 and May 20, 2015.

On July 1, 2015, WVAWC filed Tariff Form No. 6 evidencing posting, publication and separate mailing of notice to customers of these proceedings.

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[17] The Depreciation Case, Case No. 15-0674-WS-D, was originally consolidated with Case Nos. 15-0675-W-42T and 15-0676-S-42T, but the Depreciation Case was deconsolidated from the other two cases by Commission Order issued November 5, 2015.

On July 1, 2015, the Commission issued an order scheduling public comment hearings, requiring WVAWC to publish notice of the public comment hearings, and setting a date for the filing of pre-filed Rebuttal testimony by all parties.

On September 29, 2015, WVAWC filed nineteen affidavits of publication of the Notice of Public Comment Hearings and Evidentiary Hearing showing that newspaper publication occurred between September 11, 2015 and September 17, 2015. WVAWC filed better copies of two of the affidavits on October 29, 2015.

The Commission conducted two public comment hearings in each of Weston (9/30), Huntington (10/1), Fayetteville (10/7), and Princeton (10/8). The Commission conducted one public comment hearing in Charleston (10/26). The court reporter docketed a transcript of each public comment hearing in the case file.

By Order issued October 21, 2015, the Commission indicated that Chairman Albert is recused from the Depreciation Case and required the parties to file an agreed order of witness presentation at the October 27, 2015 evidentiary hearing.

By Order issued October 22, 2015, the Commission responded to a request to schedule Depreciation Case issues and testimony on Thursday, October 29, 2015, granted a motion to excuse WVAWC witnesses Baryenbruch and Herbert, responded to a WVAWC notice of intent to object to admission of pre-filed rebuttal testimony of CAD witness Majoros and WVEUG and SWVA witness Baudino, and responded to a motion to compel filed by the Advocates.

By Order issued October 23, 2015, the Commission excused WVAWC witness Spitznagel from the evidentiary hearing.

On October 26, 2015, the Commission issued an order addressing a discovery dispute between WVAWC and the Advocates regarding the Kanawha Valley Systems Comprehensive Planning Study and setting the matter for argument on the same afternoon. The Order also excused City of Charleston witness Danny Jones and granted interim protective treatment to certain information requested in discovery and supplied by the Companies since the Commission issued its first protective order in these cases.

Also on October 26, 2015, after an *in camera* hearing on the discovery dispute, the Commission, issued an Order memorializing its bench ruling that day and addressed a request regarding the order of witnesses.

The evidentiary hearing convened as scheduled on October 27, 2015, and continued on consecutive days thereafter, through November 2, 2015.

By Order issued November 5, 2015, the Commission deconsolidated the Depreciation Case from these cases and set the filing date for initial and reply briefs.

On November 12, 2015, Staff filed a Commission Request post-hearing Exhibit No. 1 showing a Staff calculation of a market-weighted average discounted cash flow (DCF) of 10.15 percent, using data presented on the WVAWC Schedule 1 to the testimony of Dr. James H. Vander Weide. Tr. 11/2 at 36-37. Staff witness Allen stated in the post-hearing exhibit that Staff did not agree with the WVAWC market-weighted average methodology, that Staff had not verified the Dr. Vander Wiede's flotation cost and market capitalization numbers.

On November 13, 2015, Staff filed a Commission Request post-hearing Exhibit No. 2 providing a reconciliation of WVAWC requested total rate increase compared to the Staff recommended rate increase. Tr. 11/2 at 89.

Also on November 13, 2015, WVAWC filed a Commission-requested revised revenue deficiency position, including explanations of variances from its filed position.

On November 13, 2015 through November 16, 2015, the court reporter filed the transcripts of the hearing testimony and exhibits that were introduced into the record as evidence in this case.

On November 18, 2015, ASWS filed a letter requesting corrections to the hearing transcripts to correct misidentification of the ASWS attorney as representing Legal Aid of West Virginia, instead of ASWS.

Initial briefs were filed by the parties on December 16, 2015. Reply briefs were filed by the parties on January 8, 2016.

Appendix C

West Virginia-American Water Company
Case Number 15-0676-W-42T
Commission Revenue Requirement

	Commission Decision
Rate Base	526,617,437
ROR	7.311%
Return on Rate Base	38,499,655
O&M Cost	58,447,739
Depreciation	20,114,183
Taxes Other	15,733,370
FIT	9,775,183
SIT	1,385,137
Revenue Requirement	143,955,276
Going-Level Revenue	126,976,212
Increase before Proforma Adj.	16,979,064
Gross Receipts	836,071
Uncollectible Expense	354,802
Total Increase	18,169,937

Appendix D

West Virginia-American Water Company
Case Number 15-0675-S-42T
Commission Revenue Requirement

	Commission Decision
Rate Base	2,594,767
ROR	7.311%
Return on Rate Base	189,697
O&M Cost	386,668
Depreciation	156,284
Taxes Other	134,229
Federal Income Tax	59,941
State Income Tax	11,906
Revenue Requirement	938,724
Going-Level Revenue	793,356
Increase before Proforma Adj.	145,368
Gross Receipts	1,676
Uncollectible Expense	4,280
Total Increase	**151,324**

Appendix E

West Virginia-American Water Company
Case Number 15-0676-W-42T
Case Number 15-0675-S-42T
Commission Capital Structure

	$	%	Cost Rate	Weighted Cost
ST Debt	33,848,348	6.470%	0.560%	0.036%
LT Debt	248,512,042	47.503%	5.870%	2.788%
Pref. Stk.	993,170	0.190%	8.930%	0.017%
Com. Equity	239,801,302	45.838%	9.750%	4.469%
Total Capital	523,154,862	100.000%		7.311%

Appendix F

West Virginia-American Water Company
Case Number 15-0676-W-42T
Rate Base

	Commission Decision
Utility Plant	781,073,210
Utility Plant for Future Use	0
CWIP	0
Accum. Depr.	(98,784,433)
RWIP	3,425,394
CIAC's	(67,723,640)
CAC's	(17,114,083)
Net Utility Plant	600,876,448
Material & Supplies	2,008,442
Prepayments	0
Customer Deposits	0
Working Cash	(2,138,157)
Accumulated Deferred Income Tax	(84,229,962)
Other Def. Credits-ITC	(536,785)
Other Deferred Debits	10,637,451
Other Deferred Credits	0
Rate Base	526,617,437

Appendix G
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West Virginia-American Water Company
Case No. 15-0676-W-42T
Commission Approved Rates

General Service Territory		Commission Authorized Rates	Current Rates	Percentage Increase
General Domestic, Commercial and Industrial Water Service				
5/8x3/4-inch meter		$26.72	$23.20	15.1%
1-inch meter		$65.45	$56.86	15.1%
1 1/2-inch meter		$129.99	$112.94	15.1%
2-inch meter		$207.51	$180.29	15.1%
3-inch meter		$388.32	$337.38	15.1%
4-inch meter		$646.62	$561.79	15.1%
6-inch meter		$1,292.38	$1,122.83	15.1%
8-inch meter		$2,067.31	$1,796.10	15.1%
First	1,500 gallons	Meter Charge	Meter Charge	
Next	28,500 gallons	$11.8526	$10.2911	15.1%
Next	870,000 gallons	$7.7923	$6.7700	15.1%
Next	8,100,000 gallons	$5.6754	$4.9308	15.1%
All over	9,000,000 gallons	$3.6917	$3.2074	15.1%
Wholesale Water Service:				
5/8x3/4-inch meter		$26.72	$23.20	15.1%
1-inch meter		$65.45	$56.86	15.1%
1 1/2-inch meter		$129.99	$112.94	15.1%
2-inch meter		$207.51	$180.29	15.1%
3-inch meter		$388.32	$337.38	15.1%
4-inch meter		$646.62	$561.79	15.1%
6-inch meter		$1,292.38	$1,122.83	15.1%
8-inch meter		$2,067.31	$1,796.10	15.1%
First	1,500 gallons	Meter Charge	Meter Charge	
Next	28,500 gallons	$11.8526	$10.29	15.1%
Next	870,000 gallons	$7.7300	$6.72	15.1%
Next	8,100,000 gallons	$5.9366	$5.16	15.1%
All over	9,000,000 gallons	$4.1842	$3.64	15.1%

Appendix G
Page 2 of 2

	Commission Authorized Rates	Current Rates	Percentage Increase
Private Fire Protection Service:			
2-inch service	$107.60	$93.48	15.1%
3-inch service	$244.63	$212.54	15.1%
4-inch service	$429.48	$373.14	15.1%
6-inch service	$1,088.66	$945.84	15.1%
8-inch service	$1,785.30	$1,551.09	15.1%
10-inch service	$3,167.32	$2,751.80	15.1%
12-inch service	$4,438.49	$3,856.20	15.1%

Appendix H

West Virginia-American Water Company
Case No. 15-0675-S-42T
Commission Approved Rates

		Commission Authorized Rates	Current Rates	Percentage Increase
General Service Territory				
General Domestic, Commercial and Industrial Sewer Service:				
First	2,500 gallons	15.7561	13.1520	19.8%
All over	2,500 gallons	13.4274	11.2082	19.8%
Minimum Charge		$39.39	$32.88	19.8%