**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

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| **Illinois-American Water Company** | : | |
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| **Proposed Rate Increases for Water and Sewer Service. (tariffs filed February 10, 2022)** | : | **22-0210** |

**ORDER**

December 15, 2022

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By the Commission:

## I. INTRODUCTION

On February 10, 2022, Illinois-American Water Company ("IAWC" or "Company") filed new tariff sheets ("Proposed Tariffs") with the Illinois Commerce Commission ("Commission") in which it proposed a general increase in water and sewer rates pursuant to Section 9-201 of the Public Utilities Act ("Act"). 220 ILCS 5/9-201. Simultaneous with and in 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. On March 17, 2022, the Commission entered a Suspension Order suspending the Proposed Tariffs to and including July 9, 2022. On June 23, 2022, the Commission entered a Resuspension Order extending the suspension to and including January 9, 2023.

Pursuant to due notice, a prehearing conference was held on April 19, 2022 before duly authorized Administrative Law Judges ("ALJs") of the Commission via videoconference. On April 20, 2022, the ALJs issued a ruling establishing a case schedule.

Appearances or Petitions to Intervene were filed by the following: the Attorney General of the State of Illinois ("AG"); City of Peoria; Federal Executive Agencies ("FEA"); Citizens Utility Board ("CUB"); United States Steel Corporation-Granite City Works, as a member of the Illinois Industrial Water Consumers ("IIWC"); Prairie Farms Dairy, as a member of IIWC; City of Champaign ("Champaign"); City of South Beloit; Villages of Philo and Savoy; Village of St. Joseph; City of Urbana; Village of Sidney; and City of East St. Louis ("ESL").

An evidentiary hearing was held on August 10, 2022. Testimony and exhibits filed by IAWC, Commission Staff ("Staff"), the AG, Champaign, jointly IIWC and FEA ("IIWC/FEA"), jointly IIWC, FEA, and CUB ("IIWC/FEA/CUB"), and ESL were admitted into evidence and the record was marked "Heard and Taken." On September 9, 2022, IAWC, Staff, the AG, IIWC/FEA, IIWC/FEA/CUB, and jointly Champaign, City of Urbana, City of South Beloit, Villages of Philo and Savoy, Village of St. Joseph, and Village of Sidney ("Municipalities") filed Initial Briefs ("IB"). On September 29, 2022, IAWC, Staff, the AG, IICC/FEA, IIWC/FEA/CUB, and the Municipalities filed Reply Briefs ("RB").

On October 28, 2022, a Proposed Order was served. On November 10, 2022, IAWC, Staff, IIWC/FEA, IIWC/FEA/CUB and the AG filed Briefs on Exceptions ("BOEs"). In its BOE, IAWC requested oral argument which was granted by the Commission on November 17, 2022. On November 22, 2022, IAWC, Staff, IIWC/FEA/CUB, the AG, and the Municipalities filed Reply Briefs on Exceptions. The Commission heard oral argument on November 30, 2022.

## II. OPERATING EXPENSES AND REVENUES

### A. Uncontested Issues

#### 1. Employee Benefits Expense (Account 604.8 Retiree Medical Expense Capital Credits Balance)

IAWC notes that the AG made an adjustment to reflect account 604.8 Retiree Medical Expense Capital Credits as a reduction to operating expense rather than an increase to operating expense as currently reflected on IAWC Schedule C-2.14. IAWC explains that this adjustment reduces other benefits expense across rate zones and totals $90,952 in total. IAWC states that it does not oppose this adjustment. The Company has incorporated this correction into its revised C-Schedules as shown on Schedule C-2. The Commission finds that this adjustment is reasonable, and it is approved.

#### 2. Pension/Other Post-Employment Benefits ("OPEB") Update

Staff proposed an adjustment for employee benefits expense, including OPEB benefits. Staff Ex. 1.0, Schedule 1.09. In rebuttal, IAWC presented updated and corrected test year amounts for pension and OPEB expense. IAWC states that Staff does not propose any adjustments to IAWC's proposed updated test year pension/OPEB costs. The Commission finds that IAWC's updated pension and OPEB expenses for text year 2023 are reasonable, and they are approved.

#### 3. Inclusion of Union Medical Costs in OPEB

IAWC notes that as explained in response to AG Data Request 8.02, the Company has been working with its tax department and outside consultants to develop a plan to repurpose the excess funding of the Union Medical Voluntary Employees' Beneficiary Association ("Union Medical VEBA") so that it would not be taxable. IAWC explains that the Company now believes that it has identified an approach to repurpose the excess funding of the Union Medical VEBA so that it would not be 100% taxable and agrees that the excess funding amounts should be included within the revenue requirement as of January 1, 2023. The Commission finds that this is reasonable, and it is approved.

#### 4. Uncollectibles Account Expense (impact of adjustments to revenues)

The AG proposed a correction to IAWC's uncollectible expense. IAWC points out that the Company responded to discovery requests AG 13.05 and 13.11, which addressed removing all uncollectible expense from net revenues. IAWC acknowledged posting and linking errors that inadvertently resulted in the amount for uncollectible accounts being related to present revenues and not proposed revenues, and the Company also provided corrected files in IAWC Ex. 31.01. The Commission finds that this is reasonable, and it is approved.

### 5. Lobbying Expenses

Staff proposed an adjustment for lobbying expenses of $341,433 that the Company inadvertently included in test-year operating expenses. Staff Ex. 4.0 at 4. The Company agreed with this adjustment. The Commission finds that this adjustment is reasonable and is approved.

### 6. Charitable Expenses

Staff proposed an adjustment for charitable contributions expenses of $13,570 that the Company included in test-year operating expenses. *Id*. at 4-5. IAWC agrees with this adjustment. IAWC Ex. 15.00 at 9. The Commission finds that this adjustment is reasonable, and it is approved.

### 7. Advertising Expenses

Staff proposed an adjustment to advertising (Staff Ex. 4.0, Schedule 4.01) of which the Company accepted $7,830 as promotional or goodwill. IAWC Ex. 17.00 at 39-40. The Company accepted this adjustment and proposed a breakdown by rate zone of this $7,830. IAWC Ex. 17.05 at 39. In Staff's rebuttal testimony, Staff proposed an additional $146,527 (which did not include the $7,830 that IAWC accepted) adjustment to advertising for advertisements not provided, invoices not fully explaining recorded expenses, or advertisements that are promotional or goodwill in nature. Staff Ex 12.0 at 3. In the interest of limiting the number of contested issues in this proceeding, the Company accepted Staff's proposed additional adjustment. IAWC Ex. 27.00 at 13-14.

Staff states that, looking at the details of Company surrebuttal, Schedule C-2, line 20 Advertising column (IAWC Ex. 25.01 at 13) only includes $146,527. It appears to Staff that the Company neglected to include the $7,830 of previously accepted advertising adjustment in their surrebuttal Schedule C-2 (IAWC Ex. 17.05 at 7, line 20 Advertising column). Therefore, Staff's appendices to Staff's Initial Brief correct this error and include the $7,830 advertising adjustment, by rate zone as reflected on IAWC Ex. 17.05 at 39, line 5.

IAWC accepts Staff's adjustment to advertising expense as shown on Staff Exhibit 12.0, Schedule 12.01, Page 1. IAWC provided a revised Schedule C-2.19 reflecting the adjustment to advertising expense. This matter is uncontested. The Commission finds that Staff's adjustment is reasonable, and it is approved.

### 8. Amortization Expense related to the IL Interurban Granite Bs Tank

IAWC agrees with the AG's proposed adjustment to remove amortization expense for the IL Interurban Granite Bs tank by $14,262 in Central Division Water and in Total Company. The Commission finds that this adjustment is reasonable, and it is approved.

### 9. Labor and Labor Related Correction for 401k and Deferred Compensation

IAWC states that the AG made an adjustment to the Central Water rate zone to move $82,181 from regulatory expense to other benefits expense. IAWC notes that this amount was incorrectly placed within regulatory expense and should be included in other benefits expense. IAWC notes that the Company does not oppose this correction and

has incorporated it into its revised C-Schedules as reflected on Schedule C-2. The Commission finds that this adjustment is reasonable, and it is approved.

**10. Lincoln Water Rate Zone – Payroll Tax**

IAWC states that the AG made an adjustment for Federal Insurance Contributions Act ("FICA") expense for the Lincoln Water rate zone. IAWC explains that due to a formula error within the Company's workpaper, FICA expense was overstated by $92,251 for the Lincoln Water rate zone. The correct amount of FICA expense for the Lincoln Water rate zone is $893. The Company does not oppose the AG's adjustment and has incorporated this correction in its updated revenue requirement as shown on IAWC Schedule C-2.7. The Commission finds that this adjustment is reasonable, and it is approved.

**11. Removal of Wastewater Disposal Costs – Chicago Metro Wastewater Rate Zone**

IAWC explains that it recovers its purchased wastewater disposal costs for the Chicago Metro wastewater rate zone through a purchased wastewater adjustment clause. IAWC notes that in its initial filing, it removed the purchased wastewater revenues from its revenue requirement but inadvertently did not remove the costs. The AG proposed an adjustment that would remove these costs. The Commission finds that this adjustment is reasonable, and it is approved.

**12. Income Tax Adjustment for Water Used in Company Facilities**

IAWC notes that the AG made an adjustment to state and federal income tax expense for the Central Water rate zone. IAWC explains that the Company's initial filing did not capture the impact on income taxes related to the adjustment for water used in company facilities. The Company accepts this adjustment and has reflected this change in its revised C-Schedules as shown on Schedule C-5. The Commission finds that this adjustment is reasonable, and it is approved.

**13. Other Operating Revenues – Chicago Metro Wastewater and Central Wastewater**

IAWC notes that the Company's Schedule A-3 Comparison of Present and Proposed Rates incorrectly identified other operating revenues in the Chicago Metro Wastewater rate zone. The correct other operating revenues for the wastewater rate zones as reflected in the rebuttal workpaper WPC-2.6a is shown below:

- Chicago Metro Wastewater $307,734
- Central Wastewater $117,218
- Total Wastewater $424,952

The Commission finds that the corrected operating revenues are reasonable, and they are approved.

## B. Contested Issues

### 1. Update of Production, Building Maintenance, and Transportation Expenses

#### a. IAWC's Position

The Company explains that after it filed its case in early February 2022, several extraordinary economic developments occurred – developments over which IAWC had no control, including:

- The Russian invasion of Ukraine in late February 2022, and its impact on energy markets;
- Supply chain problems and significant commodity price increases in spring 2022; and
- Growing inflationary pressure, changes in monetary policy by central banks; and stock market decline.

IAWC states that these extraordinary circumstances had a significant and material impact on IAWC's costs. As a result, the Company notes, as permitted by 83 Ill. Adm. Code 287.30, IAWC proposed updates related to increases in chemical, fuel, and power costs and for pension and OPEB costs. IAWC explains that these updates are based on the availability of more recent data, including post-filing market factors driving increases in chemical, fuel, and power costs, and more recent actuarial studies supporting pension and OPEB expense. IAWC states that the significant and material updates to the 2023 totaled approximately $11.3 million.

IAWC notes that in their ruling denying Staff's Motion to Strike the update, the ALJs found that "[w]hether IAWC's evidence is substantively sufficient to support [the update] increase can and should be addressed in Staff and Intervenors' rebuttal testimony." Docket No. 22-0210, Notice of ALJs' Ruling ("ALJs' Ruling"), July 22, 2022. In rebuttal testimony, the Company explains, Staff agreed with the update to pension and OPEB costs. IAWC points out that Staff did not address IAWC's updated production costs in its rebuttal testimony but reflected them in Staff's rebuttal revenue requirement.

IAWC also notes that the AG also agreed with the update to pension and OPEB costs. The Company states that the only updated costs the AG takes issue with are those related to chemical, fuel, and power pricing. Thus, IAWC maintains, the only remaining costs at issue with respect to its proposed update are Production, Building Maintenance, and Transportation Expenses. For these costs, IAWC observes that the AG does not argue they are imprudent, unreasonable in amount, or unnecessary. Instead, the Company states, as discussed below, the AG's critique does not concern the level or prudence of these cost increases but centers primarily on whether these cost increases could have been anticipated and reflected in IAWC's initial filing. IAWC states that chemical pricing and fuel and power costs increased substantially after IAWC filed its case and because of events that could not have been reasonably anticipated.

IAWC maintains that it has therefore met the requirements for an update, and its updated costs are reasonable and should be approved as part of its future test year revenue requirement.

IAWC explains that Section 287.30 of the Commission's rules governs proposed updates to future test year data: in summary, updates may be permitted when there is "a significant and material change affecting the revenue requirement." 83 Ill. Adm. Code 287.30(a). The Company states that Section 287.30 requires IAWC to introduce evidence that will allow the ALJs, during the suspension period, to make the determination whether to "require or allow" the update. *Id.*

IAWC further explains that Section 287.30(b) directs the ALJs to consider:

> (1) Whether the changes significantly and materially affect the revenue requirement;
>
> (2) Whether the changes could have been reflected in the initial tariff filing; and
>
> (3) Whether [Staff] and other participants will have an adequate opportunity to review the updated information.

83 Ill. Adm. Code 287.30(b).

IAWC states that it has presented extensive evidence of changes to Production, Building Maintenance, and Transportation Expenses, driven by changes in chemical, fuel, and power costs, that significantly and materially affect the revenue requirement. IAWC explains that these changes result in cost updates that total over $11 million. The Company explains that Staff and the AG concede that this factor is met – Staff's Motion to Strike IAWC's update acknowledged that IAWC's proposed update "includes a significant increase in its requested revenue from its direct case." Docket No. 22-0210, Staff Motion to Strike Portions of Illinois-American Water Company's Rebuttal Testimony at 1 (July 15, 2022). And, the Company posits, the ALJs' Ruling denying Staff's Motion to Strike the update confirms this factor is met, stating "IAWC introduced evidence of a material change affecting the revenue requirement…" ALJs' Ruling at 1.

The Company states that its case was filed on February 10, 2022. IAWC explains that among a variety of factors driving IAWC's test year cost update for chemical, fuel, and power costs, two major events occurring after that filing date are critical. IAWC explains that one is the Russian invasion of Ukraine in late February 2022, which had significant impacts on energy markets and the cost of chemicals and power. The Company notes that the other is the Midcontinent Independent System Operator, Inc. ("MISO") capacity auction in April 2022, which caused a significant ($1,000,000) impact to IAWC power costs. IAWC concludes that these post-filing developments, along with other factors, clearly could not have been reflected in IAWC's initial filing because they had not yet happened at the time of that filing.

The Company explains that chemicals are critical to IAWC's operations and the chemicals IAWC uses are carefully manufactured and transported to adhere to applicable standards and must be of the quality and specifications required by the American Water Works Association ("AWWA"). IAWC states that the chemical market has been highly volatile in 2022 compared to historical levels, driven by many factors such as COVID-19 impacts, inflationary growth in commodity prices, impacts on energy prices caused by the conflict in Ukraine, and overall supply and demand pressure within a consolidating chemical market. IAWC notes that prices have increased dramatically in 2022 because

of transportation costs, supplier consolidation, energy costs, and demand for other products.

The Company explains that its initial test year forecast incorporated these factors to the extent information was available to IAWC. At the end of 2021, the Company states, it had solicited and received bid pricing for 2022, but more than half of the responses were only for the first three to six months of 2022. IAWC explains that the increase in prices from 2021 to the 2022 bids (effective January 1, 2022) resulted in an increase of approximately 36% in chemical expense. The forecast developed by the Company in its initial filing resulted in over a 30% price increase from 2021 actual expense.

The Company maintains that its updated chemical pricing, however, was developed based on market developments and information that was not known until after the Company filed its case in February 2022. The information that the Company had at the time that it filed this case suggested that the drivers of chemical price increases were temporary factors in 2021 that could stabilize later in the year. After February 2022, IAWC notes, it became apparent that these factors were not temporary, but rather would be persistent. As a result, market factors have continued to put pressure on the chemical industry throughout the year, and the Company has seen continued price increases. IAWC contends that the Russian invasion of Ukraine in late February 2022 was a major factor, leading to higher energy prices (also impacting costs of chemical production), raw material cost increases (impacts from sanctions or shortages of imported materials, leading to much tighter supply and therefore, higher costs), and higher transportation costs (fuel cost increases) that have forced suppliers to continue raising prices throughout 2022. The Company points out that these factors were not known when IAWC's rate case was filed in early February 2022.

IAWC notes that examples include the price of phosphates and ammonia, which increased 30% by the end of March 2022, driven by the fact that Russia and Ukraine were among the top exporters of those agricultural commodities in the world prior to the conflict. The Company explains that natural gas price increases also resulted in higher costs of chemical production: natural gas prices fell 20% from October 2021 to January 2022, then increased by more than 80% from January 2022 to July 2022.

IAWC explains that the update to power expense for 2023 reflects two drivers: (1) the future sourcing event to replace current pricing agreements with Homefield Energy and Constellation NewEnergy ("CNE"), which will be effective January 1, 2023, with new rates under the same pricing structure (fixed price and capacity passthrough); and (2) the impact of the MISO Capacity Market auction results in April 2022.

Regarding the first driver, IAWC explains that it has two power providers that serve its operational footprint – Ameren Illinois Company d/b/a Ameren Illinois ("Ameren") and Commonwealth Edison Company ("ComEd"). IAWC's Ameren accounts are supported through an electric supply agreement with Homefield Energy. IAWC's ComEd accounts are supported through an electric supply agreement with CNE. IAWC states that the current agreements with Homefield Energy and CNE have been in place since 2016, when they were selected as the winning suppliers in a competitive sourcing event. IAWC notes that it has extended the term on these agreements several times with the same

pricing structure. The current pricing agreements, which have a lower fixed price amount than what was originally agreed to on the first agreement, expire in January 2023.

IAWC states that the most recent indicative prices for both IAWC's Ameren and ComEd accounts are significantly higher than the current fixed pricing. IAWC points out that the quoted price for the Ameren accounts is about 80% higher than the current price and for the ComEd accounts, quoted prices are 67% higher. The Company explains that these price comparisons are based on a three-year term with the prices even higher for one- or two-year terms.

IAWC states that for the second driver, the capacity auction in April 2022 resulted in an electricity increase to $236.66/megawatt ("MW")-day from $5/MW-day a year earlier, and the expectation of continued increases in capacity costs driven by growing capacity needs. A movement of $5/MW-day to $236/MW-day is substantial and not something the Company could have anticipated prior to the completion of the April auction. And, the Company maintains, the effect is significant: the April 2022 auction will increase the capacity cost pass-through by approximately $1 million over the next year (June 1, 2022 through May 31, 2023).

IAWC states that based on this market information, which reflects developments that occurred after IAWC filed its initial case, the Company increased its fuel and power cost forecast for 2023 by approximately $5 million.

The Company explains that the invasion of Ukraine also led to increased fuel (and thus transportation costs). Diesel fuel costs have risen since the rate case filing, increasing 50% since January of 2022, which has led to rising transportation costs. The Company concludes that all of these factors have resulted in unforeseen cost increases since IAWC's original rate case filing.

IAWC notes that AG witness Selvaggio asserted, "[s]ome magnitude of the [u]pdated [e]xpenses should have been known at the time IAWC filed this case" because "the [u]pdated [e]xpenses did not suddenly in mid-2022 become volatile compared to historical levels." IAWC maintains that it is true that there was price volatility, supply chain issues, and inflationary pressures impacting IAWC's costs in 2021, although many considered these to be temporary factors that could return to lower levels later in the year. As IAWC explained, those 2021 impacts were considered in developing IAWC's original test year forecast to the extent it was available at the time that forecast was prepared. There were critical and unforeseeable developments that occurred after IAWC filed its case, however, including the Russian invasion of Ukraine in late February 2022 and the MISO capacity auction in April 2022. IAWC points out that no party argues that the Company could have anticipated these major events in its initial forecast, nor could they, given that those events had not happened yet. IAWC maintains that its updated chemical, fuel, and power costs reflect those post-filing market changes.

IAWC explains that AG witness Selvaggio did not consider this new 2022 information. Her testimony focuses on 2021 information. For example, IAWC explains, she points to a December 2021 inflation rate of 7.0% in support of her assertions. But her source for the 7.0% figure also shows the monthly inflation rate increasing to 8.5% in March and 9.1% in June. It is this sort of new information, including the future direction

of inflation, which was not known to IAWC at the time it filed its case, that support IAWC's updated expense projections.

IAWC also explains that Staff and other participants have had an adequate opportunity to review the updated information. IAWC included the proposed update in its rebuttal testimony, giving parties an additional 44 days in advance of the deadline established by Section 287.30 for an update (August 12, 2022), four weeks for Staff and Intervenors to review before their rebuttal testimony, and six weeks for all parties to review before the scheduled hearings in this proceeding. IAWC notes that the ALJs' Ruling on Staff's Motion to Strike the update (which the AG supported) found that IAWC's proposed update was timely and that "IAWC introduced evidence of a material change affecting the revenue requirement and parties may review the information and respond in rebuttal testimony." ALJs' Ruling at 1.

Ultimately, IAWC states, with respect to the substance of the update, Staff does not make any adjustments to its updated costs, and the AG does not object to the update of pension/OPEB expense. IAWC points out that no other party addresses its proposed updates, and no party testified that IAWC's updated costs were imprudent, unreasonable, or unnecessary. IAWC explains that the AG's opposition to its updated expenses for chemicals, fuel, and power, waste disposal, Building Maintenance and Transportation expenses is not supported, because it does not recognize the significant changes that occurred after IAWC filed its case.

IAWC notes that Ms. Selvaggio also claimed that IAWC did not adequately support the proposed update to chemical, fuel, and power costs because IAWC did not perform an independent audit of its updated forecast and reflect that in an updated G-2 schedule. IAWC explains that Ms. Selvaggio's assertions, however, are technical in nature, and not related to the substance of the evidence supporting IAWC's updates to production, fuel and power costs. Further, IAWC posits, Ms. Selvaggio's argument assumes that an independent audit of the updated forecast was needed. As IAWC explains, a reexamination of its updated costs by its auditor was not necessary because the scope of the proposed update was limited to impacts on production, fuel, and power costs caused by extraordinary economic developments and price increases in 2022 (and pension/OPEB expense, which was supported by an actuarial study and which no party objects to). As set forth in the American Institutes of Certificated Public Accountants ("AICPA") Guide for Prospective Financial information ("AICPA Guide"), which governs forecast examination, a "responsible party should consider whether users would expect prospective statements to be updated." Under the circumstances, IAWC states that it determined that an updated examination of its projected statements of rate base and operating income would not be expected, and so an updated G-2 schedule was not required.

IAWC notes that its updated cost projections were nevertheless thoroughly vetted. The forecast update was developed through a comprehensive review of the Company's operations. IAWC explains that recent experience and developments were considered for their impact on the Company's initial test year projections, in order to make appropriate adjustments for known or projected changes to the original projections. Where necessary, contacts were made, by local and corporate management personnel, for prices of supply chain goods and services to confirm estimates.

IAWC also notes that the AG contends that a revised auditor statement should have been provided with IAWC's rebuttal testimony to verify that the new expenses comply with AICPA guidelines, and that the changes are necessary based on information that could not have been reflected in IAWC's direct testimony. Absent this revised auditor statement, the AG states that the Company's updated expenses lack the necessary and sufficient support from a certified public accountant. As IAWC explained, however, a reexamination of updated costs by IAWC's auditor was not necessary to support IAWC's updated costs or required by forecast accounting guidelines.

IAWC explains that the scope of the proposed update was limited to impacts on production, fuel, and power costs caused by extraordinary economic developments and price increases in 2022 (and pension/OPEB expense, which was supported by an actuarial study and which no party objects to). According to IAWC, there is no requirement that a "certified public accountant" provide evidence of the reasonableness of IAWC's update for these impacts. But, IAWC explains, it did provide evidence that its update was reasonable: the review of factors and assumptions underlying the update that the AG claims is lacking did take place, and IAWC's updated cost projections were vetted. IAWC also points out that the Company did identify other changes to the forecast. In the case of rate base, IAWC updated to actuals for 2021, but made no additional adjustments to rate base, even though capital investment projections are expected to increase beyond the Company's original filing. IAWC stated that other changes were, on a net basis, not deemed material and so were not reflected in revised schedules.

And the accounting AICPA Guide cited by the AG, does not require a "revised auditor report" in every instance. As set forth in the AICPA Guide, a "responsible party should consider whether users would expect prospective statements to be updated." Under the circumstances, IAWC determined that an updated examination of its projected statements of rate base and operating income would not be expected, and so an updated audit report (G-2 schedule) was not required.

In response to IIWC/FEA/CUB's assertion that the cost increases do not relate to the types of cost increases contemplated by Part 287, IAWC explains that IAWC witness O'Drain discusses market impacts on contracts and pricing for chemicals and power. Regardless, IAWC's test year cost updates relate directly to its revenue requirement and the need for that revenue requirement to be updated to reflect new information available after IAWC filed its case.

The Company notes that the AG also complains that IAWC did not provide updated G-3, G-5, and G-6 schedules. IAWC argues that these concerns are unfounded. IAWC explains that with respect to Schedules G-3 and G-5, those schedules continue to accurately reflect how IAWC's forecast was developed and remain unchanged from IAWC's original filing, so an update is not needed. Upon further review of Schedule G-6, IAWC agreed that the G-6 schedule could be viewed as affected by the forecast update and provided an updated version in its surrebuttal. The corresponding expense updates were previously included in the Company's rebuttal filings within Schedules C-2.16 Building Maintenance Expense and C-2.17 Transportation Expense.

Lastly, IAWC notes that the AG overstates the amount of chemical expense at issue in the update. The AG proposes IAWC's chemical costs should be reduced by

$8,734,519. But IAWC's update increased Projected Chemical expense by only $4,202,175. IAWC explains that the remainder of the chemical expense increase is a correction to the test year forecast that was not expressly contested: IAWC identified a correction to the 2023 test year chemical usage forecast, discussed by Mr. O'Neill (IAWC Ex. 14.00), that increased the test year projection of chemical expense by $4,527,803.

IAWC maintains that considering the requirements for an update, the record shows the ALJs should allow IAWC to update its future test year. IAWC states that the filings of the Staff and parties in this case concede that the update changes significantly and materially affect IAWC's revenue requirement. The ALJs found that IAWC's update filing was timely, with adequate time for review. IAWC argues that the updates could not have been reflected in the initial tariff filing, as they were not known at the time of the initial filing as explained above. Therefore, IAWC concludes, it has met the criteria for an update under Section 287.30 and its updated costs should be approved and reflected in the revenue requirement.

**b. AG's Position**

The AG requests that the Commission remove $15,124,519 from IAWC's operating expenses because the Company added these costs in rebuttal testimony and did not sufficiently justify the additional expenses. IAWC filed its proposed tariffs and supporting exhibits on February 10, 2022. In its direct testimony, IAWC proposed a total revenue requirement increase of $87,416,477, or 31.09% above present rates. AG Ex. 3.0 at 3. In its rebuttal testimony, IAWC requested an even higher increase of $101,127,863, or 35.97%, above present rates. *Id*. In surrebuttal, IAWC slightly reduced its proposed revenue requirement to $100,731,769.

IAWC's update included increases to the production expenses, building and maintenance costs, transportation expenses, pension expenses, and OPEB expenses it had identified only five months earlier. IAWC Ex. 15.00 at 3. The AG argues that it showed that IAWC's list of purportedly unforeseeable circumstances included conditions that predated its February 2022 filing and IAWC did not demonstrate that its updates were reasonable and prudent.

The Commission's rules permit updates to test year costs and expenses during a rate case proceeding, so long as the company provides evidence "that a significant and material change affecting the revenue requirement . . . has occurred." 83 Ill. Adm. Code 287.30(a). Evidence to support a "significant and material change" includes changes to contractual obligations, revenue requirements, changes in the number of customers served, and changes required by government agencies. 83 Ill. Adm. Code 287.30(c). IAWC bears the burden of proof and must provide substantial evidence to demonstrate that its expenses are reasonable. 220 ILCS 5/9-201(c); *see also Bus. & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n*, 146 Ill. 2d 175, 196 (1991). The AG argues that IAWC also failed to show how the impacts of COVID-19 pandemic and inflation significantly and materially changed from February 2022, when it filed direct testimony, to June 2022, when it filed rebuttal testimony.

Similar increases were anticipated by Northern Illinois Gas Company d/b/a Nicor Gas ("Nicor") in its 2021 rate case, filed more than a year before IAWC filed this case. *N. Ill. Gas Co. d/b/a Nicor Gas Co.*, Docket No. 21-0098 (tariffs filed January 14, 2021). In

that docket, Nicor's witness stated that "the financial markets have been in extreme turmoil and continue to exhibit unusual volatility," and that "[s]ince January 2021, several government assistance programs have passed, which intended to stimulate the U.S. economy . . . . This infusion of cash into the economy has created concerns about inflation. The Consumer Price Index, a common measure of inflation, increased by 4.2% from April 2020 to April 2021 - the largest 12-month increase since September 2008." *See* IAWC Cross Ex. 1 at 1. In its final Order in Docket No. 21-0098, the Commission pointed out that Nicor "argues that the use of forecasted debt rates is particularly important, given how atypical current conditions are . . . [and] in recent months many members of the Federal Open Market Committee have accelerated their timelines for when interest rates will rise." Docket No. 21-0098, Order at 71. It is unclear why these circumstances were not reflected in IAWC's direct testimony when Nicor, for example, was able to anticipate those circumstances more than a year earlier.

The AG states that according to IAWC, these examples are irrelevant because inflation rose even higher in 2022. The AG points out that IAWC failed to acknowledge that this rise was part of a greater trend of inflation, as exemplified by Nicor's testimony. There is nothing in the record to suggest that inflation was waning at the time IAWC filed its rate case in February 2022 or that IAWC did not already sufficiently incorporate inflation into its future test year expenses. Further, the AG notes that IAWC did not justify its delay in modifying its test year forecast until June 29, 2022 - 125 days after the Russian invasion of Ukraine, 76 days after the results of the MISO capacity auction were released, and 27 days after Staff and Intervenors filed their direct testimony. The AG maintains that this delay was unreasonably prejudicial and left Staff and Intervenors with only 17 business days to review and analyze the updated filings, issue discovery (with a seven-day discovery turnaround), develop a position on IAWC's update, and prepare rebuttal testimony.

The AG recommends that the Commission reject IAWC's proposed updates because the Company failed to provide sufficient evidence to support them. AG Ex. 3.0 at 19, 21. Ms. Selvaggio noted, "[w]hen expenses are selectively changed based on more recent information, the original rate base, capital structure, and other expenses may also need to be revised. An update should be reflective of all key factors and assumptions known at the time of the update." AG Ex. 3.0 at 19.

This position is supported by 83 Ill. Adm. Code 287.30(b). The AG asserts that IAWC failed to provide sufficient evidence for the Commission to make the determinations required by Section 287.30(b). The AG states that it is unclear why IAWC's initial filing could not have reflected the circumstances other utilities like Nicor were aware of. Furthermore, IAWC did not update many of its schedules until surrebuttal, denying Staff and the Intervenors' witnesses the opportunity to respond to these changes.

The AG points out that IAWC failed to update other schedules at all. For example, IAWC did not update its Schedule G-2, which should contain "a statement from the independent certified accountant that the preparation and presentation of the applicable schedules comply with the guidelines of the [AICPA Guide]." *Id*. at 21. This schedule is required by Commission rule, 83 Ill. Adm. Code 285.7010, and a revised auditor statement should have been provided with IAWC's rebuttal testimony to verify that the new expenses comply with AICPA guidelines, and that the changes are necessary based

on information that could not have been reflected in IAWC's direct testimony. Absent this revised auditor statement, the AG maintains, the Company's updated expenses lack the necessary and sufficient support from a certified public accountant.

The AICPA Guide states, "[i]t is not usually expected that prospective financial statements will be updated, and the responsible party may state in the presentation that it does not intend to update them." AG Ex. 3.0 at 22. However, in cases where statements are updated, "[u]pdating requires the reanalysis of key factors and assumptions and the preparation of new prospective financial statements." *Id*. The AICPA Guide also states that if forecasts need to be updated, "appropriate disclosure should be made to persons who currently rely or are likely to rely on the prospective financial statements." *Id*. This is consistent with Section 287.30(b), which requires the Commission consider whether Staff and other parties "will have an adequate opportunity to review the updated information." 83 Ill. Adm. Code 287.30(b).

The AG notes that IAWC argues that the AG's position that IAWC must update its schedules is "technical in nature, and not related to the substance of the evidence supporting IAWC's updates to production, fuel and power costs." IAWC IB at 16. IAWC also argues that it was not required to update its Schedule G-2 because the AICPA Guide states that a "responsible party should consider whether users would expect prospective statement to be updated," and that "IAWC determined that an updated examination of its projected statements of rate base and operating income would not be expected, and so an updated G-2 schedule was not required." *Id*. The AG shows that IAWC's suggestion that the Commission would not expect an updated statement from a certificated accountant to support the Company's increased costs and expenses is self-serving, erroneous, and unreasonable. IAWC must support all of its costs and expenses with substantial evidence to satisfy its statutory burden. 220 ILCS 5/9-201(c). This includes providing all the requisite schedules to support its costs and expenses.

IAWC's Schedule G-2 does not reflect its updated test year estimates. Schedule G-2 states, "[t]he Projected Financial Information reflects management's judgment as of February 10, 2022, the date of the Projected Financial Information." IAWC Sch. G-2 at 6. IAWC updated its test year expenses on June 29, 2022, negating the assumptions and conclusions of its February 10, 2022 Schedule. The AG maintains that the Commission should reasonably expect IAWC to provide an updated statement by a certified accountant to support its updated schedules because "an update to only certain aspects of the test year forecast without a consideration of all assumptions violates the integrity of the original projected information constituting the test year." IIWC/FEA/CUB IB at 3-4. IAWC cannot simply ignore its burden of proof by self-proclaiming that these updates are "technical in nature." The AG thus requests that the Commission deny IAWC's updated expenses because it failed to provide substantial evidence—through updated schedules—to support rebuttal changes to its revenue requirement. This results in a total reduction in operating expenses of $15,124,746.

#### c. IIWC/FEA/CUB's Position

It is the position of IIWC/FEA/CUB that IAWC significantly increased its overall requested revenue requirement in rebuttal testimony, from $87 million to $101 million (a

16% increase), for alleged increases in its projection of certain production costs (chemicals, fuel and power) and pension/OPEB costs.

IIWC/FEA/CUB point out that AG witness Selvaggio does not agree that IAWC provided evidence sufficient to justify an update under Section 287.30. AG Ex 3.0 at 19. IIWC/FEA/CUB agree that an update to only certain aspects of the test year forecast without a consideration of all assumptions violates the integrity of the original projected information constituting the test year. *Id*. When expenses are selectively changed based on more recent information, the original rate base, capital structure, and other expenses may also need to be revised. *Id*. An update should be reflective of all key factors and assumptions known at the time of the update. *Id*. The Company did not sufficiently justify that the alleged cost increase – which remain projections based on a future test year – are changes that could not have been reflected in the initial tariff filing and were not anticipated when the Company filed its case just a few months ago. Further, the cost increases do not relate to the types of cost increases contemplated by Section 287.30: contractual obligations, revenue requirements, additions or losses of customers served, and government requirements or levies. Additionally, due to the timing of the requested increase in these production costs, Staff and Intervenors did not have adequate time to fully investigate the basis for these costs. Thus, IIWC/FEA/CUB recommend the Commission disallow these additional costs of production, Building Maintenance, and Transportation.

**d. Commission Analysis and Conclusion**

The Commission notes that the ALJs already determined that the Company's update to Production, Building Maintenance, and Transportation expense met the standards of Section 287.30 of the Commission's rules, and the Company was permitted to update its schedules. ALJs' Ruling at 1. The question is whether the Company could have presented that information in its initial filing in February 2022. IAWC unequivocally claims that due to the Russian invasion of Ukraine, supply chain problems and significant commodity price increases in spring 2022, inflationary pressure, changes in monetary policy by central banks, and stock market decline, it was forced to increase its revenue requirement by $11.5 million.

The Commission agrees that this is not an insignificant increase; however, the standard by which operating expenses are judged is whether they are just and reasonable. As the Company points out, the AG does not argue they are imprudent, unreasonable in amount, or unnecessary. The record demonstrates that as of the Company's tariff filing, Russia had not yet invaded Ukraine. No party disputes that due in part to that conflict, chemical pricing, fuel, and power costs increased substantially, and supply chains were significantly affected globally. Therefore, IAWC's expenses were not knowable at the time of its initial filing. Further, MISO's capacity auction in April 2022, well after the Company's filing, caused a significant impact to IAWC power costs. While the Commission agrees with the AG that Nicor in earlier dockets mentions global financial volatility due to the pandemic, it does not and could not consider the Russian invasion or the MISO auction, which were significant, impactful, yet unpredictable events.

The AG states that the Company did not update its Section 285.7010 G-2 schedule with a new auditor's certification statement. According to Section 287.30(a), "[w]hen data

are updated, the utility shall also provide updated information for any affected schedules and work papers originally submitted as a requirement of 83 Ill. Adm. Code 285." 83 Ill. Adm. Code 287.30(a). Schedule G-2 was not affected by the update, however. The Independent Accountant's Report indicated that G-2 would not be updated due to differences between projected and actual results, even if those differences are material. The independent certified public accountant did not update the prospective financial statements, nor its report; thus Schedule G-2 was not affected. When the Company filed its rebuttal testimony, Staff filed a Motion to Strike, in part, due to a concern that certain information required to be updated by Section 287.30(a) was not provided. Staff noted three schedules requiring updates were not provided: Schedule C-4, Schedule C-11.3, and Schedule B-8.1. IAWC admitted Schedule B-8.1 was inadvertently omitted and provided the schedule. Schedules C-4 and C-11.3 have no bearing on the updated calculation. In neither the AG's Response nor its Reply to Staff's Motion to Strike, did the AG suggest that an updated Schedule G-2 was needed or required. The AG's contention that an updated Schedule G-2 Schedule is now necessary is not reasonable.

The Commission deems that the parties were not prejudiced by this test year update, as Staff and Intervenors were granted an extension to file their rebuttal testimony, and additional time for discovery was provided. Not only that, Staff and Intervenors had sufficient time to serve discovery or cross witnesses concerning the update. Moreover, Staff did not respond to the issue in its briefs, and included the increase in its revenue requirement schedules, implying Staff finds those expenses are reasonable.

### 2. Performance Pay

#### a. IAWC's Position

IAWC argues that it should be afforded full and complete recovery of its market-based employee compensation costs, including costs related to American Water Works Service Company ("Service Company") performance pay. IAWC states that this is especially true when no party has introduced any evidence that the Company's performance pay has created imprudent levels of employee compensation. IAWC notes that, to the contrary, the record contains uncontested evidence, including a compensation study, establishing that IAWC's employee compensation costs are prudently incurred, just, and reasonable. The Company concludes that it should be permitted to fully recover the totality of these costs, because:

- even including performance pay, the Company's employee compensation costs – including performance pay – are below market levels;
- Service Company costs to IAWC, which include employee compensation at cost, are considerably below the market prices for such services;
- the Company's ability to manage Operations and Maintenance ("O&M") costs and strategically grow its customer base has mitigated expense increases for and created greater efficiencies in operations that have allowed the Company's O&M cost per customer to remain virtually flat over the past decade;
- IAWC's performance pay program is applicable to all employees, including bargaining unit employees; and

- the level of excellence motivated, in part, by performance pay has reaped the desired results as, for the third consecutive year, IAWC received the J.D. Power award for ranking highest in customer satisfaction among water utilities in the Midwest.

IAWC states that accordingly, the Company's total market-based compensation costs should be recoverable like all other operating costs. The Company explains that under the standard articulated by the Commission in its Order in the Company's 2007 general rate case, disallowance of cost recovery for the performance pay component of the Company's total market-based compensation program is not justified here because the performance plans, including components tied to both operational and financial goals, produce demonstrable benefits for customers. IAWC further states that where Service Company costs have also been shown to be below market levels, there is simply no reason to look behind those costs at the employee compensation plans that underlie them as a rationale for disallowing clearly reasonable costs.

IAWC maintains that the Commission should permit IAWC to fully recover its total market-based compensation costs, and not disallow recovery of performance pay costs either as a component of the Company's employee compensation or as a component of Service Company costs.

IAWC explains that employee compensation is a necessary cost of providing utility service. Therefore, IAWC states that it should be assessed through the same lens as other operating costs: if it is prudently incurred and reasonable as measured relative to what the industry pays for the same services, it should be recoverable through rates. IAWC states further that accordingly, if the Company's total compensation level is in line with the market, regardless of the combination of fixed and variable payments that the employees earn, then the Company's total compensation expense should be fully recoverable. The Company explains that, in other words, the focus should be on whether the Company's overall level of compensation is reasonable, giving management the discretion to design the compensation package that is best structured to compensate employees properly and to motivate efficiency, safety, courtesy, and other valuable employee traits.

IAWC recognizes that the Commission has in the past disallowed costs associated with performance pay that are tied to financial goals, on the grounds that they "primarily benefit" shareholders. *Ill.-Am. Water Co*., Docket No. 07-0507, Order at 25 (July 30, 2008). IAWC contends, however, that a number of circumstances have changed over the years, not least of which is that performance pay, including financial goals, has become an integrated part of the total compensation package that businesses – including utilities – pay to their employees, which is needed to ensure utilities can recruit and retain the expertise they need to continue to provide safe and reliable service. The Company further states that the financial metrics tied to performance pay do not "primarily" benefit shareholders, but rather benefit all stakeholders including customers, employees and investors. Moreover, for IAWC specifically, the Company notes that an important change has been to provide performance pay to union employees pursuant to collectively bargained agreements. IAWC states that with the inclusion of IAWC's union employees in the performance pay compensation plan, all of IAWC's employees' efforts are aligned to drive efficiencies in the business.

IAWC points out that, in fact, the Commission's standard for recovery of performance pay has never been an absolute bar to recovery. As stated in the Order in IAWC's 2007 rate case, the Commission has "generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations which provide net benefits to ratepayers." Docket No. 07-0507, Order at 25. The Company states that as established by the record evidence in this case and as further discussed below, IAWC has met this standard and should be allowed to fully recover its total market-based employee compensation costs, inclusive of performance pay.

IAWC explains that in order to attract and retain committed, dedicated and highly qualified employees, IAWC must offer compensation that is on par with that offered by the market relative to companies with which IAWC competes for employees. The Company, therefore, targets its total direct compensation (base and variable compensation) for near the market median (50th percentile). The Company explains that by using a combination of fixed and variable compensation that includes performance compensation, IAWC satisfies a dual objective of reasonably compensating employees while motivating them to achieve goals that improve performance and efficiency to benefit customers.

IAWC explains that performance pay may be awarded under two plans – the Annual Performance Plan ("APP") and the Long-Term Performance Plan ("LTPP"). All full-time employees participate in the APP. This includes bargaining unit employees, who became eligible for APP in 2018, with their first payments in 2019.

IAWC notes that APP pay is based on a combination of individual performance and achievement of plan goals. Union employees' performance pay was established through collective bargaining and is based on the achievement of plan goals.

IAWC explains that eligibility for the LTPP is limited to certain exempt employees. The LTPP consists of restricted stock units ("RSUs") and performance stock units ("PSUs") based on three-year vesting periods. RSUs are based on time-based vesting and PSUs are based on time and performance vesting conditions.

IAWC states that as part of its direct case, the Company submitted a study by Willis Towers Watson ("WTW") that assessed both IAWC's total market-based compensation program and its performance compensation program. IAWC points out that the findings of WTW's compensation study are described in the direct testimony of Mr. Mustich. *See* IAWC Ex. 9.00. The results of this study were not contested.

IAWC explains that WTW showed that the Company's Target Total Direct Compensation (base salary, plus APP, plus LTPP) lies 11% below the competitive market median measured from a national market perspective but lies 9% below the competitive market median measured from a Midwest regional market perspective.

IAWC maintains that the Company's performance compensation plans align the interests of customers, employees, and investors. The plans emphasize customer service, environmental compliance, a safe work environment, other operational goals, and financial goals. IAWC states that all of the APP and LTPP plans' performance

objectives – both operational and financial – focus employees' efforts in ways that benefit customers.

IAWC states that the operational goals of the APP are designed to focus plan participants on the performance results that can most directly influence customer satisfaction, health and safety, and environmental performance. IAWC contends that customers benefit from the plan goals because operational performance is improved by controlling costs, capturing efficiencies, promoting effective safety and risk management practices, and enhancing customer service. The Company explains that performance is determined by goals that directly benefit customers by creating a more productive workforce that is focused on customer satisfaction and achieving efficiency, environmental and safety goals.

IAWC states that goals such as reducing Occupational Safety and Health Administration incidents increase both customer and employee safety, and that maintaining and improving high quality customer satisfaction and service quality also provide customer benefits. The Company explains that its customer satisfaction performance goals measure customer contacts at IAWC's customer service centers and in the field. They are benchmarked against other utilities' performance, as reported by third-party customer satisfaction surveys. IAWC notes that in 2021, IAWC again ranked first in the Midwest Region for customer satisfaction in J.D. Power's Water Utility Residential Customer Satisfaction Study. IAWC explains that J.D. Power's Overall Water Utility Satisfaction Index measures key performance indicators in six areas: delivery (including quality), price, conservation, billing and payment, communications, and customer service. Customer satisfaction often goes hand-in-hand with reducing customer complaints. IAWC notes that its Commission inquiries for 2021 are down by approximately 61% as compared to 2017 levels.

The Company contends that all of IAWC's goals, operational and financial, benefit the customer, employees, and investors (debt and equity). IAWC explains that the goals focus employees' efforts on controlling costs, capturing efficiencies, promoting effective safety and risk management practices, and enhancing customer service. IAWC concludes that the financial goals of the APP and LTPP are thus complementary to the operational goals, and benefit customers in many ways.

IAWC notes that, importantly, achieving performance pay financial goals, such as targeted earnings per share ("EPS") performance, demands attention to operating efficiency. That is, unless the utility controls its operating costs, it likely will not achieve a targeted EPS. The Company explains that financial goal-based performance pay ensures that employees at all levels of the organization, and not just the upper ranks, remain focused on increasing efficiency, decreasing waste, and boosting overall productivity while providing excellent customer service. As a result, IAWC argues, incentivizing employees to control operating costs unquestionably benefits customers. Consequently, when financial performance is achieved through efficiency, as the Company explains is the case here, the interests of customers, employees and investors are aligned.

IAWC notes that every company has financial targets. IAWC explains that its rate case is driven by investments the Company is making in the communities it serves to help strengthen those systems, and that growth targets are in place to help measure and

manage the pace at which the Company makes those investments and to communicate that to the investment community. IAWC states that meeting those targets will help attract the ongoing capital investments needed to maintain and improve its water and waste water systems. Furthermore, the Company explains that as Mr. Mustich testified, the performance goals of most utilities and companies in general industry are aligned, so IAWC's inclusion of financial goals in the APP program is simply aligned with the market for how employees are compensated.

IAWC notes that since the Company's last general rate case, acquisitions, and new challenges, including maintenance costs post-acquisition for systems in need of upgrades, increased fuel, power, and chemical costs, and compliance with changing regulatory standards, have increased IAWC's overall O&M costs. IAWC states that despite these cost pressures, IAWC has been highly successful in managing its O&M costs. The Company notes that its proposed O&M expense per customer has remained relatively flat for the past decade and that if IAWC's costs had increased at the same rate as inflation over the same 10-year period, those costs would have been 27% higher than they are (increasing operating expense and IAWC's rate request by over $30 million). IAWC states that its ability to hold O&M costs per customer steady is a customer benefit that no party disputes. IAWC explains that given its record of controlling its per customer O&M costs over the last decade, it is apparent that IAWC's intense focus on customers, improving water efficiency, and financial performance has benefited IAWC's customers, thus satisfying the Commission's standard for allowing recovery of these costs.

IAWC maintains that the efficiency promoted and incentivized by the Company's performance pay, including financial goals, also permits increased infrastructure investment without increased rates. Specifically, the Company explains that every dollar of operating expenses saved can fund over $8 of investment – without increasing customer bills. IAWC concludes that this benefits both customers and investors.

Furthermore, IAWC notes that because water and wastewater operations are capital-intensive and must constantly and consistently access the capital markets at reasonable cost, customers benefit from a utility's financial health. IAWC explains that a financially healthy utility benefits customers because it enables the utility to meet its service obligations with reasonable financing costs, which helps the Company mitigate its requested rate increase. The Company further states that when financial performance is achieved through efficiency, as is the case for IAWC, the interests of customers and investors are aligned.

Finally, IAWC states, the analysis of the affordability of the Company's historical and proposed rates performed by Company witness Rea demonstrates that the Company's efforts have provided net benefits to its customers. IAWC explains that Mr. Rea's analysis relates the median household income for customers in its service territory to IAWC's utility bills over time, and that even with the rate increases in this case necessitated largely by the capital program, Mr. Rea's analysis demonstrates that IAWC's water service, overall, has become more affordable over time and will remain affordable under the Company's proposed rates. The Company points out that an important way that IAWC maintains the affordability of water and wastewater service is by continuously seeking to improve business processes and make investments that improve operational efficiencies. IAWC states that performance objectives – both operational and financial –

focus employees' efforts in ways to continually improve, and that this allows it to manage and contain cost increases and benefit its customers.

In summary, IAWC explains that no party contends that the Company should not compensate its employees with a combination of fixed and performance pay. Neither do they quarrel with the evidence that financial goals are an element of virtually all compensation plans offered by utilities or businesses generally. Most importantly, IAWC notes, no party disputes that IAWC's total market-based compensation costs are reasonable. Nevertheless, IAWC states that parties oppose recovery for the performance pay component of the total market-based compensation program related to financial goals. The Company responds that all performance pay, including for financial goals, benefits customers (as well as investors and employees). For these reasons, IAWC maintains, the adjustments to remove performance pay related to financial goals should be rejected, and IAWC should be authorized to recover its full compensation costs.

The Company explains that arguments by Staff and Intervenors, including assertions that the Company has provided no new evidence aside from claims it has provided in its prior rate cases, or has not demonstrated a direct correlation or derivation between the financial factors within the Company's incentive pay programs and a direct benefit to customers, fail to meaningfully address the Company's evidence.

Specifically, the Company states that Staff and Intervenors fail to rebut: (1) the Company's undisputed evidence establishing that IAWC's total compensation for its employees, as well as Service Company costs, are below market, and thus reasonable; and (2) the Company's evidence that the Company's performance pay programs, including components linked to financial goals, provide concrete customer benefits. The Company notes that the AG, for example, expressly argues that whether IAWC's current compensation levels are below market rates is irrelevant, but responds that no party can dispute that, to attract and retain talent, IAWC must offer compensation that is on par with that offered by the market relative to companies with which IAWC competes for employees, and that no party disputes the Company's evidence that performance pay, including financial goals, has become an integrated, customary and accepted part of the total compensation package that businesses—including utilities—pay to their employees. The Company notes that Staff and Intervenors do not even mention, much less rebut, evidence establishing that an important recent change has been to provide performance pay to union employees pursuant to collectively bargained agreements, meaning that all of IAWC's employees' efforts are aligned to drive efficiencies in the business. The Company further notes that an example of the demonstrated, concrete benefits for customers provided by these components of the Company's performance pay programs, which Staff and Intervenors do not address, much less rebut, is the Company's effective management of O&M costs, contrary to Staff's claim that nothing has changed since 2007.

The Company notes in reply briefing in response to Staff and Intervenors that the Company does not dispute that the Commission has articulated a standard for assessing the recoverability of performance pay costs that such costs are not recoverable if they primarily benefit shareholders. The Company explains, however, that the fact that this is the Commission's stated standard, however, does not mean it is an insurmountable barrier to recovery of all performance pay costs tied to financial goals, as suggested by

Staff's and Intervenors' briefs. IAWC explains that instead, the Commission must consider the evidence presented by the parties and determine whether a given compensation program is reasonable overall. The Company notes that while the Commission has, in the past, considered whether performance pay tied to financial goals primarily benefits shareholders, that consideration does not establish, in this case, a presumptive standard upon which the Commission can ignore the evidence. The Company submits that Staff and Intervenors have not rebutted its evidence establishing that the components of its performance pay programs that are tied to financial goals provide meaningful, concrete benefits to customers, and do not primarily, much less exclusively, benefit shareholders.

Regarding Service Company costs, IAWC states that unrefuted evidence in the record demonstrates that the Service Company provides services to American Water Works Company, Inc.'s ("American Water") affiliates, including IAWC, at cost, and at prices that are considerably below the market prices for such services. The Company explains that the Service Company provides legal, finance, accounting, engineering, environmental, technology, customer and other valuable services to IAWC and its regulated utility affiliates. IAWC states that it submitted a study at the outset of the case which showed, among other things, that: (1) the Service Company's services were necessary; (2) the Service Company's historical period cost per IAWC customer is reasonable because it is in line with the cost per customer for the proxy service companies; (3) IAWC was charged a reasonable value for managerial and professional services during the 12 months ended June 30, 2021; and (4) the services that IAWC obtained were at costs appreciably lower than the prevailing market costs for such services. IAWC states that no party has proposed an adjustment to the overall level of Service Company charges or asserted that any Service Company service is unreasonable or unnecessary.

IAWC maintains that the opposing parties' proposed adjustments to performance pay nevertheless also remove Service Company performance pay costs related to financial metrics. The Company states that including Service Company performance pay in their adjustments, however, is misplaced. The Company explains that in examining costs for accounting, engineering, legal or other professional services, the inquiry would be as to the level of such costs, rather than whether, e.g., the firm in question provided a given benefit or not. IAWC contends that the overall question that a regulator should ask regarding these services is whether their cost is reasonable given the nature of the services and the market for them, and that Service Company costs should be treated no differently. The Company notes that here, no party disputes the reasonableness of overall Service Company charges, and that accordingly, the Company should be permitted to fully recover its Service Company costs.

IAWC also explains that recruiting skilled workers, as well as retaining existing trained workers, is critical to continuing to provide safe drinking water and perform satisfactory customer service. The Company explains that competition among companies to attract and retain the best and highest performing employees is keen, and that in recruiting new employees or retaining existing employees, both the Company and American Water compete with general industry in surrounding regions and nationally. IAWC notes that especially with respect to employee retention, the loss of skilled

employees imposes a real cost on a company that then needs to attract and train replacements.

IAWC notes that both Staff and the AG's adjustment to remove performance pay tied to financial goals exclude RSUs from the adjustment. IAWC states that as Staff acknowledges, RSUs represent the right to receive stock depending on an employee's continued employment with American Water through a defined vesting period, not the achievement of financial goals. IAWC explains that RSUs are awarded to encourage employee retention, which benefits customers by providing a stable and experienced leadership team. IAWC posits that maintaining a stable and experienced leadership team has benefits from an operational standpoint, allowing continuity of management of operational programs and personnel, which in turns promotes safe and reliable service and ongoing improvements in efficiency. The Company further explains that a stable team also avoids the costs of employee turnover, which can result in lost investment in employee training and the incurrence of costs for employee replacement, such as recruiting, hiring, and new training costs.

IAWC points out that only IIWC/FEA/CUB continue to insist that RSUs be excluded from recovery. IAWC states that IIWC/FEA/CUB's position is not consistent with Staff and the AG's position or recent Commission decisions on this issue. The Company notes that the Commission has approved recovery of the cost of RSUs in rates in several recent dockets for other utilities. *See Ameren Ill. Co. d/b/a Ameren Ill*., Docket No. 18-0463, Order (Nov. 1, 2018); *N. Ill. Gas Co. d/b/a Nicor Gas Co.,* Docket No. 18-1775, Order (Oct. 2, 2019); *Ameren Ill. Co. d/b/a Ameren Ill*., Docket No. 19-0436, Order (Dec. 16. 2019); *Ameren Ill. Co. d/b/a Ameren Ill.*, Docket No. 20-0308, Order (Jan. 13, 2021). Thus, IAWC concludes, even if the Commission were to disallow recovery of compensation costs tied to financial performance (which it should not for all the reasons explained above), it should permit recovery of the cost of RSUs.

**b. Staff's Position**

Staff argues that the Commission should approve Staff's proposed adjustments to remove the cost of incentive compensation that is based on financial metrics, not providing ratepayer benefits, just as it has done in numerous prior cases. Staff Ex. 3.0 at 7-9. Staff states that the Company has provided no new evidence aside from claims it has provided in its prior rate cases, that this portion of incentive compensation provides ratepayer benefits in the form of specific dollar savings or other tangible benefits. *Id*. at 9-10. Staff's direct testimony proposed to remove 50% of the cost of the Company's Annual Incentive Plan ("AIP") and 100% of the cost of the Company's LTPP within Staff Schedule 3.02 because they were based on the achievement of financial goals. In rebuttal testimony, Staff agreed with the Company that the portion of the Company's LTTP related to RSUs are not based on the achievement of financial performance; therefore, Staff revised its proposed adjustment in Staff Exhibit 11.0, Schedule 11.02.

Staff notes that in the Company's 2007 general rate case, the Commission summarized its practice on incentive compensation as follows:

> The Commission has consistently disallowed recovery of payouts that are tied to overall company financial goals. As is apparent from previous rate orders, the Commission has

> generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations which provide net benefits to ratepayers. In this case, no such showing has been made by IAWC.

Docket No. 07-0507, Order at 25. In the Company's two succeeding general rate cases (*Ill.-Am. Water Co*., Docket No. 09-0319 (Apr. 13, 2010); *Ill.-Am. Water Co*., Docket No. 11-0767 (Sept. 19, 2012)), the Company removed these incentive compensation expenses from its initial filings.

In Docket No. 21-0198, a rate case filed by Utility Services of Illinois, Inc., now Prairie Path Water Company ("USI" or "PPWC"), Staff proposed to remove from USI's revenue requirement incentive compensation that was based on financial metrics which was not contested by the Company:

> USI notes Staff's position that financial goals and metrics provide benefits to shareholders but not necessarily to ratepayers, and that 60% of USI's Employee Incentive Plan ("EIP") plan is based on the Company's financial performance. USI asserts that in the interest of limiting the issues in this proceeding, the Company did not contest Staff's recommendation. No other party contests the Company's calculation of incentive compensation, as adjusted by Staff, and these amounts are approved.

*Util. Servs., Inc*., Docket No. 21-0198, Order at 24 (Dec. 1, 2021).

Similarly, in a North Shore Gas Company rate case the Commission agreed that:

> when incentive compensation seeks to achieve goals that primarily benefit shareholders, then it is reasonable to require that shareholders bear the cost of that incentive compensation.

*N. Shore Gas Co*. / *The Peoples Gas Light and Coke Co.*, Docket No. 09-0166/09-0167 (Cons.), Order at 58 (Jan. 21, 2010); Staff Ex. 3.0 at 14.

The Company continues to dispute any disallowance of its incentive compensation programs arguing that its overall employee compensation costs, including performance pay, are already below market levels. IAWC Ex. 23.00 at 3-4. Staff asserts, however, that these arguments do not address Staff's initial concern since Staff's adjustments were not proposed because of the amount of incentive compensation awarded. Rather, the issue is whether incentive compensation based on financial metrics that benefit shareholders should be recovered from ratepayers at all. Staff Ex. 11.0 at 8. Staff argues that since the Company has, once again, not demonstrated a direct correlation or derivation between the financial factors within the APP and the LTTP and a direct benefit to customers, the Commission should again remove the incentive compensation costs listed on Appendices A-E from the revenue requirement, consistent with longstanding Commission practice.

### c. AG's Position

The AG requests that the Commission reduce IAWC's performance pay expenses by $3,897,310 and its proposed payroll taxes by $298,144 because IAWC's proposal would require ratepayers to reward the Company's employees for achieving goals that primarily benefit IAWC's shareholders. IAWC provides employees with incentive compensation or "performance pay" through its APP and LTPP. AG Ex. 1.0 at 4. Under the APP, IAWC rewards employees with additional compensation based on individual performance and the achievement of certain Company operating goals (short-term compensation). *Id*. Under the LTPP, IAWC rewards employees based on increases to the Company's EPS and "total shareholder return" ("TSR") with RSUs and PSUs (long-term compensation). *Id*. at 5.

The AG recommends that the Commission remove certain APP and LTPP costs, because they are based on increasing EPS, TSR, and other increases to shareholder returns. *Id*. at 5. The AG asserts that it is unreasonable to include incentive compensation based on increased shareholder returns (or profits) in IAWC's revenue requirement because that would, "in effect, require[ ] customers to reward utility management on a contingency basis for requiring them to pay higher rates." *Id*. at 5. The AG further demonstrates that if the Company achieves higher earnings than authorized or expected, related incentive costs should be borne by shareholders—the beneficiaries of achieving these financial goals—rather than ratepayers, who already will bear the additional costs of rate increases. *Id*. Staff, IIWC/FEA/CUB, and the Municipalities also recommend that these costs be removed, for similar reasons.

Excluding financial incentive compensation from the revenue requirement is consistent with the Commission's previous decisions on this matter. For example, in IAWC's 2007 rate case, the Commission disallowed the Company's proposed incentive compensation costs and noted ratepayers should not "have to help encourage IAWC's employees to meet goals benefitting shareholders and meet minimum service obligations." Docket No. 07-0507, Order at 25-26. Similarly, IAWC accepted Staff's request to remove such costs in its 2011 rate case (Docket No. 11-0767, Order at 58), and withdrew its requested incentive compensation costs from its 2016 rate case (*Ill.-Am. Water Co*., Docket No. 16-0093, Order at 23, 37 (Dec. 13, 2016)).

Further, the Commission recently removed the costs of incentive compensation based on the achievement of financial goals in Nicor's 2021 rate case, stating that "the Commission has long held that incentive compensation costs based on financial performance that primarily benefit shareholders are not recoverable in rates." Docket No. 21-0098, Order at 35–36. The Illinois Supreme Court has also held that when expenses are incurred "to achieve goals that primarily benefit shareholders, then it is reasonable to require that shareholders bear the cost of that [expense]." *People ex rel. Madigan*, 2011 IL App (1st) 100654, ¶54.

IAWC witness Matthews argued that ratepayers should be required to pay these incentive compensation costs because IAWC's employee compensation is below market levels, IAWC has reduced expenses and created operational efficiencies that benefit customers, and no party disputed whether these costs were reasonable. IAWC Ex. 13.00 at 3-5. As demonstrated above, the AG maintains that these costs are not a reasonable

cost of service because they benefit shareholders rather than ratepayers. Further, the Commission has consistently held that ratepayers are not required to pay incentive compensation costs for activities that primarily benefit shareholders. The AG points out that IAWC has not demonstrated "that it is the Company's customers that *primarily* benefit, nor has it even attempted to quantify the specific dollar savings or other tangible benefit that has accrued directly to ratepayers rather than shareholders," as a result of achieving increases in IAWC's EPS or TSR, nor has it "shown that the cause of the reduced expenses and greater efficiencies is attributable to incentive compensation related to financial goals and not operational goals." AG Ex. 3.0 at 7 (emphasis in original).

The AG notes that whether IAWC's current compensation levels are below market rates is irrelevant. There is no indication that compensation is inadequate to maintain a stable workforce. Ratepayers should not be asked to pay conditional, incentive compensation to attract employees with incentives to prospective or current employees to achieve shareholder rather than operational goals. AG Ex. 3.0 at 7-8; *see also N. Ill. Gas Co. d/b/a Nicor Gas Co.*, Docket No. 04-0779, Order at 45 (Sept. 20, 2005).

The AG maintains that IAWC witness Matthews' testimony does not justify recovery of incentive compensation based on financial metrics in light of consistent Commission precedent. In Ameren's 2015 gas rate case, the Commission made clear that "[i]ncentive compensation costs based on financial performance that primarily benefit shareholders are not recoverable." *Ameren Ill. Co. d/b/a Ameren Ill*., Docket No. 15-0142, Order at 44 (Dec. 9, 2015). Similarly, in Nicor's 2004 rate case, the Commission stated that a utility may only recover incentive compensation costs where it has demonstrated tangible ratepayer benefits in the form of "specific dollar savings or other tangible benefits" and that a public utility cannot recover these costs simply by making "vague allegations that ratepayers benefit from an incentive compensation program." Docket No. 04-0779, Order at 44-45. The Commission reiterated this point in a 2020 Order addressing Nicor's 2016 energy efficiency reconciliation, where it noted "the Commission's longstanding practice is that incentive compensation costs are not reasonable and recoverable unless the Company can demonstrate tangible benefits to ratepayers . . . . The Commission has previously found that incentive compensation incentive compensation related to financial goals primarily benefits shareholders and therefore shareholders should bear the costs." *N. Ill. Gas Co. d/b/a Nicor Gas Co*., Docket No. 16-0458, Order at 12 (Mar. 4, 2020). In the instant case, IAWC failed to demonstrate that its performance pay based on financial metrics resulted in specific dollar savings or other tangible benefits to ratepayers. Instead, the record evidence demonstrates that IAWC awarded performance pay to its employees for increasing Company revenues, which primarily benefits shareholders. The AG maintains that when shareholders benefit, shareholders should bear the cost.

The AG also states that the Company's claims that no party has disputed the reasonableness of IAWC's charges is simply wrong. To the contrary, the AG, Staff, and IIWC/FEA/CUB all recommended that the Commission disallow these incentive compensation charges. AG Ex. 1.0 at 4-9; Staff Ex 3.0 at 7-12; IIWC/CUB/FEA Ex. 1.0 at 79-86. The Company claims that these charges were reasonable by citing to the charges that natural gas and electric utilities report to the Federal Energy Regulatory Commission ("FERC"), through FERC Form 60. AG Ex. 3.0 at 8-9. But IAWC does not

file a FERC Form 60—which does not apply to water and wastewater companies. FERC reporting also does not govern Illinois regulatory policy or even mean that the costs are recovered through state-regulated rates. Therefore, IAWC's reference to FERC reporting is not relevant to this proceeding.

The AG notes that IAWC argues that "the financial metrics tied to performance pay do not 'primarily' benefit shareholders, but rather benefit all stakeholders, including customers, employees, and investors." IAWC IB at 20. To support this position, IAWC provided a table that showed its APP for 2021. IAWC IB at 23. However, no party has proposed that IAWC not recover the 50% of its APP that directly benefits customers. In fact, the AG, Staff, and IIWC/FEA/CUB agree to recommend that the Commission only remove the 50% of APP costs which are based on financial goals/EPS because these goals primarily benefit shareholders. The AG demonstrates that the Commission must deny IAWC's proposed recovery of incentive compensation based on the achievement of financial goals because IAWC has not and cannot demonstrate that the achievement of financial goals primarily benefits customers.

For these reasons, the AG requests that the Commission reduce IAWC's general expenses by $3,897,310 and its proposed payroll taxes by $298,144, as presented on AG IB Attach A, Sch. 2.

#### d. IIWC/FEA/CUB's Position

IIWC/FEA/CUB observe IAWC proposes to include in rates 100% of its short-term and long-term incentive compensation, or approximately $6.5 million of expense and some capitalized costs. This includes $4.7 million of APP expenses and $1.8 million of LTPP expenses. IIWC/CUB/FEA Ex. 1.0 at 79. The adjustment proposed by IIWC/FEA/CUB witness Walters lowers the Company's incentive compensation expense by approximately $4.2 million. *Id*. at 86.

According to IIWC/FEA/CUB, IAWC has two incentive compensation programs. APP awards incentive compensation based on the achievement of a variety of operational and financial metrics. IIWC/CUB/FEA Ex. 1.0 at 81. The plan includes goals for safety (20% of APP), customer satisfaction (15%), environmental leadership (15%), and EPS growth (50%). *Id*. at 81. The environmental leadership component is based on maintaining water quality. *Id*. American Water discusses the EPS growth metric in its APP plan description:

> We must continue to grow because growing companies can offer stable jobs, competitive compensation and benefits, and more personal development opportunities. Additionally, growth means we can deliver our outstanding service to more customers and communities across the U.S. Adjusted EPS is a key measure of our financial and operational success; achieving our earnings and strategic goals creates long-term stockholder value and provides greater total return to our stockholders.

*Id*.; IAWC/CUB/FEA Ex. 1.18 at 14.

IIWC/FEA/CUB take no issue with IAWC recovering APP costs that directly benefit customers, which amounts to 50% of the APP costs proposed in this proceeding. *Id*. However, IIWC/FEA/CUB observe the financial metrics include no benefits for current IAWC customers. IIWC/CUB/FEA Ex. 1.0 at 81-82. Rather, the plan description above clearly shows the primary beneficiary of the financial metrics is shareholders. *Id*. at 82. IAWC's second incentive compensation plan is LTPP, which provides equity awards in the form of RSUs and PSUs. *Id*. IIWC/FEA/CUB point out that as noted in Mr. Walters' direct testimony, American Water's plan description describes the two components.

> The equity award includes Restricted Stock Units (RSUs) and a performance-based stock component, which awards Performance Stock Units (PSUs) based on American Water's Total Shareholder Return (TSR) ranking among peer companies and adjusted compounded Earnings Per Share (EPS) growth. This design aligns with the external market and helps keep American Water competitive with our peers in the utilities industry.
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> * * *
>
> As an American Water employee and stockholder, you not only have the ability to influence our day-to-day performance, you also have the opportunity to share in the long term rewards of American Water's success. The weighting of LTPP is 30% RSU and 35% for each of the two PSU components. As the plan description highlights, the equity awards under this program align the interest of employees with shareholders and, therefore, should be paid for by shareholders and not customers.

*Id*. (*quoting* IIWC/CUB/FEA Ex. 1.18).

IIWC/FEA/CUB argue that as the plan description highlights, the equity awards under this program align the interest of employees with shareholders and, therefore, should be paid for by shareholders and not customers. *Id*. at 82.

IIWC/FEA/CUB point out that the Commission articulated its standard on allowable incentive compensation costs in the Nicor 2004 rate case. There, the Commission made clear that incentive compensation costs should be borne by shareholders rather than ratepayers when the payment of incentives is dependent upon, or triggered by, the achievement of financial goals. In Docket No. 04-0779, the Commission stated:

> Nicor argues that incentive compensation allows it to maintain a stable workforce "that provides safe, reliable service to [Nicor] customers, which is obviously to the customers' benefit" reveals two flaws. Most importantly, it is the duty of Nicor, as a public utility, to provide safe, adequate, reliable service. If Nicor fails to meet the financial targets, or any other goals that trigger incentive compensation payments, Nicor still has an obligation to provide safe, reliable service. Given that

> Nicor's incentive compensation outlays are so heavily dependent upon financial targets, the Commission does not believe this rationale is sufficient to require ratepayers to bear the cost of the payments.

Docket No. 04-0779, Order at 45.

This standard has been upheld repeatedly since that 2004 proceeding, not just for Nicor, but also other Illinois gas, electric, and water utilities. IAWC provides no evidence that differentiates its request in this proceeding from each of these Commission determinations.

It is IIWC/FEA/CUB's position that incentive compensation costs related to financial goals should not be included in rates for several reasons. *See* IIWC/CUB/FEA Ex. 1.0 at 85. First, shareholders can pay for the incentive compensation using the higher earnings achieved as a result of meeting the financial goals. *Id*. Second, including these costs in rates exposes customers to the risk of paying for incentive compensation without knowing if the financial goals will be achieved. Third, incentive compensation costs relating to financial goals do not provide any additional benefit to customers. *Id*. IIWC/FEA/CUB argue the Commission has therefore rightly excluded these costs from rates. Consistent with both Commission standards and fair and balanced regulatory practices, the Commission disallows incentive compensation costs based on financial goals because incentive compensation programs primarily designed to align the interests of executives with shareholders should be paid for by shareholders.

IIWC/FEA/CUB reason that in addition to excluding these costs because they are designed to primarily benefit shareholders, including such costs in rates is asymmetrical by creating risk to ratepayers but not shareholders, and therefore cannot meet the just and reasonable standard in the Act. IIWC/CUB/FEA Ex. 1.0 at 85; 220 ILCS 6/9-201. For example, if incentive compensation costs are borne by shareholders and excluded from cost of service, then shareholders will pay these incentive compensation costs only if the incentive targets are achieved. IIWC/CUB/FEA Ex. 1.0 at 85. If the incentive targets are achieved, then the Company's earnings and dividend-paying ability will be enhanced. *Id*. In this instance, shareholders can pay for the incentive compensation costs out of the higher earnings created by the employees achieving the incentive financial goals. *Id*. If the goals are not achieved, shareholders will not incur the incentive compensation costs. On the other hand, if the incentive compensation costs were included in cost of service, customers would be obligated to compensate for incentive compensation costs regardless of whether or not the incentive financial goals were actually achieved. *Id*. In this instance, customers would compensate the utility for incentive compensation expenses, but customers would not benefit from the achievement of the financial goals.

According to IIWC/FEA/CUB, in IAWC's last rate case, Docket No. 16-0093, the Company withdrew its proposal to recover its test year LTPP expenses and this program was not reviewed by the Commission. Docket No. 16-0093, Order at 37-38. The Company also withdrew its proposal to recover the 50% of APP expenses tied to financial metrics in response to Staff's questions. *Id*. In its final Order in Docket No. 16-0093, the Commission commented on whether it is appropriate for a utility to recover incentive compensation tied to financial metrics in its order as follows:

> The Commission agrees with the AG that when incentive compensation seeks to achieve goals that primarily benefit shareholders, it is reasonable to require that shareholders bear the cost of that incentive compensation. In a recent [Peoples Gas Light and Coke Company / North Shore Gas Company] rate case, the Commission stated that "incentive compensation related to financial goals, affiliate goals or shareholder goals should not be recoverable from ratepayers." Docket Nos. 09-0166/0167 (Cons.) Order at 58.

*Id*. The Commission did approve recovery of the APP portion tied to operational metrics in Docket No. 16-0093.

IIWC/FEA/CUB note that IAWC witness Matthews argues that the financial health of the utility ties directly to customer benefits because "Utility customers benefit directly from productivity and efficiency…. Infrastructure improvement is capital intensive and the ability of the Company to fund this capital due to its financial health directly impacts the ability for us to invest in our systems while maintaining affordable customer bills." IAWC Ex. 23.00 at 3. IIWC/FEA/CUB conclude this argument fully ignores the applicable legal standard, articulated above, which has been upheld for decades by the Commission, and flies in the face of the public policy supporting this legal threshold.

It is the IIWC/FEA/CUB position that IAWC witness Matthews' justification relies on the comparative studies she cites that show IAWC's compensation programs are comparable to and competitive with market practices of other similarly sized utilities. IIWC/CUB/FEA Ex. 1.0 at 83. From this she concludes that these costs represent reasonable market-based compensation and should be recovered from customers. *Id*. While it may be true that incentive compensation is a standard part of compensation packages made available by utility companies, importantly, Ms. Matthews does not offer any evidence on how these costs are typically treated for ratemaking purposes. *Id*. at 82. Mr. Walters testified that, in his experience, incentive compensation costs tied to financial metrics are often excluded from customers' rates. *Id*. at 83. Indeed, the portion of IAWC's incentive compensation tied to financial metrics is already excluded from rates and not currently being recovered from customers. *Id*. Ms. Matthews offers no evidence this has harmed the Company's ability to hire and retain employees. *Id*.

IIWC/FEA/CUB also point out that Ms. Matthews further states that "[a]ll of the APP and LTPP plans' performance objectives – both operational and financial – focus employees' efforts in ways that benefit customers." IAWC Ex. 23.00 at 2-3. IIWC/FEA/CUB argue that opportunely, by this argument, not one dollar of incentive compensation expense would be excluded as primarily benefitting shareholders, even when the compensation is solely tied to financial goals. As IAWC would have it, all incentive compensation expense benefits customers in some indirect way. This line of argument cannot withstand scrutiny.

IIWC/FEA/CUB also assert that the Commission should disallow the cost of RSUs for the same reasons LTPP costs should be disallowed. It is the IIWC/FEA/CUB position that while the Commission has previously allowed the cost of RSUs in incentive compensation expense, Mr. Walters testified that IAWC's RSUs are awarded through its

LTPP, which describes the awards as being designed to align the interest of employees and shareholders and therefore incurred to benefit shareholders. IIWC/CUB/FEA Ex. 2.0 at 10. Thus, these costs should not be treated differently than the rest of the LTPP costs, and should be disallowed under the same legal and policy prescriptions set forth above. Mr. Walters testified that "all costs of the LTPP, including RSUs, should be excluded from ratemaking cost of service, and the cost should be paid for by shareholders via meeting the LTPP award targets." *Id*. at 10. IIWC/FEA/CUB recommend that, to be consistent with Commission practice and law, the entirety of the LTPP costs, including the award of RSUs, be excluded from the Company's cost of service.

**e. Municipalities' Position**

The Municipalities oppose including the costs associated with the financial metrics in rates. While they did not file testimony concerning the inclusion of financial metrics in the calculation of IAWC's incentive compensation program paid by ratepayers, the Municipalities agree with the testimony filed by the AG, Staff, and IIWC/FEA/CUB.

The inclusion of financial metrics is inconsistent with past Commission dockets where these costs have been excluded because achieving EPS goals benefits stockholders, not ratepayers. Specifically, as explained by AG witness Selvaggio, in previous IAWC cases, (i) the Company withdrew a similar request, (ii) it did not object to the costs being excluded in another case, and (iii) in Docket No. 07-0507, the Commission specifically disallowed the costs in the Company's revenue requirements. AG Ex.1.0 at 6.

Because inclusion of financial metrics benefit shareholders, the Municipalities agree with the other Intervenors and Staff that the costs associated with the metrics should not be recovered from ratepayers.

**f. Commission Analysis and Conclusion**

The Commission has consistently found that incentive compensation programs related to financial goals primarily benefit shareholders and those costs should not be recovered by the utility from ratepayers. The testimony and evidence presented by IAWC does not distinguish this case from the Commission's prior rulings on this issue, and the Commission once again finds that incentive compensation based on financial metrics should be removed and not recoverable from ratepayers.

IAWC argues that the Commission should consider its performance pay programs as a whole and determine whether the overall level of compensation is reasonable. The Commission disagrees because it ignores the standard for recovery previously established by the Commission. If IAWC wants to recover incentive compensation expenses based on financial metrics from ratepayers, it must demonstrate that the expenses provide cost savings or other tangible benefits to ratepayers. The financial goals included in IAWC's performance pay that Staff and the AG seek to exclude primarily benefit shareholders, not ratepayers.

IAWC argues that its performance pay programs provide customer benefits through reduced expenses and greater efficiencies. However, IAWC has not shown that these customer benefits were caused by the performance metrics related to financial goals rather than the Company's operational goals. IAWC also argues performance pay

based on financial goals is an accepted part of total compensation packages in businesses. However, merely because financial metrics are standard practice in business compensation packages does not mean that such expenses should be recovered from ratepayers.

The Commission has also rejected arguments similar to IAWC's that its performance pay plans, including the financial goals, are needed to attract and retain a skilled workforce to provide safe and reliable service. In doing so, the Commission found that such arguments ignore the standard for recovery and the legal duty of a utility to provide safe, adequate, and reliable service. *See* Docket No. 04-0779, Order at 45-46.

Accordingly, the Commission approves Staff's proposed adjustments to IAWC's performance pay. The Commission notes that Staff's proposed adjustments are in line with those proposed by the AG.

IIWC/FEA/CUB support Staff and the AG's proposed adjustments, but further argue that RSUs included in the LTPP should also be excluded. IIWC/FEA/CUB contend that because RSUs are included in the LTPP they should not be treated any differently than other costs in the LTPP and therefore should be excluded. The Commission disagrees. RSUs have a defined vesting period and are not based on the achievement of financial goals. Just because some costs in an incentive compensation program should be disallowed because they do not primarily benefit ratepayers does not invalidate the program as a whole. Under IIWC/FEA/CUB's reasoning, the entirety of the APP should be disallowed even though there are parts of the program that provide tangible benefits to ratepayers. The Commission rejects IIWC/FEA/CUB's additional adjustment to IAWC's performance pay.

### 3. Rate Case Expense

#### a. IAWC's Position

IAWC notes that IIWC/FEA/CUB and Staff contend that a four-year amortization period should be approved for the rate case expense. The Company originally proposed the use of a two-year amortization period for rate case expense, but in rebuttal testimony revised its proposal to a three-year amortization period for rate case expense. In the interest of narrowing the issues in this case, however, the Company revised its proposed amortization period to four years in its surrebuttal testimony, which is consistent with the recommendation from IIWC/FEA/CUB and Staff. The Company note that AG witness Selvaggio, supported by the Municipalities, continue to propose a six-year amortization period.

The Company points out that key to the AG's position is the argument that the Commission currently allows the unpaid amount from one case to be included in the amortization period for the rate case expense in the next rate case. According to the AG, then, even if IAWC files another rate case within the next six years, it would still recover its full rate case expense from this docket. But as IAWC explains, the unamortized balance of rate case is not reflected in rate base. Thus, IAWC states that it will not recover the carrying cost, or time value of money, related to inclusion of unamortized balances in future rate case expense. IAWC concludes that the Company will not recover its "full"

rate case expense in a reamortization scenario. IAWC states that for these reasons, the amortization period should be reasonable and not extended out over many years.

The Company states that the AG's argument - that it is reasonable to expect that IAWC's riders will have the effect of postponing the need for IAWC to file another rate case in the near term – is entirely speculative. The Company notes that prior to this docket, IAWC filed general rate cases on August 31, 2007, May 29, 2009, October 27, 2011, and January 21, 2016; making the point that, historically, there is a three-year average between filings. Therefore, IAWC states, a four-year amortization period is reasonable. IAWC argues that six years is not, as it reflects twice as long an amortization period than IAWC's historical average timing of its filings supports. Accordingly, IAWC states that the Commission should approve the four-year amortization period and decline the AG's proposed six-year timeframe.

Regarding communications costs, based on the briefing of the parties, IAWC states that this is no longer a contested issue. Although IAWC believes its overall rate case expense projection remains reasonable, in order to narrow issues in this case, IAWC has reduced its rate case expense projections by $132,000, which is comprised of $32,000 related to audit fees and $100,000 of the AG's recommended $139,738 reduction related to communications costs. The AG agrees with IAWC's proposed reduction of communication expense, and the Company, Staff, and the AG now agree that the Commission should approve IAWC's rate case expense projections as reflected in IAWC Exhibit 25.03, page 2.

**b. Staff's Position**

Staff argues that the Commission should approve Staff's recommended four-year amortization period, which was agreed to by the Company. Staff initially proposed adjustments to increase the amortization period of rate case expense from two years, originally proposed by the Company, to six years based on the length of time since the Company's previous rate case. Staff Ex. 3.0 at 3-6.

In rebuttal testimony, the Company disputed Staff's proposed amortization period of six years and instead argued for a three-year amortization period due to the average time between the Company's three previous rate cases, not including this proceeding. IAWC Ex. 15.00 at 12. In rebuttal testimony, Staff noted that it generally agreed with the Company's position to use the amount of time between rate cases historically but opined that the timing of the current proceeding should be considered. Staff Ex. 11.0 at 4. Therefore, as a compromise, Staff revised its original proposal and proposed a four-year amortization period which is the average amount of time between the Company's previous three rate cases in addition to this proceeding. *Id*. at 5. Staff further agreed with IIWC/FEA/CUB's recommendation for a four-year period for amortizing rate case expense. *Id*. at 3-7, *citing* IIWC/CUB/FEA Ex. 1.0 at 79.

In surrebuttal testimony, the Company agreed to revise its proposed amortization period from three years to four years, which is consistent with the recommendation from Staff and IIWC/FEA/CUB. IAWC Ex. 25.00 at 10. Additionally, in response to the AG, the Company agreed to reduce total projected rate case expense by $132,000 which is comprised of $32,000 related to audit fees and $100,000 of the AG's recommended $139,738 reduction related to communications costs. *See* AG Ex. 3.0 at 12. The AG

continues to propose a six-year amortization period. AG Ex. 3.0 at 10. Staff and the Company's agreed upon four-year amortization period is reasonable based on past rate case frequency, and Staff argues that it should be adopted by the Commission.

In rebuttal testimony Staff provided an additional recommendation regarding Section 9-229 of the Act, which requires the Commission to expressly address the justness and reasonableness of the attorney and expert compensation expended by the public utility to prepare and litigate the rate case. Staff Ex. 11.0 at 6 (*citing* 220 ILCS 5/9-229). Staff did not propose a disallowance of any specific rate case expense costs in this proceeding, but Staff's adjustment to the amortization period for rate case costs reduces the amount of expenses included in the revenue requirement. *Id*. Therefore, Staff proposes that the final Order in this proceeding include a Commission conclusion based on the Company's partially agreed reduction to total rate case expense proposed by the AG and the amortization periods agreed to by the Company, Staff, and IIWC/FEA/CUB. Staff states that if the Commission makes any adjustments to the overall total of rate case expense or the amortization period at the conclusion of this proceeding, those adjustments should be reflected in the Commission's statement that sets forth the amount of rate case expense included in the revenue requirement.

#### c. AG's Position

In its surrebuttal, the Company reduced its total communication costs by $100,000. IAWC Ex. 25.00 at 11. The AG requests that the Commission accept this reduction.

In its direct testimony, IAWC requested that the Commission amortize its $2.508 million rate case expense over two years. In its rebuttal testimony, IAWC increased its proposed amortization period to three years. IAWC Ex. 15.00 at 12. In surrebuttal testimony, IAWC then increased its proposed amortization period to four years. The AG recommends that the Company's rate case expense be amortized over six years. AG Ex. 1.0 at 9. In support of this position, AG witness Selvaggio indicated that IAWC's current base rates became effective in December 2016 and that its new base rates will become effective in January 2023, more than six years later. *Id*. at 9. Ms. Selvaggio further noted that the Commission approved a two-year amortization period in the Company's last rate case and, as a result, ratepayers have paid IAWC's rate case expense more than three times, over the past six years. AG Ex. 3.0 at 11.

The AG notes that IAWC argues that historically it has filed rate cases at an average of every three years. However, the AG points out that this position ignores the fact that this is only IAWC's second rate case since the Commission amended the rules governing IAWC's Qualifying Infrastructure Plant ("QIP") Surcharge in 2015. *Aqua Ill., Inc. & Ill.-Am. Water Co.*, Docket No. 15-0017, Adopting Order (June 29, 2016). In Docket No. 15-0017, IAWC noted that the approval of its QIP Surcharge would result in "reduced rate case frequency." *Id*., First Notice Order at 9 (Sept. 10, 2015). The AG demonstrates that the truth of IAWC's prediction has borne out over the past seven years, with IAWC filing one rate case in 2016 and the present case in 2022. Further, IAWC has obtained multiple tariffs that track costs outside rate cases and allow the Company to adjust charges to customers based on these costs. These tariffs include at least eight riders, including some that are relatively new. *See, e.g*., IAWC Sch. E-1, Central Division Water. These riders are also included in the tariffs of IAWC's other water and sewage districts.

*See* IAWC Sch. E-1 and E-2. It is reasonable to expect that these riders will continue to have the effect of postponing the need for IAWC to file another rate case in the near term. The AG shows that it is unreasonable for IAWC's rate case expense to be amortized over a four-year period, at a higher per-year cost of $594,000 to ratepayers, compared to $396,000 per year under a six-year period, when the immediate history and its multiple riders that allow it to increase charges between rate cases show IAWC is likely to wait as long or longer before filing its next rate case.

Moreover, even if IAWC files another rate case within the next six years, it would still recover its full rate case expense from this docket. The Commission currently allows the unpaid amount from one case to be included in the amortization period for the rate case expense in the next rate case. In other words, "IAWC would recover its rate case expense regardless of when the next rate case is filed." AG Ex. 1.0 at 10-11. However, if the Commission adopts IAWC's shorter amortization period, the AG asserts that ratepayers are at risk of significantly over-paying the Company for the cost of this rate case through an amortized annual balance that would remain in base rates until IAWC files its next rate case. *Id*. at 11.

For these reasons, the AG requests that the Commission adopt a six-year amortization period for IAWC's rate case expense in this docket at an annual expense of $396,000 per year.

**d. IIWC/FEA/CUB's Position**

IIWC/FEA/CUB note IAWC estimates the rate case expense to be $2,508,000. IAWC Ex. 4.03. IIWC/FEA/CUB take the position that rate case expenses should be recovered over the time rates are expected to be in effect. IIWC/CUB/FEA Ex. 1.0 at 78-79. Therefore, given the current rates have been in effect for five years, IAWC's proposal for a three-year amortization of rate case expenses is inappropriate and not supported by evidence in this proceeding. *Id.* IIWC/FEA/CUB witness Walters recommends the amortization period for rate case expenses be increased to four years. *Id.* This is a reasonable estimate of the time rates approved in this proceeding will be in effect given the timeframe between IAWC rate cases. *Id.*

IIWC/FEA/CUB point out that as shown in IIWC/FEA/CUB witness Walters' Table CCW-R-1, the average span between rate case filing is 3.61 years. IIWC/CUB/FEA Ex. 2.0 at 10. Mr. Walters noted that the average time between rate case filings has increased, significantly, between every rate case since the 2007 rate case filing. *Id.* For example, the amount of time has increased from 637 days to more than 2,200 days. *Id.* at 11. The trend in the time between the Company's filings over this period is that each case is being filed approximately 525 days (or 1.44 years) later than the amount of time between filing the previous case. *Id.* If we add the trend in the increased amount of time between filings (1.44 years) to the average of 3.61 years, this would be a five-year rate case cycle, or, the midpoint between my proposal of four years compared to the six-year proposal by Staff and AG. *Id.* For these reasons, Mr. Walters and IIWC/FEA/CUB continue to support an amortization period of four years for the Company's rate case expense. *Id.*

### e. Municipalities' Position

The Municipalities agree with the AG that IAWC's rate case expenses be amortized over a six-year period rather than the four-year period agreed to by the Company. Initially, the Company proposed recovering rate case expenses over two years but in rebuttal testimony extended the period to four years. The more appropriate period is six years.

IAWC's current rates became effective on December 13, 2016, and any rate approved in this docket will not become effective until early 2023. Based on the greater than six-year period between its last rate case and this docket, a six-year recovery period is more appropriate. There is no harm to IAWC in establishing the six-year recovery period because, if the Company files another rate case prior to the end of the six years, any unamortized portion of rate case expenses will be included in the next case. However, the reverse is not true. If the Company is granted a four-year recovery but waits beyond the four years to file a new case, the Company will have over-recovered rate case expenses from ratepayers—and the ratepayers would not receive a refund for the overpayment.

The Municipalities agree with the AG that the more prudent course is to amortize rate case expenses over six years.

### f. Commission Analysis and Conclusion

The only contested issue remaining regarding rate case expense is the amortization period. The Commission must determine an appropriate estimate of the time rates approved in this proceeding will be in effect given the timeframe between IAWC rate cases.

IIWC/FEA/CUB recommend an amortization period of four years based on the average span between IAWC rate case filings. Staff and IAWC also agreed to a compromise position of a four-year amortization period. The AG and the Municipalities support a six-year amortization period based in part on the fact that it has been six years since IAWC's last rate case. Additionally, parties note that the time-period between IAWC rate cases has gotten longer over time.

The Commission finds that a four-year amortization period is reasonable and is approved. While IAWC's last rate case was six years ago, IAWC's historical average is closer to the four-year amortization period supported by IAWC, Staff, and IIWC/FEA/CUB.

The Commission has considered the estimated costs to be expended by IAWC to compensate attorneys and technical experts to prepare and litigate rate case proceedings and assesses that the amount included as rate case expense in the total revenue requirement of $594,000 is just and reasonable pursuant to Section 9-229 of the Act.

# III. RATE BASE

## A. Uncontested Issues

### 1. Adjustment to Rate Base for 2021 Actuals (including Materials and Supplies)

IAWC states that its initial filing showed actual rate base balances as of September 30, 2021. In rebuttal, IAWC notes that it updated its rate base to account for actual balances as of December 31, 2021, which decreased rate base by $19,158,203. The AG and Staff proposed other adjustments to rate base schedules based on actual balances as of December 31, 2021. IAWC points out that based on Staff and AG adjustments, the Company revised its rate base as shown Schedule B-1-Jurisdictional Rate Base Summary. Further, IAWC Exhibit 16.03 presents year-end 2021 adjustments to materials and supplies, construction work in progress, and contributions in aid of construction balances based on year ended December 31, 2021 amounts. These adjustments, IAWC notes, along with adjustments for all other rate base components for year-end 2021 actual balances that IAWC is accepting per the AG's proposed adjustments to rate base schedules based on actual balances through December 31, 2021, can also be found on IAWC Exhibit 16.01. IAWC states that the Company has not, aside from the update to actuals, proposed further additions to rate base projections for 2023.

In rebuttal testimony, Staff proposed Schedule 9.03 regarding adjustments to rate base, reflecting data for the future test year ending December 31, 2023. Staff Ex. 9.0 at 2. The Company did not contest Staff's proposed adjustment. Staff states that the Commission should approve Staff's adjustment to rate base for 2021 actuals.

The Commission finds that IAWC's adjustment to rate base for 2021 actuals is not contested, is reasonable, and should be approved.

### 2. Adjustments re: Acquisitions

Staff proposed adjustments for the acquisitions of Villa Grove and YES Companies EXP Fred, LLC ( "Yes Communities"). For the acquisition of Villa Grove (Central Water and Wastewater), Staff Schedule 2.01 presented adjustments to gross utility plant in service, accumulated depreciation, and depreciation and amortization expense for changes in estimates of costs related to the acquisition of Villa Grove. Staff Ex. 2.0 at 3. The Company agreed with Staff's adjustment in rebuttal testimony, and this issue is no longer contested. IAWC Ex. 16.00 at 3; Staff Ex. 10.0 at 2.

For the acquisition of YES Communities (Central Water), Staff Schedule 2.02 presented adjustments to gross utility plant in service, accumulated depreciation, and depreciation and amortization expense for changes in estimates of costs related to the acquisition of YES Communities. Staff Ex. 2.0 at 3-4. The Company did not oppose Staff's proposed adjustment; however, the Company provided an alternative calculation that included updated information for the Yes Companies water in addition to the wastewater (Central Division Wastewater) that was referenced in Staff's direct testimony as an outstanding data request response to TM 13.04. IAWC Ex. 16.02. After reviewing the data request response and the Company's rebuttal testimony and schedules, Staff found no reason to object to the Company's proposed calculation. Staff Ex. 10.0 at 2-3. Staff also indicated in direct testimony that it had outstanding issues regarding the YES

Communities wastewater acquisition, year-end adjustments to material and supplies, contributions in aid of construction, and construction work in progress. Staff Ex. 2.0 at 9. Based on the review of the Company's responses to data requests and Ms. Haugen's rebuttal testimony (IAWC Ex. 16.00, 16.02, and 16.03) addressing those outstanding issues, Staff found no reason to object to the Company's responses as stated. Staff Ex. 10.0 at 6.

This issue is not contested. The Commission approves Staff's adjustments.

**3. Qualified Infrastructure Plant ("QIP")**

The Company included in its rate base investments that would qualify as QIP under 83 Ill. Adm. Code 656. IAWC explains that upon entry of a final Order, the QIP Rider will be impacted with a reset of certain factors based on the new authorized amounts from this proceeding. IAWC supports Staff's recommendation to include amounts for NetQIP and NetDep by rate zone in a Findings and Orderings paragraph in the Final Order of this proceeding to document the QIP costs included in this proceeding. The Company agrees with Staff's recommended language, subject to the correction of the 2022 Central Division depreciation expense amount to $5,873,284. Staff agrees with the Company's suggested correction, and the Company did not oppose the language and amounts for all other rate zones. Staff recommends including a Findings and Ordering paragraph in the Final Order of this proceeding concerning the future review of QIP costs. IAWC agrees with Staff's recommended language. The Commission finds that this resolution is reasonable and is approved.

**4. Removal of Incentive Compensation Based on Financial Metrics Capitalized Since the Last Rate Case**

IAWC states that Staff and AG proposed an adjustment to rate base and depreciation expense for prior and projected capitalized performance compensation for Total Company. IAWC agrees to accept a $133,299 decrease to rate base and a $3,563 decrease in depreciation expense, as calculated by the AG. The Commission finds that this adjustment is reasonable, and it is approved.

**5. Corrections to Accumulated Deferred Income Taxes ("ADIT")**

IAWC states that Staff proposed an adjustment to as-filed average test year State deferred tax liability from ($83,094,362) to ($83,265,495). Staff proposed an adjustment to as-filed average test year Federal deferred tax liability from ($190,262,871) to ($190,605,224). IAWC notes that the AG proposed adjustments for restatement of accumulated deferred income taxes ("ADIT"), reducing State ADIT by $1,088,689 and Federal ADIT by $1,845,074 for Total Company. The Company accepts these adjustments. The Commission finds that these adjustments are reasonable, and they are approved.

**6. Calculation of Cash Working Capital ("CWC")**

Staff proposed an adjustment to calculate the CWC component of rate base for each rate zone. Staff Ex. 1.0 at 7. Staff proposed these adjustments in order to demonstrate that the total revenues should equal the total expenses. *Id*. In rebuttal testimony, the Company responded by agreeing that the final balance of CWC will be established using the revenue requirement and methodology that is ultimately approved

by the Commission in this proceeding. IAWC Ex. 20.00 at 3-4. IAWC explains that the Company summarized IAWC's CWC requirements in Schedule B-8 of Exhibit 31.01 after making the agreed to corrections of the CWC studies.

The Commission finds that, subject to its conclusions on CWC above, IAWC's proposed CWC amount is reasonable, and it is approved.

## B. Contested Issues

### 1. Cash Working Capital ("CWC")

#### a. IAWC's Position

IAWC explains that CWC is the amount of funds necessary to finance the day-to-day operations of the Company and is included in the determination of a utility's rate base. CWC bridges the gap between the time when funds are provided to the Company by investors to allow the Company to provide service to customers, and the time when revenues are received from customers as reimbursement for these services. IAWC explains that it determined its CWC requirement by conducting five lead-lag studies to determine the timing of IAWC's cash inflows and outflows in order to analyze the level of funding required to operate on a day-to-day basis.

IAWC states that only two elements of the CWC requirement remain at issue – adjustments proposed by Staff and Intervenors related to the treatment of regulatory expense and deferred taxes. IAWC argues that these adjustments should be rejected so that IAWC's CWC requirement properly reflects the amount of funds necessary to finance the day-to-day operations of the Company.

IAWC states that Staff and AG propose to remove regulatory expense (rate case expense) as an operating expense line item in the calculation of CWC. IAWC argues that Staff and the AG's adjustment to the treatment of regulatory expense in CWC should be rejected.

IAWC notes that the inclusion of regulatory expenses in the determination of CWC recognizes the fact the Company is currently making cash expenditures related to the current rate case for which ratepayers have not provided any funds. IAWC contends that the inclusion of regulatory expenses in the determination of CWC recognizes that prospectively, ratepayers will pay rates enabling the Company to recover their current cash expenditure, but the collection of the cash will experience revenue lag days, as do all revenues (e.g., Central Water revenue lag of 54.8 days). IAWC contends that only considering operating expenses that typically occur during a given year ignores that the Company is currently making cash expenditures related to the current rate case and will experience lag in its recovery.

IAWC notes that Staff and the AG argue that including the regulatory expense in the CWC calculation would transform it into an investment on which ratepayers would be required to pay a return, contrary to past Commission orders that the unamortized rate case expense should not be included in rate base. IAWC states that contrary to Staff and AG's assertions, IAWC is not recommending that the unamortized rate case expense should be included in rate base, and IAWC's recommendation does not transform this expense into an investment. Rather, IAWC recommends the inclusion of regulatory expenses in the determination of CWC to recognize the fact the Company is currently

making cash expenditures related to the current rate case for which ratepayers have not provided any capital towards, and that eventually collection of the cash will experience revenue lag days, as do all revenues. IAWC states that, in short, the Company's proposed treatment of regulatory expense is about the appropriate level of working capital for the Company, not the recovery of rate case expense. For this reason, IAWC's proposed inclusion of regulatory expense in the CWC calculation is reasonable and should be approved, and the Staff and AG adjustment to the treatment of regulatory expense in CWC should be rejected.

IAWC explains that deferred income taxes are collected from customers, but not due to be paid by the Company until a future date, and so are deducted from rate base as a source of cost-free funds. IAWC further explains that there is a lag in collection of deferred taxes, but when the deferred taxes account balance is deducted from rate base, that deducted balance includes an uncollected amount of deferred tax expense that is treated as if the amount was already collected.

IAWC states that AG witness Selvaggio proposes that deferred taxes be removed from the CWC calculation because deferred taxes are a non-cash item not currently paid, and including deferred taxes in the CWC calculation transforms the deferred income taxes into an investment on which ratepayers would be required to pay a return. IAWC states, however, that excluding the revenues associated with deferred taxes from the CWC calculation ignores the lag between IAWC's recorded deferred tax amount and its cash collection of that amount from customers. IAWC collects cash associated with its deferred tax liability from customers in the same way it collects all other revenues. But when the deferred taxes account balance is deducted from rate base, that deducted balance includes an uncollected amount of deferred tax expense that is treated as if the amount was already collected. Because of this treatment, IAWC states, when that balance is deducted from rate base, it overstates the actual amount of available cost-free capital by an amount equal to the revenue requirement lag days.

Furthermore, IAWC states, inclusion of deferred taxes in CWC would not turn deferred taxes into an investment on which ratepayers would be required to pay a return, because the deferred tax account balance is already treated as a cost-free source of cash that is deducted from rate base. The Company's CWC calculation accounts for the fact that the balance that was deducted from rate base included amounts (15% of the current year's deferred tax expense) that have not actually been collected from ratepayers yet.

IAWC states that the Company and the AG agree that deferred taxes are expenses not currently paid. But IAWC's lead-lag analysis already accounts for the fact that there is no current expense associated with deferred income taxes by applying a zero-day expense lead. Assigning a zero-expense lead to deferred income taxes in CWC recognizes that a portion of these cost-free funds have not actually been collected from customers. IAWC explains that their treatment of deferred income taxes is in accordance with the Commission's holding in Docket No. 16-0093 because IAWC's CWC proposal treats deferred income taxes as a non-cash expense by applying a zero-day expense lead.

IAWC explains that their treatment is thus wholly consistent with the Illinois Supreme Court decision cited by the AG, *City of Alton v. Ill. Commerce Comm'n*, that "A

working capital allowance is designed to provide a return on those funds which are used to pay expenses incurred before the income produced by those expenses has been received," *City of Alton v. Ill. Commerce Comm'n* ,19 Ill.2d 76, 85 (1960), because IAWC's proposal acknowledges the lag in receipt of income from customers related to deferred taxes. So, while it may be correct that "Such a [CWC] return is not justified where payments by the utility's customers make funds available to meet current expenses without additional investment by stockholders", (*id*.), in this case, the payments (in rates for deferred taxes) by the utility's customers to make funds available have not happened yet.

IAWC states that if the Commission adopts the AG's proposal to remove deferred income taxes from CWC, that decision will deprive the Company of an opportunity to earn a fair rate of return on their entire plant investment. Accordingly, IAWC urges the Commission to decline to adopt the AG's adjustment to CWC for deferred taxes.

For these reasons, IAWC concludes, the Commission should approve IAWC's CWC as presented in IAWC Exhibit 31.00.

**b. Staff's Position**

Staff argues that the Commission should approve Staff's proposed adjustments to calculate the CWC component of rate base for each rate zone. Staff Ex. 1.0 at 7. Specifically, Staff proposes removal of regulatory expense as an operating expense line item in the calculation of CWC.

As Ms. Pearce testified, Staff's position is that rate case expense should not be included in the calculation of CWC because the costs are given special recognition from a regulatory ratemaking perspective, and these costs are not representative of operating expenses that typically occur in the course of a given year. Staff Ex. 9.0 at 5. In Illinois, public utilities are permitted to accumulate the total approved rate case expense and amortize it over a specified number of years, as approved by the Commission in a rate proceeding. *Id*. It is unnecessary to include these expenses in the CWC calculation as any unamortized portion of rate case expense will be recovered from ratepayers. *Id*. at 6. Thus, investors will recover the total amount of rate case expense that is approved by the Commission, and there is no need to include the expenses in the CWC calculation. *Id*.

Additionally, Staff explains that rate case expenses are not representative of operating expenses as total rate case expenses are significant in dollar amount and are only incurred in the years that a utility is preparing and litigating a request for a rate increase. *Id*. Rate cases such as the instant case, filed pursuant to Section 9-201 of the Act, are not filed annually, but rather periodically. As a utility does not file a rate case every year, or incur rate case expenses every year, Staff notes that it logically follows that these costs require special treatment different than normally recurring operating expenses. *Id*. at 6-7. Further, Staff asserts that to include the costs in the calculation of CWC as normal operating expenses would distort the cost of service for the test year. *Id*.

IAWC argues that this treatment does not adequately compensate shareholders because the Company is currently making cash expenditures related to the instant rate case for which ratepayers have not yet provided any funds. Staff states that the costs of

a rate case are more properly viewed as deferred costs which should be spread among the years between rate cases — not as an investment on which shareholders should be allowed to earn a rate of return. If such costs were included in the calculation of CWC, that is exactly what the ratemaking impact would be.

For example, if the cost of approved rate case expenses were included as a cost in the CWC calculation and some number of lead days were assigned to the costs, the resulting amount would increase the total balance of CWC. Staff notes that, because the balance of CWC is reflected in rate base, that amount would earn an overall rate of return equal to the Commission-approved weighted average cost of capital ("WACC"). This would distort the calculation of CWC, however, because rate case expenses are not representative of service costs for a test period. *Id*. Staff notes that the well-established Commission practice of deferring rate case expenses and amortizing them over the estimated number of years between rate cases provides a reasonable method of recovery for these costs. It permits full cost recovery of the Commission-approved amount from ratepayers, while spreading those costs over the estimated period between rate cases, thereby maintaining a representative cost of service for the test year.

Based on this reasoning and the well-established treatment of rate case expense, Staff asserts that the Commission should approve Staff's removal of regulatory expense as an operating expense line item in the calculation of CWC. Further, in the final Order in this proceeding, Staff states the final balance of CWC should be updated to reflect the operating revenue and expenses ultimately approved by the Commission for each rate zone. Staff Ex. 9.0 at 7.

#### c. AG's Position

The AG proposes adjustments to IAWC's CWC to remove the Company's rate case regulatory expense and deferred taxes. *Id*. at 16. The AG proposes to remove the regulatory expense because regulatory expenses are non-cash expenses that should not be included as part of the Company's CWC. *Id*. at 17, 19. Including the regulatory expense in the CWC "transform[s] the annual amortization of rate case expense into an investment on which ratepayers would be required to pay a return," instead of a pass-through expense, which would not result in ratepayers paying IAWC a return. AG Ex. 3.0 at 15.

IAWC argues that it "is not recommending that the unamortized rate case expense . . . be included in rate base, and [that its] recommendation does not transform its expense into an investment." IAWC IB at 34. However, the AG notes that IAWC ignored that CWC — by definition — is included in rate base and entitled to a return. In fact, IAWC explicitly stated earlier in its Initial Brief that "[c]ash working capital is the amount of funds necessary to finance day-to-day operations of the Company *and is included in the determination of the utility's rate base*." IAWC IB at 32 (emphasis added). While IAWC attempts to distinguish CWC from rate base investments, the effect is the same — if the Company's rate case expense is included in CWC, then ratepayers will pay the Company's shareholders a return on this expense.

In 2018, the Commission rejected a similar attempt by USI to include its rate case regulatory expense in rate base. In the USI rate case, the Commission held that "it is long-standing Commission practice that a utility can recover its rate case costs as an

expense, but that the unamortized rate case expense should not be included in rate base," and "Rate base should include investments in the utility that result in an asset that is used and useful, which rate case expense is clearly not." *Util. Servs. of Ill., Inc*., Docket No. 17-1106, Order at 13 (Sept. 24, 2018). For these reasons, the AG requests that the Commission remove IAWC's proposed rate case regulatory expense from its CWC.

The AG also recommends that the Commission remove IAWC's deferred taxes from its CWC because deferred taxes are a non-cash expense that should not be included in CWC. AG Ex. 1.0 at 18. This proposal is consistent with the Commission's Order in IAWC's last rate case, Docket No. 16-0093, where it held that "[i]t is standard practice that deferred income taxes are treated like a non-cash item because they are not currently paid and, therefore, do not require any funds to pay the yet-to-be paid taxes." Docket No. 16-0093, Order at 16-17. The Commission also rejected the inclusion of deferred taxes in CWC in other dockets. *See, e.g*., *N. Shore Gas Co. / The Peoples Gas Light and Coke Co*., Docket Nos. 14-0224/14-0225 (Cons.), 2nd Amendatory Order, App. A at 9-10 and App. B at 9-10 (Feb. 11, 2015); Docket No. 15-0142, Order, App. Sch. 8; *MidAmerican Energy Co*., Docket No. 14-0066, Order, App. at 9 (Nov. 5, 2014).

Further, the Illinois Supreme Court found in *City of Alton*,

> A working capital allowance is designed to provide a return on those funds which are used to pay expenses incurred before the income produced by those expenses has been received. *Such a return is not justified where payments by the utility's customers make funds available to meet current expenses without additional investment by stockholders*. Where tax accruals actually make funds available, it is error for the Commission to ignore them and fail to offset the working capital allowance.

*City of Alton*,19 Ill.2d 76, 85 (emphasis added). The AG requests that the Commission remove IAWC's rate case and deferred tax expenses from its CWC calculation because they are non-cash expenses and because it is unreasonable and against Commission practice to permit IAWC to recover a return on these expenses. AG Ex. 3.1, Sch. B; AG Ex. 3.2, Sch. E.

**d. Commission Analysis and Conclusion**

IAWC asserts that its treatment of regulatory expense should be viewed in the context of what is the appropriate level of CWC for the Company and not about the recovery of rate case expense. IAWC claims that it is not recommending that the unamortized rate case expense should be included in rate base, yet that is exactly what IAWC's proposal does. IAWC seeks to include rate case expense as an operating expense, which is then included in the determination of the Company's CWC and ultimately rate base and thus IAWC's investors would earn a return on it. The Commission agrees with Staff that rate case expenses are not representative of operating expenses that typically occur in the course of a given year and should not be included in the calculation of CWC. Rate case expense is not an investment that results in an asset that is used and useful and is therefore appropriately excluded from rate base. *See e.g.* Docket No. 17-1106, Order at 13.

The Commission's longstanding practice allows for a utility to recover its rate case expenses through specialized ratemaking treatment, but those rate case expenses are not included in rate base. The Commission finds no reason to divert from this established practice based on the arguments and evidence in this proceeding.

The Commission further adopts the AG's adjustment to remove IAWC's deferred taxes from CWC. Deferred taxes are a non-cash item that should not be included in CWC. The Commission routinely rejects inclusion of deferred taxes in CWC and IAWC did not make any compelling argument to alter from this practice.

## IV. CAPITAL STRUCTURE AND RATE OF RETURN

### A. Uncontested Issues

#### 1. Cost of Long-Term Debt

IAWC states that it updated the cost of debt for the actual 2022 and proposed 2023 issuances. Staff accepts the Company's updated cost of long-term debt of 4.43%. The Commission finds the Company's updated cost of long-term debt of 4.43%, as agreed by Staff, is reasonable and should be approved.

### B. Contested Issues

#### 1. Capital Structure

##### a. IAWC's Position

IAWC explains that capital structure components must support long-lived assets, such as IAWC's water and wastewater infrastructure (which includes over $1 billion in investment since IAWC's last rate case). Therefore, a utility's capital structure tends to include long-term securities, such as common equity and long-term debt. IAWC manages the mix of debt and equity in its capital structure with the intent of optimizing its overall cost of capital, while maintaining financial strength and stability. Maintaining financial strength and stability also includes maintaining strong credit metrics consistent with an investment grade credit rating that would allow IAWC to attract new capital at a reasonable cost in all market conditions. IAWC must attract new capital to continue making significant investments to meet its obligation to provide safe, adequate, and reliable water and wastewater services to customers and to maintain its water and wastewater infrastructure. IAWC notes that the record demonstrates that IAWC expects to invest nearly $480 million in capital projects in 2022 and 2023.

IAWC proposes that its forecasted stand-alone capital structure be used for ratemaking purposes in this case. Specifically, IAWC proposes a capital structure using thirteen-month average balances as of December 31, 2023 and composed of 1.81% short-term debt, 46.24% long-term debt, and 51.95% common equity.

IAWC witness Selinger testified that the Company's forecasted capital structure is consistent with the way that the Company's assets are capitalized, with the Company's future test year of 2023, and with IAWC's proposed use of thirteen-month average balances for all items within the calculated rate base. IAWC's forecasted capital structure represents how IAWC finances its independent operations and capital investments. IAWC states that its recommended capital structure includes the costs incurred for both

debt and equity financing based on the risk factors relevant to IAWC and is in line with its peer utilities with similar risk profiles.

IAWC witness Bulkley explained why the Company's capital structure is an important consideration in determining the appropriate return on equity ("ROE") in this case. Assuming other factors are equal, a higher debt ratio increases the risk to investors, with a greater debt service requirement resulting in less cash flow available for common equity holders. Ms. Bulkley further explained why it is appropriate to consider the equity ratio of her group of proxy companies in assessing whether the Company's proposed equity ratio is reasonable and in line with the Proxy Group as a measure of the requisite authorized ROE to compensate investors for that risk. IAWC points out that because the proxy companies are relied upon in establishing the authorized ROE for IAWC, it is important that the financial risk of IAWC be similar to the financial risk of the proxy group. IAWC explains that this is accomplished when the equity ratio of the subject company is within the range established by the Proxy Group. According to Ms. Bulkley's analysis, the average common equity ratio for the Proxy Group at the operating subsidiary level is 53.43% and the median common equity ratio is 53.61% for the year 2020, within a range from 41.92% to 60.04%. Thus, IAWC's proposed common equity ratio of 51.95% approximates the average and median equity ratios found in Ms. Bulkley's Proxy Group albeit slightly below the Proxy Group.

IAWC witness Bulkley also explained that the credit rating agencies' response to the Tax Cuts and Jobs Act of 2017 ("TCJA") must be considered when determining the equity ratio. All three rating agencies have noted that the TCJA has negative implications for utility cash flows, with Standard and Poor's ("S&P") and Fitch Ratings Inc. specifically identifying increasing the equity ratio as one approach to ensure that utilities have sufficient cash flows following the federal income tax rate reductions and the loss of bonus depreciation. As S&P has noted "'[r]egulators must also recognize that tax reform is a strain on utility credit quality, and we expect companies to request stronger capital structures and other means to offset some of the negative impact'." IAWC Ex. 11.00 at 57 *citing* Standard & Poor's Ratings, "U.S. Tax Reform: For Utilities' Credit Quality, Challenges Abound," January 24, 2018, at 5. Furthermore, S&P has stated that it expects continued pressure on cash flows over the near-term as utilities continue to increase leverage to fund capital expenditure plans to reduce greenhouse gas emissions and improve safety and reliability, and prolonged inflation and rising interest rates could further constrain the credit metrics for utilities.

IAWC contends that the cash flow concerns raised by credit rating agencies as a result of the TCJA, inflation, COVID-19, and increased capital expenditures underscore the importance of maintaining adequate cash flow metrics for the industry, as a whole, and IAWC, particularly, in the context of this proceeding. IAWC points out that, while IIWC/CUB/FEA argue that none of these factors support adopting a higher common equity ratio here, the facts show otherwise.

IAWC states that the concerns of the credit rating agencies also demonstrate that it is reasonable to rely on a higher equity ratio in this case than IAWC may have relied on, or that the Commission may have approved, in prior rate cases. The adoption of a higher equity ratio here further is supported by the Commission's authorization of capital structures involving similar equity ratios in recent rate cases for other public utilities. *See*

Docket No. 21-0098, Order at 71 (adopting a capital structure for ratemaking purposes with 54.459% common equity); Docket No. 20-0308, Order at 130 (adopting a capital structure for ratemaking purposes with 52% common equity); *Aqua Ill., Inc.*, Docket No. 17-0259, Order at 21-22 (Mar. 7, 2018) (adopting a capital structure for ratemaking purposes with 53.22% common equity).

IAWC concludes that, for these reasons, its proposed capital structure for the test year ending December 31, 2023 is reasonable and appropriate and should be adopted by the Commission for ratemaking purposes in this proceeding.

IAWC observes that Staff and IIWC/CUB/FEA recommend that the Commission disregard IAWC's proposed capital structure and impute to it a structure that includes more debt and less common equity. Staff proposes an imputed capital structure with 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity, while IIWC/CUB/FEA propose the use of an imputed capital structure in which the common equity ratio would be no higher than 50%. IAWC states that Staff witness Kight-Garlisch argued that the Company's proposed capital structure contains more common equity than needed to support a financially strong water utility. She based this assertion on the Company's proposed equity ratio being higher than the 2021 common equity ratio of its parent company (approximately 40%) and the alleged average 2021 equity ratios for the Proxy Group and water industry (43.70% and 47.45%, respectively). She also argued that the Company's proposed capital structure would produce a rate of return that appears to violate Section 9-230 of the Act.

IAWC contends that it does not appear that IIWC/CUB/FEA witness Walters performed any quantitative analysis or correlated his proposed capital structure with any actual number. Instead, IAWC notes, Mr. Walters pointed to the Company's currently authorized equity ratio of 49.80%, the common equity ratios the Commission previously has approved for IAWC, and IAWC's reliance on its parent as well as American Water Capital Corporation ("AWCC") to fund its external capital.

IAWC points out that the Commission has refused to adopt an imputed capital structure absent any material facts that a utility's capital structure was manipulated. *GTE N. Inc.*, Docket No. 93-0301, Order (Oct. 11, 1994); 1994 WL 711847. IAWC further points out that the Commission also has concluded that "imputing a hypothetical capital structure to determine a utility's rates is a serious adjustment," and a utility's capital structure should not be disturbed unless it is found to be unreasonable or imprudent. *N. Ill. Gas Co. d/b/a Nicor Gas Co.*, Docket No. 87-0032, Order (Jan. 20, 1988).

IAWC argues 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. In this case, IAWC points out, neither Staff nor IIWC/FEA/CUB have even suggested, much less provided evidence, that American Water is manipulating IAWC's capital structure. Moreover, as demonstrated below, Staff and Intervenors failed to present evidence in support of their imputed capital structures and to refute IAWC's showing that its proposed capital structure is consistent with how the Company's rate base has been financed and is reasonable and in line with its peer utilities. IAWC maintains that the Commission should reject Staff's and Intervenors' imputed capital structures.

IAWC states that in response to Staff witness Kight-Garlisch's contention that IAWC has higher financial strength than the Proxy Group and the water industry, IAWC presented evidence showing that the peer group capitalization ratios utilized by Ms. Kight-Garlisch are not comparable to IAWC's proposed ratemaking capital structure, resulting in an "apples to oranges" comparison. For example, Ms. Kight-Garlisch included as part of the debt component in her capitalization ratios the full amount of short-term debt for each utility. Pursuant to 83 Ill. Adm. Code 285.4020, for ratemaking purposes, IAWC reduced its short-term debt balance by the amount of construction work in progress ("CWIP") accruing an allowance for funds used during construction ("AFUDC"). IAWC explains that this adjustment impacts the other components of IAWC's ratemaking capital structure as that reduction shifts some of the short-term capitalization balance to the other components, primarily common equity. IAWC notes that Ms. Kight-Garlisch did not make a comparable reduction, so the total debt ratios included within the peer group capitalization ratios that she utilized are overstated and the common equity ratios are understated.

In particular, IAWC points out, that the three-year average equity ratios for the Proxy Group described by Ms. Kight-Garlisch likely would look different if they had been subject to the adjustment to short-term debt detailed in Section 285.4020 (which reduced IAWC's short-term debt balance by approximately 75%). IAWC points out, by way of illustration, the three-year average capitalization ratios for California Water Service Group are 9.68% short-term debt, 43.84% long-term debt, and 46.48% common equity. Applying the same hypothetical 75% adjustment to the short-term debt balance results in three-year average capitalization ratios of 2.71% short-term debt, 49.91% long-term debt, and 50.09% common equity. The impact of this adjustment results in a common equity ratio 3.61% higher than what is reflected in the three-year average common equity ratio included within Ms. Kight-Garlisch's analysis. While the exact adjustment for each company will vary on the amount of CWIP accruing AFUDC, this example illustrates that, to varying degrees, making the short-term debt adjustment required by Section 285.4020 would result in higher common equity ratios for each company included within the analysis and, therefore, for the Proxy Group.

Further, IAWC states, the Moody's Investors Service ("Moody's") Rating Methodology Scorecard relied upon by Ms. Kight-Garlisch to support her suggestion for lower equity ratios involves multiple scoring categories in addition to a variety of other factors when contemplating its ratings. IAWC notes that her direct testimony, however, admittedly only presented a subset of those methodologies, namely the financial ratios. IAWC notes that, as Mr. Selinger explained, the Moody's report also states that it "does not include an exhaustive treatment of all factors that are reflected in our ratings and further states that the scorecard is a summary that does not include every rating consideration and that the scorecard outcome is not expected to match the actual rating of each company." IAWC Ex. 17.0 at 17. IAWC points out that Ms. Kight-Garlisch acknowledged that the Moody's report that she relied upon "does not include an exhaustive treatment of all factors that are reflected in Moody's ratings." Staff Ex. 13.0 at 18. Nevertheless, Ms. Kight-Garlisch tried to produce what she believed Moody's might have produced in its ratings analysis for her lower equity ratios without using all of Moody's ratings criteria, both objective and subjective. As IAWC witness Bulkley explained, Staff's suggestion that IAWC would have an implied credit rating from Moody's

of A2 using Ms. Kight-Garlisch's analysis is unsubstantiated because she did not consider all the factors that Moody's evaluates to establish a credit rating.

Finally, IAWC notes, Staff's and Intervenors' proposal to use an imputed capital structure fails to sufficiently account for IAWC's operating risk. IAWC states that although omitted from her direct testimony, Staff witness Kight-Garlisch argued on rebuttal that IAWC's operating risk is similar or slightly less risky than American Water's operating risk. IAWC presented evidence showing that this is not the case. As compared to American Water, IAWC has its own unique operating risk, since the factors that impact operating risk vary across jurisdictions, including unforeseen maintenance expense, as well as the types of sharp increases in power and chemical costs that IAWC has presented evidence of here. IAWC states that if it were the only utility owned by American Water, the operating risk profile of the parent and subsidiary entities would essentially be identical. In contrast, American Water's operating risk profile reflects the risk of all its regulated subsidiaries such that if one subsidiary were to experience financial difficulty, American Water's overall loss would be mitigated as long as the other utilities remained financially viable. In this respect, American Water's ownership of multiple utilities in multiple jurisdictions is a form of diversification that allows it to mitigate its operating risk. Of course, IAWC cannot mitigate its operating risk in this fashion as it bears 100% of whatever its operating risk is. The Company explains that because IAWC cannot diversify its operating risk, its operating risk profile is greater than that of its parent.

IAWC witness Bulkley also testified that additional risk factors must be considered with respect to the overall effect on IAWC's risk profile relative to the Proxy Group. Ms. Bulkley identified at least two such risk factors at issue here: (1) the Company's substantial capital expenditure program; and (2) the Company's anticipated investment in acquired systems to ensure those systems comply with state and federal water standards.

IAWC contends that, given the flaws in Staff's analysis, including those described above, the Commission should reject Staff's and Intervenors' proposal to use an imputed capital structure in favor of adopting IAWC's stand-alone forecast capital structure. IAWC notes that, unlike Staff's imputed capital structure, IAWC's proposed capital structure is consistent with how the Company's assets and rate base will be financed, is determined by IAWC, and is in line with peer utilities of similar risk profiles.

As noted above, Staff witness Kight-Garlisch suggested that the Company's affiliations with unregulated or non-utility companies have increased its risk and thus its cost of capital in violation of Section 9-230 of the Act. IAWC points out that, according to Ms. Kight-Garlisch, the increased risk is evident "in comparing [IAWC's] implied Moody's credit rating of A2 to the Moody's Baa1 rating for American Water[,]" as can be seen in the ratings of two of IAWC's sister utility subsidiaries, as well as in the Company's proposed equity ratio that is higher than the equity ratio maintained by American Water. *See* Staff Ex. 5.0 at 9.

Section 9-230 of the Act states:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates and charges, the Commission shall not include any (i) incremental

> risk [or] (ii) increased cost of capital . . . which is the direct or indirect *result* of the public utility's affiliation with unregulated or nonutility companies.

220 ILCS 5/9-230. The plain language of Section 9-230 of the Act requires that the utility's stand-alone capital structure and risk be used as a starting point in determining its cost of capital. 220 ILCS 5/9-230. Any "incremental risk" inuring to the utility due to its affiliation with unregulated or nonutility companies must be excluded from the determination of the utility's cost of capital. *Id*. In other words, Section 9-230 precludes imputing to the utility the risk of affiliated companies. As applied here, the Commission must establish the ratemaking capital structure for IAWC, the operating company, on a stand-alone basis, as if the Company were seeking to attract capital in financial markets based on its own individual merits and risk profile.

IAWC states that Section 9-230 also requires a causal connection between the increased cost of capital and the utility's affiliation with unregulated or nonutility companies. The higher cost of capital must be "*because of* its affiliation with an unregulated or nonutility company[.]" *Ill. Bell Tel. Co. v. Ill. Commerce Comm'n*, 283 Ill. App. 3d 188, 207 (2d Dist. 1996) (emphasis added).

The simple fact that IAWC is affiliated with its parent company or that IAWC's capital structure is different from American Water's consolidated capital structure is not a sufficient basis for an adjustment to IAWC's proposed capital structure. IAWC points out that its affiliation with American Water has existed in its current form since 2007 (*see* Docket No. 06-0336) and the Commission has not found IAWC's capital structure to be in violation of Section 9-230 in any of the Company's rate proceedings filed since that time. In the Company's last rate case, Docket No. 16-0093, Staff proposed to reduce the common equity balance in IAWC's capital structure (from 51.01% common equity to 49.65% common equity) but did not point to Section 9-230 in support of that argument.

IAWC states that, in this case, Staff has not attempted to show that any "increased cost of capital" is the "result of" IAWC's affiliation with American Water. IAWC states more particularly that Staff failed to present any information showing that IAWC has incurred higher costs due to the financial decisions of American Water. IAWC further states that Staff did not identify any specific statements from analysts or actions taken by American Water that would indicate that IAWC specifically is affected by the risks of its affiliates. Instead, Ms. Kight-Garlisch's conclusion was based, in part, on a comparison of the implied Moody's credit rating of A2 for IAWC that she calculated (IAWC does not maintain separate ratings) to the Moody's Baa1 rating for American Water. As discussed above, Staff's suggestion that IAWC would have a credit rating from Moody's of A2 is unsubstantiated because Staff's analysis did not consider all the factors that Moody's evaluates to establish a credit rating.

Moreover, IAWC notes, Ms. Kight-Garlisch did not quantify any incremental risk or increased cost of capital that results from this comparison or IAWC's affiliation with American Water. IAWC points out that, in response to a data request, Ms. Kight-Garlisch admitted that she "did not perform any analyses to estimate an increase in the cost of capital for IAWC that relates to an increase in the cost of equity that relates to its obligation to the parent company." *See* IAWC Ex. 32.00 at 19. Nor did Ms. Kight-Garlisch conduct

any analysis demonstrating that IAWC's equity ratio is "more than needed." IAWC contends that, having failed to provide any analysis, Ms. Kight-Garlisch is left with unsubstantiated generalized statements concluding that a utility will often maintain a higher equity ratio than it otherwise would need, thereby increasing the cost of capital and violating Section 9-230 of the Act.

If anything, IAWC argues, it is Ms. Kight-Garlisch's analysis that violates Section 9-230. Ms. Kight-Garlisch's testimony acknowledges that utilities with higher debt ratios (and so lower common equity ratios) are riskier. Ms. Kight-Garlisch is imputing a riskier capital structure to IAWC, as can be seen in her Table 1 in direct and rebuttal testimonies, where IAWC's proposed capital structure has an implied Moody's rating of A1, while Staff's proposed capital structure has a lower implied rating of A2.

Further, IAWC states that Ms. Kight-Garlisch relies on the 2021 average equity ratio of the Proxy Group companies and water industry at the holding company level. IAWC states that by relying on the 2021 average equity ratio for her Proxy Group and the water industry at the holding company level, Ms. Kight-Garlisch is directly including the risks and capital costs of the unregulated or non-utility affiliates of the Proxy Group companies for purposes of formulating her equity ratio recommendation for IAWC.

In particular, IAWC notes that included in the 2021 average for the Proxy Group and the water industry relied upon by Ms. Kight-Garlisch is an equity ratio for 2021 for Essential Utilities ("WTRG") of 45.88% and for SJW Group ("SJW") of 39.34%. However, IAWC states, each of these companies contains long-term debt at the holding company level that was issued to fund acquisitions that are not a part of the regulated or financial capital structure of the operating utilities of either WTRG or SJW. For example, SJW funded its 2019 acquisition of Connecticut Water Service, Inc. ("CTWS") with the issuance of long-term debt totaling approximately $510 million. The debt issuances associated with the acquisition had a substantial effect on the capitalization of SJW and were the primary reason the debt ratio increased from 37.40% in 2018 to 61.52% in 2019. Because the debt used to finance the acquisition of CTWS is not a part of the regulated or financial capital structures of the operating subsidies of SJW, a review of SJW's capital structure that includes the parent company debt – as conducted by Ms. Kight-Garlisch – is inappropriate because SJW's capital structure at the holding company is not reflective of how comparable regulated water utilities are being financed. IAWC states that similar to SJW, Ms. Kight-Garlisch's consideration of WTRG's capitalization at the holding company level is inappropriate because it does not reflect how comparable regulated water utilities are being financed and would incorrectly reflect the additional risks and capital costs of WTRG in the ratemaking capital structure for IAWC.

IAWC explains that while it demonstrated that it is inappropriate to use holding company capital structure data for the Proxy Group as the benchmark for determining the reasonableness of the Company's proposed capital structure here, IAWC also demonstrated that corrections were necessary to Ms. Kight-Garlisch's analysis if such a benchmark were to be used. Specifically, IAWC points out that Ms. Bulkley adjusted Ms. Kight-Garlisch's analysis to exclude the equity ratios for SJW and WTRG since each included significant holding company level debt used to fund acquisitions that is not a part of the capital structures of the operating subsidiaries and to adjust Atmos Energy Corporation's equity to exclude the debt issued as a result of costs incurred due to Winter

Storm Uri that will not be included in the company's capitalization going forward. IAWC explains that these corrections result in a Proxy Group average equity ratio of 53.56% and a water industry average equity ratio of 51.80% for 2021, both of which are clearly in line with the Company's proposed equity ratio of 51.95%.

IAWC states that to further support her argument regarding the alleged violation of Section 9-230, Ms. Kight-Garlisch argued that the Moody's credit ratings of New Jersey-American Water and Pennsylvania-American Water reflect the effects associated with their affiliation with non-jurisdictional utility affiliates or non-utility companies similar to her contention regarding IAWC. IAWC explains that the credit ratings of New Jersey-American Water and Pennsylvania-American Water are not relevant to the question of the appropriate capital structure for IAWC in this proceeding. Each individual company is subject to its own capital needs, operating risks, and market conditions. And, even if their actual (and not implied) credit ratings somehow were relevant here, they do not support the Commission's adoption of Staff's imputed capital structure. IAWC explains that is because its proposed equity ratio is lower than the authorized common equity ratios of New Jersey-American Water and Pennsylvania-American Water of 54.56% and 55.24%, respectively. IAWC points out that it also is lower than the actual equity ratios of these affiliates for the most recent calendar year of 2021 (54.31% and 55.33%, respectively).

Finally, IAWC states, in response to Ms. Kight-Garlisch's suggestion that IAWC is not sufficiently insulated from American Water's business decisions, that IAWC is a separate legal entity that maintains an independent capital structure, approved by its Board, that supports the continued provision of safe, reliable, and affordable water and wastewater service for the benefit of its Illinois customers. IAWC states that it is a stand-alone business enterprise in all material respects including, but not limited to, its independent state operations, capital investments, management, and corporate governance. IAWC explains that its capital structure includes the costs incurred for both debt and equity financing based on the risk factors that are relevant to IAWC and, as described by Ms. Bulkley, is in line with its peer utilities with similar risk profiles.

IAWC maintains that its customers have benefitted and will continue to benefit from the independence of IAWC as a stand-alone business entity, as well as its affiliation within the larger American Water enterprise, including through IAWC's financing arrangement with AWCC. The Company explains that as a subsidiary of the larger American Water enterprise, IAWC's customers benefit from American Water's size and scale to realize cost savings, the most significant of which includes lower debt costs from the Financial Services Agreement with IAWC's affiliate, AWCC. Thus, IAWC concludes, its affiliation with American Water and AWCC decreases, not increases, IAWC's cost of capital. IAWC addresses Staff's argument that authorizing a higher equity ratio than is necessary due to a utility's association with non-regulated affiliates would increase the utility's overall cost of capital in violation of Section 9-230. IAWC maintains that the statute does not allow (much less require) reductions to equity simply to lower the equity ratio to a "necessary" level. Similarly, the statute does not allow the Commission to change debt-to-equity ratios if it wants to lower rates. Reductions in the equity ratio are only permitted if certain facts have been proved: that the higher costs were caused by affiliations with

unregulated or non-utility companies. IAWC states that Staff has not made the requisite showing here.

IAWC also addresses Staff's attempt to distinguish its position on the appropriate common equity ratio here from the position it took very recently in the last Nicor rate case, Docket No. 21-0098, where Ms. Kight-Garlisch supported a 54.459% common equity ratio for the utility. IAWC points out that Staff argues that the difference between Nicor and IAWC is that IAWC does not have the same ringfencing measures in place as Nicor does, so, according to Staff, IAWC is impacted by the decisions of its parent company in a way that Nicor is not. IAWC further points out that Staff did not identify specific ringfencing provisions that it felt should be employed, nor did Staff present any evidence that ringfencing would result in a lower equity ratio for IAWC. In addition, Ms. Bulkley testified that utility mergers often include a condition of maintaining a minimum equity ratio in order to protect the utility operating company, and that the use of a lower bound on the equity ratio as a ringfencing measure to insulate the utility operating company from the parent is the exact opposite of Staff's proposal here. Ms. Bulkley further testified that there is a strong linkage between Nicor's credit ratings and the parent company, and that Staff did not substantiate its argument that Nicor was in a better financial position than IAWC. For these reasons, IAWC maintains that Staff's attempts to distinguish its support of a higher equity ratio of 54.459% in the Nicor rate case are without merit.

IAWC notes that as demonstrated by its evidence, and described above, it is reasonable and appropriate to rely on the operating company capital structures that have been used to fund utility operations for the comparison of IAWC to the Proxy Group and other water utilities as a measure of the reasonableness IAWC's proposed capital structure here. If anything, IAWC argues, it is Ms. Kight-Garlisch's analysis, which imputes a riskier capital structure due to IAWC's affiliation with American Water and considers the increased risk associated with the non-utility and unregulated affiliates of the Proxy Group and water industry, that violates Section 9-230 of the Act, not the Company's proposed equity ratio of 51.95%.

**b. Staff's Position**

Staff witness Kight-Garlisch's overall cost of capital recommendation for IAWC equals 7.01%, which reflects a capital structure including 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity; her overall cost of capital recommendation for IAWC also reflects Staff witness McNally's 9.78% recommended cost of common equity. Staff Ex. 13.0 at 2, Sch. 13.1.

Ms. Kight-Garlisch testified that the overall cost of capital equals the sum of the costs of the capital structure components (i.e., short-term debt, long-term debt, preferred stock, and common equity) after weighting each by its proportion to total capital. A primary goal of regulation is to properly balance the interests of a utility's ratepayers and investors. As Ms. Kight-Garlisch explained, this is accomplished by minimizing the cost of reliable service to ratepayers while allowing utilities to earn a fair and reasonable rate of return on rate base. Staff Ex. 5.0 at 2. Under the traditional regulatory model, ratepayer and shareholder interests are balanced when the Commission authorizes a rate of return on rate base equal to the public utility's overall cost of capital, as long as that overall cost of capital is not unnecessarily expensive. When public utilities charge rates that reflect

an authorized rate of return that exceeds the cost of capital, consumers are encumbered with excessive prices. Conversely, when public utilities charge rates that reflect an authorized rate of return below the cost of capital, the financial integrity of the utility suffers, making it difficult for the utility to attract capital at a reasonable cost, and thus, impairing service quality. Consumers are best served when the authorized rate of return on rate base equals the overall cost of capital. Staff Ex. 5.0 at 3.

Staff explains that capital structure affects the value of a business and, therefore, its cost of capital, to the extent it affects the expected level of cash flows that accrue to parties other than debt and stockholders. Employing debt as a source of capital reduces a company's income taxes, thereby reducing the cost of capital. As reliance on debt as a source of capital increases, however, so does the probability of default. *Id.* at 4. As the probability of default rises, expected payments to attorneys, trustees, and other outside parties increase. Further, the expected cash flows decline as the company foregoes investment that would have been available to it had its financial condition been stronger, including the expected value of the income tax shield from debt financing. Beyond a certain point, a growing dependence on debt as a source of funds increases the overall cost of capital. Therefore, Staff states 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. *Id.*

An optimal capital structure would minimize the cost of capital and maintain a utility's financial integrity. Unfortunately, Staff states, determining whether a capital structure is optimal remains problematic for a variety of reasons. Consequently, one should determine whether the capital structure is consistent with the financial strength necessary to access the capital markets under most economic conditions, and if so, whether the cost of that financial strength is reasonable. *Id.* at 5.

To evaluate the Company's proposal, Ms. Kight-Garlisch compared the Company's proposed forecasted debt ratio, along with three other financial ratios derived from data forecasted by the Company, to the actual 2021 and three-year average financial ratios for the Company, IAWC's parent company, American Water, the Proxy Group, and the Water Industry. Ms. Kight-Garlisch also compared the implied Moody's credit rating for each, based on those four ratios, using the Moody's Benchmark Ratios for regulated water utilities.

Moody's publishes ratio ranges that may generally be seen at different rating levels for regulated water utilities. In Staff's analysis, each ratio for IAWC, American Water, the Proxy Group, and the Water Industry was calculated for both 2021 and as a three-year average from 2019 through 2021. IAWC's ratios were also forecasted for 2023 based on both the Company's proposed revenue requirement and Staff's proposed revenue requirement for the Company in this case. The Moody's financial ratios imply credit ratings of A1 and A2 for the Company, Baa2, and Baa1 for American Water, A3 and A3 for the Proxy Group, and A3 and A3 for the Water Industry, based on 2021 data and 2019-2021 data, respectively. The Company has higher overall cash flow ratios and lower debt ratios (both indicative of higher financial strength) than American Water, the Proxy Group, and the Water Industry. Staff Ex. 5.0 at 7-8. Thus, Ms. Kight-Garlisch concluded that IAWC's proposed 51.95% equity ratio was unnecessarily high. Since the Company's proposed capital structure is not appropriate for determining IAWC's rate making capital

structure, Ms. Kight-Garlisch recommended using an imputed capital structure that contains 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity. Staff Ex. 5.0, Sch. 5.1.

Mr. Selinger criticizes Ms. Kight-Garlisch's Moody's credit rating analysis arguing that it was not a comprehensive analysis. IAWC Ex. 17.00 at 16-17. Staff disagrees. Moody's relies on several qualitative measures to assess a company's operating risk and to a lesser degree its financial risk. Moody's also relies on several quantitative measures, which are replicated in the ratio analysis presented by Ms. Kight-Garlisch. While Ms. Kight-Garlisch only presented the financial ratios in direct testimony, Ms. Kight-Garlisch's qualitative assessment of IAWC was provided to IAWC. Staff Ex. 13.0 at 18. Ms. Kight-Garlisch assessed IAWC's operating risk to be similar or slightly less risky than American Water's operating risk. *Id.* Thus, Staff argues that Mr. Selinger's criticism should be discarded, as it is without merit.

Staff notes that the Company's proposed equity ratio of around 52% is much higher than its riskier parent company's common equity ratio of only about 40% in 2021. In comparison to its peers, Staff argues that the Company's proposed capital structure indicates a relatively low degree of financial risk for a water utility. Specifically, the average 2021 equity ratios for the Proxy Group and Water Industry are 43.1% and 48.7%, respectively. The most recent three-year average equity ratios for the Proxy Group and Water Industry are 45.0% and 49.1%, respectively. This denotes a higher degree of financial risk than a common equity ratio of about 52%, as IAWC proposes for itself. Staff Ex. 5.0 at 8. Thus, the Company's proposed capital structure contains more common equity than needed to support a financially strong water utility.

In addition, Staff argues that the Company's proposed capital structure, which consists of approximately 48% debt and 52% equity, is not appropriate for determining the Company's capital structure. As a result, Ms. Kight-Garlisch recommended using an imputed capital structure that contains 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity. Staff Ex. 5.0, Sch. 5.1. Staff asserts that the Company's proposed capital structure would produce a rate of return that violates Section 9-230 of the Act. Section 9-230 states, "In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (1) incremental risk, [or] (2) increased cost of capital…which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies." 220 ILCS 5/9-230. The effect of the Company's affiliations with unregulated or non-utility companies on its cost of capital is evident in comparing its implied Moody's credit rating of A2 to the Moody's Baa1 rating for American Water. A similar effect can also be seen in the ratings of two of IAWC's sister water utility subsidiaries.

Staff asserts that it is essential to note that IAWC has less financial risk than American Water. IAWC's ratios imply financial strength equal to an A2 Moody's credit rating, whereas American Water's ratios imply financial strength consistent with its Baa1 credit rating. All else equal, a company with less risk can carry a lower percentage of equity on its balance sheet than a company with greater risk. Yet, the Company's forecasted equity ratio of around 52% is much higher than its riskier parent company's common equity ratio of only about 40%. Staff Ex. 5.0 at 11. Both the Company's implied credit ratings and financial ratios indicate that its affiliation with unregulated or non-utility

companies has increased its risk. Pursuant to Section 9-230 of the Act, the cost associated with that increased risk cannot be reflected in the Company's rates.

Staff notes that IAWC witness Selinger argues that IAWC's stand-alone capital structure should be used for setting rates in this case and that Staff has not demonstrated that Section 9-230 of the Act applies. IAWC Ex. 17.00 at 14. Similarly, IAWC witness Bulkley argues that under Section 9-230 of the Act, the Commission must establish the rate making capital structure on a stand-alone basis. IAWC Ex. 21.00 at 64-66. Staff contends that Mr. Selinger and Ms. Bulkley's arguments are without merit. Indeed, Section 9-230, by its very nature, requires a utility's affiliations to be considered when evaluating its capital structure. It is clear that corporations have incentive to maintain relatively low equity ratios (i.e., high debt levels) at the holding company level while maintaining relatively high equity ratios at the utility operating company level. This is detailed by the court in *Citizens Util. Bd. v. Ill. Commerce Comm'n*:

> When a larger corporation owns a utility, the corporation is generally motivated not to establish an optimal, lowest cost capital structure for the utility, but to use instead a structure with a greater percentage of equity than is optimal, thereby allowing the corporation to realize a greater return. The assured profits from the regulated utility can then bolster the security of the corporation, allowing it to sell its own debt instruments at lower cost and use the debt capital to finance riskier, unregulated and competitive ventures. Thus, the corporation maintains an overall capital structure with a higher proportion of low-cost debt, while reporting the capital structure of the owned utility with a higher proportion of high-cost equity.

*Citizens Util. Bd. v. Ill. Commerce Comm'n*, 276 Ill. App. 3d 730, 746 (1st Dist. 1995).

Thus, to service its parent's obligations, the utility subsidiary will often maintain a higher equity ratio than it otherwise would have needed, thereby increasing the utility's cost of capital, while leaving ratepayers with the costs. The legislature, through Section 9-230, has directed the Commission to protect ratepayers against the increased cost of capital sought by a utility with such an inflated level of equity. Specifically, in Illinois, "if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its [rate of return] calculation." *Ill. Bell Tel. Co. v. Ill. Commerce Comm'n*, 283 Ill. App. 3d 188, 207 (2nd Dist. 1996).

Further, contrary to Ms. Bulkley's assertion, Staff argues that Section 9-230 of the Act does not state that rate making capital structures must be established on a stand-alone basis; rather, it states that no increased cost of capital resulting from a utility's association with non-utility affiliates can be reflected in the utility's rates. That is, the purpose of Section 9-230 of the Act is not to remove positive effects of a utility's unregulated affiliations from the utility's rates, but rather to protect Illinois utility ratepayers from any negative effects of those affiliations. Since common equity is a utility's most expensive form of capital, authorizing a higher equity ratio than is necessary due to a

utility's association with non-regulated affiliates would increase the utility's overall cost of capital, in violation of Section 9-230 of the Act. Conversely, reducing that equity ratio to remove the effects of risk resulting directly or indirectly from non-regulated affiliates would lower the utility's cost of capital and is, therefore, not a violation of Section 9-230 of the Act, but rather, a correction necessary to prevent such a violation.

Additionally, Mr. Selinger attempts to make a comparison to Ms. Kight-Garlisch's analysis in a Docket No. 21-0098, and her analysis in the instant proceeding. However, Staff states that Mr. Selinger fails to acknowledge that the facts and timing of Docket No. 21-0098 are distinguishable from this docket. Specifically, the most notable difference between Nicor and IAWC is that the rating agencies noted ringfencing measures in place at Nicor that insulated the company from its parent and resulted in higher stand-alone credit ratings for Nicor than its parent company from both Moody's and S&P. *S&P Global Ratings*, N. Ill. Gas Co. d/b/a Nicor Gas Co., April 9, 2020. IAWC does not have the same ringfencing measures in place and therefore, is impacted by the decisions of its parent company, American Water. Mr. Selinger also notes that in Docket No. 21-0098, Ms. Kight-Garlisch compared Nicor's proposed equity ratio to the three-year average equity ratios for the Gas Sample used to estimate the ROE for Nicor and Atmos Energy ("ATO"). IAWC Ex. 17.00 at 18-19. Mr. Selinger fails to acknowledge that ATO was the only company in the Gas Sample that, like Nicor, had credit ratings in the A range from both Moody's and S&P or that ATO's 3-year average common equity ratio was 58.59%. Docket No. 21-0098, Staff Ex. 3.0 (Cor.) at 9. These factors imply that Nicor's common equity ratio in Docket No. 21-0098 was reasonable at the time of Ms. Kight-Garlisch's analysis. Further, Staff witness Phipps testified that "[t]he Gas Sample serves as a proxy for the target company, Nicor [], and should therefore reflect the risk of Nicor []. If the proxy does not accurately reflect the risk level of the target company, an adjustment should be made." Docket No. 21-0098, Staff Ex. 4.0 (Cor.) at 24. Ms. Phipps determined that Nicor had lower risk than the Gas Sample and thus, adjusted the ROE estimate derived from the Gas Sample downward to reflect the lower risk of Nicor. *Id.* Thus, both the capital structure and the cost of equity for Nicor reflected its A2/A credit rating, and Staff contends that Mr. Selinger's comparison should be disregarded in its entirety.

Furthermore, Staff states that the Company's proposed capital structure indicates a relatively low degree of financial risk for a water distribution utility. In comparison, the average capital structures of the Proxy Group or the Water Industry are not nearly as conservative. The average 2021 equity ratios for the Proxy Group and Water Industry are 43.10% and 48.74%, respectively. Staff Ex. 5.0 at 11. The most recent three-year average equity ratios for the Proxy Group and Water Industry are 45.04% and 49.08%, respectively. Thus, the Company's 51.95% requested common equity ratio is much higher than those of the Proxy Group and Water Industry, which indicates a higher degree of financial risk for the Proxy Group and Water Industry relative to the Company. The Proxy Group's cost of common equity is a fair rate of return on common equity for the Company only if the total risk (business risk plus financial risk) for the Proxy Group and the Company are similar. However, given the Proxy Group's greater overall risk (A3), its cost of common equity would be too high to apply to a company with lower overall risk as implied in the Moody's ratios for the Company based on its proposed forecasted capital structure. Stated differently, if the Proxy Group's average capital structure were equal to the Company's proposed capital structure, the Proxy Group's cost of common equity

would be lower than the 9.78% value Mr. McNally estimated. Accordingly, Ms. Kight-Garlisch recommended imputing a capital structure for the Company.

The imputed capital structure that Ms. Kight-Garlisch recommended for IAWC in direct testimony was selected based on a comparison to the 2021 common equity ratios for three groups of companies. Ms. Kight-Garlisch's analysis was a three-pronged approach: 1) Ms. Kight-Garlisch considered the average equity ratio for the Proxy Group that forms the basis of both Ms. Bulkley's and Mr. McNally's cost of equity estimates; 2) Ms. Kight-Garlisch considered the average equity ratio for the Water Industry; and 3) Ms. Kight-Garlisch considered the Proxy Group's average equity ratio after removing any individual equity ratio for which the corresponding debt ratio exceeded the maximum Moody's Benchmark debt ratio for an investment grade credit rating. Since a number of individual equity ratios for the Proxy Group companies were noticeably low, and the Water Industry and modified Proxy Group equity ratios are very similar, Ms. Kight-Garlisch relied on the latter two groups and determined an equity ratio of 49.0% was reasonable for IAWC in this proceeding.

IAWC argues that Staff's and Intervenors' proposal to use an imputed capital structure fails to sufficiently account for IAWC's operating risk. Staff addresses IAWC's operating risk throughout its analysis. Ms. Kight-Garlisch's Moody's credit rating analysis was a comprehensive analysis; specifically, Moody's assesses a company's operating risk and financial risk. Ms. Kight-Garlisch assessed IAWC's operating risk and determined it to be similar or slightly less risky than American Water's operating risk. Since the Company's proposed capital structure was unnecessarily high and not appropriate for determining IAWC's rate making capital structure, Ms. Kight-Garlisch recommended using an imputed capital structure that contains 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity. Therefore, Staff states that the evidentiary record supports its assessment of IAWC's operating risk.

In her direct testimony, Ms. Kight-Garlisch testified that the proportion of short-term debt in her imputed capital structure equals the proportion of short-term debt in the Company's forecasted average 2023 capital structure. To calculate the Company's respective long-term debt ratio, Ms. Kight-Garlisch subtracted the Company's forecasted average 2023 short-term debt ratio from the imputed 51.0% (100% total capital - 49% common equity ratio) total debt ratio. Staff Ex. 5.0 at 13.

In rebuttal testimony, Ms. Kight-Garlisch had two corrections to her ratio analysis that resulted in 2021 and three-year average equity ratios for the Water Industry of 47.45% and 47.58%, respectively. Staff Ex. 13.0 at 3. Ms. Kight-Garlisch also revised her ratio analysis of the Proxy Group to reflect a $2.2 billion reduction in debt for ATO. The adjustment to ATO's debt results in the following revised 2021 ratios: 1) debt ratio of 40.4%; 2) equity ratio of 59.6%; 3) funds from operations ("FFO") to debt ratio of 24.15%, and FFO minus dividends to debt ratio of 18.11%. In addition, the adjustment to ATO's debt balance produced a corresponding adjustment to its equity ratio, which results in a 2021 and three-year average equity ratio for the Proxy Group of 43.7% and 45.2%, respectively. Ms. Kight-Garlisch adjusted the benchmark ratios for the Proxy Group accordingly to reflect the adjustment to ATO's debt balance. Additionally, she also updated IAWC's proposed capital structure ratios to reflect the Company's rebuttal testimony position and updated Staff's Proposed Capital Structure ratios to reflect Staff's

rebuttal testimony position. Staff Ex. 13.0 at 4. Although the ratios were updated from Ms. Kight-Garlisch's direct testimony, the updated ratios did not change her conclusions. Therefore, Ms. Kight-Garlisch's recommended an equity ratio of 49.0% and determined that it is reasonable for IAWC.

Ms. Bulkley argues that Ms. Kight-Garlisch's equity ratio analysis is flawed because it relies on the capital structures of the companies in the Proxy Group from which both Staff and the Company derive their ROE recommendations. Instead, Ms. Bulkley incorrectly compares the equity ratios proposed to equity ratios for the operating subsidiaries of the companies in the Proxy Group, which are substantially higher. IAWC Ex. 21.00 at 55. Additionally, Ms. Bulkley suggests that the equity ratios for three Proxy Group companies – ATO, WTRG, and SJW – need to be adjusted upward.

With regard to the Proxy Group, upon which both Staff's and Ms. Bulkley's ROE estimates were derived, Ms. Bulkley states, "[t]he proxy companies used in my analyses all possess a set of operating and financial risk characteristics that are substantially comparable to IAWC, and, therefore, provide a reasonable basis for deriving the appropriate ROE." IAWC Ex. 11.00 at 27. Thus, the Proxy Group Ms. Bulkley used in her cost of equity analysis was selected because she believed the Proxy Group to be a good proxy for, and similar in risk to, IAWC.

However, in comparing the operating subsidiaries of the fourteen Proxy Group companies, Ms. Bulkley effectively created a distinct sixty-seven company proxy group, which she has not demonstrated to be similar in risk to IAWC. The risk of an operating subsidiary can be different than its parent company. Staff Ex. 13.0 at 23-24. Thus, any analysis of the equity ratio based on a proxy sample should be based on the same proxy sample used to derive the ROE. To do otherwise might violate Section 9-230 of the Act since utility operating companies often have lower risk (i.e., higher credit ratings and higher equity ratios) than their parents, as is the case with IAWC's sister subsidiaries Pennsylvania-American Water Company and New Jersey-American Water Company compared to American Water. Further, contrary to Ms. Bulkley's assertions, no adjustments are necessary to the equity ratios of WTRG or SJW. The "comparable regulated water utilities" Ms. Bulkley is referring to in her statement are the operating subsidiaries that she has not shown are comparable to IAWC. The proper comparison is to the actual companies in the Proxy Group, which is the analysis presented by Staff. To adjust both WTRG's and SJW's capital structures would result in capital structures that would not reflect each company's actual equity ratio. Staff notes that Ms. Bulkley fails to acknowledge that acquisitions are not unusual occurrences – it is what occurred with ATO – but are well thought out plans and the capital structures of WTRG and SJW and reflect how the companies actually financed the acquisitions. Thus, no adjustment is needed to WTRG's or SJW's capital structure.

IAWC argues that there is no evidentiary basis for using the imputed capital structures proposed by Staff and Intervenors. IAWC relies on a past Commission Order, Docket No. 93-0301, to claim that an imputed capital structure cannot be used without proof of manipulation and argues that Staff has not provided any evidence that American Water is manipulating IAWC's capital structure. IAWC also contends that Staff failed to present evidence in support of its imputed capital structure and failed to refute IAWC's showing that its proposed capital structure is reasonable. In response, Staff states that

IAWC's proposed capital structure is fatally flawed because it reflects the increased risk of its affiliated parent corporation, American Water. Further, Staff argues the Company's proposed capital structure is unreasonable because it contains more common equity than needed to support a financially strong water utility. The Company's forecasted equity ratio of around 52% is much higher than its riskier parent company's common equity ratio of only about 40%. Staff Ex. 5.0 at 11. Staff notes that this is a fundamental flaw in the Company's proposed capital structure. As the Illinois courts have explained, "equity is a more expensive form of capital than debt." *Ill. Bell Tel. Co. v. Ill. Commerce Comm'n*, 283 Ill. App. 3d 188, 204 (2nd Dist. 1996). Subsequently, the "more equity in a utility's capital structure, the higher the ROR must be to recover the cost of capital." *Id*. *See also Citizens Util. Bd.,* 276 Ill. App. 3d at 744 ("[S]ince equity always costs more than debt, as a corporation increases its proportion of equity, its total cost of capital generally increases, although the cost of debt and the cost of equity both decrease."). It is clear that corporations have an incentive to maintain relatively low equity ratios (i.e., high debt levels) at the holding company level while maintaining relatively high equity ratios at the utility operating company level.

Thus, as Staff notes, to service its parent's obligations, the utility subsidiary will often maintain a higher equity ratio than it otherwise would have needed, thereby increasing the utility's cost of capital, while leaving ratepayers with the costs. The legislature, through Section 9-230, has directed the Commission to protect ratepayers against the increased cost of capital sought by a utility with such an inflated level of equity. Specifically, in Illinois, "if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its [rate of return] calculation." *Ill. Bell Tel. Co.*, 283 Ill. App. 3d at 207. Since the Company's proposed capital structure is not appropriate for determining IAWC's rate making capital structure and reflects the incentives prohibited by Section 9-230 (harmful to ratepayers and beneficial to shareholders), Ms. Kight-Garlisch recommended using an imputed capital structure to correct the fatal flaws in the Company's proposal. Staff Ex. 5.0, Sch. 5.1.

Staff notes that the Commission has previously approved an imputed capital structure in similar circumstances. In Docket Nos. 11-0280/11-0281 (Cons.), the Commission determined that Staff's proposed imputed capital structure was reasonable and adhered to statutory requirements. *N. Shore Gas Co.,* Dockets No. 11-0280/0281 (Cons.), Order at 108-109 (Jan. 10, 2012). In Docket Nos. 11-0280/11-0281 (Cons.), Staff proposed an imputed capital structure because the Companies' proposed capital structure reflected the increased risk of its affiliated parent corporation. In addition to the Companies' proposed capital structure being in violation of Section 9-230, Staff argued that the Companies' proposed capital structure was unreasonable since it would have resulted in a lower degree of financial risk than its peers in the gas distribution industry, which causes the Companies' overall cost of capital to be unnecessarily expensive. *Id.* at 103. The Commission agreed with Staff's analysis determining that both the Companies' credit ratings and financial ratios indicate that their affiliation with the unregulated corporate parent has increased its risk. *Id.* at 108. Thus, the Commission determined that it "is prevented by the Act and precedent from adopting a capital structure that reflects the increased risk of [the unregulated corporate parent]." *Id.* The

Commission determined that Staff's analysis was reasonable and adhered to the statutory requirements. *Id.* Staff argues that the Commission should do the same here.

Further, Staff argues that IAWC's reliance on the Order in Docket No. 93-0301 is misplaced. In *GTE North*, the Commission rejected CUB's proposed imputed capital structure because it was not reasonable. *GTE North, Inc.*, Docket No. 93-0301, Order at 107 (Oct. 11, 1994). The Commission also found that CUB's assertion that GTE North's capital structure was manipulated was not supported by evidence. *Id.* While the Commission agreed with CUB's statement that a parent company has the ability and incentive to manipulate the capital structure of its subsidiaries; ultimately, CUB did not provide evidence to support its argument. *Id.* at 108. Contrary to IAWC's claim, CUB's proposal was not rejected simply because it had an imputed capital structure, rather it was rejected because CUB's proposed imputed capital structure was unsupported and unreasonable. Specifically, CUB's proposed capital structure would have resulted in a sixteen-percentage point decrease in the Company's actual common equity ratio. *Id.*

Therefore, Staff notes that *GTE North* does not stand for the blanket assertion that an imputed capital structure is inappropriate and should not be used. Nor does it stand for the proposition that an imputed capital structure can only be used if a party proves that the capital structure was manipulated. *Id.* Rather, *GTE North* highlights that the Commission cannot legally draw a conclusion without a preponderance of the evidence supporting that finding, and CUB failed to provide evidence to support its claim. *Id*. *GTE North* also emphasizes the requirement of reasonableness associated with Section 9-230 noting that "the Commission is charged with the responsibility of establishing a reasonable rate of return...[and] must examine the various components of the rate of return calculation to determine whether the components are reasonable." *Id.* at 106.

IAWC alleges that it is Ms. Kight-Garlisch's analysis that violates Section 9-230. IAWC argues that since Ms. Kight-Garlisch's analysis imputes a riskier capital structure due to IAWC's affiliation with American Water and considers the increased risk associated with the non-utility and unregulated affiliates of the proxy group and water industry, it violates Section 9-230.

Staff disagrees with IAWC's assertion. Staff argues that Section 9-230 of the Act does not state that ratemaking capital rate structures must be established on a stand-alone basis; rather, it states that no increased cost of capital resulting from a utility's association with non-utility affiliates can be reflected in the utility's rates. That is, the purpose of Section 9-230 of the Act is not to remove positive effects of a utility's unregulated affiliations from the utility's rates, but rather to protect Illinois utility rate payers from any negative effects of those affiliations. Since common equity is a utility's most expensive form of capital, authorizing a higher equity ratio than is necessary due to a utility's association with non-regulated affiliates would increase the utility's overall cost of capital, in violation of Section 9-230 of the Act. Conversely, reducing the equity ratio to remove the effects of risk resulting directly or indirectly from non-regulated affiliates would lower the utility's cost of capital and is, therefore, not a violation of Section 9-230 of the Act, but rather, a correction necessary to prevent such a violation.

For all of the reasons set forth above, Staff recommends the Commission adopt Staff's imputed capital structure for IAWC of 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity.

**c. AG's Position**

The AG supports the capital structure proposed by IIWC/FEA/CUB for the reasons set forth in the testimony of Mr. Walters. *See generally,* IIWC/CUB/FEA Ex. 1.0, 2.0.

**d. IIWC/FEA/CUB's Position**

According to IIWC/FEA/CUB, the Commission must consider the appropriate ratemaking capital structure in light of the prevailing law, including the Act and legal precedent. The Act mandates the Commission to only approve rates that are just and reasonable. 220 ILCS 5/9-101. IIWC/FEA/CUB note that this general principle has been further articulated by Illinois courts. The Illinois Appellate Court has found, "the Act requires the Commission to establish rates which are just and reasonable for both the investors and the consumers." *Citizens Util. Bd.,* 276 Ill. App. 3d at 737. Accordingly, IIWC/FEA/CUB recommend a 50.0% common equity ratio, which appropriately balances the Company's debt and equity capital, is consistent with the average capital structure regulatory jurisdictions around the country have authorized and will not cost customers more than is needed to support the Company's financial integrity and access to capital markets.

IIWC/FEA/CUB state that the Appellate Court has found, "the Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost." *Id.* at 746. Thus, the Appellate Court has been clear that the Act requires an equity ratio that is no higher than is necessary to assure the Company's financial integrity. *Id*. at 737-46. As the evidence in this proceeding demonstrates, explained below, an equity ratio higher than the 50.0% would be excessive and therefore unjust and unreasonable under the Act.

IIWC/FEA/CUB observe that IAWC's current Commission-approved common equity ratio is 49.8%, which the Company agreed to in its previous rate case. Docket No. 16-0093, Order at 67. IIWC/FEA/CUB witness Walters recommended holding this figure at roughly its current level, no more than 50.0%, using the same proxy group as Company witnesses Bulkley and Selinger, excluding South Jersey Company, which has been targeted for acquisition by JP Morgan. IIWC/CUB/FEA Ex. 1.0 at 30, 61. Mr. Walters' recommendation more closely aligns with the capital structures of the proxy companies IAWC used to estimate its cost of equity than does the Company's overstated request of 51.95%. *Id.* at 61. As Mr. Walters documented in testimony, the utility industry's common equity ratio has not deviated significantly from 50%. *Id.* at 9. Peer gas utilities in states that, like Illinois, consider only investor-supplied capital typically have experienced annual median and mean common equity ratios of roughly 50% since at least 2010, with a 2022 median approved ratio of exactly 50.0%. *Id.* at 9-10. Utility credit ratings have experienced a strong upward trend over the last decade, with 76% of utility companies now boasting bond ratings from BBB+ to A-. *Id.* at 11. These data illustrate that a 50.0% equity ratio being the industry norm has bolstered industry financial health.

It is IIWC/FEA/CUB's position that utilities also have been able to access external capital to support capital expenditure programs with equity ratios similar to what Mr. Walters recommends. S&P Global Market Intelligence's 2022 Utility Capital Expenses Update report found significant growth in investment and capital expenditures across the utilities industry, including a 7.3% increase in capital expenditures across the small investor-owned water utility industry in 2022, on top of 4.9% growth in 2021. *Id.* at 11-12. Mr. Walters concurred with S&P Global Market Intelligence's forecast that this capital expenditure growth will continue to fuel utilities' profit growth into the foreseeable future. *Id.* at 13. Market valuations of utilities remain strong, with utilities commanding high prices when selling securities. *Id.* at 14. This growth and financial health has continued while ROEs have fallen to the mid-9% range. *Id.* That this observable utility industry market data has continued to demonstrate growth through the COVID-19 pandemic is a testament to the industry's financial stability. *Id.* at 15.

IIWC/FEA/CUB point out that Mr. Walters finds recent and announced Federal Reserve Bank monetary policy actions and the outlooks of independent economists both indicate a stable capital market environment for public utilities like IAWC. *Id.* at 15-22. Mr. Walters further cited CFA Institute Research Foundation's conclusion that history of similar past armed conflicts suggest the U.S. market impacts of Russia's invasion of Ukraine and related sanctions should be transitory. *Id.* at 22-23. Throughout the pandemic, inflation, rising interest rates, and Russia's invasion of Ukraine, the S&P 500 Utilities Index has significantly outperformed the market, as measured by both the S&P 500 and the Nasdaq Composite. *Id.* at 23.

According to IIWC/FEA/CUB, taken together, all of these data support Mr. Walters' recommendation to hold IAWC's approved common equity ratio steady at no more than 50.0% and provide no basis for saddling IAWC ratepayers with the expense of a significant equity ratio hike. The Commission should reject Company witness Selinger's argument that the TCJA, the COVID-19 pandemic, the Company's capital expenditure program, and IAWC's anticipated investment in acquired systems necessitate a higher common equity ratio. *See* Selinger, IAWC Ex. 17.00 at 24. TCJA went into effect over four years ago, yet none of the market data suggests TCJA negatively impacted the Company's ability to attract capital so as to require such intervention by the Commission. The entire country been affected by the COVID-19 pandemic, beginning in 2020, yet national utility industry data show overall credit upgrades, continued growth in capital expenditures, and a robust market for utility bonds. IAWC has maintained its A credit rating from S&P and Baa1 rating from Moody's with a "stable" outlook throughout the pandemic. IIWC/CUB/FEA Ex. 2.0 at 13. The Company's capital expenditures and system acquisitions since its last rate case have been supported by its 49.8% approved common equity ratio. Its capital program does not make IAWC unique among its peers. The Company's cash flow to capital expenditures ratio under its existing approved capital resembles that of the other proxy group utilities. *Id.* at 13-14.

IIWC/FEA/CUB point out that the Company already requests that ratepayers fund its capital investments and exorbitant system acquisition costs. Nothing in the record suggests ratepayers need to pay an inflated rate of return on capital expenditures, either through an increased equity ratio or an increased ROE, to support these programs.

IIWC/FEA/CUB recommend the Commission should reject the Company's attempt to pad its profit margin through an unwarranted increase in capital costs.

**e. Commission Analysis and Conclusion**

IAWC proposes a capital structure using thirteen-month average balances as of December 31, 2023 and composed of 1.81% short-term debt, 46.24% long-term debt, and 51.95% common equity. Staff's overall cost of capital recommendation equals 7.01%, which reflects a capital structure including 1.81% short-term debt, 49.19% long-term debt, and 49.00% common equity. IIWC/FEA/CUB recommend a 50.0% common equity ratio, based largely upon IAWC's current Commission-approved common equity ratio of 49.8%.

Generally, a utility's actual capital structure is adopted unless it is found to be unreasonable, imprudent, or unfairly burdensome. If found to be unreasonable, imprudent, or unfairly burdensome, then an imputed capital structure may be adopted. Here, as always, the objective of the Commission is to balance the interests of investors and consumers. As Staff notes, the optimal capital structure minimizes the cost of capital while maintaining the utility's financial integrity.

The Commission adopts the capital structure proposed by Staff. The Commission finds the use of actual data to be consistently more accurate than forecasted data. In that vein, Staff compared the Company's proposed forecasted debt ratio, along with three other financial ratios derived from data forecasted by the Company, to the actual 2021 and three-year average financial ratios for the Company, IAWC's parent company, the Proxy Group, and the Water Industry. The Company has higher overall cash flow ratios and lower debt ratios (both indicative of higher financial strength) than American Water, the Proxy Group, and the Water Industry; thus, Staff concluded, and the Commission agrees, that IAWC's proposed 51.95% equity ratio was unnecessarily high.

While IAWC claims that Staff's Moody's credit rating analysis is not comprehensive, the Commission agrees with Staff that Moody's relies on both qualitative and quantitative measures to assess a company's risk. The Company's requested equity ratio is much higher than those of the Proxy Group and Water Industry, which indicates a higher degree of financial risk for the Proxy Group and Water Industry relative to the Company. Further, IAWC's proposed equity ratio of around 52% is much higher than its riskier parent company's common equity ratio of approximately 40% in 2021. Staff notes that since common equity is a utility's most expensive form of capital, authorizing a higher equity ratio than is necessary would improperly increase the utility's overall cost of capital. If that increased equity ratio is due to a utility's association with non-regulated affiliates, that is a violation of Section 9-230 of the Act. Specifically, the appellate court has ruled that, in Illinois, "if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter its [rate of return] calculation." Staff BOE at 4 (*quoting Ill. Bell Tele. Co. v. Ill. Commerce Comm'n*, 283 Ill. App. 3d 188, 207 (2nd Dist. 1996)).

Thus, the Company's proposed capital structure contains more common equity than needed to support a financially strong water utility due to its affiliate relationships, leaving ratepayers to pay higher costs than warranted, in contravention of Section 9-230

of the Act. For the foregoing reasons, the Commission rejects the Company's proposed capital structure and adopts Staff's proposal.

### 2. Cost of Short-Term Debt (Forecasted Interest Rates)

#### a. IAWC's Position

IAWC explains that to properly set IAWC's cost of debt, the Commission must determine the interest rates that will apply to the debt the Company will issue in the 2023 test year. IAWC proposes that its cost of short-term debt in this proceeding be set at a forecast interest rate of 3.198%. IAWC explains that this figure reflects IAWC's revised projections in rebuttal testimony to reflect ongoing market conditions and recent projected rates provided by Bloomberg Online. IAWC notes that Staff is the only other party to address this issue, and Staff proposed a cost of short-term debt of 2.07% based on July 18, 2022 interest rates for commercial paper. While Staff updated its proposal in rebuttal testimony to rely on July 2022 rates instead of May 2022 rates, Staff's recommendation does not reflect market expectations for short-term borrowing rates in the 2023 test year. IAWC urges the Commission to reject Staff's proposal.

IAWC notes that it presented evidence showing that all current information from the market signals that rates are rising and will continue to rise. IAWC explains that as of the time of IAWC's surrebuttal testimony filing on August 5, 2022, the Fed Funds Rate was at 2.5%. However, just one month prior to that date, this rate was 1.75%. Further, as of August 5, 2022, the Federal Reserve was expected to raise rates at least an additional 1% by the end of 2022, putting the Fed Funds rate above IAWC's forecasted short-term debt rate proposed here. IAWC also demonstrated that its actual short-term debt rate increased 175% from April 2022 to June 2022, and 87% from May 2022 to June 2022. IAWC states that the Secured Overnight Financing Rate, which is the benchmark based on the rates U.S. financial institutions pay each other for overnight loans, increased by 436% during that same period and by 714% from April 29, 2022 to August 1, 2022.

IAWC maintains that Staff's argument that the Commission should use current market interest rates in its cost of capital analysis is problematic for at least two reasons. First, IAWC observes that Staff's proposed short-term interest rate of 2.07% unquestionably is no longer "current." Second, IAWC points out that Staff's contention that only current market interest rates should be relied upon in a cost of capital analysis is inconsistent with Staff's own use of forecast data in this case. For example, Staff's Discounted Cash Flow ("DCF") analysis presented in connection with its cost of common equity proposal relied on growth rates forecasted by analysts.

In short, IAWC states, there is no indication as the 2023 test year draws closer that rates will not continue to rise; therefore, the Commission should set IAWC's cost of short-term debt at 3.198% as it is based upon reliable forecasts of short-term interest rates for the 2023 test year and reject Staff's proposal.

#### b. Staff's Position

Staff witness Kight-Garlisch recommended a cost of short-term debt of 1.04% in her direct testimony. Staff Ex. 5.0 at 13. However, in rebuttal testimony, Ms. Kight-Garlisch revised her recommendation and recommended a cost of short-term debt of 2.07%. Staff Ex. 13.0 at 7.

Ms. Kight-Garlisch noted that IAWC obtains short-term debt through a line of credit from AWCC, American Water's financing subsidiary. AWCC's commercial paper rating is P-2 from Moody's. Staff Ex. 13.0 at 7. The average term for IAWC's short-term debt is 15 days. *Id.* Thus, to estimate IAWC's cost of short-term debt using AWCC's cost of commercial paper, Ms. Kight-Garlisch converted the July 18, 2022, 15-day P-2 commercial paper discount rate of 2.04% into an annual yield of 2.07% using the formula discussed in her testimony. *See* Staff Ex. 13.0 at 7.

IAWC argues for the use of forecasted interest rate for the cost of short-term debt; specifically, Mr. Selinger proposes using a 3.198% forecasted short-term debt rate derived from Bloomberg Online for the year 2023. IAWC Ex. 17.00 at 26. However, as noted by Staff witness McNally, accurately forecasting interest rates is problematic. Staff Ex. 14.0 at 3. The difficulty in forecasting interest rates is further emphasized in IAWC's own one-month forecasts, which IAWC failed to address. IAWC presented a forecasted short-term debt interest rate for May 2022 of 1.11% based on information from Bloomberg online from April 2022. Staff Ex. 13.0 at 11. IAWC's actual cost of short-term debt was only 0.69% for May 2022. IAWC rebuttal testimony, Workpaper WPD-2b. IAWC's forecasted short-term debt interest rate for June 2022 was 1.70%, but IAWC's actual cost of short-term debt was 1.30%. Staff Ex. 13.0 at 11. Further, the Commission has previously concluded that:

> predicting the direction, magnitude, or timing of future interest rate changes with accuracy is not possible. The Commission observes that the record demonstrates that professional forecasting services relied on by the Companies have consistently over estimated future rates in recent years. Current interest rates have proven to be better predictors of future interest rates than professional forecasters.

Docket Nos. 14-0224/14-0225 (Cons.), Order at 111.

For this reason, the Commission has repeatedly rejected the use of forecasted interest rates and, instead, relied on current, observable market interest rates. Staff notes that IAWC failed to address the Commission's past practices of rejecting the use of forecasted interested rates due to the problematic nature of accurately forecasting interest rates. Staff argues that, significantly, actual, observable yields reflect market forces and investors' expectations for the future, while forecasts do not. Those factors are reflected in the return that investors are willing to accept in the market. As of July 18, 2022, investors were willing to accept a 2.07% return on 15-day P2 non-financial commercial paper. Staff Ex. 13.0 at 12. Staff notes that IAWC would like for the Commission to use forecasted interest rates not based on evidence, but rather based on the mere "indication as the 2023 test year draws closer that rates will continue to rise[.]" IAWC IB at 53.

Further, the use of current, observable market interest rates renders the use of forecasted interest rates unnecessary because actual yields reflect all relevant, available information, including investor appraisals of the value of current expectations for the future. In other words, if investors believe that the forecasts are valuable, that belief would be reflected in current market interest rates. Conversely, if investors believe the forecasts

are not valuable, that belief would also be reflected in current market interest rates. In sum, if one uses current market interest rates in a cost of capital analysis, speculation of whether investor expectations of future interest rates equal those from a particular forecasting service is unnecessary. Therefore, Staff states that the Commission should adopt a cost of short-term debt of 2.07% for IAWC, consistent with its previous decisions on this subject.

#### c. Commission Analysis and Conclusion

The Company and Staff dispute the interest rate on short term debt. Staff recommends the use of actual current market interest rates, and the Company uses a forecast based on Bloomberg Online. The Commission notes that interest rates on P-2 commercial paper were volatile, even during the three months when testimony was filed.

The Commission agrees with Staff that the Company's proposal of 3.198% is arbitrary. On the contrary, Staff uses the actual market interest rate as of July 2022, when Staff filed its rebuttal testimony. As the Commission has noted, "current interest rates have proven to be better predictors of future interest rates than professional forecasters." Docket Nos. 14-0224/14-0225 (Cons.), Order at 111. While the Commission agrees with the Company that interest rates increased significantly between May and September of 2022, the Commission finds that Staff's number is a more reasonable assessment of future interest rates.

### 3. Cost of Common Equity

#### a. IAWC's Position

IAWC observes that, arguably, the most difficult and highly contested issue in every rate case is the ROE — the return that the Commission authorizes a utility to earn on the equity invested in its property dedicated to the provision of public utility service. IAWC points out that the law requires the Commission to authorize a utility to earn a rate of return that is reasonably comparable to returns associated with competing investments of comparable risk.

IAWC explains that the issue is so difficult because, unlike other elements of a utility's cost of service, where reasonableness might be determined by a competitive bidding process or comparison to a (relatively) easily determined prevailing market price, the cost of equity analysis involves extensive financial modeling, which, in effect, is a type of reverse engineering, using forecasts, projections, and estimates to reveal an invisible investor-expected return embedded in, or implied by, verifiable market data, such as stock prices and interest rates.

IAWC states that this might sound like an academic exercise, but the implications are not academic at all — the returns the Commission authorizes have real world consequences for both regulated utilities and their customers. IAWC contends that a utility's ability to achieve and maintain financial stability, finance construction, and meet its service obligations depends to a great degree on its authorized return.

IAWC states that this case has proved no easier than other rate cases. The Company, Staff, and IIWC/FEA/CUB present the Commission with three ROE recommendations that cover a wide range: from 9.35% (IIWC/FEA/CUB) to 9.78% (Staff) to 10.25% (IAWC). IAWC notes, however, that only the Company's recommendation

reflects the reality in which the Company operates. Only the Company's analysis reflects current market conditions — an inflationary environment and rising interest rates that cause investors to expect higher returns from regulated utilities. IAWC argues that the analyses of Staff and IIWC/CUB/FEA are based on stale, irrelevant, and inapt data that does not capture the conditions expected to be present when the rates set in this proceeding go into effect, and their recommendations should not be relied on by the Commission. Accordingly, IAWC concludes, the Commission should set the Company's ROE at 10.25%.

**i. Legal Standard**

IAWC explains that the United States Supreme Court's decisions in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Waterworks & Imp. Co. vs. Pub. Serv. Commn. of W. Va.*, 262 U.S. 679 (1923) (*"Bluefield"*), established the standards for determining the fairness or reasonableness of a utility's authorized ROE. IAWC explains that among the standards established by the Court in those cases are: (1) consistency of the return with other businesses having similar or comparable risks; (2) adequacy of the return to support credit quality and access to capital; and (3) the principle that the specific means of arriving at a fair return are not important, only that the result leads to just and reasonable rates. As noted in *Bluefield*, a proper rate of return not only assures "confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit [but also] enable[s the utility] to raise the money necessary for the proper discharge of its public duties." *Bluefield*, 262 U.S. at 693. As the Court later explained in *Hope*, "[t]the rate-making process ... involves balancing of the investor and consumer interests." *Hope*, 320 U.S. at 603.

IAWC states that this Commission recognizes the *Hope* and *Bluefield* standards. Recently, in Docket No. 20-0308, involving the gas base rates of Ameren, the Commission stated that:

> As the Commission set out in Docket [No.] 16-0093, "In estimating the cost of common equity, the Commission must consider not only the outputs of the financial models, but whether the authorized ROE satisfies the standards set forth in *Bluefield*, 262 U.S. 679 and *Hope*, 320 U.S. 591." See Docket [No.] 16-0093, . . . Order at 65. "These decisions established that a regulatory body such as the Commission must consider whether an authorized return is sufficient to maintain the utility's financial integrity and to attract capital at reasonable terms, while ensuring that customers do not pay an excessive or unreasonable return on those rates". *Id*. at 65 (*citing Bluefield*, 262 U.S. at 692-93; Hope, 320 U.S. 591 at 603). *Bluefield* and *Hope* also dictate that the Company provide safe, reliable service at just and reasonable rates. *Bluefield*, 262 U.S. at 693; *Hope*, 320 U.S. 591 at 603; see also Docket 16-0093 at 65. The cases further state that the return on investment should be commensurate with returns investors could earn by investing in other companies of

> comparable risk. *Bluefield*, 262 U.S. at 692; *Hope*, 320 U.S. 591 at 603; *see also* Docket [No.] 16-0093 at 65.

Docket No. 20-0308, Order at 168. IAWC notes that the Commission has further explained that:

> The Commission understands that an authorized rate of return that is not competitive will deter continued investment in the State of Illinois. The Commission also appreciates that a reasonable authorized ROE helps ensure that the Company can attract capital in order to meet the Commission required infrastructure repair and replacement needs of the State. Notwithstanding, the Commission recognizes too that it should protect customers against bearing the cost of unreasonable returns through higher rates.

Docket No. 18-1775, Order at 119.

IAWC explains that utilities compete directly for capital with other investments of similar risk, which include other water, natural gas, and electric utilities. Therefore, IAWC maintains, the ROE awarded to a utility sends an important signal to investors regarding whether there is regulatory support for financial integrity, dividends, growth, and fair compensation for business and financial risk. IAWC contends that the cost of capital represents an opportunity cost to investors. IAWC states that if higher returns are available elsewhere for other investments of comparable risk, investors have an incentive to direct their capital to those investments. Thus, IAWC states, an authorized ROE significantly below authorized ROEs for other water, natural gas, and electric utilities can inhibit a utility's ability to attract capital for investment.

#### ii. Significance of Current Market Conditions

IAWC notes that the ROE estimation models rely on market data. IAWC states that it should not be surprising then that the results of the ROE estimation models can be affected by prevailing market conditions at the time the analysis is performed. While the ROE established in a rate proceeding is intended to be forward-looking, the analyst uses current and projected market data, specifically stock prices, dividends, growth rates, and interest rates, in the ROE estimation models to estimate the required return for the subject company.

IAWC states that the cost of equity for regulated utility companies is being affected by several factors in the current and prospective capital markets, including: (1) the dramatic shifts in market conditions during 2020, the economic recovery in 2021, the expectations for 2022, and the effect of these changes on the assumptions used in the ROE estimation models; and (2) effects of Federal tax reform on utility cash flows. In particular, IAWC points out, the Commission must take into account the increases in the Federal funds rate, the fact that inflation is at a 40-year high and increases in the yield on the 30-year Treasury bond ("T-bond"). IAWC argues that it is unreasonable to ignore the effects of current monetary policy intended to restore more normal inflation and to assume that it does not affect the cost of capital today.

IAWC states that the economy is currently in the recovery phase of the business cycle. Utilities, which are a defensive sector, have historically underperformed the market during periods of economic expansion. Therefore, IAWC states, investors are currently expecting utilities to underperform over the near-term, which means the share prices of utilities will likely decline. IAWC explains that a decline in share prices will increase the dividend yields of utilities and thus the cost of equity for utilities is expected to increase over the near-term. IAWC contends that this is important because the cost of equity in this proceeding is being estimated for the period that IAWC's rates will be in effect. Since the cost of equity is expected to increase over the near-term for utilities, ROE estimates based on current market conditions will understate the ROE during the period that the Company's rates will be in effect. The Commission should not compound that problem by basing the ROE determination on market conditions that are not up to date.

IAWC explains that these conditions have verifiable impacts on the financial modeling used to estimate ROE that should be addressed when choosing which inputs to use and how to weight the outcome of the models. IAWC further explains that the effect of the low interest rate environment can be seen in the low dividend yields for utilities, which result in DCF cost of equity estimates that are understating the forward-looking cost of equity. The Capital Asset Pricing Model ("CAPM") and Empirical CAPM ("ECAPM") offer some balance to the sensitivity of the DCF model to low Treasury yields. But low interest rates also affect the CAPM in two ways: (1) the risk-free rate is lower; and (2) because the market risk premium is a function of interest rates (i.e., it is the return on the broad stock market less the risk-free interest rate), the risk premium should move higher when interest rates are lower. Therefore, IAWC maintains, it is important to consider using projected market data in the models to estimate the return for the forward-looking period.

Additionally, IAWC states that relying exclusively on historical assumptions in these models, without considering whether these assumptions are consistent with investors' future expectations, will underestimate the cost of equity that investors would require over the period that the rates in this case are to be in effect. In this instance, IAWC states that relying on the historically low dividend yields that are not expected to continue over the period that the new rates will be in effect will underestimate the ROE for IAWC.

Furthermore, IAWC contends that the use of current averages of T-bond yields as the estimate of the risk-free rate in the CAPM is not appropriate since recent market conditions are not expected to continue over the long-term. Instead, IAWC proposes, analysts should rely on projected yields of T-bonds in the CAPM. The projected T-bond yields result in CAPM estimates that are more reflective of the market conditions that investors expect during the period that the Company's rates will be in effect.

### iii. Financial Modeling

IAWC states that because the cost of equity is not directly observable, it must be estimated based on both quantitative and qualitative information. When faced with the task of estimating the cost of equity, analysts and investors gather and evaluate as much relevant data as reasonably can be analyzed. IAWC notes that several models have been developed to estimate the cost of equity, and Ms. Bulkley used multiple approaches

to estimate the cost of equity. As a practical matter, however, all of the models available for estimating the cost of equity are subject to limiting assumptions or other methodological constraints. Consequently, IAWC states that many well-regarded finance texts recommend using multiple approaches when estimating the cost of equity.

IAWC explains that the quantitative models then produce a range of reasonable results from which the market-required ROE is selected. That selection must be based on a comprehensive review of relevant data and information and does not necessarily lend itself to a strict mathematical solution. IAWC states that the key consideration in determining the cost of equity is to ensure that the methodologies employed reasonably reflect investors' views of the financial markets in general and of the subject company (in the context of the Proxy Group) in particular.

IAWC states that in a recent rate case, the Commission emphasized that it has traditionally considered the ROE estimates produced by several "financial analysis tools" in determining the reasonable cost of equity for a company. IAWC points out that the Commission considered the results of each of the models presented by the ROE witnesses. Specifically, the Commission noted that:

> each of the proposed models has arguable flaws. CAPM measures systemic risk, beta, for which the cost of equity must compensate investors, but parameters are measured against historical data. This creates a model that adjusts slowly to changes in the industry. In contrast, DCF models incorporate current market prices in the most recent dividends and growth outlook, thereby making DCF modeling, arguably, too sensitive to short-term market phenomena, which may not be representative of capital market conditions and the required investor returns that will prevail in the future. The bond yield plus risk premium models contain proxy sample flaws and can use outdated data. The expected earnings method incorrectly posits that earned returns on book common equity are the same as investor-required returns on common equity. The Commission has in the past rejected the use of bond yield plus risk premium models as well as the expected earnings analysis. While historically the Commission has focused on the DCF and CAPM models, the Commission acknowledges that there may be a value in exploring additional models presented by the parties, specifically the Risk Premium and Expected Earnings, to bring our methodology into closer alignment with how investors inform their investment decisions. The Commission is cognizant that other regulatory agencies are also considering this approach to ensure that the chosen return on equity is based on substantial evidence and does not overvalue any one model.

Docket No. 18-1775, Order at 119.

Ultimately, IAWC notes that the Commission authorized Nicor an ROE of 9.73%, which was based on the results of the DCF, CAPM, and risk premium models. Thus, IAWC states that the Commission recognizes the importance of considering the results of each model presented in the rate case to more accurately reflect the approach employed by investors in determining investment decisions.

### iv. Proxy Group

IAWC explains that because the Company is not publicly traded, Ms. Bulkley used a Proxy Group of publicly traded companies that possess a set of operating and financial risk characteristics that are substantially comparable to IAWC in order to derive the Company's ROE. She began with the group of U.S. utilities that Value Line classifies as "Water Utilities" and "Natural Gas Distribution Companies". That combined group includes 17 domestic U.S. utilities. She simultaneously applied the following screening criteria to select companies that:

- pay consistent quarterly cash dividends because companies that do not cannot be analyzed using the Constant Growth DCF model;
- have investment grade long-term issuer ratings from S&P and/or Moody's;
- are covered by at least two utility industry analysts;
- have positive long-term earnings growth forecasts from at least two utility industry equity analysts;
- derive more than 60.00% of their total operating income from regulated operations; and
- were not parties to a merger or transformative transaction during the analytical periods relied upon.

IAWC explains that due to consolidation in the water utility industry, there is only a small group of water companies that can be included in the Proxy Group. Accordingly, IAWC states that Ms. Bulkley also considered the group of 36 companies that Value Line classifies as "Electric Utilities". In determining which electric utilities would qualify for inclusion in her Proxy Group, she relied first on the criteria used to screen the water and natural gas utilities. She then applied two additional screening criteria to only include electric utilities that would be considered risk comparable to IAWC. The Company explains that the Electric Utilities must have owned generation making up less than 10% of the company's MW-hours sales to ultimate customers to ensure that the Electric Utilities included did not own a substantial amount of generation, and therefore, had operations that were primarily transmission and distribution; and they must own water and wastewater operations.

### v. Discounted Cash Flow Model ("DCF")

IAWC explains that the DCF approach is based on the theory that a stock's current price represents the present value of all expected future cash flows. IAWC notes that Ms. Bulkley employed the Constant Growth DCF model, which requires the following assumptions: (1) a constant growth rate for earnings and dividends; (2) a stable dividend payout ratio; (3) a P/E ratio; and (4) a discount rate greater than the expected growth rate.

IAWC contends that, to the extent any of these assumptions is violated, considered judgment and/or specific adjustments should be applied to the results.

IAWC notes that the dividend yield in Ms. Bulkley's Constant Growth DCF model was based on the proxy companies' current annual dividend and average closing stock prices over the 30-, 90-, and 180-trading days as of January 31, 2022. She used an average of recent trading days to calculate the price term in the DCF model to ensure that the ROE is not skewed by anomalous events that may affect stock prices on any given trading day. She explained that the averaging period should also be reasonably representative of expected capital market conditions over the long-term. However, the averaging periods that she used rely on historical data that are not consistent with the forward-looking market expectations. She cautioned, therefore, that the results of her Constant Growth DCF model using historical data may underestimate the forward-looking cost of equity. As a result, IAWC explains, Ms. Bulkley placed more weight on the mean to mean-high results produced by her Constant Growth DCF model.

IAWC notes that she also adjusted the dividend yield to account for periodic growth in dividends. Since utility companies tend to increase their quarterly dividends at different times throughout the year, it is reasonable to assume that dividend increases will be evenly distributed over calendar quarters. Given that assumption, it is reasonable to apply one-half of the expected annual dividend growth rate for purposes of calculating the expected dividend yield component of the DCF model. IAWC explains that this adjustment ensures that the expected first year dividend yield is, on average, representative of the coming twelve-month period, and does not overstate the aggregated dividends to be paid during that time.

IAWC explains that in its Constant Growth form, the DCF model assumes a single long-term growth rate in perpetuity. IAWC notes that in order to reduce the long-term growth rate to a single measure, one must assume that the dividend payout ratio remains constant and that EPS, dividends per share, and book value per share all grow at the same constant rate. IAWC points out that over the long run, however, dividend growth can only be sustained by earnings growth. For example, earnings growth rates tend to be least influenced by capital allocation decisions that companies may make in response to near-term changes in the business environment. Since such decisions may directly affect near-term dividend payout ratios, estimates of earnings growth are more indicative of long-term investor expectations than are dividend or book value growth estimates.

IAWC states that Ms. Bulkley's Constant Growth DCF model incorporates the following sources of long-term growth rates: (1) consensus long-term earnings growth estimates from Zacks Investment Research ("Zacks"); (2) consensus long-term earnings growth estimates from Thomson First Call (provided by Yahoo! Finance) ("First Call"); and (3) long-term earnings growth estimates from Value Line. She adjusted the dividend yield to reflect the growth rate that was being used in that particular scenario to ensure internal consistency in the calculations.

IAWC explains that Ms. Bulkley calculated a range of results for her DCF modelling. She calculated the low result for her DCF model using the minimum growth rate (i.e., the lowest of the First Call, Zacks, and Value Line earnings growth rates) for each of the Proxy Group companies. Thus, the low result reflects the minimum DCF

result for the Proxy Group. She used a similar approach to calculate the high results, using the highest growth rate for each Proxy Group company. The mean results were calculated using the average growth rates from all sources.

IAWC notes that in this inflationary environment, with rising interest rates, utility stocks are expected to underperform. Ms. Bulkley explained that, accordingly, it is important to consider the DCF results with caution because the DCF tends to understate the cost of equity in rising interest rate and higher inflationary environments. Accordingly, IAWC points out, she also gave weight to other ROE models.

**vi. Capital Asset Pricing Model ("CAPM")**

IAWC explains that the CAPM is a risk premium approach that estimates the cost of equity for a given security as a function of a risk-free return plus a risk premium to compensate investors for the non-diversifiable or "systematic" risk of that security. IAWC states that systematic risk is the risk inherent in the entire market or market segment. This form of risk cannot be diversified away using a portfolio of assets. Non-systematic risk is the risk of a specific company that can be mitigated through portfolio diversification.

IAWC explains that Ms. Bulkley relied on three sources for her estimate of the risk-free rate used in the CAPM: (1) the current 30-day average yield on 30-year U.S. T-bonds (i.e., 2.03%); (2) the projected 30-year U.S. T-bond yield for Q1 2022 through Q1 2023 (i.e., 2.42%); and (3) the projected 30-year U.S. T-bond yield for 2023 through 2027 (i.e., 3.40%). Based on current market conditions, she placed more weight on the results of the projected yields on the 30-year T-bonds. IAWC notes that, as discussed previously, the estimation of the cost of equity in this case should be forward-looking because it is the return that investors would receive over the future rate period. Therefore, IAWC concludes, the inputs and assumptions used in the CAPM analysis should reflect the expectations of the market at that time. IAWC notes that while she included the results of a CAPM analysis that relies on the then current average risk-free rate, this analysis fails to take into consideration the effect of the market's expectations for interest rate increases on the cost of equity.

IAWC points out that she used the beta coefficients for the Proxy Group as reported by Bloomberg and Value Line. The beta coefficients reported by Bloomberg were calculated using ten years of weekly returns relative to the S&P 500 Index. Value Line's calculation is based on five years of weekly returns relative to the New York Stock Exchange Composite Index.

IAWC notes that she considered an additional CAPM analysis which relies on the long-term average utility beta coefficient for the companies in her Proxy Group. IAWC explains that the long-term average utility beta coefficient was calculated as an average of the Value Line beta coefficients for the companies in her Proxy Group from 2016 through 2021.

IAWC states that Ms. Bulkley estimated the market risk premium as the difference between the implied expected equity market return and the risk-free rate. The expected return on the S&P 500 Index is calculated using the Constant Growth DCF model for the companies in the S&P 500 Index. In her calculation of the market return, Ms. Bulkley included companies in the S&P 500 Index that: (1) had either a dividend yield or Value

Line long-term earnings projection; and (2) had a Value Line long-term earnings growth rate that was greater than 0% and less than or equal to 20%. Based on an estimated market capitalization-weighted dividend yield of 1.62% and a weighted long-term growth rate of 11.28%, the estimated required market return for the S&P 500 Index is 12.99%. IAWC maintains that given the range of annual equity returns that have been observed over the past 95 years, a current expected return of 12.99% is not unreasonable. In 49 of the past 95 years (i.e., in approximately half of all observations), the realized total equity return was at least 12.99% or greater.

IAWC explains that Ms. Bulkley's traditional CAPM analyses produced a range of returns from 10.07% to 11.36%.

### vii. Empirical CAPM ("ECAPM")

IAWC notes that Ms. Bulkley also considered the results of an Empirical CAPM ("ECAPM") in estimating the cost of equity for IAWC. In essence, IAWC explains, the ECAPM addresses the tendency of the traditional CAPM to underestimate the cost of equity for companies with low beta coefficients, such as regulated utilities. In that regard, the ECAPM is not redundant to the use of adjusted betas; rather, it recognizes the results of academic research indicating that the risk-return relationship is different (in essence, flatter) than estimated by the CAPM, and that the CAPM underestimates the "alpha," or the constant return term.

As with the CAPM, IAWC notes that Ms. Bulkley's application of the ECAPM uses the forward-looking market risk premium estimates, the three yields on 30-year Treasury securities noted earlier as the risk-free rate, and the Bloomberg, Value Line, and long-term average beta coefficients.

The ECAPM analysis results range from 10.77% to 11.74%.

### viii. Recommended ROE

IAWC states that based on the results from these methodologies and the qualitative analyses presented in her testimony, Ms. Bulkley concluded that a reasonable range of ROE results for IAWC is from 9.90% to 11.25%. IAWC notes that Ms. Bulkley specifically recommended, however, that the Commission set the Company's rate of return on common equity at 10.25%. The recommended return of 10.25% considers current and prospective capital market conditions, as well as IAWC's company-specific risks relative to the Proxy Group, discussed below.

### ix. Company-specific Risks

IAWC explains that the results discussed above provide only a range of the appropriate estimate of the cost of equity for a Proxy Group of comparable companies. IAWC argues that additional risk factors must be considered when determining where IAWC's cost of equity falls within the range of results. There are at least two: the Company's substantial capital expenditure program and, relatedly, its anticipated investment in acquired systems to ensure those systems comply with state and federal water standards. IAWC maintains that these factors should be considered with respect to their overall effect on IAWC's risk profile relative to the Proxy Group.

IAWC states that although there are several positive aspects of Illinois regulation that render IAWC somewhat less risky than the Proxy Group as a whole, the Company is not without unique risks as compared to the Proxy Group that suggest that the ROE should be within the range established by the average to the high end of the range of returns estimated for the Proxy Group companies. IAWC projects that the Company will spend approximately $1.063 billion on capital investments for the period from 2022-2026, including significant investment to replace aging infrastructure necessary to continue to meet the needs of its customers and to comply with various regulations. IAWC notes that this is a substantial increase in investment over the year-end 2020 net plant in IAWC of $1.77 billion.

IAWC states that from a credit perspective, the additional pressure on cash flows associated with high levels of capital expenditures exerts corresponding pressure on credit metrics and, therefore, credit ratings. An S&P 500 Index report explains this point in the context of the electric industry:

> We believe the higher capital spending and subsequent rise in debt levels could strain these companies' financial measures, resulting in an almost consistent negative discretionary cash flow throughout this higher construction period. To meet the higher capital spending requirements, companies will require ongoing and steady access to the capital markets, necessitating that the industry maintains its high credit quality. We expect that utilities will continue to effectively manage their regulatory risk by using various creative means to recover their costs and to finance their necessary higher spending.

IAWC Ex. 11.00 at 53.

IAWC explains that although this report refers to electric utilities, the same analysis applies to water utilities. Further, in an August 2016 report, S&P explained the importance of regulatory support for large capital projects:

> Broad support for all capital spending is the most credit-sustaining. Support for only specific types of capital spending, such as specific environmental projects or system integrity plans, is less so, but still favorable for creditors. Allowance of a cash return on construction work-in-progress or similar ratemaking methods historically were extraordinary measures for use in unusual circumstances, but when construction costs are rising, cash flow support could be crucial to maintain credit quality through the spending program. Even more favorable are those jurisdictions that present an opportunity for a higher return on capital projects as an incentive to investors.

S&P Global Ratings, "Assessing U.S. Investor-Owned Utility Regulatory Environments," August 10, 2016 at 7. Further, IAWC faces risk associated with the acquisitions of water and wastewater systems. IAWC has acquired, or currently has pending at the Commission the acquisition of 37 water and wastewater systems. IAWC states that it

must operate in compliance with state and federal laws and regulations, many of which are included in the Clean Water Act of 1972, the Safe Drinking Water Act of 1974, and many U.S. Environmental Protection Agency ("EPA") regulations related to these Acts. IAWC explains that some of the acquired systems were not in compliance with state and federal laws and regulations and thus require significant investment and increased maintenance expense to meet and sustain compliance with federal and state laws and regulations. IAWC notes that these increased costs create additional risk for IAWC and require continued regulatory support. IAWC points out that in its most recent report on American Water, Value Line recognized the Company's commitment to the acquisition of small fragmented systems and the incremental investment required in these systems. IAWC notes that Value Line also noted that regulatory treatment remains a key factor in the Company's performance.

Accordingly, IAWC states, there would be no basis for concluding that IAWC's risk is lower than that of the Proxy Group, and the Company needs the full support of the Commission to sustain its financial performance and condition.

**x. Response to other parties**

As discussed, IAWC states that interest rates have increased and are expected to continue to increase to combat inflation. The Company explains that since utility stock prices are inversely correlated with the yields on long-term government bonds, rising interest rates are projected to result in declining utility stock prices and increasing utility dividend yields. IAWC states that this means ROE models that rely on current and historical market data (i.e., current share prices in the DCF model and current yields on T-bonds in the CAPM) will likely underestimate the cost of equity over the near-term.

IAWC notes that Ms. Bulkley explained that neither of the other ROE witnesses in this proceeding has fully considered the effect of a rising interest rate environment or the effects of inflation on the cost of equity for IAWC when developing their respective ROE recommendations. Since interest rates are expected to increase, it is reasonable to conclude that the DCF and CAPM results presented by Mr. McNally and Mr. Walters are likely understating the cost of equity for IAWC. Moreover, IAWC states that the expected increase in interest rates warrants consideration of other ROE estimation models such as the CAPM and ECAPM analyses, which may better reflect expected market conditions.

**(a) Response to Staff**

Ms. Bulkley explained that when Staff's analysis is adjusted to correct problems with the inputs, it produces reasonable results. IAWC states that although Staff witness McNally recommends an ROE for IAWC of 9.78% based on the average of his Constant Growth DCF result of 9.19% and his CAPM result of 10.38%, reasonable adjustments to his CAPM analyses to reflect more appropriate inputs would result in an adjusted ROE estimate that is consistent with Ms. Bulkley's recommended ROE of 10.25%.

IAWC notes that Mr. McNally relies on the spot yield on the 30-year T-bond as of May 12, 2022 which was 3.02% as the estimate of the risk-free rate in his CAPM; however, as of June 14, 2022, the spot yield on the 30-year T-bond was 3.45%, an increase of 43 basis points. IAWC contends that given that interest rates are expected to continue to increase, it is reasonable to rely on projected yields on the 30-year T-bond

as the risk-free rate assumption in the CAPM. Adjusting Mr. McNally's CAPM analysis to rely on the near-term projected 30-year T-bond yield from *Blue Chip Financial Forecasts* ("*Blue Chip*") results in an updated CAPM result of 10.50% which, when combined with his DCF result of 9.19%, results in an updated ROE for IAWC of 9.84% as opposed to Mr. McNally's 9.78% ROE recommendation.

Furthermore, IAWC states, adjusting Mr. McNally's CAPM analysis to rely on the near-term projected 30-year T-bond yield from *Blue Chip* and Value Line beta coefficients calculated using weekly returns as opposed to an average of beta coefficients calculated using weekly and monthly returns, results in an updated CAPM result of 11.24%. IAWC notes that the average of this CAPM result and the result from Mr. McNally's DCF analysis is an ROE of 10.22%, 44 basis points higher than Mr. McNally's recommended ROE.

And, IAWC states, while the adjusted ROE result of 10.22% is consistent with Ms. Bulkley's recommended ROE of 10.25%, it is important to note that the DCF model result Mr. McNally used to calculate his average ROE result is likely understating the forward-looking cost of equity. As Ms. Bulkley explained, the results of the DCF model are likely to increase during the period that IAWC's rates will be in effect given that interest rates are expected to increase.

Staff contends that IAWC witness Bulkley's ROE estimate is a "meaningless amalgam of data for multiple time periods" and that therefore Staff's conclusion is Ms. Bulkley's analysis is "unusable" for setting IAWC's rates." Staff IB at 34. The Company states that the flaw, however, is not in Ms. Bulkley's analysis, but in Staff witness McNally's analysis. The Company explains that Ms. Bulkley, unlike Mr. McNally, considered current and prospective market conditions, including the expectation that interest rates will increase over the near-term in response to increased inflation and the Federal Reserve's normalization of monetary policy. Her conclusion, in the exercise of her judgment as an experienced financial analyst, was that her recommendation of 10.25% was reasonable and appropriate.

The Company contends that Mr. McNally, on the other hand, offered a recommendation that was effectively frozen in time on May 12, 2022. As Ms. Bulkley observed, the use of spot market data, particularly the use of stale, historical data in an environment where monetary policy has been changing and is expected to continue to change, is likely to misrepresent market expectations. The Company states that Mr. McNally's failure to consider that interest rates were increasing at the time that he prepared his analysis, and have continued to increase since that time, results in an understatement of the cost of equity.

According to the Company, the record shows the following, all of which undercut Staff's analysis and recommendation:

- The data that has been presented in this case demonstrates that the Company is operating in a rising interest rate environment, which will increase the investor required ROE.
- In the weeks after Mr. McNally produced his ROE estimate, the Federal Funds rate increased by 150 basis points, inflation remained at a 40 year high of 9.0 percent and the yield on the 30-year T-bond was increasing.

- Staff's suggestion that changes in the market conditions should not be considered over the duration of a case violates the comparable return standard of the seminal *Bluefield* and *Hope* cases.
- The rates that will be set in this proceeding will need to be able to attract capital over a forward-looking period. Therefore, it is necessary that the most up to date information, including investors' expectations, be considered in the development of the ROE.
- Recent authorized ROEs provide a range of historical returns; however, in the current rising interest rate environment, it should be expected that ROEs will be at the higher end of the range, and even increase the high end of the range that was established based on lower interest rate and lower inflationary market conditions.

Additionally, Ms. Bulkley proposed two adjustments to Mr. McNally's CAPM analysis: (1) rely on the near-term projection of the 30-year T-bond yield published by *Blue Chip* as the estimate of the risk-free rate; and (2) rely on Value Line beta coefficients calculated using weekly returns as opposed to an average of beta coefficients calculated using weekly and monthly returns. These adjustments result in an updated CAPM result of 11.40% and an updated DCF and CAPM average of 10.22%—which is consistent with Ms. Bulkley's recommendation of 10.25%.

Staff notes that Ms. Bulkley cited a 30-year T-bond yield of 3.21% from June to support her argument that the 3.02% yield employed by Mr. McNally was too low. Staff then argues that "if one accepts Ms. Bulkley's argument that updates should be provided 'over the duration of the proceeding' and that a higher interest rate indicates that Staff's ROE estimate is understated, then the lower August 4, 2022, T-bond yield indicates that, if anything, Staff's ROE estimate is slightly overstated." Staff IB at 33. Staff reports that on August 4, the yield was 2.97%, below the May 12 effective yield of 3.02% that was used in Mr. McNally's ROE analysis.

The Company states that Staff relies on a scatter plot of authorized ROE data from January 2018 through May 2022 to argue that the Company's requested ROE is inconsistent "with prevailing capital costs." Staff IB at 35. The Company explains, however, that the record shows that the return that is authorized in this proceeding should be higher than the average authorized ROEs in the period from 2018 through the first half of 2022 because the cost of capital is now undeniably higher. The ROEs that were established over the time period cited by Staff were, according to the Company, likely based on data prior to the current rapid increase in interest rates and the persistent high inflation that has been experienced in much of 2022. Therefore, the Company concludes, it is reasonable to expect that decisions made using data from market conditions that were not characterized by 40-year high inflation, significant changes in monetary policy, and rising interest rates in response to these conditions, would be lower than the current investor-required return.

Lastly, the Company addresses Staff's proposed adjustments to the ROE, which the Company says are unwarranted. Staff proposes that the Commission make three conditional, downward adjustments to ROE: 10 basis points if the Commission adopts the Company's proposed capital structure; 5 basis points if the Commission approves

proposed Environmental Surcharge Rider ("Rider ESR"); and 4 basis points if the Commission permanently adopts the Bad Debt Expense Rider ("Rider BDE").

The Company explains that its proposed capital structure does not warrant a reduction in ROE. The Company states Staff's adjustment is based on a flawed comparison of average equity ratios of the proxy companies used to set the ROE at the holding company level rather than at the operating company level. IAWC says that its proposed equity ratio of 51.95% is below the average and well within the range of equity ratios for the utility operating subsidiaries of the Proxy Group companies. The Company contends that, given that the ROE is determined by, *inter alia*, the relative financial risk of the Proxy Group to IAWC, if IAWC's equity ratio is consistent with that of the Proxy Group – and it is, albeit slightly lower – then no adjustment is necessary. The Company further states that Staff provided no evidence as to the relative risk of IAWC compared to the operating subsidiaries of the Proxy Group companies.

The Company states that, moreover, ROE should not be reduced simply because the Company implements a cost recovery mechanism. Staff proposed additional reductions of 4 basis points for making Rider BDE permanent and 5 basis points for the approval of Rider ESR, or a total of 9 basis points: nearly the same, the Company points out, as Mr. McNally's proposed adjustment for the risk differential with the Proxy Group. Ms. Bulkley testified that Staff presented no convincing analysis to support its proposed adjustments for Rider BDE or Rider ESR. While Mr. McNally claimed the closer a company's pattern of recovery matches its pattern of cost incurrence, the lower the risk, the Company argues that he presented no specific identification of any changes in credit ratings that IAWC can expect as a result of approval of the riders in this docket. Rather, the Company explains, his adjustments were based entirely on his calculation of the generic spread between utility bonds rated A and Baa by Moody's. He then attributed a portion of the spread to each of the riders. The Company contends that he did not and could not demonstrate that approval of the riders would result in any change in IAWC's cost of equity, cost of debt or credit ratings, or that if such a change occurred, that his calculations accurately reflect the consequences. The Company states that his calculations offer only a veneer of reliability: they are in fact calculations, but Staff has not demonstrated that they represent what is likely to happen in the real world.

**(b) Response to IIWC/FEA/CUB**

IAWC states that Mr. Walters recommends an ROE of 9.35% for IAWC, which is the midpoint of his estimated range of 8.90% to 9.80%. Mr. Walters' DCF result sets the low end of this range, and his risk premium sets the high end of the range. The Company contends that the 9.35% ROE recommended by IIWC/FEA/CUB is simply too low to be adopted as—or even to be factored into—the ROE authorized in this proceeding.

The Company explains that Ms. Bulkley proposed three adjustments to Mr. Walters' ROE analyses to improve their reasonableness. These reasonable adjustments alone would increase Mr. Walters' ROE recommendation by nearly 50 basis points, from 9.35% to 9.83%. Even that adjusted amount likely understates the cost of equity during the period the rates will be in effect due to the reasonable expectation that interest rates will increase.

Before describing Ms. Bulkley's adjustments, the Company first points out that, in establishing his recommended ROE, Mr. Walters has not provided any analytical basis for assuming that the Company has less risk than comparable water and natural gas utilities. IAWC notes that this is particularly important as current market conditions demonstrate greater risk resulting from rising interest rates and persistent inflation that is higher than has been experienced in 40 years. IAWC states that considering these factors, Mr. Walters' recommendation, which is well below the historical average authorized ROEs, would not meet the comparable return standard of *Hope* and *Bluefield*.

The Company notes that Mr. Walters presents three DCF models — however, the only DCF model that Mr. Walters developed that produces results that are close to the 8.90% ROE that defines the bottom end of his range is the Constant Growth DCF model, which relies on projected earnings growth rates. The results of this model are a mean ROE of 8.69% and a median ROE of 9.00%. IAWC explains that excluding the DCF result for Middlesex Water Company, which was 3.90%, and is below Moody's utility bond yields, increases the average and median DCF result to 9.08% and 9.04%, respectively.

IAWC states that adjusting Mr. Walters' risk premium analysis to rely on the most recent *Blue Chip* report as of the date of Mr. Walters' analysis (April 29, 2022) and projected utility bond yields to be consistent with his use of projected T-bond yields, his risk premium would result in an ROE range of 10.29% to 10.95%. IAWC explains that the average of these adjusted risk premium results is 10.60% which is 80 basis points higher than the 9.80% ROE that Mr. Walters indicates his risk premium supports.

Additionally, IAWC explains, the results of Mr. Walters' CAPM analyses that are based on S&P Global market intelligence betas and the Kroll (formerly Duff & Phelps) market risk premium (which does not reflect the inverse relationship between interest rates and the risk premium) do not appear to be included in Mr. Walters' reconciled CAPM result and should not be considered. The remainder of Mr. Walters' CAPM analysis produce a range of results from 9.70% to 11.66%. The midpoint of the adjusted CAPM range is 10.68%.

IAWC points out that Mr. Walters relies on the midpoint of his range to determine his recommendation. IAWC explains that using the DCF, CAPM, and risk premium analyses, as adjusted, results in a midpoint ROE estimate of 9.83% (i.e., average of 9.05% and 10.60%). However, IAWC notes, if greater weight is placed on the results of the CAPM and risk premium to better approximate the market conditions expected during the period that IAWC's rates will be in effect than the adjusted ROE model results would produce an ROE that is generally consistent with Ms. Bulkley's recommended ROE of 10.25% and well above Mr. Walters' recommendation of 9.35%.

The Company contends that Ms. Bulkley's adjustments to Mr. Walters' analysis are reasonable because they reflect the reality in which the Company operates. As the Commission observed in Docket No. 18-1775, its determination of ROE has real world consequences:

> An authorized rate of return that is not competitive will deter continued investment in the State of Illinois. A reasonable ROE helps ensure that the company can attract capital in order to meet the Commission required infrastructure needs.

Docket No. 18-1775, Order at 119. In that proceeding, the Commission averaged the results of various financial models to calculate the required ROE. It excluded from consideration every result below 9.5% as being inadequate to be considered competitive. *Id*.

The Company states that, under the approach used by the Commission in Docket No. 18-1775, the intervenors' DCF result of 8.9%, CAPM result of 9.3%, and overall recommendation of 9.35% would be disregarded. The Company contends that the Commission should not gamble, as IIWC/FEA/CUB would, that the markets will fix themselves quickly and that a low ROE will somehow prove to be enough to encourage and support the continued investment that Illinois utilities require. The Company asks the Commission to see the intervenors' recommendation for what it is: a backward-looking analysis that does not rely on current monetary policy.

**b. Staff's Position**

Staff argues that the Commission should adopt Mr. McNally's cost of equity analysis. As discussed below, Staff notes that the models and inputs he relied upon have been repeatedly tested through litigation and found by the Commission, and the Appellate Court, to be financially sound. Staff demonstrates that this approach produces a reasonable estimate that maintains IAWC's financial strength and is consistent with the types of returns available to other utilities. In contrast, Ms. Bulkley's analysis relies on approaches rejected by the Commission and produces a cost of equity estimate that would unfairly burden ratepayers, in violation of the *Hope* and *Bluefield* standards.

The Company asserts that "[o]nly the Company's analysis reflects current market conditions ─ an inflationary environment and rising interest rates that cause investors to expect higher returns from regulated utilities." IAWC IB at 54. The Company further argues that Staff and IIWC/CUB/FEA analyses are "based on stale, irrelevant, and inapt data that does not capture the conditions expected to be present when the rates set in this proceeding go into effect" and that the Commission should not rely upon their recommendations. *Id.* Staff argues that the Company's assertions are meritless and lack support. Staff asserts that its ROE analysis produces a reasonable and fair ROE recommendation for IAWC and is based on reliable, current data. Contrary to the Company's claim, Staff states that its proper reliance on current market data does reflect current market conditions and is consistent with the data that this Commission has repeatedly endorsed and accepted in prior rate cases. In contrast, Staff argues that the Company seems to suggest that the Commission should endeavor to predict the future, repeatedly suggesting that the ROE the Commission adopts should reflect the ROE for the period over which the rates set in this case are to be in effect. As Staff explained, not only is that an impossibility, but the Company's analysis does not even attempt to do so. Rather, Staff argues that the Company cobbled together a meaningless amalgam of data for multiple time periods, combining speculation as to the interest rate in 2027 – the only input in its analysis that was actually projected – with stock prices from as far back as May of 2021 and beta estimates from as far back as 2016. Thus, unlike Staff's analysis, Staff argues that it is the Company's analysis that does not reflect current market conditions.

The Company further argues that neither Staff's nor IIWC/FEA/CUB's witness has "fully considered the effect of a rising interest rate environment or the effects of inflation on the cost of equity for IAWC when developing their respective ROE recommendations." IAWC IB at 72. The Company states that "ROE models that rely on current and historical market data (*i.e.*, current share prices in the DCF model and current yields on T-bonds in the CAPM) will likely underestimate the cost of equity over the near-term." *Id.* The Company continues to focus on the proposition that rising interest rates warrant a reliance on forecasts and updated analyses during the proceeding. According to Staff, the Company's attempt to argue that Staff did not properly consider the effect of a rising interest rate environment is unequivocally wrong. Staff explains in detail why its DCF model and use of current yields on T-bonds in the CAPM is reasonable and more reliable than the Company's models. Thus, Staff argues that the Commission should adopt Staff's ROE estimate of 9.78% and reject the Company's inflated ROE estimate of 10.25%.

### i. Staff's Analysis

Mr. McNally estimated IAWC's investor-required rate of return on common equity to be 9.78%. Staff Ex. 6.0 at 18. Mr. McNally measured the investor-required rate of return on common equity with DCF and CAPM analyses. IAWC is a wholly-owned subsidiary of American Water and does not have market-traded common stock. Thus, to reduce measurement error, Mr. McNally applied those models to a sample of fourteen water utility and public utility companies (the "Proxy Group"). The Proxy Group was the same sample used by Company witness Bulkley in her analysis. Staff Ex. 6.0 at 2. The fourteen companies that compose the Proxy Group are: American States Water, Atmos Energy, California Water, Essential Utilities, Eversource Energy, Middlesex Water, NiSource, New Jersey Resources, Northwest Natural Gas, One Gas, SJW Group, South Jersey Industries, Spire, and York Water. IAWC Ex. 11.00 at 27-29.

#### (a) DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in the Proxy Group pay dividends quarterly. Therefore, Mr. McNally applied a quarterly DCF model. Staff Ex. 6.0 at 2-3.

DCF methodology requires a growth rate that reflects the expectations of investors. Mr. McNally used a constant growth DCF model in which he measured the market-consensus expected growth rates with 3- to 5-year growth rate forecasts published by Zacks, S&P's Market Intelligence, and Value Line. For each company in the Proxy Group, the average growth rate estimate was combined with the closing stock price and dividend data as of May 12, 2022. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimate of the cost of common equity was 9.19% for the Proxy Group. Staff Ex. 6.0 at 3-7.

#### (b) CAPM Analysis

According to financial theory, 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 risk

premium methodology is consistent with the theory that investors are risk-averse and that, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the CAPM, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. Staff Ex. 6.0 at 7-8.

The CAPM requires the estimation of three parameters: the risk-free rate, the required rate of return on the market, and beta. For the risk-free rate parameter, Mr. McNally considered the 0.61% yield on four-week U.S. Treasury bills and the 3.02% yield on thirty-year U.S. T-bonds. Both estimates were measured as of May 12, 2022. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.5% and 4.6%. Thus, Mr. McNally concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. Staff Ex. 6.0 at 8-12. For the expected rate of return on the market parameter, Mr. McNally 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 equals 12.97%. Staff Ex. 6.0 at 12-13. Finally, for the beta parameter, Mr. McNally combined adjusted betas from Value Line, Zacks, and a regression analysis. The Proxy Group's average Value Line, Zacks, and regression beta estimates were 0.82, 0.66, and 0.66, respectively. The Value Line regression employs 259 weekly observations of stock return data regressed against the New York Stock Exchange ("NYSE") Composite Index. Both the regression beta and Zacks betas employ sixty monthly observations; however, while Zacks betas regress stock returns against the S&P 500 Index, the regression beta regresses stock returns against the NYSE Index. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Mr. McNally averaged the Zacks and regression results to avoid over-weighting monthly return betas. He then averaged that result with the Value Line beta, which produced a beta for the Proxy Group of 0.74. Staff Ex. 6.0 at 13-17. Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 10.38% for the Proxy Group. Staff Ex. 6.0 at 17.

### (c) Recommended ROE

Mr. McNally recommends a cost of common equity for IAWC of 9.78%, based on a simple average of the mean sample estimates from his DCF and risk premium models for the Proxy Group. Mr. McNally, however, noted that the Proxy Group Staff and the Company used to estimate IAWC's ROE serves only as a surrogate for IAWC. If IAWC is less risky than the Proxy Group, the ROE estimate derived from the riskier Proxy Group will be too high for IAWC. Conversely, if IAWC is riskier than the Proxy Group, the ROE estimate derived from the Proxy Group will be too low for IAWC. Therefore, Mr. McNally performed an analysis to assess IAWC's risk relative to that of the Proxy Group. That analysis indicated that the risk of IAWC is appreciably lower than the overall risk of the Proxy Group. Specifically, he found that IAWC's three-year averages (2019-2021) for the four ratios that Moody's focuses on to assess financial strength are consistent with a strong A2 rating, when weighted in accordance with the Moody's rating methodology for regulated water utilities. In contrast, the average credit rating for the Proxy Group was a weak A3.

Although his analysis indicates that the risk of IAWC is appreciably lower than the overall risk of the Proxy Group, Mr. McNally does not recommend a reduction to his ROE estimate, as Staff witness Kight-Garlisch recommended an adjustment be made to IAWC's capital structure to put it more in line with the risk profile of the Proxy Group. However, if the Commission rejects Staff's proposed capital structure in favor of the Company's proposed capital structure, Mr. McNally recommends adjusting his ROE estimate downward to align IAWC's authorized ROE with its lower relative risk profile. Staff Ex. 6.0 at 19-20. Mr. McNally estimated that conditional adjustment from the 31-basis point spread between long-term utility bonds rated A and Baa by Moody's, as of May 12, 2022. Because there are three sub-grades within each letter ratings (i.e., A1, A2, and A3 within the Moody's A rating range), he divided the spread between A and Baa utility bond yields by three to estimate a spread between the A2 and A3 ratings of 10 basis points, to estimate the adjustment. Thus, if the Commission rejects Staff's proposed capital structure in favor of the Company's proposed capital structure, Mr. McNally recommends adjusting the Proxy Group's ROE downward by 10 basis points (or 0.10%), producing an ROE estimate for IAWC of 9.68%. Staff Ex. 6.0 at 20-21.

Mr. McNally further advised that, if the Commission adopts the Company's Rider BDE and Rider ESR proposals, additional downward adjustments to the Company's ROE would be necessary to recognize the reduction in risk associated with those riders. Specifically, Mr. McNally explained that the closer a company's pattern of recovery matches its pattern of cost incurrence, the lower the operating risk. The purpose of both of the proposed riders is to help match IAWC's cost and recovery. Thus, downward ROE adjustments are necessary for each, if they are adopted. Staff Ex. 6.0 at 21, 23.

Mr. McNally estimated those adjustments based on the Moody's approach to water utility rating analysis. Among the various subfactors considered in its analysis, Moody's assigns 15% weighting to the cost and investment recovery sub-factor. Mr. McNally concluded that this sub-factor would improve by one credit rating for each the proposed riders. Since the sub-factor affected by the riders is assigned 15% weighting, Mr. McNally multiplied the previously noted 31-basis point spread between A and Baa long-term utility bonds by 15% to estimate the full incremental effect of each rider of 0.05%. Thus, he recommends an adjustment of 5 basis points, for the risk-reduction associated with Rider ESR. However, recognizing that Rider BDE was approved on a temporary basis in the Spring of 2021 and, thus, was in place for approximately 25% of the period over which Mr. McNally performed his relative risk assessment of IAWC vis-à-vis the Proxy Group, he recommends that the full 5 basis point adjustment be multiplied by 75%, to avoid duplicating the previously reflected effect of that rider. This results in a final adjustment of 4 basis points if the Commission grants the adoption of Rider BDE on a permanent basis. Staff Ex. 6.0 at 21-24.

#### ii. Analysis

##### (a) Overall Results

The Company's testimony regarding Staff's ROE analysis focuses largely on the proposition that rising interest rates warrant a reliance on forecasts and updated analyses during the proceeding. Ms. Bulkley objects that Mr. McNally relied on 30-year U.S. T-bond spot rate rather than forecasts and did not update his analysis after the May 12,

2022, analysis put forth in his direct testimony, which she concludes causes his results to understate IAWC's ROE. She claims that if updated, his results would be higher. IAWC Ex. 32.00 at 10-11. However, Staff argues that Ms. Bulkley did not demonstrate as much. In fact, she cannot know that to be true, as she never fully updated Mr. McNally's analysis. Ms. Bulkley merely noted that the T-bond yield, from which Mr. McNally drew the risk-free rate estimate used in his CAPM analysis, had risen after his analysis was performed. However, as Mr. McNally explained, even if an update to certain inputs would have an upward effect on the models, other components may have changed that would have a downward effect on the models. Thus, Staff asserts that a partial update will not produce an accurate estimate of the cost of common equity. Staff Ex. 14.0 at 7-8.

Moreover, Mr. McNally explained that updating an ROE analysis in the middle of a rate case is problematic for a number of reasons, particularly as it introduces the potential for gamesmanship, as parties will likely call for updates only when (and only to the inputs for which) doing so favors the outcome they seek. Staff Ex. 14.0 at 7-8. Nonetheless, Ms. Bulkley persisted, stating in her surrebuttal testimony that "it is necessary that the most up to date information … be considered" and that updates should be provided "over the duration of the proceeding." IAWC Ex. 32.00 at 4, 11. Yet, Staff notes that in that same surrebuttal testimony, filed August 5, 2022, she cited back more than a month prior, to the 3.21% yield from June 23, 2022, to claim that the 3.02% T-bond yield Mr. McNally employed was too low. IAWC Ex. 32.00 at 4, 11. However, if Ms. Bulkley had followed her own directive and reviewed the most up-to-date interest rates as of her surrebuttal testimony filing date, she would have come to a different conclusion. As indicated in her own testimony, by June 23, 2022, the 30-year T-bond rate was falling. IAWC Ex. 21.00 at 35. The interest rate continued to fall from that time, such that, by August 4, 2022, the 30-year T-bond yield had fallen below the yield relied on by Staff.[1] Thus, if one accepts Ms. Bulkley's argument that updates should be provided "over the duration of the proceeding" and that a higher interest rate indicates that Staff's ROE estimate is understated, then the lower August 4, 2022, T-bond yield indicates that, if anything, Staff's ROE estimate is slightly overstated. As indicated above, Staff does not agree with Ms. Bulkley's argument. Nonetheless, the fact the interest rates have fallen below the yield Mr. McNally employed undermines the thrust of the Company's position and validates the arguments Mr. McNally put forth with respect to forecasting interest rates and use of updates.

Ms. Bulkley repeatedly asserts that Staff's objective on this subject should be to estimate the cost of equity for the period over which the rates established in this case will be in effect and claims that her estimate accomplishes that objective. IAWC Ex. 21.00 at 5, 6, 11, 13, 25, 27, 34, 35, 37, 38, 44-46, 47, 78, 79, 85, 86, 87, 90, 100, 101-102, 111; IAWC Ex. 32.00 at 10, 22. Staff asserts that she is wrong on both counts. Staff states that the objective in this proceeding is to estimate the current investor-required rate of return, not to estimate what the cost of equity will be at some future time. In fact, the precise period over which the rates set in this proceeding will be in effect is unknown.

[1] Specifically, the 3.02% effective yield used in Staff's analysis was derived from bond equivalent yield of 3.00% as of May 12, 2022, for the 30-year T-bond. Staff Ex. 6.0, Sch. 6.5. As of August 4, 2022, the bond equivalent yield on that same security was 2.97%. Staff Cross Ex. 1.0.

Staff states that it is difficult enough to estimate the current investor-required return when actual data is available, but to attempt to project what investors will demand at some period in the future is pure speculation. Staff Ex. 14.0 at 4. Regardless, according to Staff, Ms. Bulkley's estimate does not represent a future cost of capital. In fact, it does not represent the investor-required rate of return at any given time, but rather, a meaningless amalgam of data for multiple time periods. Despite Ms. Bulkley's emphasis on developing an ROE for the period rates will be in effect, other than forecasted interest rates, no input in her analysis is projected. Staff states she did not forecast the market return; she did not forecast betas; she did not forecast future growth rate expectations; she did not forecast dividends; and she did not forecast stock prices. Most of the data inputs Ms. Bulkley employed are from January 2022. However, she used stock prices from as far back as May 2021 and beta estimates from as far back as 2016. IAWC Ex. 11.00 at 40; IAWC Ex. 11.06. In contrast, she used forecasted interest rates for as far forward as 2027. IAWC Ex. 11.00 at 45. As Mr. McNally explained, it is important to synchronize the inputs in an ROE analysis, as mismatching data from different time periods will not produce an accurate estimate of the market-required rate of return on common equity. Staff Ex. 6.0 at 6. Ms. Bulkley's mismatching of data renders her analysis unusable for setting IAWC's rates.

In contrast, Staff asserts that its analysis is based on the sound application of models and approaches repeatedly accepted by the Commission. Staff demonstrated that its recommendations result in financial ratios that maintain IAWC's financial health. Staff Ex. 14.0 at 14. Moreover, Staff also showed that its ROE recommendation is consistent with prevailing capital costs, while showing Ms. Bulkley's recommendation to be far from mainstream. Ms. Bulkley's 10.25% recommendation is higher than 90% of authorized ROEs since January 2018, with not one authorized ROE greater than her recommendation issued in the last three years. Indeed, her recommendation would have been well above average even in 2018, when the trend line was at its highest at proximately 9.75%, and the average has continued to fall through May of this year, with the trend line indicating the most recent outcome would typically be below 9.50%. In contrast, Mr. McNally's 9.78% recommendation is much more moderate, falling in the upper end of the middle third of authorized returns during that period.

As Ms. Bulkley noted in her testimony, the fair return standard established by the *Hope* and *Bluefield* decisions requires that the authorized return be consistent with the returns for other companies with similar or comparable risk. IAWC Ex. 11.00 at 9-10; IAWC Ex. 21.00 at 6-7. Mr. McNally's recommendation is consistent with that standard, while Ms. Bulkley's recommendation is unnecessarily high.

**(b) DCF Analysis**

Staff argues that the Value Line growth rates that Ms. Bulkley used in her DCF analysis are inflated and should be averaged with the Value Line growth rates for the Proxy Group. Doing so would decrease her recent Value Line growth estimate by approximately 100 basis points. This accounts for nearly the entire difference between her 9.51% DCF average and Mr. McNally's 9.19% DCF average. Staff Ex. 6.0 at 25-26. She also used 30-, 60-, and 180-day average stock prices; as discussed above, mismatching historical stock prices with current growth expectations increases the

inaccuracy of the estimate. In addition, Ms. Bulkley utilized an annual DCF model, which fails to account for the quarterly payment of dividends.

In contrast, to provide a true cost of equity estimate, Staff utilized a correctly specified quarterly DCF model with data properly synchronized as of its May 12, 2022, measurement date, using inputs and approaches consistently adopted by the Commission. Staff Ex. 6.0 at 3-7.

**(c) CAPM Analysis**

Staff notes that the primary differences between Staff's and the Company's CAPM analyses are the use of a spot or forecasted interest rate to estimate the risk-free rate and the use of beta estimates derived only from weekly observations or from both weekly and monthly observations. With respect to interest rate forecasts, Mr. McNally explained that it is preferable to rely on the recent spot rate, as the Commission has repeatedly done in prior rate proceedings. Staff argues that interest rate forecasts do not directly reflect investors' expectations but are merely analysts' proxies for the expectations of those actually investing their money. In contrast, and contrary to Ms. Bulkley's implications, Staff argues that current interest rates do reflect investors' current expectations regarding prospective market conditions. Actual current interest rates reflect all publicly available information, including any influence forecasts may have on investor expectations. Thus, Staff asserts that it is not only unnecessary, but inappropriate to employ proxies that do not reflect market forces to speculate regarding what investors' expectations will be in the future, as Ms. Bulkley repeatedly suggests, when current market data is available. Moreover, interest rate forecasts are notoriously inaccurate and, therefore cannot be relied upon, as Ms. Bulkley implicitly acknowledged. Staff Ex. 6.0 at 27-28; Staff Ex. 14.0 at 2-4. As she herself noted, the June 14, 2022, spot yield on the 30-year T-bond was more than a full percent off from the near-term projected yield she relied on in her CAPM, demonstrating the inaccuracy of her forecasts. IAWC Ex. 21.00 at 12-13. Indeed, in a prior proceeding, the Commission found:

> predicting the direction, magnitude, or timing of future interest rate changes with accuracy is not possible. The Commission observes that the record demonstrates that professional forecasting services relied on by the Companies have consistently over estimated future rates in recent years. Current interest rates have proven to be better predictors of future interest rates than professional forecasters.

Staff Ex. 6.0 at 27-28, *citing* Docket Nos. 14-0224/14-0225 (Cons.), Order at 111. For the foregoing reasons, the Commission has repeatedly rejected the use of forecasted interest rates in favor of spot yield.

Ms. Bulkley noted that interest rates rose after Staff's analysis was performed. She suggests that that validates her use of higher forecasted interested rates and shows that reliance on the current Treasury yield is likely to understate the cost of equity over the period that IAWC's rates will be in effect. IAWC Ex. 21.00 at 12-13; IAWC Ex. 32.00 at 10-11. Because Mr. McNally did not reconsider his analysis on that basis, Ms. Bulkley went so far as to state that "Mr. McNally appears determined to ignore financial reality." IAWC Ex. 32.00 at 10. Staff asserts that Ms. Bulkley's claims are unequivocally wrong.

The financial reality is that interest rates are volatile and accurately predicting them is impossible. Another financial reality is that the most recent 30-year T-bond yield in the record is below the rate from the date of Staff's analysis. Staff argues that by Ms. Bulkley's reasoning, if a higher ex post interest rate indicates Staff's risk-free rate estimate is understated, then a lower ex post interest rate would indicate Staff's risk-free rate estimate is overstated. None of that makes speculation as to the level of future interest rates any more accurate or reliable.

Ms. Bulkley claims that the use of spot yields can "bias" results downward due to potentially inefficient pricing. IAWC Ex. 21.00 at 12, 31. According to Staff, she did not, however, provide any evidence that May 12, 2022, was in any way an anomalous day in the markets or that spot yields on that date would lead to a biased ROE estimate. In contrast, Mr. McNally repeated his analysis once a week for three weeks to determine whether or not his proposed cost of common equity reflects anomalous data. The results of those three analyses are all within 16 basis points of one another, with the first result slightly lower than his recommended ROE of 9.78% and the second slightly higher. Staff states that this demonstrates that Mr. McNally's May 12th result was clearly not an anomaly, as the market was reasonably stable and not exhibiting any particular trend in one direction or the other at the time of his analysis. Thus, Staff argues, those results do not warrant the abandonment of the traditional Commission practice of relying on spot data, from which the Commission has stated it is reluctant to deviate. Staff Ex. 14.0 at 8; *see also N. Shore Gas Co. and Peoples Gas Light and Coke Co.*, Docket Nos. 07-0241/07-0242 (Cons.), Order at 92 (Feb. 5, 2008). Moreover, Staff states that Ms. Bulkley's argument in defense of the use of forecasts over spot yields is circular, as it is premised on the "expectation" that interest rates will continue to increase, for which the only evidence is her forecasts, the use of which is unnecessary and inappropriate, as discussed above.

With respect to beta estimation, Ms. Bulkley claimed that betas derived from weekly observations are superior to betas derived from both weekly and monthly observations, as Mr. McNally employed. IAWC Ex. 21.00 at 42. As Mr. McNally explained, the betas Ms. Bulkley and Mr. McNally employed are merely estimates of the true beta, which is unobservable. Consequently, which beta estimates are more accurate is unknown. The Value Line methodology is not inherently superior to Staff's or Zacks' beta methodology. In fact, different beta estimation methodologies can produce different betas when those methodologies employ different samples of stock return data. Thus, just as the analysts in this proceeding used multiple models to determine the cost of equity, Mr. McNally used multiple approaches to estimate beta. In contrast, Ms. Bulkley proposes to exclude monthly betas and rely solely upon weekly betas, a proposal which has been repeatedly rejected by the Commission. In adopting Staff's multiple-source approach to estimating beta, the Commission has stated:

> We agree that, in the same way we rely on multiple models to determine the cost equity, Staff's well-considered use of multiple beta sources is beneficial to reduce measurement error from any individual estimate. Moreover, we find that Staff's beta estimate appropriately weights the beta estimates from those three sources.

Docket Nos. 09-0166/09-0167 (Cons.), Order at 126-27. Further, the Commission's repeated conclusion that the use of both weekly and monthly betas is superior to the use of one or the other was upheld by the Illinois Appellate Court in Docket No. 13-0192. Staff Ex. 14.0 at 9.

**(d) ECAPM Analysis**

Ms. Bulkley's analysis includes the results of an ECAPM to which she applied adjusted betas. She argued that an adjustment to beta coefficients and an adjustment to the CAPM model are discrete, unrelated adjustments and that both adjustments are warranted. IAWC Ex. 21.00 at 47-51. Staff asserts that Ms. Bulkley's argument is misguided. Ms. Bulkley's ECAPM ostensibly attempts to adjust the CAPM for the flatness of the empirically measured security market line ("SML") relative to the predicted SML. Staff cited research by Litzenberger *et al.* that studied various ways to alter the CAPM itself or beta to address this discrepancy and, thus, bring the resulting predicted return more in line with actual results. Staff Ex. 6.0 at 28-29. Significantly, Litzenberger never combines adjusted betas, as both Ms. Bulkley and Mr. McNally employ, with alternative versions of the CAPM. In fact, Litzenberger observes that if the raw betas are adjusted, as Ms. Bulkley's are, then the cost of equity estimates using the resulting adjusted betas would be identical to those using unadjusted betas in an empirically-derived CAPM. Consistent with that finding, Mr. McNally demonstrated that the mathematical effect of either adjustment (to beta or to the CAPM model) is equivalent – it raises the returns for securities with raw betas below one and lowers returns for securities with raw betas greater than one. Thus, the beta adjustment does correct for the observed flatness in the linear relationship between risk and return, making the use of an adjusted beta when employing an ECAPM unnecessary, and vice versa. Staff Ex. 14.0 at 10. Ms. Bulkley, however, combined both adjustments. By using adjusted betas in the ECAPM model, she effectively adjusted twice for the flatness of the empirical SML and, thus, inflated the estimate of her sample's cost of common equity.

Staff argues that a review of recently authorized utility ROEs supports the conclusion that Ms. Bulkley's ECAPM estimates are inflated. The vast majority of recently authorized utility ROEs fall between 9.35% and 10.25% (with none above 10.25% in the last three years), indicating a central tendency in the mid to upper 9% range (the downward trend in those observations notwithstanding). Ms. Bulkley's average CAPM model result of 10.72% is already approximately 50 basis points higher than the high end of that range. Her average ECAPM result is significantly higher still, at 11.26%, a full percentage point above the high end of that range and approximately 150 basis points above its central tendency (again, ignoring the downward trend of those ROEs). This indicates that, contrary to Ms. Bulkley's conclusion, the CAPM is not understating returns for companies with betas less than 1.00, but rather, her ECAPM (using adjusted betas) is overstating them. That is consistent Mr. McNally's explanation that, by using adjusted betas in the ECAPM model, Ms. Bulkley effectively adjusted twice for the flatness of the empirically measured security market line and, thus, inflated the estimate of her sample's cost of common equity. Staff Ex. 14.0 at 11-12.

The Commission has consistently rejected the use of the ECAPM to determine the cost of common equity in several prior proceedings, stating in a previous IAWC rate case:

> 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.

Docket No. 11-0767, Order at 109. Staff's position is that the Commission should likewise reject Ms. Bulkley's ECAPM in this proceeding.

**(e) Staff's Conditional ROE Adjustments**

As noted previously, Mr. McNally performed an analysis that indicated that the risk of IAWC is appreciably lower than the overall risk of the Proxy Group. Specifically, he estimated IAWC's implied credit rating to a strong A2, compared to a weak A3 average credit rating for the Proxy Group. Thus, he concluded that, if the Commission rejects Staff's proposed capital structure in favor of the Company's proposed capital structure, his recommended ROE for IAWC should be adjusted downward by 10 basis points. Staff Ex. 6.0 at 19-20. Ms. Bulkley dismissed that finding, arguing that his analysis does not take into consideration the regulatory and business risks that Moody's considers. IAWC Ex. 21.00 at 51-52. Staff states that she is wrong. As Mr. McNally explained, his analysis is based on the reasonable assumption that the regulatory and business risks of the sample companies, which are all regulated water and utility companies, are reasonably similar to those of IAWC. In fact, Ms. Bulkley concluded that the operating characteristics of the companies that compose the Proxy Group are "substantially comparable" to IAWC. Moreover, of the six supportive cost recovery mechanisms available in the states in which IAWC's parent, American Water, operates, Illinois is the only state to offer all of them, indicating that IAWC faces, if anything, less operating risk than water utilities operating in those other states. Further, the reasonableness of Mr. McNally's approach is corroborated by his application of the same credit rating estimation procedure to American Water and to Essential Utilities, which is one of the Proxy Group companies. Both of those companies have assigned credit ratings from Moody's that match the credit ratings he estimated for those companies. Moreover, Mr. McNally's one-notch adjustment was conservative, given that, not only did his analysis indicate an approximate 1.5 notch difference in ratings between IAWC and the Proxy Group, but the difference in risk between IAWC and the Proxy Group grew throughout the period studied. Staff Ex. 14.0 at 14-15.

Ms. Bulkley also suggested that the use of credit ratings in Mr. McNally's relative risk assessment is not appropriate because credit ratings do not relate to equity. IAWC Ex. 21.00 at 52. Again, Staff argues she is wrong. The risk/return tradeoff (i.e., investors require higher returns to accept greater exposure to risk) is a fundamental principle of finance. That concept forms the basis of Mr. McNally's adjustment. Issuer credit ratings reflect the general financial health of a company. In fact, Ms. Bulkley identifies long-term issuer credit ratings as one of the criteria she used to select the Proxy Sample, which she employed to estimate IAWC's ROE. While the relationship between credit ratings and

common equity risk is not perfect, credit ratings and common equity risk are certainly related. Common equity costs are affected by debt leverage; likewise, credit ratings are affected by debt leverage. That is, as debt leverage rises the cost of common equity rises and credit ratings fall, and vice versa. Thus, there is an inverse relationship between credit ratings and common equity costs, which is precisely the relationship Mr. McNally modeled. While there is no way to directly measure that relationship, to ignore the risk differential between IAWC and the Proxy Group, as Ms. Bulkley espouses, would clearly be inappropriate. Staff asserts that the approach Mr. McNally adopted is consistent with the approach Staff has taken, and the Commission has accepted, under similar circumstances in previous proceedings. Staff Ex. 14.0 at 15-16.

Ms. Bulkley's final argument against Mr. McNally's 10 basis point downward ROE estimate is that, while the development of an ROE from a Proxy Group of risk-comparable companies is based on relative risk, a comparative analysis is not part of a credit rating analysis. IAWC Ex. 21.00 at 53. Staff argues that this is a straw man argument and mischaracterizes Mr. McNally's performed analysis. Mr. McNally did not use a comparison to the Proxy Group to estimate IAWC's implied credit rating; rather, he completed an absolute assessment of IAWC's financial ratios. Mr. McNally concluded that those ratios are consistent with a strong A2 rating in accordance with the Moody's rating methodology for regulated water utilities. Only after establishing IAWC's risk profile did he compare that risk profile to that of the proxy sample to determine the relative ROE based on those risk profiles. Staff Ex. 6.0 at 19-20. Thus, Staff asserts that Ms. Bulkley's argument should be rejected.

Ms. Bulkley claims that Mr. McNally provided no support for his 4 basis point ROE adjustment for the Company's proposed Rider BDE or his 5 basis point ROE adjustment for the Company's proposed Rider ESR. IAWC Ex. 21.00 at 55. Staff argues that is inaccurate. In addition to the quantitative analysis that Mr. McNally provided for deriving the specific adjustments he proposes, he also provided a qualitative analysis of the need for the adjustment: Rider BDE addresses fluctuations in bad debt while Rider ESR ensures the recovery of capital investments related to new environmental regulations, both of which would draw IAWC's pattern of cost recovery closer to its pattern of cost incurrence, and thus, lower its operating risk. Staff Ex. 6.0 at 21-24. Ms. Bulkley does not deny that those riders would reduce IAWC's risk and, unlike Mr. McNally, did not provide any qualitative counterargument, much less present any quantitative analysis to refute his conclusion. Thus, according to Staff, his argument regarding the need for such adjustments stands unrefuted. Given that fact, it would be improper to not make an adjustment. Since, Ms. Bulkley provides no alternative for consideration, it is Staff's position that the Commission must adopt Mr. McNally's adjustments if the Commission approves Rider BDE and/or Rider ESR.

#### c. AG's Position

The AG supports the ROE recommendations proposed by IIWC/FEA/CUB for the reasons set forth in the testimony of Mr. Walters. *See generally,* IIWC/CUB/FEA Ex. 1.0, 2.0.

### d. IIWC/FEA/CUB's Position

IIWC/FEA/CUB take the position that the Act tasks the Commission with determining the market-required cost of equity for IAWC and authorizing an equivalent ROE for the Company. A utility's cost of common equity is the expected return that investors require on an investment in the utility. IIWC/CUB/FEA Ex. 1.0 at 24. Investors expect to earn their required return through dividends and stock price appreciation. *Id.* at 24. The return is to be commensurate with the return investors could earn by investing in other companies of comparable risk. *Bluefield*, 262 U.S. 679, 692-693; *Hope*, 320 U.S. 591, 603. Under these precedents, a utility is allowed to earn a return sufficient to maintain its financial integrity and to attract capital at reasonable terms.

The Act requires that the Commission set just and reasonable rates. 220 ILCS 5/9-201(c). The purpose of this statutory provision is to "prevent exorbitant rates and unjust discrimination and undue preferences in rates" and to enable consumers to protect themselves. *Springfield Gas & Electric Co. v. Springfield*, 292 Ill. 236, 247, 126 N.E. 739, 744 (1920). Thus, the Act calls on the Commission to ensure IAWC's ROE is no higher than necessary to satisfy *Hope* and *Bluefield.* As the *Hope* decision noted: "fixing just and reasonable rates involves a balancing of investor and consumer interests." *Hope*, 320 U.S. 591, 603. IIWC/FEA/CUB's recommended ROE meets that standard.

Furthermore, according to IIWC/FEA/CUB, other jurisdictions have observed that regulation is not intended to allow a utility a ROE that is higher than necessary to meet the standards set in *Hope* and *Bluefield*. Regulation is intended to protect consumers from exorbitant prices and unfair business practices, as the provisions of the statutes establishing the regulation of utilities show. *See Pub. Sys. v. FERC*, 606 F. 2d 973, 979 n.27 (1979). IAWC's requested 10.25% ROE is higher than necessary to meet the standards set forth in *Hope* and *Bluefield* and therefore should be rejected.

IIWC/FEA/CUB note that in light of the lack of peer water utilities, IIWC witness Walters used the same Proxy Group of investor-owned gas utilities as Company witness Bulkley, excluding South Jersey Company, which has been targeted for acquisition by JP Morgan. IIWC/CUB/FEA Ex. 1.0 at 30. Mr. Walters observed that authorized utility ROEs have declined over the last 10 years, with industry averages consistently below 10% since 2011 for gas utilities and 2013 for electric utilities. *Id.* at 6-7. Since 2016, the majority of authorized gas utility ROEs have been below 9.7%, often below 9.5%. *Id.* at 8. There are fewer examples of authorized water utility ROEs to draw upon, but Mr. Walters cited S&P Capital IQ's analysis showing a range of 9.0% to 9.8% over the 12 months ending April 30, 2022. *Id.* at 8-9. As discussed above, the utilities sector has enjoyed financial stability and growth throughout this time period. *Id.* at 11-23. These trends illustrate that a decade of declining authorized ROEs, including the recent norm of ROEs in the mid-to-low 9% range, have supported utilities' financial strength.

IIWC/FEA/CUB point out that Mr. Walters observed that while IAWC does not receive credit ratings of its own, its parent company, American Water, and its financing entity, AWCC, both have A ratings from S&P and Baa1 ratings from Moody's. *Id.* at 26-27. S&P gives American Water an "Excellent" business risk rating and a "Significant" financial risk. *Id.* at 27. S&P stated in its most recent report concerning IAWC's parent company that American Water "will reduce its business risk by selling its [Homeowners

Services Group] business," which S&P believes "will almost certainly close." *Id.* at 27. In light of the Homeowners Services Group business sale and other factors, the report concluded, "[g]iven the company's relative positioning within its business risk profile and financial risk profile categories, we apply a positive comparable ratings analysis modifier," meaning the company's financial standing is even stronger than current statistics indicate. *Id.* at 27.

IIWC/FEA/CUB state that to determine IAWC's cost of equity, Mr. Walters utilized five financial projection models: (1) a constant growth DCF model using a consensus of analysts' growth rate projections; (2) a constant growth DCF model using sustainable growth rate estimates; (3) a multi-stage growth DCF model; (4) a risk premium model; and (5) a CAPM. *Id.* at 26. Mr. Walters input Proxy Group data through these models to calculate a range of reasonable cost of equity estimates. *Id.* at 26.

**i. Constant Growth DCF Model**

It is the IIWC/FEA/CUB position that the DCF model infers that a stock price equals the sum of the present value of expected future cash flows discounted at the investor's required rate of return or cost of capital. *Id.* at 31. For the constant growth DCF model, Mr. Walters input the average of the weekly high and low stock prices of Proxy Group utilities over the thirteen-week period ending April 29, 2022 and the most recently paid quarterly dividends reported in *Value Line*. *Id.* at 32-33. Mr. Walters found that securities analysts' growth estimates have been shown to be more accurate than historical data in predicting future returns. *Id.* at 33. Accordingly, Mr. Walters used the mean of professional securities analysts' earnings growth estimates as a proxy for investors' dividend growth rate expectations. *Id.* at 34. The mean growth rate for the Proxy Group was 5.99%; the median, 6.10%. *Id.* at 34-35. Using these inputs, Mr. Walters' constant growth DCF model calculated a mean return of 8.69% and a median return of 9.00%. *Id.* at 34. However, Mr. Walters found that the three- to five-year growth rates this model assumes are nearly 40% higher than the projected long-term gross domestic product ("GDP") growth rate of 4.10% and are therefore unsustainable. *Id.* at 35-36. Mr. Walters based this 4.10% figure and his finding that a utility's earnings and dividends cannot sustain long-term growth exceeding that of the U.S. GDP on his review of historical data and academic literature on the subject. *Id.* at 39-43.

**ii. Sustainable Growth DCF Model**

IIWC/FEA/CUB observe that Mr. Walters then conducted a sustainable growth DCF model analysis. A sustainable growth rate is based on the percentage of the utility's earnings that is retained and reinvested in utility plant and equipment (*i.e.*, rate base). *Id.* at 36. The model calculates the sustainable, or "internal," growth rate by subtracting the dividend payout ratio from one, reflecting the inverse relationship between payout and retention of funds. *Id.* at 36. Mr. Walters calculated the Proxy Group's long-term sustainable growth rate as an average of 6.05% and median of 5.59%. *Id.* at 37. Plugging these sustainable growth rates into the DCF model produced average and median cost of equity estimates of 8.74% an 8.11%, respectively. *Id.*

### iii. Multi-Stage Growth DCF Model

IIWC/FEA/CUB point out that growth rates are not necessarily constant over time. *Id.* at 37-38. Accordingly, IIWC/FEA/CUB witness Walters also conducted multi-stage DCF model analysis applying different growth rates to short-term (first five years), transition period (next five years), and long-term (beyond ten years) time periods. *Id.* at 39. Mr. Walters applied the consensus analysts' growth rate (8.74% and 8.11%) to the short-term, the maximum sustainable growth rate (4.10%) for the long-term, and a linear interpolation between those two points for the transition period. *Id.* at 39, 43. The resulting estimates from his multi-stage DCF model analysis was a mean cost of equity of 7.08% and a median of 7.19%. *Id.* at 43.

Based on these six (three medians, three means) DCF model estimates, Mr. Walters concluded that a reasonable ROE based on his DCF analyses was 8.9%. *Id.* at 44. This figure was higher than all but the highest one of the estimates, the 9.0% median constant growth DCF model output. *Id.* at 44, Tbl. CCW-9.

### iv. Risk Premium Model

IIWC/FEA/CUB state the risk premium model is based on the principle that investors require a higher return to assume greater risk. Common equity investments carry greater risk than bonds because bonds have more security of payment in bankruptcy proceedings and the coupon payments on bonds represent actual contractual obligations. *Id.* at 44. The risk premium model uses two estimates of an equity risk premium: (1) the difference between regulatory commission-authorized ROEs and contemporary U.S. T-bond yields; and (2) the difference between regulatory commission-authorized ROEs and contemporary Moody's "A"-rated utility bond yields. *Id.* at 44-45. Mr. Walters chose the years 1986 through 2021 because public utility stocks consistently traded at a premium to book value in that time period. *Id.* at 45.

IIWC/FEA/CUB witness Walters' analysis indicated an average equity risk premium over T-bond yields of 5.70%. *Id.* To account for fluctuations over time, Mr. Walters calculated five-year rolling averages ranging from 4.17% to 7.23% and ten-year rolling averages from 4.30% to 6.93%. *Id.* at 45-46, 47. Using the same method, Mr. Walters calculated an average risk premium over contemporary Moody's "A"-rated utility bond yields of 4.30% and five-year and ten-year rolling averages ranging from 2.80% to 5.97% and from 3.11% to 5.75%, respectively. *Id.* at 46.

IIWC/FEA/CUB point out Mr. Walters also considered the average utility bond yield spreads over T-bonds for utility bonds rated "A" (1.48%) and "Baa" (1.91%) for the same time period. *Id.* at 47-48. These yield spreads indicate that utility bond securities have average to above average demand relative to Treasury securities over the last several years. *Id.* at 48. Mr. Walters' recommended ROE for IAWC based on his risk premium study was 9.80%. *Id.* at 48-49.

### v. CAPM Model

IIWC/FEA/CUB argue that the CAPM posits that the market requires a rate of return for a security equal to the risk-free rate, plus a risk premium associated with the specific security. *Id.* at 50. This mathematical model utilizes a beta coefficient that represents the investment risk that cannot be diversified away in a portfolio ("non-

diversifiable" or "systemic" risk). *Id.* at 50-51. For the market risk-free rate, Mr. Walters used *Blue Chip's* projected thirty-year bond yield of 3.30%, which Mr. Walters notes is higher (and therefore a more generous assumption to the Company) than the current thirty-year T-bond yield of 2.51%. *Id.* at 51-52.

IIWC/FEA/CUB observe that in selecting a beta, Mr. Walters rejected the current Proxy Group average and median *Value Line* beta estimates because, in his experience, these estimates have been abnormally high and therefore unlikely to be sustained long-term. *Id.* at 53. Instead, Mr. Walters relies on Market Intelligence's beta Generator model, which derives 0.57 average and 0.59 median betas from S&P 500 market data. *Id.* at 53-54.

According to IIWC/FEA/CUB, Mr. Walters derived his market risk premium estimates via two methods: risk premium and DCF. *Id.* at 54. He also considered the normalized market risk premium of 5.50% with the normalized risk-free rate of 3.00% published by Kroll. *Id.* at 54. Mr. Walters derived his forward-looking risk premium-based estimate by estimating the expected return on the market (via the S&P 500) and subtracting the risk-free rate. *Id.* at 54. He calculated the expected return on the S&P 500 by adding an expected inflation rate to the long-term historical mean real return on the market (achieved return above inflation). *Id.* Kroll estimates the historical mean real market return from 1926 to 2021 to be 9.20%. *Id.* at 55. A current consensus for projected inflation using Consumer Price Index is 2.60%. Taken together, the expected market return is 12.04%, which after subtracting the 3.30% projected risk-free rate yields a 8.74% market risk premium. *Id*.

IIWC/FEA/CUB state Mr. Walter's first constant growth DCF model estimate, using the FERC's method using the dividend-paying companies of the S&P 500 index, to estimate expected market return, produced an expected market return of 13.51%. *Id.* at 55-56. Subtracting the 3.30% projected risk-free rate brings the risk market risk premium to 10.20%. *Id.* Mr. Walters' second DCF-based estimate used all companies in the S&P 500 index rather than just the dividend-paying companies. *Id.* at 56. This method produced a 13.61% expected market return and therefore a 10.30% market risk premium (13.61% - 3.3% risk free rate = 10.30%). *Id.* Collectively, the DCF-based method produced an average expected market return of 13.56% and an average market risk premium of 10.25%.

IIWC/FEA/CUB indicate the three methods used to estimate the expected market return (*i.e.* risk premium method – 12.04% DCF method – 13.56% and Kroll's normalized method – 8.50%) produce an average expected market return of 11.37%. Mr. Walters' 11.37% average estimated expected market return exceeded the long-term market expectations of several financial institutions, in all but one case by more than double. *Id.* This comparison illustrated that, if anything, Mr. Walters' estimated market risk premiums were toward the higher end. *Id.* at 57. This characterization is further bolstered by Kroll's analysis, which finds the same low-end estimate (5.50%) but a significantly lower high-end estimate (7.46% compared to 10.25%). *Id.* at 58.

IIWC/FEA/CUB report that based on the nine different versions of the CAPM Mr. Walters applied, Mr. Walters estimated an average ROE of 8.97% and a median of 9.18%. *Id.* at 59-60. Accordingly, he recommends a CAPM ROE estimate of 9.3%. *Id.* at 60.

### vi. ROE Summary

Taken together, Mr. Walters calculated recommended ROEs of 8.9% (DCF), 9.8% (risk premium), and 9.3% (CAPM). *Id.* at 61. Mr. Walters recommends as an ROE for the Company the midpoint of this range, 9.35%. *Id.* However, Mr. Walters based his recommendation on the assumption that the Company's approved common equity ratio not exceed 50.0%. *Id.* IIWC/FEA/CUB state that if the Commission approves an equity ratio greater than 50.0%, an ROE in the lower half of Mr. Walters' range would be more appropriate. *Id*.

#### (a) Response to IAWC

Mr. Walters testified that Ms. Bulkley's constant growth rate DCF results are based on unsustainably high growth rates, she relies on her "Mean High" DCF results produced using only proxy companies' highest growth rates, her CAPM uses inflated market risk premiums, and her ECAPM inappropriately relies on adjusted betas. *Id.* at 62. A conspicuous pattern one cannot help but notice in Ms. Bulkley's analysis is that every one of these suspect methodological choices points in the same direction of increasing the estimated cost of equity. Ms. Bulkley's analysis supports the reasonableness of Mr. Walters' recommendations once these inflationary flaws are corrected. *Id.* at 63. The corrected average ranges are 8.75% to 8.96% for DCF and an average of 9.55% for CAPM. *Id.* at 64. Mr. Walters' recommended 9.35% ROE falls squarely in the middle of this range. *Id.*

IIWC/FEA/CUB observe that for her constant growth DCF analysis, Ms. Bulkley assumes a 6.71% growth rate, which is dramatically higher than the 4.10% maximum long-term sustainable growth rate described above. *Id.* at 65-66. Ms. Bulkley could have corrected this unreasonable assumption by adopting a multi-stage DCF with an empirically-supported long-term growth figure, such as the long-term GDP growth rate Mr. Walters used. *Id*. Rather than correct for the inflationary impact of unreasonably high long-term growth rate estimates, Ms. Bulkley doubled down by affording particular weight to her Proxy Group's average high growth rate of 8.44%, which is more than double expected GDP growth. *Id.* at 66-67. Even her Proxy Group's average low growth rate of 5.09% exceeded the 4.10% estimated long-term growth rate of the U.S. economy; 8.44% is entirely implausible. *Id.* IIWC/FEA/CUB state that a more reasonable DCF estimate would fall between the average of Ms. Bulkley's mean and mean-low DCF results (8.75%) and the average of her median and median-low CDF results (8.96%). *Id.* at 67. Mr. Walters' constant growth DCF results of 8.69% (average) and 9.00% (median) provide an almost identical range. *Id.* at 67.

According to IIWC/FEA/CUB, Ms. Bulkley's CAPM analysis errs by relying entirely on a single DCF-derived expected market return, which overestimates the cost of equity. *Id.* at 68, 69. Mr. Bulkley's own testimony elsewhere recognizes the need to consider multiple analytical methods. *Id.* at 69 *quoting* IAWC Ex. 11.00 at 34. Academic literature on the subject stresses the importance of considering the results of multiple methods as well. *Id.* at 69-70. However, IIWC/FEA/CUB note that Ms. Bulkley fails to heed her own sound advice, conducting only one CAPM analysis, using only inputs that result in an unusually favorable number for her client. Mr. Walters recommends a simple fix. He takes no issue with Ms. Bulkley's risk-free rate estimates or her historical beta estimates.

Specifically, Mr. Walters recommends replacing Ms. Bulkley's inflated average return on the market with his estimate of 11.37%. *Id.* at 70. This results in a reasonable CAPM range of 8.95% to 10.09%, with an average of 9.55%. *Id.*

Mr. Walters takes issue with Ms. Bulkley's reliance on an ECAPM analysis with an adjusted beta coefficient. *Id.* at 71. Mr. Walters explains that the ECAPM method itself already applies weighting adjustments that are the mathematical equivalent of using the adjusted beta. *Id.* Performing both of these redundant adjustments inflates the estimated cost of equity by flattening the expected security market return line twice. *Id.* at 72-74. Academic research supporting the development of the ECAPM does not support using the method in this way. *Id.* at 73 (citing several published studies). Further, IIWC/FEA/CUB state that regulatory commissions have widely rejected the use of the ECAPM, particularly when it incorporates an adjusted beta. *Id.* at 74. Accordingly, Mr. Walters recommends the Commission reject Ms. Bulkley's ECAPM altogether. IIWC/CUB/FEA Ex. 1.0 at 74.

For the reasons stated above, IIWC/FEA/CUB urge the Commission to adopt Mr. Walters' recommended ROE of 9.35% and reject Company witness Bulkley's excessive request of 10.25%. IIWC/FEA/CUB note this recommendation is contingent on the adoption of an equity ratio equal to or less than 50.0%. If the Commission adopts a capital structure with more than 50.0% equity, IIWC/FEA/CUB request that the Commission approve an ROE lower than 9.35%.

**e. Commission Analysis and Conclusion**

Return on equity is the return that the Commission authorizes a public utility to earn on the equity invested in its property used in its provision of utility service. As has become typical, the three parties in this docket who addressed the cost of common equity have presented the Commission with three proposals, with three significantly different results. The Company proposes 10.25%; Staff proposes 9.78%; and IIWC/FEA/CUB propose 9.35%. The AG supports IIWC/FEA/CUB's analysis and proposed ROE.

As all parties repeatedly mention, the *Hope*/*Bluefield* body of caselaw dictates the goals of determining a reasonable rate of return. "An authorized ROE that is too low restricts the utility's access to capital at a reasonable cost. Conversely, an ROE that is too high will result in rates that are neither just nor reasonable." *N. Shore Gas Co.*, Docket No. 20-0810, Order at 85 (Sept. 8, 2021), *citing Bluefield*, 262 U.S. at 692; *Hope*, 320 U.S. at 603.

The crux of the Company's argument for an ROE that is higher than Staff/Intervenors is that the models are affected by the data at the time of the analysis, and there has been such a large market shift since 2020 as well as Federal tax reform that results in understated cost of common equity. For this reason, IAWC claims that using the DCF model understates ROE and must be balanced by the higher results from the CAPM and the ECAPM models. The Commission agrees with Staff that using its DCF model and the use of current yields on T-bonds in the CAPM is reasonable and more reliable than the Company's models. The Commission has always demonstrated a preference for current, accurate data in modeling for just that reason – it is current and accurate. The Company repeatedly complains that Staff uses data at the time it filed its testimony, versus repeatedly updating it, and the Company appears to pick and choose

what components of its analysis will consist of current data, past data, or forecasted data. The Commission agrees that not only is such a method not analytically sound, it appears only to produce the highest possible number. Moreover, the Company has total discretion as to when it decides to file a rate case and could choose to file a rate case when the financial data is not volatile.

Staff applied a quarterly DCF model that reflects the expectations of investors. Mr. McNally used a constant growth DCF model in which he measured the market-consensus expected growth rates with three- to five-year growth rate forecasts published by Zacks, S&P's Market Intelligence, and Value Line. The Commission finds this reasonable and consistent with a reasoned ROE analysis.

IIWC/FEA/CUB modeled three types of DCF analyses - Constant Growth, Sustainable Growth, and Multi-Stage Growth. IAWC critiques IIWC/FEA/CUB for their use of three different DCF models and claims that only the Constant Growth method produces an estimate close to their bottom range of ROE. IIWC/FEA/CUB counter that independent academic research on the subject has concluded that growth beyond the growth rate of the economy in which the Company operates cannot be sustained indefinitely and that this approach would assume annual growth rates 40% higher than the projected long-term gross domestic product growth rate. However, IIWC/FEA/CUB include an outlier utility with an ROE below 5%, which is atypical and should be removed. The Commission agrees with Staff and the Company that the Constant Growth method is the most accurate in this circumstance.

IAWC also criticizes Mr. Walters' use of old data for the Risk Premium model. IAWC claims Mr. Walters should have used a recent *Blue Chip* report and projected utility bond yields to be consistent with his use of projected T-bond yields. The Commission agrees that Mr. Walters' use of historical data (from 1986-2021) is flawed, although it disagrees with the Company's alternative proposal to rely on forecasted interest rates, as discussed below.

Staff notes that the primary differences between Staff's and the Company's CAPM analyses are the use of a spot or forecasted interest rate to estimate the risk-free rate and the use of beta estimates derived only from weekly observations or from both weekly and monthly observations. With respect to interest rate forecasts, Mr. McNally explained that it is preferable to rely on the recent spot rate, as the Commission has repeatedly done in prior rate proceedings. The Commission has also expressed its preference for using a combination of weekly and monthly beta estimates. Therefore, consistent with prior rate case proceedings, the Commission once again rejects the use of forecasted interest rates in favor of the recent spot rate and adopts Staff's use of a combination of weekly and monthly beta estimates.

To supplement its ROE proposal, IAWC uses the ECAPM, which produces an ROE that is consistently higher than the other proven methods. Specifically, IAWC's ECAPM analysis results range from 10.77% to 11.74%, which the Commission notes is not reasonably comparable to authorized ROEs for any Illinois water utilities in the last several years. The Commission agrees with Staff that the use of the ECAPM model as a component of ROE analysis has been continually proposed by utilities and rejected by the Commission. *See* Docket No. 11-0767, Order at 109. Staff, however, critiques other

specific aspects of IAWC's ECAPM method, such as Ms. Bulkley's use of weekly data in its beta adjustments. For these reasons, the Commission again foregoes the use of ECAPM.

The Commission has consistently approved the use of DCF and CAPM in modeling the cost of common equity. "Historically, the Commission has given substantial weight to the results of the DCF and CAPM analyses' of the parties' expert witnesses." *N. Shore Gas Co.,* Docket No. 20-0810, Order at 47-48 (Sept. 8, 2021). The Commission will again approve that modeling in this docket. The Commission finds that the DCF and CAPM models meet the goals of *Hope* and *Bluefield* in allowing the Company to attract capital yet charge reasonable rates. Therefore, the Commission adopts Staff's proposed ROE.

With the exception of South Jersey Industries, which Mr. Walters excluded from his analysis, the parties all use the same Proxy Group, a sample of fourteen water utility and public utility companies. The Commission agrees the Proxy Group is a reasonable sample upon which to apply the various models, since IAWC is wholly-owned by a parent and does not have its own market traded common stock.

The Company argues that its substantial capital expenditure program as well as its investment in acquired water systems to ensure those systems comply with state and federal water standards renders IAWC riskier than its cohorts in the Proxy Group such that no downward ROE adjustment should be made. However, Staff points out that based on credit ratings, IAWC is far less risky than its cohorts in the Proxy Group. As Mr. McNally explained, his analysis is based on the reasonable assumption that the regulatory and business risks of the sample companies, which are all regulated water and utility companies, are reasonably similar to those of IAWC. Since the Commission agrees with Staff's proposed capital structure, Staff's proposed 10 basis point reduction is not adopted.

The Commission declines to adopt Rider ESR or make Rider BDE permanent. *See* Section VI., below. Therefore, Staff's additional proposed downward adjustments for ROE need not be considered.

In its BOE, IIWC/FEA/CUB argue that if the Commission does not adopt its recommended ROE of 9.35%, the Commission should use an averaging approach. IIWC/FEA/CUB recommend the Commission instead average the DCF and CAPM results of Staff (9.79%) and IIWC/FEA/CUB (9.1%). This results in an ROE of 9.44%. IIWC/FEA/CUB BOE at 12.

IAWC asks the Commission to adopt a higher ROE than the 9.78% adopted in the Proposed Order, arguing that the Commission is not bound by Staff's decision to weight its DCF and CAPM results equally. Instead, in light of the record evidence regarding the substantial turbulence in the capital markets and current inflationary conditions, and their effects on the cost of capital, the Commission should employ its technical expertise and exercise its substantial discretion to weight Staff's DCF and CAPM results in a manner the Commission believes will produce a fair and reasonable ROE. IAWC suggests that the Commission use a weighted average, weighing the DCF 33% and the CAPM 67% in the average. The resulting ROE is 9.98%. IAWC BOE at 34-35.

The Commission declines to consider an averaging approach. Both IIWC/FEA/CUB's and IAWC's suggested alternatives seem to be means to an end result, rather than a reasoned basis for calculating ROE. The Commission has recently expressed that the averaging method is not precedent and on the two occasions where it used averaging, the Commission did not approve any of the underlying components of each party's method. Docket. No. 21-0198, Order at 83.

#### 4. Recommended Cost of Capital

Having considered the conclusions above concerning the Company's capital structure and costs of debt and equity, the Commission finds that the Company should be authorized to earn a rate of return of 7.01%. The rate of return incorporates an ROE of 9.78%. The Company's rate of return was derived as follows:

| Capital Component | Percent of Total Capital | Cost | Weighted Cost |
|---|---|---|---|
| Short-term Debt | 1.81% | 2.07% | 0.04% |
| Long-term Debt | 49.19% | 4.43% | 2.18% |
| Common Equity | 49.00% | 9.78% | 4.79% |
| Total | 100.00% | | 7.01% |

## V. RATE DESIGN

### A. Uncontested Issues

IAWC states that it accepts Staff's recommendations regarding wastewater rate design for Jerseyville and Mount Pulaski pricing zones, where rates are dictated by the respective Asset Purchase Agreements.

#### 1. Central Zone Collection-Only Rate

IAWC states that Staff recommended that the Commission approve the Company's proposal to place all current acquisitions that take service under individual tariffs on Central Zone wastewater rates, approve the Company's proposal to create a Collection Only rate option for the Central Zone wastewater tariff, and approve the Company's proposal to move Piasa wastewater service territory from its Chicago Metro rates tariff to the proposed Central Zone Collection Only tariff. The Company agrees with these recommendations. The Commission finds these recommendations are reasonable and they are approved.

#### 2. Chicago Metro Rate Increase

IAWC notes that Staff recommended that the Commission approve the Company's proposal to increase rates in the Chicago Metro service territory sufficient to recover the full cost to serve the Chicago Metro customers (Recommendation #13). The Company agrees. The Commission finds this recommendation is reasonable, and it is approved.

### 3. Increase to Competitive Service Customers

IIWC/FEA recommend a minimum increase of 10% for Competitive Service customers. IAWC states that in the interest of narrowing the issues in this proceeding, the Company agrees to a 10% increase for Competitive Service customers. The Commission finds this recommendation is reasonable, and it is approved.

## B. Contested Issues

### 1. Wastewater Revenue Requirement Reallocation

#### a. IAWC's Position

IAWC explains that treating wastewater to meet ever more stringent Illinois public health and environmental requirements requires significant investment and operational expertise. IAWC notes that this is particularly true for smaller or municipal systems that have experienced underinvestment over many years. IAWC states that many municipal and private water and wastewater systems, particularly in economically challenged regions of Illinois, are unable to afford adequate levels of investment, ongoing maintenance, and retention of operational expertise to ensure safe and clean drinking water and wastewater systems that protect the health and safety of the local communities, rivers, streams, and groundwater. The Company notes that investor-owned utilities such as IAWC, however, are well positioned to make significant ongoing investments in water and wastewater systems, and they have the required expertise to support investments.

IAWC notes that since the Company's last rate case, the Commission has approved the Company's assumption of responsibility for numerous such wastewater systems that require substantial investment. Certain of these systems have been included in IAWC's Central Wastewater tariff district. IAWC explains that if the revenue requirement for the Central Wastewater district – which includes investment that no party has contested – were recovered only from Central Wastewater customers, those customers would experience a rate increase of approximately 100%, or an increase of $31 over current bills, which would result in a monthly charge of approximately $61. IAWC asserts that to mitigate this rate increase, while continuing to advance Illinois clean water and environmental policy, IAWC is proposing to recover approximately $11.8 million of Central Wastewater revenue requirement from IAWC's water customers. IAWC explains that the result of this partial reallocation is that Central Wastewater customer rates would increase by $9.79 for the average wastewater customer, while IAWC water customers would pay on average only an additional $2.72 per month. IAWC explains that this reallocation ensures that rates remain affordable for all customers while avoiding rate shock for Central Wastewater customers and advances the critical policy goal of providing much needed investment and expertise to Illinois wastewater systems.

IAWC states that the Commission is not prohibited from making an allocation of wastewater revenue requirements to water customers when designing rates. IAWC asserts that there is clear and long-standing caselaw confirming the role of the Commission in ratemaking decisions. In fact, IAWC maintains, rate design is uniquely a matter for the Commission's discretion. The courts defer to the Commission's ratemaking authority, which is guided by discretion and sound judgment rather than strict formulaic analyses and does not require enabling legislation to guide its decisions.

IAWC asserts that the Staff and Intervenor claims that the Company's wastewater reallocation proposal is somehow unlawful or in violation of the Act are wrong. Both Staff and the Company agree that the Act contemplates the consideration of factors other than cost of service in regulatory decisions, and IAWC asserts that no party points to statutory language that states otherwise. Further, IAWC argues, regardless of how many bills have been introduced in the General Assembly regarding this ratemaking approach, the fact that those bills never made it through the legislative process does not mean that the approach is somehow now prohibited. No law prohibiting the Company's proposed reallocation exists. IAWC also states that despite the AG's mischaracterization of the legislative process, the Company's proposed reallocation is not proscribed by any legal authority, and the Commission does not require any enabling legislation to authorize its consideration of the Company's ratemaking proposal – it has the authority to exercise ratemaking discretion and adopt the Company's proposal.

IAWC explains that the U.S. Supreme Court case cited by the AG in support of its claim that the Commission's authority is restricted is irrelevant and easily distinguishable. In that case, the U.S. Supreme Court considered whether Congress had granted the U.S. EPA the authority to devise emissions caps based on a generation shifting approach that "restructur[es] the Nation's overall mix of electricity generation." *West Virginia v. EPA*, 142 S. Ct. 2587, 2595 (2022). The Court decided that issue under the major questions doctrine, which evaluates whether there is "clear congressional authorization" for the authority the agency claims. *Id*. That clear authorization is required because, as the Court explains, there are "'extraordinary cases' in which the 'history and the breadth of the authority that [the agency] has asserted,' and the 'economic and political significance' of that assertion, provide a 'reason to hesitate before concluding that Congress' meant to confer such authority." *Id*. (*citing FDA v. Brown & Williamson Tobacco Corp*., 529 US 120, 159-160, 120 S. Ct. 1291 (2000)). IAWC avers that such extraordinary circumstances are not present in this proceeding, where the Commission's authority to exercise ratemaking discretion is clear and long-standing and unequivocally authorized by the Act. And, while the EPA "admitted that issues of electricity transmission, distribution, and storage are not within its traditional expertise," *see West Virginia*, 142 S. Ct. at 2596, IAWC argues that the AG cannot reasonably claim that the Commission's authority is similarly limited here.

IAWC's proposed partial reallocation of wastewater revenue requirements to water customers asks the Commission to exercise its rate design discretion to further important policy goals for the water and wastewater industry, including the need to address water sector fragmentation, distressed and deteriorating systems, bill affordability, and water equity. This is consistent with the intent of the Act: "that the health, welfare and prosperity of all Illinois citizens require the provision of adequate, efficient, reliable, environmentally safe and least-cost public utility services at prices which accurately reflect the long-term cost of such services and which are equitable to all citizens." 220 ILCS 5/1-102. IAWC states that key goals and objectives include equity, affordability, and the fair treatment of customers and investors. 220 ILCS 5/1-102(d); *Util. Servs. of Ill., Inc*., Docket No. 14-0741, Order at 29 (Sept. 22, 2015), aff'd at *Lake Holiday Prop. Owners Assoc., Inc., v. Ill. Commerce Comm'n*, Case No. 3-15-0816 (3d. Dist. 2015) ("*USI 2014 Rate Order*").

IAWC asserts that these goals cannot be achieved through a strict reliance on cost causation principles alone – as the National Association of Regulatory Utility Commissioners ("NARUC") acknowledged in its 2022 Winter Policy Summit, "helping struggling customers pay their water and wastewater bills takes the combined efforts of utilities, regulators, policy leaders, and communities." IAWC Ex. 12.02 at 2. In fact, IAWC states, NARUC advocates "exploring whether consolidated pricing and/or consolidated water and wastewater revenue requirements assist utilities in leveraging economies of scale to achieve price stability by spreading costs across a broader customer base." *Id*. Thus, to "successfully balance safety, reliability, and affordability", utilities and regulators must critically consider regulatory mechanisms and competing principles of rate design to evolve modern ratemaking and address the real and significant concerns facing the industry today. *Id*.

IAWC explains that its proposed wastewater service rate design does just that. It calculates rates based on reasonable and well-supported cost of service studies that incorporate cost causation principles and relies on other principles of rate design – including but not limited to gradualism and affordability – to re-allocate a portion of the Central Zone wastewater revenue requirement to the Company's water customers. IAWC maintains that this proposal enables the Company to make continued and prudent investment in deteriorating systems while also ensuring that rates remain affordable for all of the Company's customers.

IAWC states that as explained in the 2022 Report Card for Illinois Infrastructure issued by the Illinois Section of the Society of Civil Engineers ("2022 Report Card"), "approximately 85% of Illinois' residents [10.9 million people] are served by more than 800 wastewater treatment facilities and 690 wastewater collection systems; the remaining [2 million] residents rely on septic systems." IAWC Ex. 22.01 at 20. The report finds:

> Far too often, the approach toward public infrastructure is to build and operate systems with minimal maintenance until the infrastructure wears out. Water systems need to fully account for the costs to manage their assets accounting for the life cycle of the system … agencies should be able to put together a maintenance and replacement plan for their water systems, similar to the way transportation agencies rate and schedule roadways for improvements. Thus, by appropriately managing all assets, a system's overall investment needs and operating costs can be reduced.
>
> Aging infrastructure and new wastewater discharge limits [also pose] challenges to Illinois' municipal wastewater utilities.
>
> Adequate prioritization of Illinois' water infrastructure is vital to protecting our abundant water resources and providing a safe and clean resource for all users. Unfortunately, deficiencies in Illinois' wastewater infrastructure poses a threat to our water resources.

*Id.* IAWC explains that the 2022 Report Card noted that Illinois needs $6.5 billion to meet the water quality and water-related public health goals of the Clean Water Act, according to survey results published in 2012. *Id*. at 22. IAWC notes that state and federal programs to help municipalities upgrade their aging water and wastewater systems, however, are inadequate to meet this significant need. The 2022 Report Card provides an example:

> The state of Illinois operates a Water Pollution Control Loan Program. Under this program, Illinois aids in construction and improvement of wastewater treatment facilities. Since 2018, Illinois has maintained a priority project list (PPL) with needed assistance that exceeds available funds. As such, Illinois continues to help as many applicants as possible with the existing resources. *For the Fiscal Year 2022, Illinois EPA has identified $1.7 billion in projects, of which only $350 million can be funded with available resources*. An examination of the PPL reveals many projects are for facility upgrades, including phosphorus removal to meet new permit limits, disinfection, and collection system repair.

*Id*. at 20-21 (emphasis added).

IAWC contends that as a result and because "federal funding cannot be used to pay for operations and maintenance… the burden falls on the rate payers." *Id*. at 21. These increased rates are "often insufficient to address the needs of an aging wastewater system" (*id*.) and the increased costs and decreased water quality often "perpetuat[es] environmental problems and caus[es] disproportionate harm to low-income communities." IAWC Ex. 12.01 at 2. IAWC notes that no witness in this proceeding challenges the underlying need for significant investments in water or wastewater infrastructure or disputes the level of investment required.

IAWC explains that municipal water and wastewater infrastructure in Illinois is specifically in distress, with potential adverse consequences for the health and safety of Illinois residents. As the 2022 Report Card explains, aging infrastructure and new wastewater discharge limits pose challenges to Illinois' municipal wastewater utilities, and many municipal systems face sewer overflow events that affect local waterways and pose risks to public safety, new groundwater quality standards regulating per- and polyfluoroalkyl substances ("PFAS"), and major operations and maintenance expense to improve deteriorating infrastructure. IAWC notes that systems are experiencing historic flooding in the midst of deteriorating infrastructure. Illinois citizens are faced with drinking water that fails EPA safety standards. Deteriorating wastewater infrastructure adversely impacts, and in fact endangers, drinking water quality as well. State and national policy, analyses, engineering reports, and legislation all come to the same conclusion – the water and wastewater industry is troubled and requires investment by large utilities with expertise and financial ability.

IAWC states that ESL illustrates this need for investment at the specific, municipal level. IAWC explains that the ESL sewer system has about 6,600 customer connections, serving the City's population of 25,000. ESL Ex. 1.0 at 2. ESL residents face numerous

economic challenges, with a poverty level of about 30%. *Id*. at 2-3. About two-thirds of the ESL system is a combined sanitary/stormwater system, with significant inflow and infiltration into the system, which results in regular combined sewer overflows and basement backups. *Id*. at 2. But with an uncollectible rate of about 30%, ESL lacks the funds to properly operate and maintain the system or make necessary investments. *Id*. IAWC contends that, as discussed below, it would be in a position to address these problems if it could purchase the system. But, IAWC maintains, approval of its wastewater revenue requirement reallocation proposal is needed to make that happen.

IAWC states that in February 2022, the NARUC Board of Directors published Resolutions on Water Equity that were passed by the Committee on Water. IAWC states that these Resolutions identified many of the pervasive concerns facing the water industry today, and concluded:

> Resolved that the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2022 Winter Policy Summit in Washington, DC, supports and encourages regulators, utilities, and policymakers to consider the paths to water equity identified herein; and be it further
>
> *Resolved*, that NARUC recommends that economic regulators consider and adopt as many as appropriate of the regulatory mechanisms identified herein as a means to achieving water equity; *and be it further*
>
> *Resolved*, that the Committee on Water stands ready to assist economic regulators with implementation of any of the paths to water equity set forth within this resolution.

*See* IAWC Ex. 12.01 at 2-3; https://www.naruc.org/resolutions-index/2022-winter-policy-summit-resolutions/.

IAWC states that the NARUC Resolutions are unequivocal. IAWC notes that they urge regulators and utilities to "advance water equity to ensure customers of all income levels have access to high-quality water," to "encourage and incentivize prudent, incremental, and consistent investment in water and wastewater infrastructure," and to ensure that "customers are able to pay for these essential services." *Id*. As part of this effort, the Resolutions ask utilities, regulators, policy leaders, and communities to consider alternative ratemaking mechanisms, including "exploring whether consolidated pricing and/or consolidated water and wastewater revenue requirements assist utilities in leveraging economies of scale to achieve price stability by spreading costs across a broader customer base." *Id*. at 2. IAWC points out that this approach is not novel – in July 2013, NARUC advised regulators to consider certain practices that were identified as "means to improve sustainable and continued investment in small water system infrastructure at cost-effective rates." One of the best practices identified was:

> …combining water and wastewater revenue requirements for purposes of rate cases, as appropriate, if the water and wastewater utilities are under the same ownership, which will

> reduce rate case expense and offer rate increase mitigation options driven by economies of scale that would be unavailable otherwise.

https://pubs.naruc.org/pub.cfm?id=53A0D971-2354-D714-51EB-8A01C0909879.

IAWC contends that this shows that its rate design proposal has, for many years, been considered to be fair, just, and a best practice to ensure water safety, reliability, and affordability for all customers – not just those who can afford to pay for consistent investment in their systems.

IAWC notes that Illinois already recognizes the need to assist small, struggling utilities that are unable to invest in and maintain infrastructure, with the passage of the Systems Viability Act ("SVA") in 2013 and its renewal in 2018. 220 ILCS 5/9-210.5. The SVA recognizes the value of giving municipalities and other water and wastewater systems the option to apply the financial and managerial resources of regulated public utilities to meet the challenge of providing safe water and sanitary services for their residents. The SVA provided a streamlined mechanism through which utilities with the financial, technical, and managerial expertise can acquire smaller systems and invest in their water and wastewater infrastructure, enhancing the adequacy, reliability, efficiency, and safety of service that is provided to water and wastewater customers in Illinois. IAWC explains that pursuant to this law, systems acquired pursuant to the SVA are subject to review in a docketed proceeding before the Commission. This review includes an analysis of rate base, current rates, future rates, and investment needs. The Company notes that, consistent with the policy intent of the SVA, IAWC has acquired and invested in smaller systems throughout Illinois; as discussed above, this has already improved water safety, reliability, and affordability throughout the state.

IAWC points out that no party disputes that IAWC has demonstrated the financial capability to make significant ongoing investments in water and wastewater systems, and has the managerial expertise needed to improve water and wastewater operations in the communities it serves. IAWC states that when permitted to do so, the Company can take advantage of significant economies of scale and spread a portion of needed investments over its broad customer base – approximately 375,000 customers, or a population of 1.3 million – at a time of historically high inflation when affordability concerns are paramount, to mitigate rate increases for the communities it serves.

IAWC contends that the benefits of these economies of scale are evident in the compliance costs of water quality mandates, as recognized by the EPA. For example, the cost of complying with the Safe Drinking Water Act was estimated by the Congressional Budget Office to be $4 per customer with systems servicing more than 500,000 people, but $300 per person in systems only serving up to 100 people. IAWC explains that it serves a population of approximately 1.3 million. The cost of complying with the Arsenic Rule provides a similar example. IAWC notes that cost of compliance depends on system size and ranges from $38 to $327 per household annually for small systems (less than 10,000) to $0.86 to $32 per household for larger systems. According to the EPA the disparity is "due to economies of scale" – larger systems are able to spread the costs of compliance over a larger customer base.

IAWC states that, as indicated, many water and wastewater systems in Illinois have neither the economies of scale nor the technical expertise needed to affordably meet increasingly stringent water and wastewater quality standards, from both capital investment and operational perspectives. As a result, investments and maintenance are deferred and the quality of water and wastewater service suffers. Acquisitions by a large water and wastewater utility such as IAWC, however, can facilitate the necessary investment and achieve these economies of scale. As discussed, the SVA is intended to support such acquisitions. But the SVA mechanism is not enough, by itself. IAWC maintains that the consolidation of water and wastewater systems, called for by NARUC and enabled by the SVA, is needed to fully allow infrastructure investments and operating costs to be spread over a larger customer base, thus dampening the effects of rate increases associated with these costs and investments on any single cluster of customers and providing long-term rate stability for all customers.

IAWC explains that its proposed revenue requirement reflects the acquisition of 14 wastewater systems since its last case - of these 14 systems, six were incorporated into the Central Wastewater tariff district. IAWC argues that these systems need substantial investment to address legacy infrastructure needs, in order to improve resiliency and protect the health and safety of customers. IAWC explains that this investment is underway: IAWC is working to improve the systems' ability to handle heavy rainfall, to protect against uncontrolled overflows of partially treated or untreated wastewater entering local water bodies and backing up within residential areas. IAWC asserts that examples of major investments include required improvements in the Village of Godfrey ("Godfrey") to address discharge permit requirements, administrative orders of consent, or Long-Term Control Plans to reduce Combined Sewer Overflows and Sanitary Sewer Overflows that could impact the health and safety of the communities and environment during large rain events.

IAWC notes that its investments have already provided specific and tangible benefits to those systems and to the State, as a whole. For example, prior to IAWC's acquisition of Godfrey's sewer system (approximately 6,200 connections) in November 2019, Godfrey had over 5.4 million gallons of sanitary sewer overflows during rain events between 1.5 to 5 inches during a 24-hour period. IAWC states that these events significantly and adversely affected residents and the environment of the community. In fact, the EPA, Region 5, had started an enforcement action against the Village to eliminate sanitary sewer overflows in four areas that had experienced systemic overflows. IAWC explains that upon acquiring the system, the Company became party to the enforcement action and entered into an Administrative Order on Consent to eliminate the sanitary sewer overflows in the four areas between 2022 and 2023. IAWC notes that the Godfrey community has already seen the benefit of the Company's investment work – during the recent rain event on Tuesday, July 26, 2022, where nearly four inches of rain fell over a seven-hour period, there were no sanitary sewer overflows within the community.

IAWC also notes that more work is and will be needed. As a result of IAWC's acquisitions of wastewater systems, the proportion of IAWC's investment in its wastewater facilities has increased from 10% in 2017 to 21% in 2023 ($55 million of the overall investment of $258 million planned investment). IAWC states that it anticipates $139 million in investment will be required in the wastewater systems during the period

2018 through 2023. As discussed, these investments will provide (and have already provided) tangible benefits for the communities these wastewater systems serve. And by extension, IAWC explains, these investments benefit Illinois as a whole, both environmentally, in improved water quality, and economically, through jobs created by the construction activities. To secure these benefits over the long term, IAWC contends, rate design policies such as IAWC's proposed partial wastewater revenue reallocation are needed to support the recovery of these substantial investments consistent with the goals of gradualism and affordability.

IAWC explains that the Company currently provides wastewater service under the Chicago Metro tariff, the Central Zone tariff, and several individual tariffs for recently acquired systems. IAWC's Chicago Metro wastewater tariff serves customers in the Company's Chicago area service territory and in the acquired service territory of Piasa. In this proceeding, IAWC proposes to increase rates for Chicago Metro wastewater customers by the total amount of the Chicago Metro revenue requirement increase over present rate revenues, resulting in an average increase to bills of approximately $7.12 per month. IAWC notes that, as discussed further below, no party contests this proposed rate increase.

IAWC explains that the Company's Central Zone wastewater tariff serves customers in selected service territories that were not included in rates in Docket No. 16-0093. IAWC notes that in this proceeding, it proposes to increase Central Zone rates by approximately $5.8 million – this increase will bring the Central Zone closer to Chicago Metro rates and continue the Company's transition towards single tariff pricing and a single consolidated wastewater tariff. Because many of the existing and future Central Zone customers come from systems that IAWC has acquired since its last rate case and which require significant investment in order to improve water quality and safety, this proposed rate increase does not, however, recover the entirety of the Central Zone revenue requirement increase.

Instead, the Company proposes to reallocate $11.8 million (or 20% of the Central Zone wastewater revenue requirement) to IAWC's existing water customers. IAWC argues that the impact of this reallocation is significant and undeniable. As explained above, if the Company sought to increase rates for Central Zone customers based on the total amount of the Central Zone revenue requirement increase, those customers would experience significant rate shock, doubling their bills with an average increase of approximately $31.35 per month. Under the Company's proposed reallocation, however, that rate shock would be alleviated, and Central Zone wastewater customers would experience an average bill increase of approximately $9.79 per month. In contrast, IAWC notes that the corresponding impact on the Company's water customers, who would absorb that revenue requirement reallocation, would be an average increase of only approximately $2.72 per month. As IAWC's affordability analysis shows, rates remain well within affordability benchmarks for both Central Zone wastewater, and importantly, water customers, under IAWC's proposal.

IAWC states that although multiple parties object to the Company's reallocation proposal, no party disputes the affordability analyses that underlie IAWC's proposal. IAWC points out that no party disputes that water industry fragmentation is a serious concern that has led national and state leaders to encourage acquisitions of small,

troubled systems and investment in deteriorating infrastructure that independently owned systems cannot provide.

IAWC states that the Company's proposal to reallocate a portion of wastewater revenue requirements to water customers allows the Company to manage needed investment in newly acquired systems in a way that maximizes the affordability of its service for all its customers, both newly acquired and existing. IAWC notes that it is true that the Company's proposal slightly increases costs for a large group of customers, by approximately four percent, but it does so to significantly improve affordability for smaller, more vulnerable, groups of customers. IAWC explains that this reallocation will benefit all communities by creating economies of scale and spreading the cost of system improvements across a bigger base.

And crucially, IAWC states, approval of its proposal would align the Commission's regulatory policy to be constructive and consistent with the intent of state law and policy—namely in recognizing that water and wastewater consolidation is in the public interest and provides communities that otherwise are unable to invest in and manage critical infrastructure a mechanism to ensure that their residents have access to clean water.

IAWC explains that approval of its proposal would promote Illinois environmental policy goals. As discussed above, IAWC states that the SVA supports the acquisition of and investment in smaller systems throughout Illinois, thereby improving water safety, reliability, and affordability throughout the state. IAWC's proposed wastewater revenue reallocation furthers the policy objectives of the SVA, in the ratemaking context. It represents a rate design that, at its core, establishes a regulatory path towards water equity, safety, and reliability through critical investments in vulnerable water and wastewater systems across the state while providing for affordability of service for all IAWC customers.

IAWC states that the Company already considers the potential rate impact of future investments on the acquired system and the customers in the consolidated rate class the acquired system will join when the Company's acquisitions are reviewed by the Commission. IAWC explains that for those acquisitions that were approved pursuant to the SVA, the Commission evaluated and ultimately approved each system's rate base, revenue requirement, any potential revenue shortfalls, proposed rates at close, and the full consolidation of those systems into the Company's existing tariff groups. IAWC notes that the SVA expressly authorizes this approach. 220 ILCS 5/9-210.5(f). IAWC asserts that all of its acquisitions were found to be necessary for the public convenience and necessity, and in no instance has the Commission determined that the proposed rates are contrary to the public interest. IAWC argues that the AG's request that the Commission "maintain the current regulatory landscape" ignores this law, contradicts Commission acquisition approval orders, and dismisses national policy urging regulators, stakeholders, and utilities to undertake exactly what IAWC is requesting here. AG IB at 25.

IAWC states that its proposal also represents a form of "consolidated pricing" or "consolidated water and wastewater revenue requirements" that the NARUC Resolutions on Water Equity recommend as a pathway to affordability:

> Whereas helping struggling customers pay their water and wastewater bills takes the combined effort of utilities, regulators, policy leaders, and communities. Potential pathways to address affordability include: … (5) *exploring whether consolidated pricing and/or consolidated water and wastewater revenue requirements assist utilities in leveraging economies of scale to achieve price stability by spreading costs across a broader customer base*;

IAWC Ex. 22.00 at 10 (emphasis added).

The Company states that the plain language of the NARUC Resolutions on Water Equity is a clear endorsement of IAWC's acquisition activity and the Company's proposal to reallocate a portion of its wastewater revenue requirement to water customers.

IAWC maintains that its proposal is also consistent with the NARUC Resolutions on Water Equity generally, which recognize prudent investment as the best means to improve water and wastewater efficiency and the importance of addressing water and wastewater sector fragmentation. *Id*. at 9-10.

IAWC states that the example of ESL starkly illustrates how IAWC's reallocation proposal supports NARUC and Illinois policy goals, and conversely how rejection of its reallocation proposal could frustrate those goals. IAWC states that ESL, where 30% of the population lives in poverty, faces significant problems with its wastewater system. ESL sought to sell the system in early 2020, issuing a Request for Qualifications ("RFQ") and Request for Proposals ("RFP") for a sale. IAWC Ex. 12.00 at 8. IAWC was very interested in the potential sale and believed that the Company could bring its substantial experience to the table and benefit the community by acquiring the System. Consequently, IAWC spent considerable time drafting a response to the RFP. But ultimately, IAWC notes, it did not submit a bid. IAWC explains that a major issue that kept arising in developing the bid was the level of customer rates. The rates necessary to support the purchase and, more significantly, the level of investment that would enable the Company to provide safe and reliable service, were higher than IAWC believed the community could afford. As IAWC's president explained, a modification in the regulatory landscape – a reallocation of the wastewater revenue requirement to water customers – was needed to help smooth the rate structure IAWC could offer to ESL residents while allowing necessary investments in the system.

IAWC asserts that it would be prepared to submit a bid for the system if the proposed wastewater revenue requirement reallocation were granted in this case. IAWC states that ESL needs to have safe, reliable, and affordable service for its citizens. IAWC notes that if an acquisition were to occur as a result, the Company would provide the much-needed management and operational expertise, as well as required capital investment in the ESL system. IAWC contends that this would be a tremendous benefit to the residents of ESL. The Company would be able to provide the same high level of service to wastewater collection customers as it currently provides to its water customers in ESL and to its wastewater customers, generally.

IAWC explains that parties' testimony in opposition to IAWC's wastewater revenue requirement reallocation proposal falls into three main categories: that the proposal is

contrary to the cost causation principle of rate design, that IAWC's proposal is "unfair" to water customers, and that the increase to Central wastewater rates reflects "mismanagement" on IAWC's part. IAWC states that none of these arguments blunt the point of the Company's proposal.

IAWC notes that much of the objection to the Company's proposal centers around perceived violation of the cost causation rate design principle. IAWC explains that while cost causation is the foundation of the Company's rate design proposals (as demonstrated in the Company's cost of service ("COS") studies), it is almost the entirety of Staff and Intervenors' rate design proposals in this case. IAWC further states that while it does not dispute that it is a widely accepted principle of rate design that customers should pay for the costs that they cause to be incurred – however, cost causation is not the only rate design principle that the Commission should consider when establishing rates, nor can it be. Additional factors that impact the development of rate design include consideration of principles like avoidance of undue discrimination, efficiency of use, gradualism and stability, predictability of revenue for the service provider, and social objectives such as affordability and equity. IAWC emphasizes that the balancing of rate design principles is well-established in Illinois and is recognized by the Act. The language of Section 1-102 of the Act clearly establishes that equitable rates can and should be based on more than cost causation alone. IAWC notes that Staff acknowledges that the Act contemplates the consideration of "factors other than cost of service in regulatory decisions." Staff IB at 46, *citing* 220 ILCS 5/1-102(d)(iv). Rather than prohibit or constrain the use of those additional rate design factors, the Act simply requires that, in the interest of the "fair treatment of consumers and investors … the rationale for [the consideration of factors other than cost of service] should be set forth." 220 ILCS 5/1-102(d)(iv).

IAWC contends that it is undisputed that strict adherence to cost causation does not guide every element of traditional rate design. For example, within districts and customer classes, IAWC argues that nobody would suggest that rates for customers served by a more expensive new main should be higher than those in a neighborhood served by an existing main. As IAWC has pointed out, the Company's proposal is analogous to other widely accepted practices that spread costs over a broader customer base in order to improve affordability for a smaller group of customers, even when one customer's actual cost of service varies from the cost to serve his or her neighbor. These practices include single tariff pricing, the use of energy efficiency and rebate programs by energy utilities, and the low-income tariff programs that are currently gaining traction in Illinois.

IAWC notes that while each opposing party dismisses out of hand the similarities between the Company's reallocation proposal here, and the widely accepted use of single tariff pricing, rebate programs, and – increasingly – low-income programs, no party is able to articulate how those approaches are functionally different. The Company's proposal to reallocate a portion of wastewater revenue requirement to water customers is in the public interest because it is in the long-term best interest of all customers, supporting necessary and critical investments in vulnerable water and wastewater systems across the state and ensuring that investments will continue to be made in these communities in a way that does not expose customers to rate shock while maintaining the affordability of water and wastewater services for all customers. IAWC argues that it is in the public

interest to charge larger groups of customers a little more in order to reduce costs for smaller groups of vulnerable customers, greatly improve affordability of service for them, and improve affordability for all customers.

IAWC notes that its proposed low-income tariff accomplishes the same goal. It moves costs away from a relatively small group of customers in order to significantly improve affordability of service for that group and moves those costs to a larger group of customers where the affordability of service is not significantly harmed. All parties in this case that have commented on the Company's proposed tariff support this effort. While the method of cost-recovery is still being litigated in this proceeding, non-low-income customers will be expected to assume increased costs to support a smaller, more vulnerable group of low-income customers. Non-low-income customers will not receive that service (the discounted volumetric rate) but will still assume costs associated with that benefit.

IAWC also explains that its proposal is analogous to designing rates for single tariff or consolidated pricing – charge larger groups of customers a little more to reduce costs for small groups of vulnerable customers, greatly improve affordability of service for them, and improve affordability for all customers. IAWC explains that single tariff pricing has long been ratemaking practice in Illinois generally and for IAWC specifically. As the Commission explained in IAWC's 2007 rate case, single tariff pricing is "the use of a unified rate structure for multiple water (or other) utility systems that are owned and operated by a single utility, but that may or may not be contiguous or physically interconnected" and noting that for the IAWC system, the Commission has approved gradual movement towards increased single tariff pricing. Docket No. 07-0507, Order at 94. And as the Commission found when approving the rate consolidation of many small water and sewer divisions for USI, consolidation "will allow the Company to spread capital costs over a larger base of customers, thus mitigating rate shock to a smaller stand-alone division's customer base when infrastructure improvements are necessary." *USI 2014 Rate Order* at 30.

IAWC believes that the same logic applies here. IAWC explains that consolidated ratemaking expands the customer base over which water and wastewater investments are made so that the cost impacts of those investments to customers can be smoothed out and ultimately minimized in the long run. IAWC explains that instead of individual communities' bearing the cost of significant investments when those investments are made in rate cases, those investments are spread over broader groups of customers to mitigate the impact of significant rate changes on everyone. All IAWC water and wastewater customers benefit from this consolidated pricing at varying times and will continue to do so in the future. The Company argues that its proposal to reallocate a portion of wastewater revenue requirements to water customers is a logical extension of that practice: it moves the immediate cost of upfront needed investment away from smaller communities where the cost impacts of those investments are significant to a larger group of water service customers, in order to mitigate the rate impacts of these needed investments for everyone.

IAWC states that parties' concerns ignore that IAWC is an integrated water and wastewater service utility. IAWC explains that water and wastewater services are - although sometimes separate - inextricably linked and often rely on the same services

related to collecting, treating, and moving water and wastewater. IAWC does all these things with the same workers, same tools and equipment, same service company, same funding and capitalization process, and the same capital structure for both water and wastewater operations. Rate design for individual services offered by a multi-service utility like IAWC necessarily involves an allocation of costs between the two services across the entire IAWC system of which all customers, including water-only customers, are a part of. More important, IAWC explains, the opposing parties ignore the indisputable fact that water and wastewater are part of one continuous cycle, from extraction from surface and groundwater resources to treatment, to distribution, to various uses, to collection, treatment and then discharge back into surface and groundwaters.

IAWC also states that its proposal is consistent with other key rate design principles as well. It supports the rate design principles of gradualism and affordability, while ensuring also that the Company is able to recover the Commission-approved revenue requirement needed in this case to effectively invest in and manage the business. In particular, IAWC notes, the reallocation supports gradualism by reducing the significant rate shock to Central Zone customers and improves affordability of service to this group of customers.

IAWC states that the proposal also supports the continued investment in communities across the state where water and wastewater investment is needed. Ultimately, the Company's proposal for reallocation of a portion of the wastewater revenue requirement to water customers takes a long-term view of rate design and its impact on continued investment and job creation in the state, and the affordability of service in communities across the state. IAWC explains that this proposal encourages and supports continued investment in water and wastewater systems and communities across the state while improving the affordability of service for customers both in the short term and in the long term.

IAWC explains that the Company's rate design proposals in this case are designed to recover targeted revenues by customer class for water customers and by tariff zone (Chicago Metro and Central) for wastewater groups. IAWC explains that the foundation for these targeted revenues is Revenue Stability and Cost Causation. IAWC explains that Revenue Stability is achieved by allocating the entire proposed revenue requirement to customer groups so that rates can be designed to recover the Company's approved revenue requirement. Targeted revenues then begin with the results of the Company's cost of service analysis, which allocates revenue requirements to customer class based on cost causation principles. IAWC explains that the class allocation of costs from the cost-of-service analysis, which reflect cost causation principles and only cost causation principles, are then adjusted to reallocate revenues from some classes to other classes to accommodate other rate design goals.

IAWC states that although COS is the foundation of IAWC's rate design, it is not the only consideration that may be used to determine whether rates are just and reasonable - the Commission is permitted under the Act to consider many factors other than costs when designing rates, including equity, which is the fair treatment of customers and investors. *USI 2014 Rate Order* at 29; 220 ILCS 5/102(d).

IAWC further states that any consideration of rate design must consider these principles too, as the testimony of the various parties on other rate design issues illustrates. For example, virtually all parties in this case have either proposed or agreed to rate design adjustments in the name of gradualism, and in some cases have argued that proposals made by the Company and other parties don't consider gradualism enough.

IAWC notes that its proposal to reallocate a portion of wastewater revenue requirement to water customers supports these other rate design principles, including gradualism and affordability, while ensuring also that the Company is able to recover the Commission-approved revenue requirement needed in this case to effectively invest in and manage the business. IAWC points out that the proposal also supports the continued investment in communities across the state where water and wastewater investment is needed.

IAWC states that as the parties' embrace of gradualism as a rate design principle in other contexts demonstrates, exclusive reliance on cost causation for rate design overlooks the complexity of measuring and allocating joint and common costs. IAWC maintains that avoidance of undue discrimination, efficiency of use, gradualism and stability and predictability of revenue for the service provider are also important rate design considerations. Social objectives, such as affordability and equity, are more recent principles that are also used by utilities and regulators to guide rate design decisions. IAWC's proposal to reallocate wastewater revenue requirements is consistent with these other rate design principles, and the fact that it is not strictly based on cost causation is not a basis to reject it.

The Company's proposal to reallocate a portion of wastewater revenue requirement to water customers is not "unfair" to water customers – it is in fact in the public interest because it is in the long-term best interests of all IAWC customers. IAWC notes that this proposal supports necessary and critical investments in vulnerable water and wastewater systems across the state and ensures that investments will continue to be made in these communities in a way that does not expose customers to rate shock, while maintaining the affordability of water and wastewater services for all customers.

IAWC points out that examples of this already exist. IAWC notes that low-income discount tariffs slightly increase costs for a large group of customers in order to significantly improve affordability for smaller, more vulnerable groups of customers. As discussed above, consolidated pricing spreads the costs of utility investments over large groups of customers so that individual groups of customers immediately benefiting from a large investment project aren't forced to absorb the entire cost of that investment as if they were making the investment on their own. IAWC also notes that consolidated pricing is now widely accepted as wise public policy because ultimately, it is in the long-term best interests of all customers. IAWC explains that water customers in one area of the Company's service territory might not get immediate direct benefit from paying for a portion of the Company's wastewater investments in another area because they receive sewer service from another provider, but they also do not immediately benefit from paying for a portion of the Company's water investments in that other area either. The Company has many water customers who today are not also wastewater customers, but the rate design that benefits all customers the most in the long-term is one that allows for making

cost-effective water and wastewater system investments without significantly impacting the affordability of service. IAWC concludes that the Company's proposal for reallocation accomplishes these goals.

IAWC argues that the Intervenors' objections to the Company's proposal are not persuasive because they look at rate design principles based on a snapshot in time. IAWC notes that there is little to no discussion from Intervenors around rate design policy and its effect on future investment in water and wastewater systems in the state, or the future affordability of service in the communities IAWC serves. But it is critical to take a long-term, not short-term view. IAWC states that the Company's proposal for reallocation of a portion of the wastewater revenue requirement to water customers takes a long-term view of rate design and its impact on continued investment, job creation, and the affordability of service in communities across the state.

IAWC also asserts that the Municipalities, which include Champaign, rely heavily on cost causation, arguing that the Company's proposed reallocation is "unjust and unreasonable…because it would make customers pay for a service they do not receive." Municipalities IB at 8. As an example, the Municipalities argue that "it is neither appropriate from a rate design or policy perspective to have Champaign customers subsidize customers in other locations through the State of Illinois by surcharging them for services that are not provided to them by IAWC." *Id* at 6. IAWC asserts that the premise of this argument – that IAWC is "surcharging" Champaign for services that are not provided to them by IAWC – is incorrect. IAWC is not charging water customers for a service it is not providing, IAWC is charging water customers for water service. The rates for that water service are higher than a strict 1:1 ratio to the cost of service. But this is not unusual – it is routine for rate design proposals to set rates that do not match the cost of service; in fact, various parties have proposed rate designs that do not exactly match the COS.

IAWC further notes that the Municipalities' opposition to the socialization of costs associated with utility services that do not confer a direct benefit is surprising, considering that in the Company's 2007 rate case, the Commission approved significant investment in Champaign, including a new production and treatment facility and six new wells. Docket No. 07-0507, Order at 49-52. The cost of those investments in Champaign totaled approximately $60 million. Docket No. 07-0507, IAWC Ex. 7.00 (Rev.) at 18. In a subsequent rate case, the Commission approved consolidation of Champaign into IAWC's Zone 1 tariff group, thereby spreading the costs of the Champaign investments over a larger customer base, sparing Champaign residents higher rates. Docket No. 09-0319, Order at 154. Champaign, a party to that proceeding, notably, did not object to having the costs of those investments allocated to other IAWC customers.

Thus, IAWC concludes, while water-only customers in Peoria and Champaign may not immediately benefit from supporting wastewater investments in Alton and Granite City, all customers on the system at one point will benefit from the ability to spread investment costs in individual communities across a large statewide customer base through. Water customers in Champaign helping to support wastewater investments in Alton is not fundamentally different than water customers in Champaign helping to support water investments in Alton, and vice versa. IAWC maintains that this

arrangement is ultimately in the long-term best interest of all customers, as it helps improve the affordability of service across the state.

IAWC states that another misguided claim in opposition to IAWC's proposal is that acquisition activity was not managed effectively given the rate shock for Central Zone wastewater customers (in the absence of reallocation), and the suggestion that if the magnitude of Central Zone wastewater costs proposed for recovery are excessive, the Company's shareholders should share this cost burden.

IAWC explains that this unsubstantiated assertion is contradicted by examples that show the opposite: IAWC is effectively managing its acquisitions to provide investment with tangible customer benefits, and so fulfilling the policy goals discussed above and reflected in mechanisms like the SVA. IAWC notes that each acquisition has been reviewed and approved by the Commission and found to be required for the public convenience and necessity. IAWC states that there are clear examples that demonstrate that IAWC's acquisitions were not only managed effectively, but they provided specific and tangible benefits to those systems and to the State, as a whole.

IAWC states that significant infrastructure investment in newly acquired systems is not a sign of mismanagement, but is expected, especially in situations where the acquired systems may have been under-invested in the past. IAWC explains that these investments affirm that IAWC is making the infrastructure improvements which are necessary to advance the public interest of Illinois and its citizens, as well as providing the environmental resources for now and into the future, in ways that were directly expected when the acquisitions were approved. In fact, because these investments and the increase in rates they often necessitate were directly anticipated, and in many cases have already been reviewed by the Commission as part of QIP reconciliation and acquisition approval dockets, the assertion that shareholders should bear the revenue shortfall is completely untenable. IAWC notes that this is especially true when the investments made in these under-capitalized systems benefit the State and its citizens in the form of cleaner water and jobs created by the construction activities.

In summary, IAWC states that it is essential that the Commission's regulatory policy be constructive and consistent with the intent of state law — namely in recognizing that water and wastewater consolidation is in the public interest and providing communities that otherwise are unable to invest in and manage critical infrastructure a mechanism to ensure that their residents have access to safe and reliable water and wastewater service. IAWC maintains that reallocation will benefit all communities by creating economies of scale and spreading the cost of system improvements across a bigger base, while at the same time supporting investment in smaller, under-invested systems and improving water quality and meeting state policy goals. Parties' objections to IAWC's proposal disregard both the long-term environmental benefits and economies of scale that the wastewater revenue requirement reallocation supports, for IAWC's recently acquired wastewater systems and for systems where IAWC's investment could make a real difference, like ESL. But IAWC urges the Commission to focus on these important policy goals and approve its wastewater revenue requirement reallocation proposal to support them.

**b. Staff's Position**

Staff recommends the Commission reject the Company's proposal to reallocate approximately $11.8 million of IAWC's wastewater revenue requirement to be recovered from IAWC's water customers. Staff Ex. 15.0 at 14.

Staff notes that one of the fundamental goals of equitable ratemaking is that the costs of supplying public utility services are allocated to those who cause the costs to be incurred. 220 ILCS 5/1-102(d)(iii). In fact, the Act indicates that if factors other than COS are considered in regulatory decisions, the rationale for these actions should be set forth. 220 ILCS 5/1-102(d)(iv). Thus, Staff argues COS and cost causation should be primary considerations for the Commission.

Staff witness Boggs explained that although concepts such as gradualism, undue discrimination, and efficiency of use, among others, can be considered in rate design proposals, the Company's proposal to reallocate costs from one utility service to another utility service would violate basic cost causation principles. Basic cost causation principles would necessitate wastewater customers to pay rates to recover all costs that the Company incurs to provide service to wastewater customers. Staff opines that IAWC's proposal to have water customers pay rates so the Company can recover a portion of the costs to serve wastewater customers runs counter to the cost causation principles of rate design. Staff Ex. 7.0 at 37.

IAWC witness Rea argues that the Company's proposal is in the public interest in the same way as single tariff pricing and the rebate programs applicable to Illinois gas and electric utilities. IAWC Ex. 18.00 at 34. Staff asserts that Mr. Rea's argument is without merit. Single tariff pricing is guided by ratemaking principles whereas the Company's proposal runs afoul to ratemaking principles since it results in water customers subsidizing wastewater customers. Staff argues that there is very little parallel between the Company's reallocation proposal and single tariff pricing. In Docket No. 92-0116, single tariff pricing was an issue in the Company's rate case proceeding. *Ill.-Am. Water Co*., Docket No. 92-0116, Order at 35-46 (Feb. 9, 1993). In Docket No. 92-0116, the Company proposed to consolidate the Southern Zone to achieve consolidated pricing for the Company's Southern Division. Staff agreed with IAWC's single tariff pricing proposal to consolidate pricing of the Company's Southern Division (which has since been consolidated with the Central Division). *Id*. at 38. In Docket No. 92-0116, the Southern Division to be consolidated was a water division only. Staff explained that although differences existed in the COS for each of the separate districts to be consolidated, each district had similar sources of supply; the districts shared common costs and paid the same Customer Charge; had similar usage characteristics by customer class; and the Company would have a larger base of customers to spread costs so no individual district would be impacted severely if a capitol project became necessary for an individual district. *Id*. The Commission approved the Company's proposal to implement single tariff pricing in the Southern Division. *Id*. at 45.

Staff argues that this proceeding is distinguishable from Docket No. 92-0116 for multiple reasons. Specifically, IAWC's water and wastewater customers do not have the same Customer Charges (current Customer Charge for Central Division water is $20, current Customer Charge from Central Zone wastewater is $14.50); water and sewer

customers do not have the same usage characteristics; and water and wastewater are separate utility services. Further, in Docket No. 92-0116, customers were not paying monthly fees to an unrelated utility while also subsidizing the costs to serve a different utility from which they received no services, as would be the case with IAWC customers in Champaign and Farmington in this proceeding. Thus, Staff asserts that the Company's comparison of its proposed reallocation to single tariff pricing fails.

Furthermore, Staff notes there is no enabling legislation in Illinois that allows reallocation of costs from one utility service to an entirely different utility service. The Company states, "The Commission is not prohibited from making an allocation of wastewater revenue requirements to water customers when designing rates." IAWC IB at 78. Staff states that the Company's assertion is misguided. One of the fundamental goals of equitable ratemaking is that the costs of supplying public utility services are allocated to those who cause the costs to be incurred. 220 ILCS 5/1-102(d)(iii). In fact, the Act indicates that if factors other than COS are considered in regulatory decisions, the rationale for these actions should be set forth. 220 ILCS 5/1-102(d)(iv). Thus, Staff notes, the Act requires the Commission to consider COS and cost causation in setting rates.

Staff recommends that the Commission reject the Company's proposal to reallocate a portion of the Company's wastewater revenue requirement to water customers and recommends that the revenue shortfall be recovered by Central Zone wastewater customers through rate design. Staff Ex. 7.0 at 38-39. Specifically, Staff witness Boggs recommends instituting smaller annual increases for Central Zone wastewater rates until rates are adequate to generate full COS revenue recovery. *Id*. Staff's approach would not involve re-allocating costs to an entirely different utility service customer base. Staff argues that its approach is consistent with the rate design concept of cost causation – i.e., recovering costs from those who caused the cost to be incurred – which is a primary objective of rate design. *Id*. at 38-39. Staff also argues its proposal is consistent with the guiding rate design principles of gradualism, simplicity and feasibility, and affordability. Staff Ex. 15.0 at 14. Implementing annual step increases in rates, as proposed by Staff witness Boggs, would benefit customers by reducing the magnitude of rate increases in the short-term and gradually increase rates until the Company reaches full revenue recovery from Central Zone wastewater customers – i.e., gradualism. Staff Ex. 7.0 at 39.

#### c. AG's Position

The AG requests that the Commission reject the Company's proposal to reallocate $11.8 million of its Central Zone wastewater revenue requirement to water customers, who in most cases do not receive wastewater service from IAWC. Tacitly acknowledging that this would be radical departure from well-settled ratemaking policy, the Company asked for a "modification in the regulatory landscape." IAWC Ex. 12.00 at 9. The AG urges the Commission to decline IAWC's invitation to "evolve modern ratemaking" in this manner because it would be contrary to the Act, violate well-settled ratemaking principles, and would result in unfair and unreasonable rates to water customers.

The fundamental dictate of ratemaking under the Act is that all rates or other charges "be just and reasonable," and "[e]very unjust or unreasonable charge . . . is

hereby prohibited and declared unlawful." 220 ILCS 5/9-101. To aid in the interpretation of this statutory directive, the AG explains how the Act specifies that utility regulation should be designed to promote fair and equitable treatment of consumers and investors, meaning, in part, that "the cost of supplying public utility services is allocated to those who cause the costs to be incurred." 220 ILCS 5/1-102(d)(iii).

Accordingly, the principle of cost causation—that the COS should be paid by those who cause it—is a requirement of the Act and is well-established in Commission practice. *See, e.g*., Docket No. 17-1106, Order at 61 (adopting Staff's recommendation to remove demand-related costs from proposed customer charges because it was "consistent with cost causation principles); *Commonwealth Edison Co.*, Docket No. 10-0467, Order at 231-32 (May 24, 2011) (concluding that "it is important to design rates that reflect cost causation" and when rates "do not accurately reflect cost causation, that inefficiency results and society suffers"); *Central Ill. Light Co. d/b/a AmerenCILCO*, Docket Nos. 09-0306–09-0311 (Cons.), Order at 295 (Apr. 29, 2010) ("It is a widely held ratemaking policy that rates should be designed to reflect cost causation, maintain gradualism, and avoid rate shock."). For this reason, combination gas and electricity utilities, such as Ameren and MidAmerican Energy Company, set the rates for each service separately. For example, the revenue requirement for Ameren gas and electric services are set independently, with its electric delivery service set under Section 16-108.5 (*see Ameren Ill. Co. d/b/a Ameren Ill.*, Docket No. 21-0365), whereas its gas delivery service is set under Article IX of the Act. *See* Docket No. 20-0308.

Illinois courts have held that it is unjust and unreasonable for a water and sewer utility to charge individuals for a service they do not receive. *Citizens Util. Co. v. Ill. Com. Comm'n*, 157 Ill. App. 3d 201, 206-207 (1st Dist. 1987). In *Citizens Util. Co*., the Commission found that a water and sewer utility "charged a noncustomer for services which were never rendered" for seven years and ordered the utility to repay the amounts in question. *Id.* at 206. As the court noted, "it would be difficult to envision a more unjust and unreasonable charge than for a service never rendered by a utility." *Id.* at 207 (internal quotations omitted). The situation in this proceeding is scarcely different for the Company's water customers — like the residents and businesses in the Municipalities — who already obtain wastewater service from a different provider. IAWC is asking these customers to pay for a service they do not receive. The AG therefore requests, consistent with case law, that the Commission reject this "unjust and unreasonable charge" for "services never rendered." *Id.* at 206.

The AG also points out that legislation enabling this type of reallocation has been proposed, and rejected, multiple times, providing further proof that such a reallocation would exceed the Commission's authority. Legislative archives show that multiple bills have been introduced in the General Assembly that would change the language of the Act to expressly allow water and wastewater utilities to allocate costs across services. In each case, the Company actively supported these bills by filing witness slips in support. And in each case, the bills failed to become law. Having failed to secure the necessary legislation, the Company is now asking the Commission to exercise authority it has, to date, not previously claimed. The Commission should deny the Company's attempt at an end run around the legislative process and continue to apply fundamental ratemaking principles that are consistent with the Act and fundamental fairness.

The Company attempts to dodge the issue of cost causation by arguing that the Commission may consider ratemaking principles other than cost causation when approving rate designs. *USI 2014 Rate Order* at 29-30. In the *USI 2014 Rate Order*, the Commission concluded that it "is permitted under the Act to consider many factors other than costs when designing rates," including "equity, which is the fair treatment of customers and investors." *Id*. at 29 (*citing* 220 ILCS 5/1-102(d)). The Company argues that, in addition to cost causation, the Commission ought to consider principles such as revenue stability, efficiency of use, gradualism, avoidance of undue discrimination, simplicity and feasibility, and affordability. But as the AG explains, the Company's proposed rate design failed on its own terms because the balance of these factors clearly weighs against the reallocation of sewer costs to water customers.

First, the AG explains that the Company does not further the cause of equity by using a radical approach to rate design to enable the Company to acquire more systems, as the Company's use of the ESL demonstrates. The Company, which currently provides water service to ESL, claimed that it "would be prepared to submit a bid" on the ESL wastewater system if the reallocation were approved. IAWC IB at 94. The Company declined to submit a bid previously out of concern that the community would not be able to pay the higher rates associated with IAWC's management of the system. *Id*. But under the Company's proposed reallocation, "[ESL] water customers, like all water customers, would be paying higher water rates to cover the cost of wastewater acquisitions of other systems." AG Ex. 4.0 at 11. Regardless of whether the Company ultimately acquires, or even bids on, ESL's wastewater system, under the Company's approach, ESL water customers would see an increase to their bills that they can ill-afford under the Company's proposal.

The AG likewise explains how the other factors the Company urges the Commission to consider do not support the proposed reallocation. Recovering the COS from customers who do not receive the service is neither simple nor feasible, and it unduly discriminates against those customers who do not receive sewer service from IAWC. As for gradualism and affordability, the alternative rate design proposed by Staff discussed below would address these important principles by phasing in the increased rates over time while at the same ensuring that the COS is borne by those who caused it. Staff Ex. 7.0 at 39.

IAWC also argued that the reallocation is "analogous to designing rates for single tariff or consolidated pricing," which "has long been ratemaking practice in Illinois generally and for IAWC specifically." IAWC IB at 95. As AG witness Larkin-Connolly explained in rebuttal, "[w]hile it is correct that principles such as single tariff pricing are designed to capture the stability and benefits of economies of scale for a large customer base, pricing is based on the costs of providing a consistent service to consumers." AG Ex. 4.0 at 14. The Company "ignores the requirement that costs be related to the service customers actually receive by suggesting that recovering wastewater costs from water customers is somehow akin to single tariff pricing." *Id*. at 248-50. The Company's analogy failed because "it does not accurately parallel the scenario where a water-only customer, that has a septic system or is served by a non-IAWC wastewater provider, is asked to subsidize wastewater services *it does not and cannot* receive." *Id*. at 15 (emphasis in original). Moreover, the Company's claim that the proposed reallocation had "long been

ratemaking practice in Illinois" is contradicted by the Commission's consistent treatment of gas and electric services provided by the same utility as separate (as noted above), the Commission's rules (83 Ill. Adm. Code 280) that require separate billing for separate services, and the Company's inability to point to a modern example of the Commission having approved a comparable rate design.

The AG explains that the proposed reallocation is proscribed for good reason, as it would result in unjust and unreasonable rates for those customers who are asked to pay for a service from which they receive no benefit. In the Central Zone alone, only 25% of IAWC water customers also receive wastewater service from the Company, meaning that 75% of Central Zone water customers get their wastewater service from elsewhere, either via septic systems or another provider. AG Ex. 2.0 at 16. Thus, under the Company's proposal, the vast majority of water customers would be paying for wastewater services from another provider and for IAWC services that they do not receive. *Id*.

The AG points out that the Company's proposal is even more unreasonable when considering why the Company is seeking to reallocate the wastewater revenue requirement to water customers. The Company claimed that the reallocation is necessary to prevent rate shock. *See* IAWC Ex. 7.00 at 16. But the Company admitted that the only customers who would experience significant rate increases without the reallocation are those on newly acquired systems. AG Ex. 2.3. In other words, the Company is seeking to reallocate wastewater revenue because, by its own admission, its costs exceed what it can reasonably expect to charge these newly acquired customers and maintain affordable wastewater service. *Id*. This is troubling given that the Company has acquired 29 water and wastewater systems since its last rate case, with at least eight more on the way. IAWC Ex. 4.05. Based on the testimony submitted in this proceeding, the Company expects this trend to continue, and it appears its appetite for acquisitions is directly related to its request for the ability to reallocate revenue requirements across types of service. *See* IAWC Ex. 12.00 at 2 ("With the reallocation of a portion of IAWC's wastewater revenue requirement, [IAWC] will have the regulatory treatment needed to support acquiring and investing in these systems . . . ."). In light of this admission, the AG cautions the Commission against straying from well-established ratemaking principles, which would encourage IAWC to make costly acquisitions that harm existing ratepayers and will result in rate shock for the acquired customers.

The Company claims that the SVA (220 ILCS 5/9-210.5), which was enacted in 2013 and renewed in 2018, is evidence that this type of reallocation is consistent with a State policy of promoting system consolidation. The Company claims that the SVA provided a "streamlined mechanism" through which utilities can obtain approval to acquire smaller systems, addressing the issue of water system fragmentation. Because the legislature purportedly supports system consolidation, the Company reasons, then it must also support novel rate designs like the proposed reallocation in order to facilitate acquisitions of smaller water and sewer systems. But the AG points out that nothing in the SVA indicates a legislative intent, implicit or otherwise, to disregard traditional ratemaking principles such as cost causation. Indeed, the General Assembly has on multiple occasions refused attempts to make this reallocation the explicit policy of the State of Illinois. The AG urges the Commission to resist making policy judgments that

the General Assembly considered and rejected to upend long-settled principles of rate regulation.

Instead, the AG argues that the Commission should maintain the current regulatory landscape to ensure that acquisitions by private companies are in the public interest. As Mr. Larkin-Connolly testified, "a water utility should be encouraged to appropriately account for costs and risk when it acquires systems, while at the same time ensure that the acquired customers continue to receive affordable service." AG Ex. 4.0 at 13. Moreover, this should be done "without unfairly burdening existing customers or customers who do not receive the service (i.e., wastewater services) from IAWC." *Id*. at 13. Put simply, when determining whether to acquire a system, the Company should "consider the potential rate impact of future investments on the acquired system and the customers in the consolidated rate class the acquired system will join." *Id*. at 19. If shareholders are unwilling to bear the consequences of costly acquisitions, they should not be made.

In lieu of the reallocation, the AG recommends that the Commission adopt the approach proposed by Staff witness Boggs. *See* Staff Ex. 7.0 at 38-39. Under Mr. Boggs' approach, the Company would "institute annual step increases that are one-sixth of the way to full cost recovery for the next six years," which corresponds to the amount of time since the Company's last rate case filing. *Id*. at 38. This approach would adhere to the established rate design principles of gradualism and cost causation. Staff Ex. 7.0 at 39; AG Ex. 4.0 at 20. While this approach would result in a portion of the wastewater revenue remaining unrecovered from ratepayers, Staff Ex. 7.0 at 39, the AG argues that the Company's shareholders should bear the cost of management's decisions to acquire these wastewater systems. The Company's shareholders benefit from the wastewater acquisitions far more than the water customers in the Municipalities, and when expenses are incurred "to achieve goals that primarily benefit shareholders, then it is reasonable to require that shareholders bear the cost of that [expense]." *See People ex rel. Madigan*, 2011 IL App (1st) 100654, ¶54.

The AG argues that the Company is asking the Commission to exercise unprecedented authority. The Company admitted as much when it asks the Commission to "evolve modern ratemaking" and "modify the regulatory landscape" by approving the proposed reallocation. IAWC IB at 80, 94. As the AG points out, legislation enabling this type of reallocation has been proposed and rejected multiple times. Even if the Commission could exercise this extraordinary legal authority, the AG argues, it should decline to do so here because the Company has failed to demonstrate a compelling rationale from a public policy and rate regulation perspective. Thus, the Commission should not approve an unjust and unreasonable rate design that the legislature and courts have refused to endorse. For these reasons, the AG requests that the Commission deny the Company's request to reallocate a portion of its wastewater revenue requirement to water customers.

#### d. IIWC/FEA/CUB's Position

IIWC/FEA/CUB take the position that IAWC's proposed reallocation of wastewater revenue requirements to water customers violates basic principles of cost causation. Staff Ex. 7.0 at 37. IIWC/FEA/CUB witness Walters testified that the Company's proposal

to have water customers subsidize service to wastewater customers should be rejected. If there is a need to mitigate the increase in rates to wastewater customers, it would be appropriate to spread the wastewater COS over all IAWC wastewater customers in the State. IIWC/CUB/FEA Ex. 1.0 at 76. It is not appropriate to require customers of the water utility to subsidize service for customers of the wastewater utility. *Id*. The requested subsidy should be denied.

IIWC/FEA/CUB note that Staff has made a proposal, which would mitigate the rate increase that would result for wastewater customers if there is no reallocation of a portion of the Central Zone wastewater revenue requirement to water customers. Staff has proposed that IAWC institute an annual six-step increase for Central Zone wastewater customers, until wastewater rates are set at a level that allows recovery of the wastewater revenue requirement from wastewater customers, without recovery of any wastewater revenue requirement shortfall from other customer groups. Staff Ex. 7.0 at 38-39. In the alternative, IIWC/FEA/CUB agree with Staff's proposal and maintains their opposition to any reallocation of the Central Zone wastewater revenue requirement to water service customers.

**e. IIWC/FEA's Position**

IIWC/FEA oppose the reallocation of the wastewater revenue requirement to water customers. IAWC originally proposed to reallocate $14,284,494 (reduced to $11.8 million in rebuttal) in costs to serve Central Zone wastewater customers to all water customers. IAWC Ex. 7.00 at 14; IAWC Ex. 18.00 at 42.

IIWC/FEA note, as several witnesses testified in this proceeding, shifting costs of wastewater customers to water customers is contrary to cost causation principles and wastewater revenue requirements should be recovered from wastewater customers. IIWC/FEA Ex. 1.0 at 12-13; Champaign Ex. 1.0 at 4-5; Staff Ex. 7.0 at 37; AG Ex. 2.0 at 16. Furthermore, IAWC's proposal to reallocate wastewater costs to water customers violates a primary rate design objective to recover costs from those who cause the incurrence of those costs. Staff Ex. 7.0 at 39. IIWC/FEA confirm it is an underlying goal and objective of regulation in Illinois that "the cost of suppling public utility services is allocated to those who cause the cost to be incurred." 220 ILCS 5/1-102(d)(iii). IIWC/FEA argue the evidence in this case supports the conclusion that the reallocation of wastewater revenues to water customers would result in unfair and inequitable water rates and, thus, is inappropriate from a ratemaking perspective. AG Ex. 2.0 at 4-5.

IIWC/FEA recommend spreading the original $14.3 million Central Zone wastewater revenue requirement (now $11.8 million) across all IAWC wastewater customer classes in Illinois. IIWC/FEA assert this approach better reflects cost causation and is consistent with how water rates have been transitioning to consolidated or single tariff pricing over the years. IIWC/FEA Ex. 1.0 at 13. Under this approach, the entire water revenue requirement would remain with water customers across the State and the wastewater revenue requirement would remain with wastewater customers throughout the State. *Id*.

In the alternative, IIWC and FEA believe Staff's recommendation to phase in the increase necessary for wastewater customers, as proposed by Staff witness Boggs, would be an appropriate approach. Mr. Boggs recommended a six-step annual rate

increase for the Company to allow it to fully recover the cost to serve Central Zone wastewater customers through equal and progressive annual increases until IAWC files its next rate case. Staff Ex. 7.0 at 39. IIWC and FEA understand that under the Staff's proposal, any revenue shortfall from wastewater customers associated with the six-step approach would be the responsibility of the Company. *Id*. at 38-39.

IIWC/FEA conclude the Commission should reject IAWC's proposal to reallocate a portion of the wastewater revenue requirement for the Central Zone to water customers. IIWC/FEA point out the proposal is inconsistent with fundamental ratemaking principles and Illinois regulation. IIWC/FEA also note the reallocation is opposed not only by IIWC/FEA, but also the AG, Champaign, and Staff.

IIWC/FEA recommend that the Commission adopt the IIWC/FEA proposal to spread the Central Zone wastewater requirement among all wastewater customers in the State or, in the alternative, adopt Staff's six-step increase approach to phase in the increase for wastewater customers, with any shortfalls in recovery from wastewater customers being the responsibility of the Company.

**f. Municipalities' Position**

The Municipalities oppose IAWC's request to shift $11.8 million of wastewater revenue requirements to water customers, which would impose improper charges on water customers who do not even receive wastewater service from the Company. Imposing costs on customers who do not receive the services is inappropriate and contrary both to established Commission practice and the Act.

The Municipalities witness Nagy testified that Champaign maintains its sanitary sewer collection system within Champaign's city limits. Wastewater treatment is provided by the Urbana and Champaign Sanitary District ("UCSD"), a municipal corporation created in 1921 to provide wastewater treatment for Champaign, Urbana, and the Villages of Bondville and Savoy. Champaign Ex. 1.0 at 2-3. The monthly bill for sewage treatment for a residential customer using 3,500 gallons of water is $20.39 per month in Champaign. Champaign Ex. 1.0 at 4. "For Champaign customers who already pay separate wastewater fees, it is neither appropriate from a rate design or policy perspective to have Champaign customers subsidize customers in other locations through the State of Illinois by surcharging them for services that are not provided to them by IAWC." Champaign Ex. 1 at 4-5. IAWC's proposal would require customers located within the Municipalities to pay twice for wastewater service—once to the entity that actually provides the service and a second time to IAWC for "services" that the Company does not, and cannot, provide.

The Act requires that a utility's rates and other charges for "any service rendered or to be rendered" must be just and reasonable. 220 ILCS 5/9-101. "A public utility is entitled to just and reasonable compensation for the service given to the public." *United Cities Gas Co. v Ill. Commerce Comm'n*, 163 Ill.2d 1, 23-24. It is, therefore, just not reasonable for utility customers to pay more than what the service provided to them is reasonably worth, nor should they pay for costs not legitimately incurred for their benefit. *Id*. at 24. In *Citizens Util. Co.*, the water utility provided no wastewater service but charged the customer for the service. The court agreed with the Commission's ordering a refund of the charges because "it would be difficult to envision 'a more unjust and unreasonable

charge than for a service never rendered by a utility.'" *Citizens Util. Co.*, 157 Ill. App. 3d at 207. The Commission "must ensure that consumers are treated fairly (220 ILCS 5/1102(d) (West 2008), that the 'application of rates is based on public understandability and acceptance of the reasonableness of the rate structure and level.'" *Apple Canyon Lake Prop. Owners' Ass'n v Ill. Commerce Comm'n*, 2013 Il App (3d) 100832, ¶41.

IAWC argues that the improper cost shifting was necessary because, if the Company had to collect the wastewater costs from wastewater customers, those customers would see a large increase in their bills. The Municipalities assert that the problem is one of IAWC's own making. The Company admitted that it made various acquisitions of wastewater systems by apparently paying too much for them, leaving IAWC with insufficient capital to make necessary improvements. AG Ex. 2.0 at 15. The Commission should not encourage the Company to continue making bad investment decisions by allowing it to impose improper costs on water customers who do not benefit from IAWC's wastewater system. As the court noted in *Central Ill. Pub. Serv. Co. v Ill. Commerce Comm'n*, 243 Ill. App. 3d 421, 428 (4th Dist. 1993), one of the goals and objectives of utility regulation "is to ensure that 'the cost of supplying public utility services is allocated to those who cause the costs to be incurred.'" *Id*. at 428. To allow IAWC to allocate wastewater costs to water customers would violate the goal and objective of allocating costs to those who cause the costs to be incurred.

**g. Commission Analysis and Conclusion**

The Commission agrees with Staff and Intervenors that allowing IAWC to reallocate approximately $11.8 million of IAWC's Central Zone wastewater revenue requirement to be recovered from IAWC's water customers would violate the standard principle of cost causation. A regulatory objective in Illinois is that "the cost of suppling public utility services is allocated to those who cause the cost to be incurred." 220 ILCS 5/1-102(d)(iii). IAWC's proposal would be a direct violation of this principle and it is rejected.

IAWC points to policy direction from NARUC. Policy directions are not statutory regulations, like the principle of cost causation. As other parties indicate, such a policy change would be more appropriately addressed by the General Assembly.

The Commission understands the problems faced by small water and wastewater companies and the aging of those systems. IAWC made the business decision to acquire 14 wastewater systems since its last rate case, six of which were incorporated into the Central Zone division, that need improvements to the wastewater systems. As a result of IAWC's business decisions, this results in the current problem of a significant increase in rates to wastewater customers in the Central Zone. Staff's general proposal to gradually increase rates to customers in the Central Zone appears reasonable. However, Staff's proposal to have any revenue shortfall be covered by the Company would result in IAWC being unable to recover its Commission-approved revenue requirement, and thus violate the Commission's policy of implementing cost-based rates. Therefore, the Commission rejects Staff's proposal as written.

Both IAWC and IIWC/FEA's proposals, in different ways, attempt to mitigate rate shock by spreading out the costs over a larger customer base. While IIWC/FEA's proposal to allocate the original $14.3 million (now $11.8 million) of IAWC's Central Zone

wastewater revenue requirement to all wastewater customers in Illinois to some extent also goes against cost causation principles, it at least applies to customers that are receiving the same type of services from IAWC.

The Commission finds value in combining elements of both Staff's initial proposal and IIWC/FEA's proposal in a way that avoids under-recovery by IAWC of its full revenue requirement and sunsets the allocation of portions of Central Zone's wastewater revenue requirement across all IAWC's wastewater customers within a fixed time-frame. Accordingly, based on the evidence and proposals presented in this docket, the Commission adopts the following approach: re-allocating in the first year following the effective date of the new rates the $11.8 million in IAWC's Central Zone wastewater revenue requirement across all IAWC's wastewater customers statewide, as IIWC/FEA propose, followed in the second through sixth years by an incremental phase down of the socialization, similar to what Staff proposes. Specifically, beginning in the second year after the rates' implementation, the share of the $11.8 million Central Zone wastewater revenue requirement borne by the non-Central Zone wastewater rate customers should be reduced from non-Central Zone rates by one fifth, with an equivalent amount added to the Central Zone wastewater rates. This incremental shifting of costs from the non-Central Zone to the Central Zone should continue annually each year for five years. Thus, beginning in the sixth year after the rates are implemented, Central Zone wastewater rates will fully satisfy cost causation principles by entirely recovering the $11.8 million in revenue requirement at issue. Simultaneously, in the sixth year, non-Central Zone wastewater rates will cease covering any portion of Central Zone wastewater revenue requirement. The Table below illustrates the Commission's adopted approach.

| Example Methodology Table for Allocation of $11.8 Million in Revenue Requirement Across IAWC Wastewater Rate Zones | | | |
|---|---|---|---|
| **Year** | **Non-Central Zone Wastewater Rate Allocation** | **Central Wastewater Rate Zone Allocation** | **Total IAWC Revenue Requirement Recovered** |
| Year 1 | # Non-Central Zone Ratepayers / Total # IAWC Wastewater Ratepayers * $11.8 Million | # Central Zone Wastewater Ratepayers / Total # IAWC Wastewater Ratepayers * $11.8 Million | $11.8 Million |
| Year 2 | (% Non-Central Zone Ratepayers out of Total * $11.8M) * 0.8 | (% Central Zone Ratepayers out of Total * 11.8M) + (% Non-Central Zone Ratepayers out of Total * 11.8M * 0.2) | $11.8 Million |

| | | | |
|---|---|---|---|
| Year 3 | (% Non-Central Zone Ratepayers out of Total * $11.8M) * 0.6 | (% Central Zone Ratepayers out of Total * 11.8M) + (% Non-Central Zone Ratepayers out of Total * 11.8M * 0.4) | $11.8 Million |
| Year 4 | (% Non-Central Zone Ratepayers out of Total * $11.8M) * 0.4 | (% Central Zone Ratepayers out of Total * 11.8M) + (% Non-Central Zone Ratepayers out of Total * 11.8M * 0.6) | $11.8 Million |
| Year 5 | (% Non-Central Zone Ratepayers out of Total * $11.8M) * 0.2 | (% Central Zone Ratepayers out of Total * 11.8M) + (% Non-Central Zone Ratepayers out of Total * 11.8M * 0.8) | $11.8 Million |
| Year 6 | (% Non-Central Zone Ratepayers out of Total * $11.8M) * 0.0 | (% Central Zone Ratepayers out of Total * 11.8M) + (% Non-Central Zone Ratepayers out of Total * 11.8M * 1.0) | $11.8 Million |

This compromise mitigates rate shock, permits IAWC to recover its full revenue requirement, and adheres to rate design principles of cost causation, gradualism, and affordability without shifting some portion of the $11.8 million at issue onto the IAWC's non-Central Zone water or wastewater customers for a potentially longer period, until IAWC's next rate case.

### 2. COS Studies

#### a. IAWC's Position

IAWC explains that its water and wastewater COS studies, provided as IAWC Exhibits 7.05 and 7.06, are analyses that calculate IAWC's total investment and operating costs incurred to provide service to various customer groups, or service classes, for the purpose of establishing cost-based rates. IAWC explains further that the COS studies provided in this proceeding allocate the Company's total revenue requirement for water and wastewater operations, respectively, to various cost categories. The revenue requirement for each of those cost categories are then allocated to customer classes using a class allocation factor that differs depending on the nature of the costs.

IAWC explains that the methodology used in the COS studies in this proceeding differs from that used in Docket No. 16-0093, where the Company's external consultant allocated account balances directly to customer class using an appropriate class allocation methodology. In this proceeding, however, the Company has determined that its proposed two-step COS allocation methodology simplifies its cost-of-service analysis and makes the resulting allocation to customer classes more intuitive. IAWC states that adopting an approach that first allocates revenue requirement and account balances to cost categories, after which the cost category revenue requirements are allocated to customer classes, unbundles the Company's revenue requirement into business functions and allows stakeholders to see what the COS is for each customer class by business function.

Notably, IAWC states that no party has offered any substantive criticisms of the Company's proposed methodologies – Staff is the only party to specifically object to the Company's proposed COS methodologies, and that objection is based entirely on a preference to avoid deviation from methodologies previously reviewed and approved by the Commission. IAWC points out that Staff specifically recommends that the Commission bind IAWC to its historical COS analyses "until such a time that the Company's methodology is litigated and determined to provide. . . beneficial improvements…" Staff Ex. 15.00 at 21. IAWC points out that it is unclear what additional litigation Staff seeks, given that this is a contested case, IAWC proposed its COS methodologies at the outset of this proceeding, and all parties, Staff included, have been offered the opportunity to litigate its analyses throughout this proceeding. And, IAWC argues, short of implementing the rates based on the COS analyses offered here, Staff has not clarified how "beneficial improvements" can otherwise be demonstrated. IAWC also asserts that Staff has not offered any evidence that IAWC's COS studies and underlying analyses are somehow deficient or incorrect, nor has Staff provided any alternative analyses for consideration.

IAWC notes that IIWC/FEA is the only other party in this proceeding to raise concerns about the Company's proposed COS studies. IAWC explains that while IIWC/FEA generally agree with the classifications and cost allocations in the Company's COS studies, IIWC/FEA identify a concern that the Company's maximum day and maximum hour ratios may need to be updated and recommends that IAWC perform an updated demand study in its next rate case proceeding. IAWC notes that concern, and IAWC's agreement to perform an updated demand study in its next rate case proceeding, is discussed further below.

IAWC states that it provided substantial evidence that its COS studies are reasonable and appropriate, including testimony discussing its rationale for implementing a change in methodologies. IAWC argues that Staff ignores this evidence, and instead mischaracterizes the Company's testimony and discovery responses, arguing that IAWC "used a different methodology in this rate case because the same methodology was used and approved in a COS study for an electric utility filed by MidAmerican Energy Company." Staff IB at 49. IAWC asserts that this assertion, which is based on a discovery response provided by IAWC (*see* Staff Ex. 7.0, Att. 7.01) is simply wrong.

IAWC explains that in that discovery request, Staff asked for an explanation of the differences between the COS studies submitted in this proceeding compared to those approved in Docket No. 16-0093. Staff also asked for a detailed rationale for each change. In response, IAWC explained that it changed its COS methodologies:

> because the two-step approach simplifies the cost-of-service analysis and makes the resulting allocation to customer class more intuitive. This approach unbundles revenue requirement into business functions and allows stakeholders to see what the cost of service is for each customer class by business function.

Staff Ex. 7.0, Att. 7.01.

IAWC explains that its discovery response clarified that the COS studies utilized in this case and the approach described above and in IAWC Exhibit 7.00 are similar in these respects to the electric COS study filed by MidAmerican Energy Company in Docket No. 14-0066. IAWC asserts that it has been clear about the rationale behind its proposed COS studies and methodologies, a rationale that Staff has not addressed or rebutted, and Staff's misstatement of the record is wrong and should be rejected.

Moreover, IAWC states that it has demonstrated that the operational differences between water/wastewater utilities and electric utilities (like MidAmerican Energy Company) do not change the fundamental process of functionalizing, classifying, and allocating costs which is at issue in this case. Electric utilities and water utilities both have production, transmission, distribution, metering, and customer service functions to which revenue requirements are assigned and that are allocated to customer class using a variety of allocation methodologies. The fact that they operate differently does not change this fundamental foundation for how the COS study in each case could or should be structured.

IAWC argues that it is well-established that prior Commission orders are not controlling: the Illinois Supreme Court has "long recognized that the Commission 'is not a judicial body, and its orders are not res judicata in later proceedings before it.'" *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 2016 IL 118129, ¶24 (*citing Miss. River Fuel Corp. v. Ill. Commerce Comm'n*, 1 Ill. 2d 509, 513 (1953)). And, IAWC asserts, the Commission must consider the issues in this proceeding based on the evidence and record established in this docket. *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 405 Ill. App. 3d 389, 407-408 (2nd Dist. 2010); *Miss. River Fuel Corp*, 1 Ill. 2d at 513.

IAWC asserts that the Company's proposed COS studies in this proceeding are intuitive, easier to understand, and a significant improvement over the Company's past studies. IAWC further states that the evidence and record in this proceeding are clear – IAWC's proposed COS studies, including its classifications and cost-allocations, are reasonable, supported by the evidence, and should be adopted.

<u>Water COS Study</u>

IAWC states that it has provided two water COS studies in this proceeding, consistent with its proposal to consolidate water service rates: a primary COS study that includes all water service except for Pekin, and a separate COS study for the Pekin district. IAWC's water COS study allocates the total revenue requirement for IAWC water operations to various cost categories, which are then allocated to the various customer classes IAWC services, with different cost categories allocated to customer classes using a class allocation factor that differs depending on the nature of the costs.

IAWC explains that most of the accounts that make up the Company's revenue requirement are directly assigned to a single cost category (including net plant for Collecting and Impounding Reservoirs, Purchased Water for water pumping, and Water Treatment labor expenses). Accounts not directly assignable to a single cost category are allocated among cost elements based on appropriate allocation factors (including general and intangible plant, miscellaneous rate base deductions, administrative and general expenses, and payroll taxes). IAWC explains that the cost categories that the Company assigns to specific accounts include:

- Variable Costs, such as purchased electric power, purchased water, treatment chemicals and waste disposal costs that tend to vary directly with the amount of water consumed and are allocated to customer classes in direct proportion to each class's annual water consumption.
- Capacity Costs, such as source of supply, water pumping, water treatment, transmission mains, distribution mains, and storage, which refer to the cost of owning, operating, and maintaining the Company's water production, pumping, and distribution system that do not vary directly with the amount of water consumed and are generally allocated to customer classes through the Base/Extra capacity methodology.
- Customer Related Costs, which are allocated to customer classes based on a weighted number of customers calculation (including metering costs and service line cost components) or based on the total number of customers in each class (including customer service cost components).
- Fire Service Costs, which are determined through information on firefighting requirements provided by the American Insurance Association and are split between private fire and public fire customer classes based on the relative potential water demand for each class.

IAWC explains that its water COS study is based on the AWWA M1 manual (Principles of Water Rates, Fees, and Charges), which provides guidance on the appropriate allocation methodologies to use in allocating different types of costs to customer classes. IAWC notes that pursuant to the AWWA M1 manual's guidance, it uses the Base/Extra capacity method to allocate production and distribution costs to customer classes. As Staff witness Boggs and IIWC/FEA witness Collins acknowledge, the Base/Extra capacity method is generally accepted as a sound method for allocating the cost of water service and was used by IAWC in previous rate cases. IAWC notes that the Base/Extra capacity methodology relies upon a combination of the average water consumption across the year for each customer class (the "Base" component) and the difference between each class's average daily consumption and estimated maximum daily consumption for the year (the "Extra" component) to allocate the fixed costs of the water production and distribution system to customers. IAWC explains that for each class, the Base/Extra allocator is calculated as a weighted average of the Base and Extra allocators, resulting in maximum day peaking factors and maximum hour peaking factors that are used in the COS study to allocate revenue requirements for various cost categories to customer class. The Company's maximum day and maximum hour peaking factors by customer class are the same factors that were used in the COS studies provided in Docket No. 16-0093. IAWC notes that while no party contests the use of the maximum day and maximum hour peaking factors in this proceeding, IIWC/FEA recommend that the Company update its peaking factors in its next rate case filing.

IAWC asserts that it provided substantial information in this proceeding explaining how each of its water cost categories were allocated to customer classes based on specific cost classifications and allocation methodologies. IAWC points out that no party contested the analyses underlying these cost allocations, including the allocation

methodologies and the cost categories used. IAWC contends that they should be approved.

Wastewater COS Study

IAWC states that it has provided two wastewater COS studies in this proceeding, consistent with the Company's proposal for wastewater rate design: a COS study for the Chicago Metro wastewater service, which is the legacy group of customers from the Company's last rate case (Docket No. 16-0093), and a second COS study for Central Zone rates, which includes all of the acquisitions included in this proceeding since Docket No. 16-0093 was completed. As with the water COS analyses, IAWC's wastewater COS study allocates the total revenue requirement for IAWC wastewater operations to four cost categories, which are then allocated between two service classifications IAWC serves (Collection Only, and Collection & Treatment) with different cost categories allocated to customer classes using a class allocation factor that differs depending on the nature of the costs.

IAWC explains that like water, the majority of the accounts that make up the Company's revenue requirement are directly assigned to a single cost category (including net plant for Treatment & Disposal functions, Sewage Treatment labor expenses, and plant related to Customer Facilities). IAWC states that accounts not directly assignable to a single cost category are allocated among cost elements based on appropriate allocation factors (including general and intangible plant, miscellaneous rate base deductions, administrative and general expenses, and payroll taxes).

IAWC provided substantial information in this proceeding explaining how each of its wastewater cost categories were allocated to service classifications based on specific cost classifications and allocation methodologies. IAWC notes that no party contested the analyses underlying these cost allocations, including the allocation methodologies and the cost categories used. IAWC concludes that they should be approved.

**b. Staff's Position**

Staff recommends the Commission reject the Company's COS allocation factor approach used in this proceeding.

The Company implemented a significant change in its COS study approach for the instant rate case filing. In this case, the Company first allocated the revenue requirement and account balances to cost categories. IAWC Ex. 7.00 at 42, 54. Staff witness Boggs explained that the Company used a different allocation approach in this case than the approach that the Commission approved in the Company's last rate case, Docket No. 16-0093. Staff Ex. 7.0 at 13. In Docket No. 16-0093, the Commission-approved COS study allocated account balances directly to customer classes using the appropriate class allocation methodology as detailed in Staff witness Boggs' direct testimony. Staff Ex. 7.0 at 10.

Staff witness Boggs explained that the COS study determines the cost to serve customers and, thus, provides the basis for designing rates for a utility. Specifically, a COS study is performed to allocate costs among all customer classes based on the responsibility of each respective customer class for the costs imposed on the utility. In other words, the various costs on the utility system are allocated among the customer

classes according to cost causation principles. The results are summarized in rate of return for customer classes, which document the relative performance of each customer class in recovering costs. Classes generating above average returns are considered to be paying more than their fair share of the Company's revenue requirement, while classes with below average returns are viewed as paying less than their fair share of the Company's revenue requirement. *Id*.

IAWC stated that it used a different methodology in this rate case because the same methodology was used and approved in a COS study for an electric utility filed by MidAmerican Energy Company in Docket No. 14-0066. Staff Ex. 7.0, Att. 7.01. Staff witness Boggs asserts that a COS study allocation method approved in an electric utility rate case is not appropriate for a water and sewer utility COS study. Staff Ex. 7.0 at 13. There are a multitude of differences between electric and water and sewer utilities so using methods that are specific to water and sewer utilities consistent with AWWA M1 manual are applicable in this proceeding. *Id*. Additionally, the COS study methods provided in the Company's most recent three rate cases (Docket Nos. 09-0319, 11-0767 and 16-0093) were consistent with what the Commission has approved in other water/sewer utilities in Illinois since at least 2009. *Id*. at 14.

Staff witness Boggs clarified that Staff does not object to the Company's Base-Extra Capacity method used in the Company's COS study. *Id*. at 11. Rather, Staff objects to the Company's method to first allocate the revenue requirement and account balances to cost categories and, after determining a revenue requirement for each cost category, the allocation of the cost category revenue requirement to each customer class using a single allocation methodology. *Id*. Using a new two-step approach obscures information Staff gleans from the typical water/sewer COS study, which allocates the account balances directly.

Staff argues that IAWC witness Rea mischaracterizes Intervenor testimony when he states that all parties to this proceeding have approved of the Company's proposed allocation process except for Staff. Staff also asserts that Mr. Rea mischaracterizes Intervenor testimony when he states that all parties to this proceeding have approved of the Company's proposed allocation process except for Staff. *Id*. at 56-57. While most Intervenors, including Staff have agreed that the Base-Extra Capacity approach to allocation is an accepted industry practice (Staff Ex. 7.0 at 9; AG Ex. 2.0 at 9; IIWC/FEA Ex. 1.0 at 7), none except Staff have commented on Mr. Rea's proposed process to allocate a revenue requirement for each cost category first and then allocate the cost category revenue requirement using a single allocation methodology for each cost category which deviates from the allocation process that has been approved by the Commission for at least a decade. Staff Ex. 15.0 at 19-20.

Staff argues that Mr. Rea errs when he contends that Staff's primary consideration for the COS study allocation approach is "doing things the way we've always done them." IAWC Ex. 18.00 at 56. His statement is inaccurate. Staff disagrees with the Company presenting a COS study methodology that deviates from the methods that have been litigated and found by the Commission to be reasonable for developing rate designs for water and wastewater utilities. Mr. Rea's methodology has not been proven to be a "beneficial improvement" to water and wastewater COS studies and he has failed to make

a convincing argument such that the Commission should consider his approach for approval.

### c. IIWC/FEA's Position

IIWC/FEA generally agree with the classifications and cost allocations in the Company's Class Cost of Service Study ("CCOSS"). However, IIWC/FEA are concerned that the maximum day and maximum hour ratios need to be updated because, as discussed in more detail below, relying on the peak demand ratios contained in the Company's 2016 load study for the Company's current CCOSS may result in an inaccurate measure of the cost to the Company of providing service to each customer class. IIWC/FEA Ex. 10 at 5.

IIWC/FEA witness Collins explained peak demand ratios as follows:

> The class base, maximum day and maximum hour rates of water usage for customer classes serve as the basis for allocating base, maximum day and maximum hour capacity costs between the Company's customer classes.
>
> Maximum rates of water usage are expressed in terms of peak demand ratios, or peaking factors. The maximum rate of usage, whether daily or hourly, can be expressed as a percent of average annual usage (i.e., base usage). This percentage relationship to the base usage is the peaking factor.
>
> Typically, weather sensitive customers whose water consumption increases during the summer due to discretionary outdoor water use have higher peak demand ratios than customers whose water use is steady year round.

IIWC/FEA Ex. 1.0 at 4.

IIWC/FEA point out the maximum day and maximum hour peaking factors by customer class used in this proceeding are the same as those used in the COS studies provided in the Company's last base rate case proceeding, Docket No. 16-0093. IAWC Ex. 7.00 at 45. IIWC/FEA note, that according to the Company, IAWC has not conducted a new demand study in this proceeding because the Commission's Order in Docket No. 16-0093 stated that assuming there has not been a significant change in the ratio peak to average demand, IAWC needs to "only conduct a demand study using the AWWA-method once every ten years." *Id*. (quoting Docket No. 16-0093, Order at 90).

IIWC/FEA point out, since its last rate case, IAWC has acquired 15 new water systems and 14 wastewater systems, totaling over sixty thousand additional customer connections. IAWC Ex. 1.00 at 6. These new systems consist primarily of residential customers. IIWC/FEA Ex. 1.1. IIWC/FEA suggest this is significant to note because residential customers typically have larger extra capacity demands exceeding their base consumption when compared to non-residential customers. IIWC/FEA Ex. 1.0 at 5. IIWC/FEA indicate the Company has not examined the maximum day or maximum hour demand ratios of all of these newly acquired systems. IIWC/FEA Ex. 1.1. IIWC/FEA identify their concern that since the Company has continued to use the demand ratios based on the 2016 load study in the current CCOSS, these ratios may not result in an

accurate measure of the Company's cost of providing service to each customer class. As IIWC/FEA witness Collins explained, "relying on prior peak demand ratios will not accurately reflect each customer class's extra capacity demand, and therefore will not accurately allocate extra capacity costs across customer classes." IIWC/FEA Ex. 1.0 at 5-6.

IIWC/FEA recommend that the Company be required to conduct a new demand study which includes the load characteristics of the 15 newly acquired water systems and any other systems acquired before the next rate case and utilize the new maximum day and maximum hour customer class peaking factors in the CCOSS for the next rate case. *Id*. at 7. IIWC/FEA reveal the Company agrees "it would be useful to update the Company's capacity study in the next rate case to reflect the acquisitions the Company has made and might make before the filing of the next rate case." IAWC Ex. 28.00 at 40. IIWC/FEA recommend that the Commission require the Company to perform an updated demand study, which includes load data for all water systems acquired since the Company's last rate case up to its next rate case, for use in the Company's next water CCOSS.

#### d. Commission Analysis and Conclusion

No party takes issue with the Company's Base-Extra Capacity method used in the COS studies. Staff objects to IAWC's allocation factor, which first allocates the revenue requirement and account balances to cost categories and then to customer classes using a class allocation factor that differs depending on the nature of the costs.

The Commission is not averse to trying new allocation factors. As parties note, the allocation factor used by IAWC was approved once before for MidAmerican Energy Company. However, having reviewed the record, the Commission finds that IAWC has not fully supported its proposed change in this proceeding. IAWC makes assertions that the new two-step process is more simple, more intuitive, and will provide benefits to stakeholders. Staff claims that IAWC's proposed allocation factor obscures information that Staff uses in its analysis of the COS studies.

The traditional method used by IAWC, and approved by the Commission, is consistent with the AWWA M1 manual. Considering the record before the Commission, IAWC's new allocation factor methodology is rejected. IAWC is directed to provide COS studies for this rate case that apply the class allocation methods used in the COS studies previously approved in the last three IAWC rate cases.

IIWC/FEA's request for a new demand study, which is agreed to by the Company, is addressed in Section VIII.A.4 of this Order.

### 3. Central Division Class Revenue Allocation, including Large Public Authorities Class

#### a. IAWC's Position

IAWC states that its water COS study indicates that rates for the Central Zone Large Public Authorities class must be raised by approximately 55.6% in order to recover its COS. IAWC explains that in order to gradually increase rates to recover the class's COS, the Company proposed to increase rates by 25% with the uncollected revenue

requirement reallocated to other customer classes based on total present rate revenue by class.

IAWC states that to mitigate the reallocation of the cost to serve the Large Public Authorities Class from other customer classes, Staff recommends that the Company increase the Large Public Authorities water rate by 35%, reallocating the remaining 20.6% revenue shortfall to other customer classes. IAWC notes that in the interest of narrowing the contested issues in this proceeding, the Company accepted Staff's recommendation.

**b. Staff's Position**

Staff argues that the Commission should approve Staff's recommendation to increase the Large Public Authorities class rate by 35% to move the Large Public Authorities class closer to full COS recovery. Staff Ex. 7.0 at 31. The Company initially proposed to increase rates for the class by 25%, which is approximately one half of the 55.6% increase that the COS study indicates it would take for the Company to recover the full cost to serve this class. IAWC Ex. 7.00 at 9.

Mr. Boggs explained in testimony that, as with any customer class, one of the primary functions of rate design is to set rates so that the Company can fully recover the cost to serve a customer class from those who cause the Company to incur those costs. Mr. Boggs explained in testimony that, as with any customer class, one of the primary functions of rate design is to set rates so that the Company can fully recover the cost to serve a customer class from those who cause the Company to incur those costs. Staff Ex. 7.0 at 30. In this case, the Large Public Authorities class would require a 55.6% rate increase so the Company could fully recover the cost to serve the class. Staff Ex. 7.0, Att. 7.05. Because the Company proposes only a 25% rate increase for this class, the remaining approximately 30.6% of the needed rate increase would need to be collected from other customer classes. IAWC Ex. 7.00 at 9-10. The Company's initial proposal was to recover $419,587 from Central residential customers; $126,535 from Central commercial customers; $39,372 from Central industrial customers; $30,479 from Central public authority customers; $60,447 from Central resale customers; and the additional $12,015 from Central miscellaneous and private fire customers. Staff Ex. 7.0, Att. 7.05. The Company makes several proposals in this proceeding to reallocate revenues to other customer classes in an effort to mitigate the increases in revenue recovery that would be necessary for the Company to collect the full cost to serve smaller customer classes. Staff argues that proposing to increase rates for customer classes that do not contribute to the costs to serve - in this instance, the Large Public Authorities class - can result in unjust rate increases that must be absorbed by customers that are burdened with re-allocated costs that are above and beyond the cost the Company incurs to serve them. Therefore, Staff recommends increasing the Large Public Authorities class rate by 35% to move this rate class closer to full cost recovery.

**c. IIWC/FEA's Position**

IIWC/FEA agree that an increase of slightly above 50% is necessary but propose a more reasonable 27% increase for this class. IIWC/FEA Ex. 2.0 at 6. The IIWC/FEA proposal is greater than the 25% increase proposed by the Company and is in line with the system average increase for the Central Water Division. *Id*. at 6. Importantly, IIWC/FEA's proposal provides a more gradual movement toward COS. Such gradual

movement is more appropriate given the IIWC/FEA concerns raised regarding the accuracy of the Company's CCOSS. *Id*. at 6. IIWC/FEA assert the increases proposed by Staff and the Company should be rejected and IIWC/FEA's more reasonable recommended increase of 27% for the Large Public Authorities class should be accepted.

#### d. Commission Analysis and Conclusion

The Commission finds that increasing the Large Public Authorities class rate by 35% and reallocating the remaining 20.6% revenue shortfall to other customer classes, as agreed by Staff and the Company, is reasonable and is approved. The end purpose is to move the Large Public Authorities class more towards cost-based rates. This increase is a gradual step toward that purpose. Staff's proposal allows the Company to recover a substantial amount of its COS from the Large Public Authorities class while recognizing that a more significant increase in rates may result in rate shock for customers.

### 4. Central and Pekin Customer Charges

#### a. IAWC's Position

IAWC explains that its current rate structure for its Central Water, Lincoln, and Pekin rate zones include a monthly fixed customer charge that varies with the size of the meter and volumetric rates. IAWC states that the primary residential water service meter charge for most customers is set at $20 per month for a 5/8" meter, and the meter charge increases with the size of the meter. With the exception of South Beloit, Lincoln, and Villa Grove, IAWC is not proposing to change its monthly meter charges in this proceeding. IAWC states that its proposed customer charges generally collect the revenue requirement allocated to the metering, service line, and customer service business functions provided in the water COS study, ensures simplicity in the fixed rate assessed to customers, provides consistency in rates in the midst of a complicated rate design and fluctuating volumetric rates, and should be adopted.

IAWC notes that Staff argues that the customer charges for a 5/8" meter should be set at $18.21 for Central Zone customers and $18.41 for Pekin customers, in an effort to perfectly align with COS calculations. IAWC argues that Staff's proposal should be rejected – while Staff attempts to closely align the customer charge with COS calculations, the customer charge does not recover the entirety of the Company's total amount of fixed cost to provide service to customers. Moreover, Staff's proposed charges introduce a calculation that is neither simple nor consistent with previous rates and may introduce an element of confusion for ratepayers that observe a $1.79 (Central Zone) or $1.59 (Pekin) decrease in their monthly service charge, while simultaneously experiencing an increase in volumetric rates. IAWC contends that Staff's proposed changes to the Company's fixed customer charges offer no significant change in cost recovery, less clarity, less efficiency, and less consistency, and should be rejected.

IAWC points out that IIWC/FEA also propose a change to the Company's customer charges, recommending an increase in charges for meter sizes that are two-inches in diameter and greater, while removing an equivalent amount of revenue from the Company's proposed volumetric rate blocks (excluding the first block). IAWC argues that this proposal should also be rejected. Although IIWC/FEA argue that the "costs of

providing water utility service are primarily fixed in nature," IIWC/FEA provide no analysis, evidence, or rationale to support that proposal. IIWC/FEA does not make a recommendation addressing how much additional revenue should be collected from increased meter charges, or why the equivalent flow ratios established by the AWWA should be abandoned in this proceeding. IAWC concludes that IIWC/FEA's proposed change to the Company's customer charges should be rejected.

**b. Staff's Position**

The Company proposes to set the residential Customer Charge for 5/8" meter customers at $20 for Central Division and Pekin water customers. IAWC Ex. 7.00 at 7; IAWC Ex. 7.01 at 1. IAWC did not calculate a Customer Charge for any water service area in this proceeding. IAWC Ex. 7.00 at 7. The Company indicates setting meter charges precisely implies a level of precision that is not warranted for rate design purposes. IAWC Ex. 18.00 at 47. The Company states that simplicity and consistency in its Customer Charge are more reasonable and plausible than Staff's proposal of cost-based rates. *Id*. at 48.

The Company argues that the Customer Charge does not recover the entirety of the Company's total amount of fixed cost to provide service to customers, and that Staff's proposed charges introduce a calculation that is "neither simple nor consistent with previous rates and may introduce an element of confusion for ratepayers…." IAWC IB at 111-12. Staff argues that this is false and pure speculation by the Company. It is doubtful that ratepayers completely understand how Customer Charges are calculated nor what costs the Company attempts to recover. Staff states it would seemingly be easier for the Company to explain to an inquiring customer that Customer Charges are necessary to recover the fixed customer costs to provide service rather than explain to the customer that IAWC's Customer Charges are an arbitrary number that is set by the Company because it is easier for a ratepayer to understand a $20 Customer Charge than an $18.21 Customer Charge.

Staff recommends the Commission reject the Company's proposal to set the residential Customer Charge for 5/8" meter customers at $20 for Central Division and Pekin water customers (IAWC Ex. 7.00 at 7; IAWC Ex. 7.01 at 1) because the Company's proposed Customer Charges are not cost-based. Staff Ex. 7.0 at 24-25.

According to the Company's COS study (Staff Ex. 7.0, Att. 7.03), cost-based rates for Central Zone water indicate the Company would be able to recover the fixed costs that the Company incurs with a Customer Charge for a 5/8" meter of $18.21. *Id*. This fixed cost recovery would include Lincoln water customers in the Central Zone as proposed by the Company. For Pekin, the cost-based Customer Charge to recover the fixed costs to serve residential water customers calculates to $18.41 for a 5/8" meter. *Id*. Staff witness Boggs recommends approval of its proposed, cost-based Customer Charges.

IIWC/FEA indicates that it would be more appropriate to recover a portion of any approved revenue increase through the fixed monthly meter charges, with an offsetting reduction in volumetric rate blocks. IIWC/FEA Ex. 1.0 at 14. Staff recommends the Commission reject IIWC/FEA's recommendation to recover a portion of the revenue deficiency by increasing the meter charges for meter sizes that are two-inches and

greater. Staff Ex. 15.0 at 27. Specifically, IIWC/FEA does not provide any rationale or cost basis behind its proposal other than it would be more appropriate to make the change so that an equivalent amount of revenue could be recovered through the Usage Charge to offset the additional revenue being recovered through the Customer Charge from customers with meter sizes two-inch or larger. *Id*. The Commission has routinely approved water rate designs around the standard of the AWWA M1 manual which provides equivalent meter size pricing factors that correspond to the amount of water that flows through meter sizes greater than 5/8". Because IIWC/FEA does not provide a cost basis or rationale behind its proposal, Staff argues that the Commission has no foundation from which to consider approving the proposal and therefore, should reject it.

**c. IIWC/FEA's Position**

IIWC/FEA note the Company proposes to leave its current monthly meter charges unchanged, and to collect its claimed revenue deficiency primarily through volumetric rates. IAWC Ex. 7.00 at 7-8. IIWC/FEA propose to recover a portion of any approved revenue increase through the monthly meter charges, with an offsetting reduction in the volumetric rate blocks. IIWC/FEA Ex. 1.0 at 14.

Company witness Rea disagrees with the IIWC/FEA proposal stating IIWC/FEA provided no rationale to support their proposal other than to say it would increase fixed cost recovery and reduce volumetric revenues. IAWC Ex. 18.00 at 48. However, IIWC/FEA did indeed provide a rationale. IIWC/FEA witness Collins noted that the costs of providing water utility service are primarily fixed in nature, and importantly do not vary with the volume of water used by customers. IIWC/FEA Ex. 1.0 at 14. Although Company witness Rea agrees with this assessment, the Company's rate structure is primarily volumetric. IAWC Ex. 28.00 at 38.

IIWC/FEA explain that the Company's CCOSS shows that for the Central Water Division, approximately 5.6% of the total COS is variable and 94.4% is fixed. IIWC/FEA Ex. 2.0 at 8 *citing* Staff Ex. 7.05. Despite this fact, IIWC/FEA point out that under the Company's current rates, approximately 45% of revenues are collected through meter charges. IIWC/FEA Ex. 2.0 at 8. Under the Company's proposed rates, only about 36% of revenues would come from meter charges. *Id*. at 8.

IIWC/FEA emphasize that the costs of providing water utility service are primarily fixed in nature, and do not vary with the volume of water used by customers. Even so, IIWC/FEA note the Company continues to rely heavily on volumetric charges for collecting fixed costs. Since the Company's rate structure is largely based on volumetric charges, the Company recovers both Base and Extra Capacity costs through its volumetric charges. *Id*. at 8. IIWC/FEA argue this approach does not reflect a cost-based rate structure, fails to provide accurate price signals to customers, and can contribute to revenue instability for the Company. *Id*. at 8.

IIWC/FEA argue it is more appropriate, from a cost causation standpoint, to recover a portion of any approved revenue increase through the fixed monthly meter charges, with an offsetting reduction in volumetric rate blocks. IIWC/FEA Ex. 1.0 at 14. Therefore, IIWC/FEA witness Collins recommended recovering a portion of the revenue deficiency by increasing the meter charges for meter sizes that are two-inches and greater. *Id*. In doing so, an equivalent amount of revenue should be removed from the

Company's proposed volumetric rate blocks, excluding the first block of the Metered General Service rate structure. *Id*. at 14-15.

IIWC/FEA specify it is appropriate for the first volumetric rate block to be priced higher than the tail blocks due to the fact that the first volumetric block of the Metered General Service rate structure should primarily recover the utility's fixed costs of providing service to smaller volume users, such as residential and commercial customers. *Id*. at 15. IIWC/FEA suggest the tail blocks should be less expensive because they should primarily recover the utility's variable cost of providing service. *Id*.

Company witness Rea also criticizes IIWC/FEA's proposal because IIWC/FEA witness Collins did not make a recommendation on how much additional revenue should be collected from increased meter charges for two-inch meters and above. IAWC Ex. 18.00 at 48. While Company witness Rea is correct, IIWC/FEA point out the Company's rate design and proof of revenue workpapers are not set up in a manner that allows for efficient development and testing of alternative rate design by customer class and district. IIWC/FEA Ex. 1.0 at 15. However, IIWC/FEA witness Collins explained in his rebuttal testimony that, at a minimum, he recommends the amount of revenue collected under present meter charges as a percent of total revenue should be maintained, which would provide the Company more revenue stability than provided by the Company's proposal. IIWC/FEA Ex. 2.0 at 9.

IIWC/FEA assert that their proposal should be approved as it is simply more appropriate, from a cost causation standpoint, to recover a portion of any approved revenue increase through the fixed monthly meter charges, with an offsetting reduction in volumetric rate blocks. IIWC/FEA further argue that at a minimum, the percentage of revenue requirement collected through meter charges should remain the same as it is under current rates for those customers with meters of two-inches and above.

#### d. Commission Analysis and Conclusion

IAWC proposes to leave the monthly Customer Charge for a 5/8" meter for Central and Pekin customers unchanged at $20 per month. Staff proposes that the meter charges be based on the COS, which for demonstrative purposes would be $18.21 for the Central zone and $18.41 for the Pekin zone based on the Company's current COS study. IAWC states that "simplicity and consistency justifies leaving monthly meter charges unchanged . . . ." IAWC Ex. 18.00 at 48. IAWC opposes Staff's proposal primarily because IAWC believes it would cause customer confusion. The Commission finds that Staff's proposal to base the Customer Charge for a 5/8" meter for the Central and Pekin customers on the COS is just and reasonable. To the extent customers in those areas are confused as to why their Customer Charge is being reduced, IAWC should have the resources to address any such inquiries. The Commission further finds that, based on record evidence, IIWC/FEA's proposal lacks sufficient cost basis and foundation for the Commission to consider such a change. As the Company notes, IIWC/FEA make no recommendation regarding the amount of additional revenue that should be collected from increased meter charges for larger meters.

### 5. Lincoln Water Rates

#### a. IAWC's Position

IAWC states that in direct testimony, it proposed to continue movement towards single tariff pricing by moving rates in its Lincoln water tariff zone closer to the Company's Central Zone water rates. To do so, IAWC explains, it included revenue requirements for the Lincoln tariff zone with the Central Zone revenue requirements as an initial step that will eventually result in consolidating Lincoln Zone rates with Central Zone rates. Based on the Company's water COS study, the Lincoln zone would require an increase in its revenue requirement of $3.6 million on a stand-alone basis. IAWC states that it proposed, however, to limit that increase to approximately $2.3 million, which is roughly halfway between the increase that Lincoln customers would see if Lincoln rates continued to be calculated on a stand-alone basis and the total increase that the Company proposed in this proceeding.

IAWC notes that Staff acknowledged that under the Company's proposal, Lincoln water customers would experience an increase of approximately 25.79% to its customer charge, and an increase of approximately 84.42% to its usage charge, while approximately $1.3 million in revenues would be recovered from non-Lincoln customers. IAWC states that to reduce the amount of revenues that would be recovered from non-Lincoln customers, and in light of the benefits of allowing IAWC 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 recommends that the Commission reject IAWC's proposed partial consolidation and instead approve full consolidation of the Lincoln water territory into the Central Zone water territory, increasing the customer charge for Lincoln water customers by 25.79% and increasing the usage charge by 139.51%. IAWC states that in the interest of narrowing the contested issues in this proceeding, IAWC accepts Staff's recommendation.

IAWC states that, while this issue is agreed between Staff and the Company, the AG argues that the Commission should reject Staff's proposal and either adopt IAWC's original proposed partial consolidation and rate increase, or that IAWC be required to submit an alternative Lincoln rate design that limits the revenue increase for any Lincoln water customer class to 50% of revenues for the class under current rates. IAWC states that the AG also recommends that, in the event the Commission does not adopt IAWC's proposal to reallocate a portion of its wastewater revenue requirement to water customers, any subsequent rate transition path the Company submits to move Central wastewater customers from the current rates to consolidated cost-based rates should also limit any single increase to 50% of revenues under the prior rate structure.

IAWC argues that the AG's position should be rejected. IAWC explains that the basis of AG witness Larkin-Connolly's argument that the revenue increases proposed for Lincoln customers are "excessive" is a misreading of the statutory language of Act by a witness with no legal background, proffering a novel interpretation of the Act for the first time in rebuttal testimony. Specifically, IAWC points out, Mr. Larkin-Connolly argues that Section 8-306(a) of the Act must be interpreted in the context of a base rate proceeding to require that "no customer should experience a bill increase of more than 50% in the

first billing period that new rates are adopted." AG Ex. 4.0 at 23. IAWC concludes that this interpretation has no basis in law or fact and must be rejected.

IAWC states that Section 8-306 of the Act requires that the Commission "shall prepare, make available to customers upon request, and post on its Internet web site information concerning the service obligations of water and sewer utilities and remedies that a customer may pursue for a violation of the customer's rights." 220 ILCS 5/8-306(a). This information is intended to "specifically address the rights of a customer of a water or sewer utility" in specific situations, including when "a customer's bill increases by more than 50% within one billing period", as well as when "a rate is filed, including without limitation a surcharge or annual reconciliation filing, that will increase the amount billed to the customer." 220 ILCS 5/8-306(a)(2), (6). In other words, IAWC explains, Section 8-306 establishes an informational requirement for the Commission regarding customer rights and has no bearing on a utility's tariff rate increase under Section 9-201 of the Act. Section 8-306 itself clearly delineates between a situation in which a customer's bill abruptly changes by more than 50% within one billing period, versus a situation in which a customer's bill changes due to a rate filing. IAWC asserts that it is a tenet of statutory interpretation that statutes should be considered as a whole, and "words and phrases should not be construed in isolation but must be interpreted in light of other relevant provisions of the statute." *People ex rel. Madigan v. Wildermuth*, 2017 IL 120763, ¶17; *citing Mich. Ave. Nat'l Bank v. Cty. of Cook*, 191 Ill. 2d 496, 504 (2000). IAWC argues that the AG's novel interpretation of the Act would ignore the other situations identified in Section 8-306(a), conflating abrupt changes between billing periods with bill increases related to rate filings in pursuit of a new and untimely proposed limit on rate increases allowed in this proceeding.

Further, IAWC explains, the Commission has never interpreted Section 8-306(a) to limit or somehow cap an increase in rates resulting from a rate case proceeding where the Commission has reviewed a Company's proposed rates and determined that they are just and reasonable pursuant to Section 9-201. IAWC states that Mr. Larkin-Connolly offers no evidence to support this novel interpretation of the Act, much less to demonstrate how such an interpretation comports with the other provisions of the Act governing changes in rates and hearings before the Commission to evaluate the propriety of those proposed changes. IAWC argues that the AG's recommendation that the Commission reject movement towards single tariff pricing and consolidation of Lincoln water customers with Central Zone customers, as well as the AG's proposal to impose a limit on rate increases in rate case proceedings regardless of the record evidence, should be rejected.

#### b. Staff's Position

Staff asserts that the Commission should approve Staff's proposal to consolidate the Lincoln water division with the Central Zone water division. The Company states that, in the interest of narrowing the issues in this proceeding, it does not oppose Staff's proposal to consolidate the Lincoln water division with the Central Zone water division. IAWC Ex. 18.00 at 2-3.

Staff recommends fully consolidating the Lincoln water service territory and the Central Zone service territory because it would move the Company toward single tariff

pricing, which is the use of a unified rate structure for multiple systems that are owned and operated by a single utility, but that may or may not be contiguous or physically interconnected. Staff Ex. 7.0 at 18. Staff states that consolidated rates service territories would allow IAWC to spread capital costs over a larger base of customers; thus, mitigating rate shock to a smaller standalone division's customer base when infrastructure improvements become necessary in a particular rate area. In addition, in the long-term, consolidated rates will allow the customers to experience lower rates via fewer rate cases and lower rate case expenses.

The Company provided a COS study and rate design for the Lincoln water service territory that assumes Lincoln is a stand-alone service territory. Staff Ex. 7.0, Att. 7.02. In that COS Study, the Company showed that if Lincoln stood on its own, a Customer Charge of $20.07 for a 5/8" meter would be necessary to recover the fixed costs the Company incurs to service the Lincoln water territory. The Usage Charge to recover the rest of the revenue requirement for a stand-alone Lincoln service territory would need to be $1.110145 per 100 gallons. The COS study for the Central Zone indicated that the Customer Charge of $18.21 for a 5/8" meter would be necessary to recover the fixed costs the Company incurs to service the Central Zone water territory and the residential Usage Charge would need to be $0.98198 per 100 gallons used to recover the rest of the revenue requirement for the Central Zone water district. Staff Ex. 7.0 at 18-19.

Staff witness Boggs explained that the Company has a history of consolidating smaller rate territories into larger rate territories where the territories have common rate structures, and the Commission has been amenable to those proposals. In a recent Company rate case, Docket No. 11-0767, the Company observed:

> The Commission has expressed a general policy of favoring cost–based rates and movement towards single tariff pricing and rate uniformity. The Docket [No.] 07-0507 Order (see pages 94-98) discussed various approaches to single tariff pricing. As discussed by the Commission, one approach is to combine individual rate areas with other rate areas and develop common rates for customers in the combined group based on the group revenue requirements.

Docket No. 11-0767, IAWC Ex. 5.0 at 20.

The Company does not object to Staff's proposal to consolidate the Lincoln water division with the Central Zone water division. IAWC Ex. 18.00 at 2-3. Consolidation would eliminate the recovery of $1.3 million in revenues from non-Lincoln water customers that was initially proposed by the Company to partially consolidate the Lincoln water division with the Central Zone water division. Although the Lincoln customers will experience a larger revenue recovery increase than what the AG recommends as a cap (50%), no other (non-Lincoln) customers will be required to contribute additional revenues to accommodate this proposed consolidation. If the Commission approves this consolidation move, Lincoln customers will be subject to the same rate increases as all other Central Zone water customers upon the Company's next rate design proceeding and will move the Company one step closer to achieving single tariff pricing for all its

water customers. Staff argues that the Commission should approve Staff's proposal to consolidate the Lincoln water division with the Central Zone water division.

**c. AG's Position**

The AG recommends that the Commission limit increases in the rates charged to Lincoln water customers to no more than 50% higher than the rates they previously paid. In an effort to move toward single-tariff pricing while mitigating the impact of rate increases on customers in the Lincoln water tariff zone, the Company initially proposed a transition rate that was less than the full Central Zone rate. IAWC Ex. 7.00 at 8. In direct testimony, however, Staff witness Boggs recommended that the Lincoln water rates be consolidated with Central Zone water rates in this proceeding. Staff Ex. 7.0 at 23. In response to Mr. Boggs' direct testimony, the Company adopted Staff's position and proposed consolidating the Lincoln water rates into the Central Zone rates. IAWC Ex. 18.00 at 3. Under the Company's revised rate design, water customers in the Lincoln service area would see a 73.55% increase in their rates, with residential customers seeing an even higher increase of 83.38%. AG Ex. 4.0 at 22. The AG opposes the consolidation of Lincoln water rates because it would result in rate shock to Lincoln water customers.

The AG recommends that the Commission adopt an alternative rate design limiting the increase for all Lincoln water customer classes to no more than 50% of revenues for the class under current rates. *Id*. at 24. The AG's recommendation is informed by the fact that the General Assembly appears to view rate increases of more than 50% as excessive. *Id*. at 23. Section 8-306(a) of the Act provides that the Commission must make "information concerning the service obligations of water and sewer utilities and remedies that a customer may pursue for a violation of the customer's rights" in certain specified situations. 220 ILCS 5/8-306(a). Among the situations where the Commission "shall specifically address the rights of a customer" is when "[t]he customer's bill increases by more than 50% within one billing period." 220 ILCS 5/8-306(a)(2). Mr. Larkin-Connolly testified that this strongly suggests that "no customer should experience a bill increase of more than 50% in the first billing period that new rates are adopted." AG Ex. 4.0 at 23.

Contrary to IAWC's claims, Mr. Larkin-Connolly did not assert that the Commission is obligated to limit the increase to 50% or less under Section 8-306(a). Rather, Mr. Larkin-Connolly "was concerned about the magnitude of the bill impacts that Lincoln water customers would experience by moving to fully consolidated Central water rates" and developed a recommendation to reduce the impact consistent with similar guidance under the Act. AG Ex. 4.0 at 21. Because Section 8-306(a) indicates a 50% or greater increase in one billing period may be considered a violation of a customer's rights, the AG argues that the Commission should carefully assess any situation where a utility requests such a rate increase.

The Company and Staff's proposed consolidation of Lincoln water rates into the Central Zone tariff would result in increases of more than 70% (and even higher for residential customers). *Id*. at 23. Thus, the Commission should order the Company to revert to the transition rate it originally proposed or order an alternative rate design that, in either case, does not result in an increase for any Lincoln water customer class of more than 50%.

#### d. Commission Analysis and Conclusion

As an initial matter, Section 8-306 of the Act establishes an informational requirement for the Commission regarding customer rights. IAWC asserts that the AG represents that Section 8-306(a) limits any increase in rates to 50% or less. The AG indicates that IAWC misconstrues AG witness Larkin-Connolly's testimony. The Commission finds that Section 8-306(a) does not limit or somehow cap an increase in rates resulting from a rate case proceeding where the Commission has reviewed a Company's proposed rates and determined that they are just and reasonable pursuant to Section 9-201.

IAWC and Staff agree to fully consolidate the Lincoln water territory into the Central Zone water territory. The AG opposes full integration at this time and suggests a more moderate approach is appropriate. The AG does not proffer a specific proposal but requests that the Commission either: (1) adopt IAWC's initial proposal; or (2) adopt any increase that the Commission deems reasonable provided it does not increase Lincoln's rates by more than 50%.

The Commission understands parties' concerns regarding rate shock in consolidating the Lincoln and Central Zone territories. However, fully consolidating the Lincoln territory with the Central Zone territory moves the Company towards single tariff pricing for its water customers. While this full consolidation will result in an increase in rates, this increase is reasonable and consolidation will allow IAWC to spread out capital improvement costs over a larger customer base, thereby mitigating potential rate shock when large improvement projects need to be made. Moreover, consolidation eliminates the need to recover revenues from non-Lincoln water customers, which would be the case under IAWC's initial proposal.

Staff's proposal to fully consolidate Lincoln into the Central Zone water territory is approved.

### 6. Public Fire Protection Rates

#### a. IAWC's Position

IAWC states that, although the Company's water COS study indicates that public fire surcharges should be raised in the Central Zone by 34.1% and in Pekin by 74.9% in order to recover the full COS, the Company proposed to raise public fire surcharges in all districts by 30%, with the uncollected revenue requirement reallocated to other customer classes based on total present rate revenue by customer class. IAWC explains that because most public fire surcharges are directly collected as meter charges from retail customers, it is the Company's position that the reallocation of public fire revenue requirement will not significantly affect the revenue requirement that would otherwise be allocated to those customer groups.

IAWC notes that Staff objected to the Company's proposal, and instead recommended that IAWC increase public fire charges in the Central Zone by 34.1% in order to allow the Company to fully recover its public fire protection costs. IAWC points out that Staff also recommended that the Company increase public fire charges in Pekin by 37.5%, which would allow IAWC to recover 50% of the increase that is required to recover full public fire protection costs from the Pekin public fire protection customers.

IAWC states that although the final percentage increases in the Central Zone and Pekin may ultimately change based on the final revenue requirement approved in this proceeding, IAWC agreed in rebuttal with Staff's rate design strategy to recover the entire COS for Public Fire from Central Zone customers and approximately one-half of the COS for Public Fire from Pekin customers.

IAWC states that while the Company and Staff are in agreement, IIWC/FEA argue that the Commission should reject Staff's proposal (agreed to by IAWC), reject IAWC's original proposal, and instead approve an increase of 27.6% for the Central Zone. IAWC explains that IIWC/FEA argue that Staff's proposed increase of 34.1% would increase the Public Fire Protection Class in the Central Zone above the class's COS, and that an increase of 27.6% is reasonable, because IAWC's "class [COS] study may not be producing the most accurate measure of the cost of providing service to each class." IAWC argues that IIWC/FEA's proposal should be rejected. First, Staff's proposed increase of 34.1% is, in fact, the increase needed to recover the class's COS. IAWC notes that IIWC/FEA's proposal would still require recovery of the shortfall in revenue from other customers. Second, IIWC/FEA's argument that the Company's COS studies may not produce the "most accurate measure" of the cost of providing service has no basis in the record. IAWC points out that IIWC/FEA has not provided any evidence demonstrating that IAWC's COS study is deficient or inaccurate, and likewise has not provided any analysis or evidence demonstrating why a rate increase of 27.6% is more reasonable or accurate than the increase agreed to by Staff and IAWC. IAWC concludes that the Commission should reject IIWC/FEA's proposal and adopt the rate design strategy agreed to between Staff and IAWC – namely, to recover the entire COS for Public Fire from Central Zone customers and approximately one-half of the COS for Public Fire from Pekin customers.

**b. Staff's Position**

Staff recommends the Commission approve a 34.1% increase to Public Fire Charges in the Central Zone. Staff Ex. 7.0 at 29. Staff witness Boggs explained that this will allow the Company to fully recover the public fire protection costs from those who caused the costs to be incurred by the Company. *Id*. In addition, Staff recommends an increase of 37.5% to Public Fire Charges for the Pekin service territory. *Id*. This recommendation will allow the Company to recover 50% of the increase that is required to recover full public fire protection costs from the Pekin public fire protection customers. *Id*. Fire protection costs should be fully recovered from those who cause the costs to be incurred by the Company. Because public fire costs are a benefit to the community, reallocation of some of the costs for Pekin public fire protection should be considered for this proceeding only. The increase for Pekin Public Fire Charges in the next rate proceeding filed by the Company should attempt to adequately recover the full cost of public fire costs in the Pekin service territory incurred by the Company.

The Company does not object to Staff's rate design strategy to recover the entire COS for Public Fire from Central Zone customers and approximately one-half of the increase in Public Fire indicated by a final COS study in this case to Pekin Zone customers. IAWC Ex. 18.00 at 3. Staff argues that the Commission should approve Staff's recommendation.

#### c. IIWC/FEA's Position

IIWC/FEA take issue with Staff witness Boggs' proposed revenue allocation for the Public Fire Protection class. Staff witness Boggs has proposed an increase of 34.1%, or approximately 1.25 times the system average increase for the Central Water Division, to the Public Fire Protection class. Staff Ex. 7.0 at 29; IIWC/FEA Ex. 2.0 at 6. Mr. Boggs argues his proposed increase will allow the Company to fully recover the public fire protection costs incurred by the Company. Staff Ex. 7.0 at 29. However, IIWC/FEA note IAWC's CCOSS shows that its proposed increase of 30.6% is sufficient to bring this class to COS. IAWC Ex. 7.05. IIWC/FEA point out Mr. Boggs' proposal would increase this class's rate above COS. Differing with both the Company's 30.6% and Staff's 34.1% proposal, IIWC/FEA have proposed a more reasonable 27.6% increase for this class. IIWC/FEA Ex. 2.0 at 6-7. IIWC/FEA believe this is most appropriate given that the Company's CCOSS may not be producing the most accurate measure of the cost of providing service to each class.

IIWC/FEA argue both the Company's and the Staff's proposals should be rejected and IIWC/FEA's 27.6% recommended increase for the Public Fire Protection class should be accepted.

#### d. Commission Analysis and Conclusion

As an initial matter, the Commission finds that IIWC/FEA's argument that IAWC's COS studies may not produce the "most accurate measure" of the cost of providing services is not supported by the record. Record evidence shows that Staff's proposed increase of 34.1% is an accurate measure of the increase needed to recover the class's COS. IIWC/FEA's proposal would still require recovery of the shortfall in revenue from other customers. Therefore, the Commission adopts the rate design strategy agreed to between Staff and IAWC – namely, to recover the entire COS for Public Fire from Central Zone customers and approximately one-half of the COS for Public Fire from Pekin customers.

## VI. RIDERS

### A. Uncontested Issues

#### 1. Rider Factors

Below is a description, by rate rider, of each factor that will be set with the final order in this proceeding:

VBA

- Rate Case Revenue shall mean the dollar amount of volumetric revenues reflected in the revenue requirements approved by the Commission for the applicable Service Classification in the Company's most recent general rate case.
- Rate Case Sales ("RCS") shall mean the forecasted sales for customers for the identified Service Classifications in 100 gallons.
- Unit Production Cost shall mean the authorized amount of production costs (power, chemical, water waste disposal) divided by the RCS to determine a

cost per 100 gallons in the test year in the Company's most recent general rate case.

- Unit Treatment Cost shall mean the authorized amount of treatment costs (power, chemical, waste disposal) divided by the RCS to determine a cost per 100 gallons in the test year in the Company's most recent general rate case.

Invested Capital Tax ("ICT")

- Rate Case Expense shall mean the dollar amount of ICT expense reflected in the revenue requirements approved by the Commission in the Company's most recent general rate case.

QIP

- PTR = Pre-tax return as described in 83 Ill. Adm. Code 656.50(a)(1).
- 83 Ill. Adm. Code 656.50(a)(1): The pre-tax return is calculated using the weighted cost of debt and weighted cost of equity determined in the utility's last rate case for the rate zone. The weighted cost of equity is multiplied by the GRCF. The product is then added to the weighted cost of debt to obtain the pre-tax return.

Variable Income Tax

- OpInc represents the Operating Income from the Company's rate case used in setting base rates in effect during the Tax Period.
- PrIT represents Income Tax Expense included in the calculation of authorized revenue requirement and operating income from the Company's rate case used in setting base rates in effect during the current Tax Period.
- INT represents the Synchronized Interest from the Company's rate case used in setting base rates in effect during the current Tax Period.
- EDT is allocated to the tariff zones by using Factor F (Utility Plant Balance-Adjusted Average Balance) from the rate case.

IAWC states that the Company will provide compliance reports as required by the Illinois Administrative Code and/or the Company's tariffs, along with supporting workpapers that incorporate the results of the final Order of this proceeding on the calculation of each rider. The Commission finds IAWC's rider factors are reasonable and should be approved.

## B. Contested Issues

### 1. Environmental Surcharge Rider ESR ("Rider ESR")

#### a. IAWC's Position

IAWC explains that in this proceeding, it is requesting approval to implement a new Rider ESR pursuant to Section 9-220.2(a) of the Act, for recovery between rate cases of the revenue requirement associated with non-QIP eligible capital investments made to comply with new and emerging state and federal environmental standards or to advance

state and federal environmental regulatory policy objectives. As explained by Company witnesses Selinger and O'Neill, these investments can be significant, are driven by changes to drinking water and wastewater standards over which IAWC has no control, are difficult to predict, and fluctuate from year to year.

Specifically, the Company states that it anticipates investing approximately $88 million over the next 5 years to address new and emerging regulations and standards through the construction of new facilities and equipment. The Company states that it anticipates that additional investment needed to address perfluorinated compounds, pharmaceuticals, personal care products, nanomaterials, microplastics and algal toxins will occur over the next decade that will impact both the water and wastewater systems. IAWC notes that with more than 80,000 chemicals currently being used in society, and about 2,000 new chemicals being developed each year, it is expected that future regulations will require the water and wastewater treatment facilities to make further improvements to protect the environment and health of the public. IAWC explains that some of the technology needed to remove these contaminants may require large investments that will impact the overall investment plan for the company. IAWC states that it will be required to incur costs in order to meet new environmental standards, but cannot with any reasonable specificity identify the amount, magnitude, or timing of those investment costs.

IAWC states that with the approval of Rider ESR, the Company can make prudent investments to address new regulations and standards and serve the long-term interests of customers in a fiscally prudent manner, while moderating future rate increases on customers more efficiently and effectively.

IAWC explains that Section 9-220.2(a) of the Act provides that "[t]he Commission may authorize a water or sewer utility to file a surcharge which adjusts rates and charges to provide for recovery of" purchased water, purchased sewage treatment service, qualifying infrastructure plant, and "(iii) other costs which fluctuate for reasons beyond the utility's control or are difficult to predict." 220 ILCS 5/9-220.2(a). Subsection (c) provides that "[o]n a periodic basis, the Commission shall initiate hearings to reconcile amounts collected under each surcharge authorized pursuant to this Section with the actual prudently incurred costs recoverable for each annual period during which the surcharge was in effect." 220 ILCS 5/9-220.2(c). The Company also cites *Citizens Util. Bd. v. Ill. Commerce Comm'n*, 166 Ill. 2d 111, 138, 651 N.E.2d 1089, 1102 (1995) ("[A] rider mechanism is effective and appropriate for cost recovery when a utility is faced with unexpected, volatile, or fluctuating expenses.").

IAWC further explains that the costs that it proposes to recover through Rider ESR are the kinds of costs that Section 9-220.2(a)(iii) was intended to address, as they both "fluctuate for reasons beyond the utility's control" and "are difficult to predict." 220 ILCS 5/9-220.2(a)(iii). IAWC states that Section 9-220.2(a) does not establish any additional limitations on the kinds of costs recoverable under this subsection. For example, it does not establish, require, or even discuss a minimum dollar threshold that would be used to determine if a proposed surcharge is lawful or appropriate. Nor does it limit eligible riders to addressing specific issues such as fluctuations in market or commodity prices. And, the Company explains, no such limitations have been imposed by the Commission's implementing regulations, which only address purchased water and sewage treatment

surcharges (83 Ill. Adm. Code 655 ("Part 655")), and qualifying infrastructure plant surcharges (Part 656).

In response to Staff's assertion that Section 9-220.2(a)(iii) does not contemplate capital assets or infrastructure, and that the language in the statute referencing 'other costs' refers to expenses rather than capital investments of new infrastructure, equipment, and technologies, IAWC notes that statute does not say "expenses." IAWC states that, consistent with Staff's argument, if the General Assembly only meant for this provision to allow recovery of "expenses," it could have specifically used the word expenses. IAWC explains that the General Assembly similarly could have expressly specified that "other costs" excludes capital investments (i.e., it could have said "other costs, except for costs associated with capital investments of new infrastructure, equipment, and technologies, which fluctuate for reasons beyond the utility's control or are difficult to predict"), but it did not. The Company explains that instead, the plain language of the statute establishes Section 9-220.2(a)(iii) as a "catchall" for any unpredictable costs fluctuating beyond the utility's control, without any other express limitation that those costs must be related, or not related, to capital investment, expenses, or any other type of cost. That the General Assembly defined a subset of "costs" recoverable under Section 9-220.2(a)(iv) as "costs associated with an investment in qualifying infrastructure plant" contradicts Staff's argument, as it confirms that the catchall "other costs" could include other types of "costs associated with investment." The Company notes that where statutory language is clear and unambiguous, statute must be applied as written, and a court or agency may not "depart from the plain language of the statute by reading in any exceptions, limitations, or conditions that would frustrate the expressed intent of the legislature." *M.U. by & Through Kelly U. v. Team Ill. Hockey Club, Inc*., 2022 IL App (2d) 210568, ¶ 25

IAWC notes that the State of Illinois has statutorily authorized cost recovery mechanisms associated with qualifying infrastructure (*see* 220 ILCS 5/9-220.2(a)(iv); 220 ILCS 5/9-220.3), renewable energy mandates (220 ILCS 5/16-107.6(h)), energy efficiency (220 ILCS 5/8-103), and zero carbon electricity generation (220 ILCS 5/16-108(k)). IAWC states that the Commission has recognized the need to utilize cost recovery mechanisms related to environmental compliance as well, having authorized recovery of expenses associated with manufactured gas plant remediation through cost recovery riders and cites *Commonwealth Edison Co*., Docket No. 05-0597, Order at 212-13 (Jul. 25, 2006) (authorizing rider to recover manufactured gas plant remediation costs). More recently, in Docket No. 20-0722, the Commission approved modified extension policies for Nicor to facilitate the connection of renewable natural gas facilities to the Company's distribution system. *N. Ill. Gas Co. d/b/a Nicor Gas Co.*, Docket No. 20-0722, Order (July 8, 2021). IAWC contends that this type of action demonstrates the Commission's ability to advance state environmental policy goals, while enhancing operational efficiency. As further discussed below, IAWC believes it is important to not only be a leader in environmental compliance but also in reducing its impact on the environment. IAWC proposes to do so by examining ways that the Company can become more energy efficient, and to recover through Rider ESR investment in facilities that would support those initiatives and goals.

The Company explains that it is subject to a host of new and emerging regulations and standards governing both water supply and wastewater treatment, and that while the undisputed need to meet environmental compliance standards is expected and ordinary, the costs and investments associated with doing so are not. The Company notes that even proposed regulations and standards can and do change and evolve up until rules are finalized, giving companies little certainty about the scope and extent, or the timing, of necessary investments. IAWC states that the regulatory and rulemaking processes for developing the new regulations provides the Company with an understanding of what limits may be forthcoming, but the lengthy regulatory processes often result in changes, updates, and modifications to the science, the proposed standards, and the guidance. IAWC states that the proposed methods of determining the health impact level of various contaminants, for example, can and do change before regulations are complete, and it is difficult for the Company to determine the level of investments, techniques, or treatments that will be needed until regulations are finalized and the maximum contaminant level ("MCL") is established.

IAWC explains that water and wastewater utilities are subject to a complex array of regulations at the federal, state, and local levels with respect to water quantity, water quality and other environmental aspects of their facilities and operations. IAWC notes that drinking water quality is addressed by a combination of federal regulations under the Safe Drinking Water Act of 1973 and state regulations under Title 35, Subtitle F, Chapter I and Chapter II of the Illinois Administrative Rules. The Company explains that the federal act established the EPA as the federal regulatory body governing drinking water. Pursuant to that authority, the EPA has established standards for contaminant levels in drinking water, mandatory treatment methods, monitoring and reporting requirements, and public notification mandates in the event of contaminant level or treatment method noncompliance. *See* 40 C.F.R. Parts 141-143. The EPA also has granted "primacy" to the Illinois EPA ("IEPA") to administer the federal regulatory standards.

IAWC states that in recent years there has been an increase in public concern over water quality standards and regulation. IAWC explains that this increase has led to increased stringency in EPA and state drinking water regulation, and the extension of regulatory protections through the establishment of MCLs or treatment requirements that target additional contaminants. MCLs determine the maximum level of each covered substance that is deemed safe for the customer, and include requirements for monitoring, remediation, and public notice when standards are exceeded. IAWC states that there are now MCLs for 88 individual organic and inorganic chemicals, including groups like trihalomethanes and haloacetic acids ("HA"), and E. coli bacteria indicator microorganisms. In addition, IAWC notes, treatment technology requirements include specifications for surface water filtration and groundwater disinfection cover protozoa, viruses, and other bacteria.

IAWC states that MCLs provide an example of how regulations can shift during the regulatory and/or rulemaking process. IAWC explains that regulations on contaminates usually take into account the potential human exposure and risks of adverse health effects based on readily available sciences and the technology available to detect and treat the contaminate. As science, and the understanding of the long-term health effects of the contaminants evolve, the considered MCLs can change during the development of the

underlying rules and regulations, as well as after the MCL is initially set. The Company notes that an example of this is the June 15, 2022 EPA issuance of interim updated drinking water Health Advisories for perfluorooctanoic acid ("PFOA") and perfluoroocatanesulfonic acid ("PFOS") that moved the 2016 HA level of 70 parts per trillion (ppt) for individual or combined concentrations of PFOA and PFOS to levels of PFOA and PFOS that are 0.004 ppt and 0.02 ppt, respectively. In addition, an example of an MCL that was changed after a rule was in effect was the January 2001 revised standard for arsenic in drinking water, which replaced the 1975 standard of 50 parts per billion ("ppb") with a limit of 10 ppb due to a better understanding of the human health effects associated with chronic low-level exposure to arsenic.

IAWC states that the EPA continues to make its regulations concerning disinfection byproducts more stringent, has identified new contaminants and established more stringent standards for existing contaminants, and now, the Company must anticipate that the EPA may adopt more stringent lead concentration requirements under the federal "Lead and Copper Rule."

IAWC states that currently identified contaminants are not the only contaminants the Company may have to address: with advances in testing and health research, experts are learning of new potential dangers in our drinking water chemicals that had not previously been detected (or were previously known but are being able to be detected in far lesser concentrations) and are now being discovered in the water supply. IAWC explains that these chemicals are known as "emerging contaminants" or "contaminants of emerging concern"; prior to the emergence of these contaminants, source waters were considered relatively clean and, for the most part, required minimal levels of treatment followed by disinfection. IAWC points out that emerging contaminants can now be detected at trace levels, and even these very small amounts can pose a chronic health risk. IAWC states that over the past several decades it has seen an increasing interest in identifying unregulated substances within the environment that may pose a risk to human health, aquatic life, or the environment. These substances may not have been previously detected or were at concentrations that testing, and monitoring equipment could not detect until recently. IAWC explains that in all cases, these substances are considered important to continue to monitor and evaluate as experts work to determine the true risk they pose to human health and the environment.

IAWC explains that stringent new drinking water standards to address these potent compounds demand more innovative treatment approaches. IAWC further explains that emerging pollutants such as perfluorinated compounds, pharmaceuticals, personal care products, nanomaterials, microplastics, and algal toxins are becoming more prominent within the source of water, wastewater and potential entry into our drinking water. IAWC states that most water and wastewater treatment facilities were not designed to address these pollutants and will most likely not be able to treat them to the lower levels of concentration that is expected to be considered in new regulations as those regulations address the long-term impact of lower levels of contaminates, which the health and science community has been able to determine through improvements in analytical instruments.

IAWC states that, for the most part, these emerging contaminants are not yet federally regulated. Regulations governing the treatment of emerging contaminants are

currently moving through the EPA evaluation and rulemaking process. IAWC notes that several statutes authorize the EPA and the states to address those emerging contaminants, the most prominent of which are the Clean Water Act and the Safe Drinking Water Act, which Congress established to restore and protect the quality of the nation's surface waters and authorized the EPA to set the standards for drinking water quality and monitors states, local authorities, and water suppliers who enforce those standards.

IAWC states that, for example, in the near term, the Company will need to address PFAS in drinking water. IAWC maintains that until final regulations are enacted regarding these emerging contaminants, it is difficult to determine what systems will be impacted or the extent to which IAWC will need to invest in its systems. PFAS are a group of manufactured chemicals that have been used in industry and consumer products since the 1940s because of their useful properties.

IAWC states that current studies indicate that in order to remove PFAS from drinking water, IAWC may need to employ additional treatment technologies at existing water treatment facilities; these treatments could include activated carbon treatment, ion exchange resins, high-pressure membranes, nanofiltration, or reverse osmosis. IAWC notes that a determination of what technologies to employ if PFAS compounds are present will require a review of the effectiveness of each technology and an analysis of the costs and operational feasibility for each location. IAWC cannot determine the scope or cost of these treatment options until final regulations have been enacted, but the remediation techniques may be potentially very extensive and expensive.

IAWC states that additional contaminants, such as Legionella and Endocrine-disrupting chemicals, are becoming more prevalent in the environment and are increasingly posing a greater risk to human health. IAWC notes that it will almost certainly be required to invest in its systems to address and remediate these contaminants, although the scope and cost of such efforts will not be known until final regulations are adopted. IAWC points out that it also must comply with new and emerging environmental standards for wastewater systems, which similarly will require IAWC to incur unpredictable costs.

IAWC notes that wastewater systems are also seeing continued and increased regulatory initiatives to address surface water quality and the environment as a whole. Wastewater utilities continue to see an effort to reduce the number of CSO and sanitary sewer overflows ("SSO") through discharge permits (National Pollutant Discharge Elimination System ("NPDES") permits) and agreements to ensure compliance in meeting the goals of the Clean Water Act. IAWC states that wastewater systems are also seeing an increasing emphasis on assisting with reducing nutrient pollution in lakes, rivers, and streams by addressing the amount of phosphorus and nitrogen that is released into the environment by wastewater systems.

IAWC points out that in the short term, phosphorus and nitrogen nutrients in the discharge of wastewater facilities are being further reviewed by the EPA and the IEPA for their impact to the nutrient enrichment of lakes, streams, and rivers. As NPDES permits for IAWC wastewater facilities are renewed, IAWC anticipates that more stringent phosphorus and nitrogen limits will be required for those wastewater facilities, and, consequently, improvements will be needed to meet these requirements. IAWC states

that it anticipates that it will need to invest in its system to address lower phosphorus and nitrogen limits through changes in chemical or biological treatment enhancements over the next five years.

IAWC states that it expects to continue to make the appropriate changes in process, and investments in enhancements to wastewater chemical and treatment facilities, to allow it to meet these current and emerging regulations. IAWC explains that through meeting clean water standards, it ensures that it is returning water to the streams, rivers and lakes that protects the environment and the health of the community. IAWC maintains that by making the prudent investments to ensure compliance with these standards, IAWC protects its customers and the communities that are served.

IAWC explains that the Company has already experienced changes in or new regulatory compliance initiatives that have required investment in its facilities in order to comply with the new or changed regulatory requirements. IAWC explains that since 2000, there have been 13 EPA rules or regulations that have had an impact on how IAWC monitors, operates, or treats the drinking water within its facilities and distribution systems. IAWC explains that due to the rules or regulations enacted since 2000, the Company has undertaken 19 direct projects with an investment of over $88 million in enhancements or additions to treatment facilities.

IAWC states that the Long Term 2 Enhanced Surface Water Treatment Rule ("LT2") (adopted in 2006), which is the second phase of rules required by Congress to address microbial pathogens, provides a good example of investments that would be recovered through Rider ESR. IAWC states that the rule supplements existing regulations by targeting additional Cryptosporidium treatment requirements in facilities that take steps to decrease formation of disinfection byproducts that result from chemical water treatment. This rule has required enhancements and improvements in IAWC's treatment facilities. IAWC notes that it has implemented UV disinfection and other enhancements to several water treatment facilities to meet LT2 Cryptosporidium requirements. These facilities include the ESL Water Treatment Plant, Granite City Water Treatment Plant, Alton Water Treatment Plant, and the Streator Water Treatment Plant. In addition, IAWC states that it expects to carry out improvements at the Cairo Water Treatment Plants to allow it to meet the requirements of the LT2 Cryptosporidium requirements that are included in this case.

IAWC explains that recent changes to Illinois Title 35, Subtitle F, Chapter I, Part 604, Section 604.725 now require that a minimum combined chlorine residual of 1.0 mg/L be maintained in all active parts of the distribution system at all times. IAWC states that this change makes meeting the Stage 2 Disinfectant By Product Rule requirements challenging at times. To meet the IEPA chlorine residual requirement, IAWC has proposed that numerous Rechloramination Stations be installed in several of its larger distribution systems over the next several years that are included within the case. Each Rechloramination Station is designed specifically for each location to account for the size of the station covers and the amount of water that is required to be treated and must take into account how the station features and aesthetics to fits into the community where it is located. Thus, IAWC states, the scope, cost, and timing of each project is variable and currently unknown.

IAWC states that it has experienced similar investment needs for wastewater as well: IAWC has invested approximately $6.7 million since 2017 on wastewater system improvements to address regulatory, administrative order of consent, or Long-Term Control Plans.

IAWC states that between 2024 and 2026, the Company expects to invest approximately $39 million, or approximately $12.8 million per year, on projects that it has currently identified to address regulatory requirements that have recently been revised or expected to be introduced or revised. IAWC explains that this represents a significant portion of IAWC's projected annual capital expenditures.

For example, to address water system requirements, IAWC anticipates investing approximately $6.5 million on projects to address IEPA Chlorine Residual requirements and Stage 2 DBPR requirements over the next several years through the continued addition of rechloramination stations and improvements at facilities to improve chlorine residual and chlorine contact time. IAWC notes that to address wastewater requirements, it expects to invest approximately $30.1 million in improvements to the wastewater collections system in Alton and Godfrey to address the requirements of the Long-Term Control Plan and the administrative order of consent that is in place for each of those communities. In addition, IAWC states that it expects to invest about $7 million in improvements to the Godfrey and Jerseyville WRF to address phosphorus removal associated with the reduction of nutrient limits to protect receiving waters that receive the WRF's discharge flow.

IAWC states that it also expects that additional investment will be needed to address regulatory requirements associated with emerging contaminates that have not been included in the present 2022 to 2026 Capital Investment Plans. IAWC states that it would expect that investments will be needed to address the removal of PFAS compounds at some of its groundwater facilities and that additional investment will be needed to address phosphorus and nitrogen nutrients limits at some of its wastewater reclamation facilities as their discharge permits are renewed. IAWC notes that at the present time, it has not included these within its Capital Investment Plans due to uncertainty of the projects and limited understanding of the types of investments that will be needed.

IAWC states that the Company anticipates that the additional investment needed to address perfluorinated compounds, pharmaceuticals, personal care products, nanomaterials, microplastics and algal toxins over the next decade will result in additional spend that would result in an annual investment of between $15 and $20 million in its water and wastewater systems.

IAWC explains that the Company's analysis of the type, level, and timing of system investment to satisfy environmental standards is impacted by a multitude of factors. The type, source, climate, and environment of each water and wastewater facility, along with the unique characteristics of the distribution system and the existing type and age of the treatment that each facility employs, are main contributors to the determination of when a new or updated investment is needed to meet regulatory limits. IAWC notes that unexpected changes in weather, such as greater intensity storms, drought, and long-term temperature changes can all impact the watershed and source of the raw water to the

Company's water and wastewater facilities, which subsequently affect the levels of naturally occurring or manmade contaminates that the Company regularly monitors, which can lead to an unfavorable change in the contaminate levels that require the Company to make an unplanned investment to ensure that customers' health is protected.

In addition, IAWC contends, there can be unintended consequences of a new regulation on an existing established limit, which the Company also cannot control. As an example, IAWC explains that when the State of Illinois made changes to Illinois Title 35, Subtitle F, Chapter I, Part 604, Section 604.725 to require that a minimum combined chlorine residual of 1.0 mg/L be maintained in all active parts of the distribution system at all times, these changes resulted in the use of more chlorine through the system to ensure compliance. IAWC states that the increase in the use of chlorine increased the likelihood that the amount of disinfection byproducts being created in the distribution system as the chlorine naturally degraded would exceed the limit set by the Stage 2 Disinfection By Product Rule. IAWC explains that this required the recent investment of approximately $1.8 million in rechloramination systems along with the anticipated investment of approximately $8 million over the next several years to allow for decentralized control of chlorine residuals and disinfection byproducts that was unplanned until the new regulations were put in place.

IAWC points out that Staff and the AG do not address, much less rebut, all of this evidence. The Company asserts that, instead, Staff and the AG attack a straw man argument that the Company has never made (i.e., that environmental regulation is somehow new or a "unique business challenge that only IAWC faces") or attempt to wave away the Company's evidence by unfairly and inaccurately characterizing it as "generalized and vague arguments about environmental regulation." *See* Staff Ex. 1.0 at 16; AG Ex. 2.0 at 25. In response to the AG's argument that decisions relating to environmental compliance are no different from any other decision utility management faces, the Company explains that the Company's unrebutted evidence establishes that these investments are, in fact, different than other investment decisions the Company faces. As an example, the Company notes that the investments required to comply with environmental regulations are quite different than investments necessary to replace aging facilities or water transportation or distribution infrastructure, which costs are much more predictable in both timing and amount, and the timing and extent of which are more within in the Company's control.

IAWC explains that consistent with Section 9-220.2 of the Act, Rider ESR would allow the Company to recover the cost for enhancement or improvements to treatment plant items or facilities that are necessary to meet the new and emerging treatment and/or water quality standards described above. Specifically, Rider ESR would recover costs for treatment structures, pumping equipment, generators, water quality sampling equipment, supervisory control and data acquisition ("SCADA") equipment, chemical equipment, and treatment equipment, as well as non-QIP distribution system structures, supply mains, power generation equipment, pumping equipment, transmission and distribution mains, and storage tanks to meet water quality standards within the distribution system. Inclusion of these items would allow the installation of enhanced and new facilities/equipment to meet new standards that allow IAWC to continue to provide high-quality water service and safe drinking water.

IAWC explains that not all investments to meet new standards and regulations will require new infrastructure or be recovered through Rider ESR. There are several investments that will need to be made to meet emerging standards and regulations from the EPA and IEPA that will involve the replacement of existing infrastructure that may be recovered through IAWC's existing QIP Rider. For example, IAWC explains that to meet most of the upcoming standards established by the Lead and Copper Rule and the Illinois Lead Service Line Replacement and Notification Act, along with investments necessary to reduce/eliminate CSO and SSO, IAWC will be required to replace existing water and wastewater system infrastructure, and the Company will seek recovery of those costs under the QIP rider. The Company notes that parts of CSO and SSO improvement projects will be included within Rider ESR, however. IAWC explains that a major portion of the improvements necessary to address CSO and SSO in wastewater systems is the replacement and renewal of gravity sewers and service laterals. This work would not be included within Rider ESR since it is related to the replacement and renewal of existing wastewater facilities and is eligible for the QIP Rider. IAWC further explains that there will be some level of investment associated with the installation of equalization storage and collection system additions that will allow the wastewater collection system to accommodate high flow conditions that will involve the installation of new facilities. IAWC states that it would propose that these types of investments in new facilities would be included within Rider ESR.

IAWC notes that it also believes it is important to not only be a leader in environmental compliance but also in reducing its impact on the environment. IAWC proposes to do so by examining ways that the Company can become more energy efficient, increasing use of renewable energy and increasing our alternative-fuel fleet. IAWC explains that all of this supports American Water's goal to reduce absolute scope 1 and scope 1 greenhouse gas emissions by more than 40% by 2025 from a 2007 baseline. IAWC states that it would support this through investment in facilities that will support its transition to alternative-fuel vehicles. These facilities could include electric charging stations and alternative-fuel storage, fueling stations. In addition, IAWC notes that it would continue to look to expand its renewable energy use through the installation of solar, wind and hydro facilities. IAWC proposes that these types of investments be included within Rider ESR.

IAWC states that the required investments covered by Rider ESR will benefit customers through the provision of safe and reliable water and wastewater service that meets evolving governmental requirements and advances environmental policy objectives. IAWC notes that implementation of Rider ESR would allow IAWC to recover these unpredictable costs in a timely manner, reducing regulatory lag and supporting the Company's efforts to comply with these important environmental requirements.

IAWC further explains that the Rider ESR mechanism will mitigate future rate increases as it will facilitate smaller, more gradual increases to customers' bills. Rider ESR's recovery of these investments, which represent a significant portion of the Company's annual capital budget, will occur over time and not all at once in a general rate proceeding. IAWC further explains that riders such as the proposed Rider ESR also have the potential to extend the period of time between rate case filings and reduce the expense associated with those proceedings.

IAWC states that a reliable water and wastewater system is an important asset to the entire community. It protects the public health and enhances the ability of the communities that IAWC serves to compete for new businesses and industries, which is often an important economic benefit to the community.

In addition, IAWC argues that Illinois, as a whole, would benefit from the investment made through Rider ESR. IAWC explains that jobs in water utilities are accessible to workers with a range of educational and training backgrounds and offer opportunities for workforce development and advancement. Contractors, too, will hire diverse individuals throughout the state to support the infrastructure enhancements and improvements funded by the Rider. IAWC states that according to a 2014 study undertaken by the Clean Water Council, 16 jobs throughout all sectors of the economy are supported for every $1 million spent on infrastructure. IAWC points out that the jobs created are not just in the construction industry, but in supporting fields such as architecture, engineering, industrial machinery, and truck transport. As such, IAWC states that not only would the increase in infrastructure investment maintain and improve service reliability, but it would also benefit the local economy as well since an improved water and wastewater systems and the resulting customer benefits noted above can also attract new business to the area and support economic development goals.

Moreover, IAWC states that there are many studies that show that increased spending on infrastructure investments produces positive economic development results. IAWC points out that in a study released in 2016 on the economic impact of under-investing in our water and wastewater infrastructure, the American Society of Civil Engineers estimated that remaining on the current track will cost American businesses $896 billion in sales between 2016 and 2025, and the cumulative loss to our GDP will be $508 billion, directly due to deteriorating water infrastructure. IAWC contends that a modest increase in investment would prevent 489,000 job losses during the same period. Additionally, IAWC points out that according to the U.S. Conference of Mayors, every dollar invested in water infrastructure adds $6.35 to the national economy. IAWC also points to additional studies that show further economic benefit in infrastructure investment, including recent EPA surveys which tallied a 20-year need of over $650 billion for needed water and sewer infrastructure improvement projects. IAWC maintains that this would create between 10.5 and 17.5 million jobs over 20 years or 525,000 – 875,000 jobs annually. IAWC concludes that annual creation of jobs would be enough to annually employ one third of our nation's 1.8 million annual bachelor's degree graduates.

IAWC states that these statistics would hold true for infrastructure investment in Illinois. IAWC explains that not only would the increase in needed infrastructure investment provide safe water and improve service reliability, but it would also benefit the local economy as well. IAWC states that a water and wastewater system that meets all standards and regulations not only benefits the customer but can also provide interest in a community for new businesses and support local economic development goals. The Company notes that, like its other evidence regarding this issue, Staff and the AG ignore or otherwise fail to rebut the Company's evidence regarding the anticipated benefits of Rider ESR.

IAWC notes that the Company's initial proposal for the design of Rider ESR was prospective based on a forecasting process where the Company would forecast the

amount of qualifying environmental capital expenditures it will make for the upcoming year to calculate the revenue requirement necessary to recover that capital investment, followed by a true-up reconciliation to actual investments at the end of each year. IAWC explains that the Company subsequently accepted Staff's recommendation that Rider ESR be implemented using a historic operation year. IAWC explains that this change will allow Staff and others to review ESR investments included for recovery in the mechanism after they are placed in service, which along with the Company's prior agreement to multiple reporting and auditing commitments, should alleviate concerns expressed by Staff and others associated with the nature and review of Rider ESR investments.

Additionally, IAWC notes that the Company accepted Staff's recommendation to limit the amount of ESR investments and proposed a cap at 2.5% of authorized annual base rate revenues. IAWC points out that the Company also agreed to add language to its proposed tariff that specifies: (1) that the Company will provide information regarding the state or federal regulation requiring each investment as part of its annual filings; and (2) to specify the months in which its ESR reconciliation charge would be charged/credited to customers. IAWC explains that to address other recommendations made by Staff, the Company included in its proposed Rider ESR tariff an O factor in the ESR reconciliation calculation that would address any adjustments made by order of the Commission, as well as language to specify that the ESR would be billed as a separate line item on customer bills.

IAWC notes that the Company made several other changes to respond to input from the AG:

- IAWC added language to the proposed tariff confirming that investments to be recovered will not be revenue producing.
- IAWC added language requiring the Commission to find that ESR investments are prudent, reasonable in cost, and used and useful.
- IAWC added an annual audit requirement, with the following conditions:

  The utility shall submit annually to the Commission's Manager of the Accounting department no later than September 15th, an internal audit report that determines whether:

  i. Internal controls are effectively preventing the double recovery of costs through the Rider ESR and other approved tariffs;

  Costs recovered through the Rider ESR are recorded in the appropriate accounts;

  i. Costs recovered through Rider ESR are properly reflected in the calculation of the surcharge percentage and annual reconciliation;

  ii. The Rider ESR surcharge percentage and annual reconciliation properly reflect all applicable adjustments from prior Rider ESR surcharge reconciliation Orders;

- The Rider ESR surcharges are properly calculated.

- The Rider ESR surcharge percentage is being properly billed to customers.
- IAWC will also submit information describing which environmental standard or policy objective requires each investment.

IAWC explains that other aspects of the operation of Rider ESR are as follows:

- All items included for recovery through the ESR, including capital costs and annualized depreciation and property tax expense, will be set to zero at the conclusion of the next IAWC rate case. At that time, the abovementioned items will be subsumed within IAWC's base rates and afforded ratemaking treatment similar to IAWC's other capital investments.
- The ESR shall not be applied to any add-on taxes, to any revenues attributable to the Purchased Water and Sewage Treatment Surcharges developed pursuant to Part 655, QIP Surcharges, or to any other revenues not recorded in a ESR base rate revenue account.
- The revenue requirement for the ESR will be calculated using the pre-tax return ("PTR") as approved as approved in the Company's most recent general rate case. In the event there is more than one PTR during an ESR period, the PTRs will be prorated based on the number of days they were in effect during the period.
- Rider ESR will use the depreciation rates approved by the Commission, for the respective plant accounts in which the specific items of qualified Environmental Surcharge Rider plant are recorded.
- Rider ESR will use the property tax rates currently in effect and applicable to the Company's investments.

The Company notes that many of Staff's arguments against Rider ESR appear either mooted or otherwise ignore these changes that the Company has adopted in response to Staff and Intervenor input. The Company notes that Staff's assertion that the cost of capital investments should not be recoverable prior to a determination of prudence and reasonableness ignores that the Company added language to the Rider ESR tariff requiring Commission to find that ESR investments are prudent, reasonable in cost, and used and useful, along with an annual audit requirement, as conditions of recovery. Similarly, Staff's arguments regarding "speculative changes" and capital investments that the Company "might make" to comply with environmental regulations are moot since the Company accepted Staff's recommendation that IAWC's proposed Rider ESR operate on a historic basis. IAWC states that for this reason, the Commission should reject Staff's recommendation that it "remove language from the rider that permits the Company to include investment projects to comply with 'emerging' standards or environmental policy objectives." Staff IB at 62. The Company explains that Staff's argument that "there is no limit on the amount of ESR investment the Company could project for a given operating period," is moot given the Company's agreement to cap the investments that could be recovered through Rider ESR at 2.5% of authorized annual base rate revenues.

The Company states that the Commission should reject arguments from Staff and the AG that these costs are more appropriately recovered through base rate cases. IAWC

states that these arguments are essentially arguments against rider mechanisms generally, with the AG arguing that riders eliminate regulatory incentives to control costs and can result in increased rates and revenues. IAWC notes that the legislature, however, has expressly provided for water and wastewater utilities to implement riders as a recovery mechanism for costs of the type proposed for Rider ESR. 220 ILCS 5/9-220.2(a)(iii). IAWC further notes that the Illinois Supreme Court has consistently upheld the Commission's authority to implement riders "in proper situations and under circumstances that are lawful and reasonable" and that "reflect the need for pragmatic adjustments," which the Company explains is the case here. *In Re N. Shore Gas Co*., Case No. 07-0241, Opinion 2008 WL 631214. The Company contends that the fact that the Company could recover these costs through base rate case proceedings does not necessarily mean that it must do so, and that instead, these costs are appropriately recovered through Rider ESR, consistent with legislative intent in establishing the rider framework in Section 9-220.2(a).

Finally, the Company responds to Staff's argument that the rate of return for Rider ESR should equal the midpoint of long-term Aaa-rated bond yields and the WACC most recently approved by the Commission in a rate proceeding. IAWC explains that, contrary to Staff's arguments, the fact that Section 656.50(a) of the Commission's rules provides that "the pre-tax return is calculated using the weighted cost of debt and weighted cost of equity determined in the utility's last rate case for the rate zone" supports the use of the same approach here. 83 Ill. Adm. Code 656.50(a). IAWC states that there is no principled distinction between the nature of the utility assets recoverable under water QIP riders, as to which the Commission determined that the appropriate rate of return is the utility's WACC, and the assets recoverable under Rider ESR. IAWC notes that, like Rider ESR, QIP riders include an annual reconciliation mechanism and a review of the prudence and reasonableness of assets.

IAWC asserts that the Commission should adopt the same approach for Rider ESR that it adopted for QIP riders, and that nothing in Staff's position justifies a different approach, including the electric utility consolidated billing ("UCB")/purchase of receivables ("POR") cases Staff cites. IAWC notes that those cases – which are over 10 years old and concern the rate of return on capital investment in implementation costs (namely, for information technology assets associated with billing processes) required for UCB and reflected in the UCB discount rate, are based on a different statutory provision applied in a vastly different factual context, with a citation to *Central Ill. Light Co. d/b/a AmerenCILCO*, Docket No. 08-0619 (Cons.), Order at 24 (Aug. 19, 2009). The Company explains that the costs at issue in those cases were also shared with retail electric suppliers through the calculated UCB discount rate, so the recovery "risk" that the Commission considered was very different than with Rider ESR investment. IAWC states that, accordingly, the cases Staff cites are not applicable to Rider ESR's rate of return.

IAWC concludes that given IAWC's acceptance of the proposal to shift Rider ESR to historical operation, and other changes recommended by Staff and Intervenors, IAWC's revised Rider ESR tariff is reasonable and should be approved.

**b. Staff's Position**

Staff argues that the Commission should reject the Company's proposed Rider ESR. The Company relies on Section 9-220.2(a) of the Act as the statutory basis for its proposed Rider ESR. *Id*. at 23-24. The Company hinges its argument on subsection (a)(iii):

> (a) 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. A surcharge approved under this Section can operate on an historical or a prospective basis.

220 ILCS 5/9-220.2(a)(iii) (emphasis added).

However, Staff argues that the statutory language the Company relies upon in order to justify recovery through Rider ESR does not contemplate capital assets or infrastructure. Rather, the language in the statute referencing "other costs" refers to expenses rather than capital investments of new infrastructure, equipment, and technologies. This is evident when looking to the plain language of the statute in the next subsection. Specifically, subsection (a)(iv), refers to "costs *associated with an investment in [QIP]*…" (emphasis added). Staff's position is that this is significant because if the General Assembly intended to reference infrastructure in subsection (a)(iii), it would have explicitly done so as it did in subsection (a)(iv). The primary purpose of statutory interpretation is to ascertain and give effect to the intent of the legislature. *Skaperdas v. Cty. Casualty Ins. Co*., 2015 IL 117021, ¶15. Legislative intent should be sought primarily from the language of the statute, since the language of the statute is the best evidence of legislative intent and provides the best means of deciphering it. *Bruso v. Alexian Bros. Hosp.*, 178 Ill. 2d 445, 451-52 (1997). The plain language of the statute is clear in that it does not list or anticipate recovery of cost of plant anywhere. Therefore, Staff asserts that the Company's reliance on Section 9-220.2(a) for the implementation of Rider ESR is unpersuasive and is not applicable to the costs in question.

While the Company maintains that the expenditures it proposes to recover through Rider ESR are unexpected, Staff argues that IAWC has failed to provide evidence that the costs are difficult to predict or that they fluctuate beyond the utility's control to merit rider recovery. Unknown costs are particularly "unpredictable" or "fluctuating" per the language in the statute. Staff points out that as a regulated entity, IAWC must be responsive to and in compliance with new standards and regulations. It is not a benefit to customers that the Company meet all standards and regulations; rather, it is a requirement of the utility as a regulated entity to be in compliance with standards and regulations. Environmental regulation is not new; nor are regulations in general. Changing standards and regulation have been, and will continue to be, a constant. It is the nature of the utility business environment that it must be responsive to statutory

environmental standards, and it is not a unique business challenge that only IAWC faces. Staff Ex. 1.0 at 16. The Company's generalized and vague arguments about environmental regulation are unconvincing to show that those particular unknown costs are unpredictable and fluctuating. Thus, Staff contends that the Company makes generalized and vague arguments about environmental regulation that are thoroughly unconvincing to demonstrate that Rider ESR is needed and that the costs are unpredictable and fluctuating.

Additionally, Staff states that Rider ESR is unnecessary and imposes additional costs to ratepayers equal to the revenue requirement for such non-QIP eligible capital investments between rate cases, prior to a determination of prudence and reasonableness by the Commission. Staff Ex. 1.0 at 14. Rider ESR would include not only a return on the cost of the capital investments, but also the cost of depreciation expense and real estate taxes. *Id*. Further, there is no limit on the amount of ESR investment the Company could project for a given operating period. *Id*. at 9. Staff argues that this could encourage unnecessary capital spending that would unreasonably increase customer bills. *Id*. Therefore, Staff concludes that the traditional method of filing a rate case is sufficient to provide the Company with a return of and on its additional capital investments. *Id*. at 15. As the frequency and timing of a rate case is up to the utility, the Company is free to file a rate case whenever it believes the existing rates are insufficient to cover operating costs and provide investors with a reasonable return. *Id*.

Moreover, the Company already has a QIP rider, authorized by statute, that allows recovery of capital investments between rate cases for QIP eligible plant additions. *Id*. at 16. As noted by Ms. Pearce, the cost of capital investments should not be recoverable prior to a determination of prudence and reasonableness, except as a result of statutory approval. Notably, there has been no showing that IAWC needs an additional rider to recover the projected cost of capital investments that IAWC might make "to comply with new and emerging state and federal environmental standards or to advance state and federal environmental policy objectives." *Id*. at 13. The Company also fails to acknowledge that some emerging standards and policy objectives might never be enacted; thus, only actual changes, not speculative changes, would result in actual investment costs to the Company. Further, if changes or standards were enacted, there would likely be ample time for water and wastewater utilities to comply with the final regulation. *Id*. at 10.

If the Commission decides to approve Rider ESR, which it should not, Staff recommends that the Commission instruct IAWC to change Rider ESR to include Staff's recommendations:

(1) To utilize a historical, versus prospective, investment period; and

(2) To remove language from the rider that permits the Company to include investment projects to comply with "emerging" standards or environmental policy objectives.

Staff Ex. 9.0 at 13.

The Company states it accepts Staff's recommendation to limit the amount of ESR investments and proposed a cap at 2.5% of authorized annual base rate revenues. The

Company goes on to explain it included in its proposed Rider ESR tariff an O factor in the ESR reconciliation calculation that would address any adjustments made by order of the Commission, as well as language to specify that the ESR would be billed as a separate line item on customer bills. *Id*. However, the Company's proposal does not address Staff's concerns that Rider ESR would encourage unnecessary capital spending that would unreasonably increase customer bills. Staff maintains that the traditional method of filing a rate case is sufficient to provide the Company with a return of and on its additional capital investments.

The Company also claims that its design of Rider ESR has evolved to address the input from parties in this case, and for that reason, it is now reasonable and should be approved. Staff disagrees. Staff has multiple issues with Rider ESR; further, the Company completely fails to address or adopt some of Staff's recommended changes. Specifically, the Company failed to remove language from the rider that permits the Company to include investment projects to comply with "emerging" standards or environmental policy objectives. Further, IAWC failed to adopt or respond to Ms. Kight-Garlisch's recommendation that the return component for Rider ESR equal the midpoint of long-term Aaa-rated bond yields and the WACC most recently approved by the Commission in a rate proceeding. Staff Ex. 13.0 at 10. IAWC proposes to use the pre-tax return approved in the Company's most recent rate case as the interest rate for the return component for Rider ESR. IAWC Ex. 6.02 at 2-3. In direct testimony, Ms. Kight-Garlisch recommended that the Commission rely on the customer deposit rate for the return component. Ms. Kight-Garlisch explained that, generally, when a return component is not stated in the Act or in the Administrative Code, the Commission utilizes the Customer Deposit Rate 5 as the return component for riders due to the low-risk nature of the rider assets and the short time horizon. Staff Ex. 5.0 at 6.

In response to Ms. Kight-Garlisch's recommendation in direct testimony, IAWC argued that the return component will be applied to capital assets and thus, should receive a rate that is higher than the customer deposit rate. In her rebuttal testimony, Ms. Kight-Garlisch adjusted her recommendation and recommended that the return component for Rider ESR equal the midpoint of long-term Aaa-rated bond yields and the WACC most recently approved by the Commission in a rate proceeding. Staff Ex. 13.0 at 10. Utilizing the approach recommended by Ms. Kight-Garlisch in her rebuttal testimony recognizes that, while Rider ESR ensures dollar for dollar cost recovery of Rider ESR assets, the prudency and reasonableness of Rider ESR assets will remain subject to periodic review by the Commission. Thus, there remains a degree of risk related to non-recovery of costs. Therefore, Ms. Kight-Garlisch relied on the midpoint between the ROE that the Commission authorizes for rate base assets and lower risk Aaa-rated bond yields.

The Company's proposal to apply the most recent Commission-authorized rate of return on rate base to the Rider ESR assets implies that the risk inherent in the recovery of Rider ESR assets equals the risk of the Company's assets included in rate base. Ms. Kight-Garlisch noted that Rider ESR has features that reduce the risk of Rider ESR assets relative to rate base assets. Staff Ex. 13.0 at 9. Specifically, Rider ESR includes an annual reconciliation mechanism that ensures dollar for dollar cost recovery. This effectively eliminates both regulatory lag and the risk of non-recovery of prudent and reasonable costs incurred by the Company in implementing the ESR program. *Id*.

As Ms. Kight-Garlisch notes, authorizing a rate of return for Rider ESR assets that exceeds the investor-required rate of return on ESR assets would not balance the interests of investors and ratepayers. Rather, it would benefit Company shareholders at the expense of customers because the portion of return that exceeds the investor-required rate of return would be collected from customers and passed through to investors. Investors would receive more return than they require given the risk level of the Rider ESR assets, and customers would receive no benefit from guaranteeing the recovery of prudent and reasonable ESR costs. As such, that reduced risk should be reflected in the cost of common equity used to calculate the rate of return component in Rider ESR.

Mr. Selinger argues that because IAWC's QIP rider uses the WACC to determine the revenue component, Rider ESR should also use the WACC. IAWC Ex. 17.00 at 31. However, the return component calculation for QIP riders is specified in Part 656.50(a). Specifically, the Commission rules require QIP riders to apply the pre-tax WACC from the last rate case. 83 Ill. Adm. Code 656.50(a). In contrast, there is no similar rule for the proposed Rider ESR.

Notably, the Commission has adopted a similar approach to Ms. Kight-Garlisch's rebuttal recommendation for estimating an authorized return for utility assets that were guaranteed dollar for dollar cost recovery and also subject to periodic reviews for prudence and reasonableness in Docket Nos. 08-0618/0619/0620 (Cons.) and Docket No. 10-0138. *Central Ill. Light Co. d/b/a AmerenCILCO*, *Central Ill. Pub. Service Co. d/b/a Ameren CIPS, and Ill. Power Co. d/b/a AmerenIP*, Docket Nos. 08-0619/08-0620/08-0621 (Cons.), Order at 32-33 (Aug. 19, 2009); and *Commonwealth Edison Co*., Docket No. 10-0138, Order at 48 (Feb. 9, 2011).

Staff argues that it is clear that the Company's proposed use of the WACC from the Company's most recent rate case would not reflect the risk of Rider ESR and would be contrary to past Commission decisions. Staff also notes that the Company failed to address the Commission's previous decisions on riders that have similar risk to the Company's proposed Rider ESR. Therefore, Staff does not recommend approval of Rider ESR; however, if the Commission does approve Rider ESR (which Staff does not recommend), Staff recommends the Commission adopt Ms. Kight-Garlisch's revised recommendation regarding the return component for Rider ESR.

#### c. AG's Position

The AG recommends that the Commission reject the Company's proposed Rider ESR. The Company is proposing Rider ESR for the purpose of recovering its "costs associated with new investment in qualifying, non-QIP eligible utility plant required to comply with new or emerging federal and state environment and safety requirements or to satisfy other state or federal environmental policy objectives." IAWC Ex. 27.01 at 1. The AG explains that Rider ESR is not authorized under the Act, and it is not necessary because the costs in question are neither unpredictable nor uncontrollable such that a rider mechanism is necessary.

The Company asks the Commission to authorize Rider ESR under Section 9-220.2(a) of the Act. The AG explains that principles of statutory interpretation lead to the conclusion that Section 9-220.2(a) of the Act does not authorize Rider ESR.

When interpreting a statute, the "primary objective is to ascertain and give effect to the intent of the legislature," the most reliable indicator of which is the language of the statute. *Oswald v. Hamer*, 2018 IL 122203, ¶ 10. If a "literal reading of a statute produces absurd results, the literal reading should yield," and the statute must be construed in such a way that "avoids absurd or unjust results." *People v. Hanna*, 207 Ill. 2d 486, 498 (2003). The doctrine of *ejusdem generis* is particularly helpful "where a statute or document specifically enumerates several classes of persons or things and immediately following, and classed with such enumeration, the clause embraces 'other' persons or things." *Farley v. Marion Power Shovel Co*., 60 Ill. 2d 432, 436 (1975). In such a case, "the word 'other' will generally be read as 'other such like,'" meaning that the "other costs" described in Section 9-220.2(a)(iii) should be read as other costs like purchased water, purchased sewage treatment, and qualifying infrastructure plant and "not of a quality superior to, or different from, those specifically enumerated." *Id*. Applying these principles of statutory construction, the AG demonstrates that Section 9-220.2(a) does not authorize Rider ESR.

First, recovery of capital investments needed to comply with environmental regulations would be fundamentally unlike the other items listed in Section 9-220.2(a). As AG witness Larkin-Connolly explained, costs that "fluctuate" and "are difficult to predict" in this context typically refer to "market or commodity prices that can be volatile and unpredictable." AG Ex. 2.0 at 27. Therefore, it is more likely that "the intent of this clause is to promote the adoption of mechanisms used to shield utilities from input cost volatility, not changes in regulations." *Id*.

Second, the Company's interpretation would lead to an absurd result. According to the Company, "Section 9-220.2(a) does not establish any additional limitations on the kinds of costs recoverable under this subsection." IAWC IB at 120. The Company interpreted the requirement that the costs in question be "difficult to predict" to simply mean that the Company does not know what they are yet (because, for instance, a regulation has yet to be finalized). IAWC IB at 119–20. Thus, the Company is effectively arguing that the Commission has authority to permit a rider for any costs that the Company may incur in the future, but which are not yet known. The AG argues that it is unlikely that the legislature enacted Section 9-220.2(a) with the intent of swallowing the traditional ratemaking process entirely, and therefore the Company's proposed interpretation of the Act should be rejected.

Even if the Act authorized Rider ESR, it would not be appropriate because the costs in question are neither unpredictable nor uncontrollable. As discussed above, Section 9-220(a)(iii) authorizes a rider to recover "other costs which fluctuate for reasons beyond the utility's control or are difficult to predict." 220 ILCS 5/9-220.2(a)(iii). Echoing the statutory language, riders are traditionally meant to recover "*unexpected, volatile, or fluctuating* expenses." *A. Finkl & Sons Co. v. Ill. Commerce Comm'n*., 250 Ill. App. 3d 317, 327 (1st Dist. 1993) (emphasis in original). Thus, the Commission should only approve a rider "if the utility cannot influence the cost" and "the expense is a pass-through item that does not change other expenses or increase income." *Commonwealth Edison Co*., 405 Ill. App. 3d at 414 (*citing Citizens Util. Bd.*, 166 Ill. 2d at 138).

As demonstrated by Staff and AG witnesses, the costs that the Company proposes to recover under Rider ESR are neither unpredictable nor beyond the Company's control. *See, e.g.*, Staff Ex. 9.0 at 8-10; AG Ex. 3.0 at 28; AG Ex. 4.0 at 26. With respect to

compliance-related costs, there is nothing new or exceptional about IAWC's need to comply with environmental and safety regulations; indeed, it is a core responsibility of any utility. *See* 220 ILCS 5/8-401. As Mr. Larkin-Connolly testified:

> Since Congress enacted the Safe Drinking Water Act [] in 1974, giving the [EPA] the mandate to set standards for drinking water quality, there have been dozens of regulations adopted at the state and federal levels that require water and wastewater operator compliance. Changes in water and wastewater regulations have been an ever-present factor in the industry for over 40 years.

AG Ex. 2.0 at 25. And as Staff witness Pearce pointed out, "[e]volving statutory environmental standards are the nature of the utility business environment and not a unique business challenge that only IAWC must address." Staff Ex. 9.0 at 9.

While regulations and compliance standards evolve, they are rarely unexpected or volatile. The AG illustrates how the "process for identifying and regulating new contaminants at the federal level is . . . clear and predictable" using several examples that the Company cited in support of Rider ESR. For instance, PFOS and PFOA — two of the "emerging contaminants" cited by the Company as the reason Rider ESR is necessary— have been under consideration by the EPA for over ten years. AG Ex. 2.0 at 25-26. As Mr. Larkin-Connolly explained, before the Company will have to implement any compliance changes, the EPA will commence a rulemaking process that will likely take at least one to two years and will ultimately set forth the standards for water utilities like the Company. *Id*. at 26. Once the rulemaking is finished and the standards are finalized, public water system providers will have at least three more years to comply with the final standards and up to five years if capital improvements are necessary. *Id*. In all, PFOS and PFOA have been "emerging" as a contaminant for over a decade since the Contaminant Candidate List process began, and regulations of these contaminants may not take effect for another five years. *Id*.

The Company also pointed to several other examples at the federal level. For instance, the Company cited the January 22, 2001 change to the standards for levels of arsenic in drinking water, which was reduced from 50 ppb to 10 ppb, as an example of changing regulations. But according to the EPA website, "[w]ater systems had to meet the new standard by January 23, 2006," meaning that the Company would have had a full five years to comply. Another example cited by the Company, the LT2 requiring monitoring and treatment of cryptosporidium for water systems that was published January 5, 2006, gave the largest systems more than six years to comply with the treatment technique requirements, and states were allowed to grant systems up to two additional years for capital improvements. The Company also points to the June 15, 2022 updated interim health advisory for PFAS as evidence of emerging contaminants it will need to address. However, in announcing the updated health advisories, the EPA noted that drinking water health advisories "are non-enforceable and non-regulatory," meaning there was not an immediate and uncontrollable regulatory requirement resulting from the updated advisory, and at the same time the EPA announced $10 billion in funding through the Bipartisan Infrastructure Law to assist systems in addressing PFAS and other emerging contaminants. At the state level, the Company pointed to the Stage 2

Disinfectant By Product Rule that the Illinois Pollution Control Board implemented in 2019. But the AG points out that there was nothing unique about this rulemaking. The proceeding began in August 2017 and did not conclude until August 2019, during which time it went through the ordinary procedural process of allowing for interested parties, including the Company, to provide input on the proposed rules. What these examples demonstrate is that the Company has "ample time" and considerable discretion in determining how to comply with applicable environmental requirements and standards. Staff Ex. 9.0 at 10; AG Ex. 4.0 at 30.

The AG notes that the Company appears to conflate costs that are "unpredictable" with costs that are unknown. AG Ex. 4.0 at 28. The Company knows that environmental standards will continue to evolve as they always have, but it does not know what the "anticipated costs associated with investment in order to meet new environmental regulations" will be. IAWC Ex. 14.00 at 7. The Company's argument appears to be that although the event that causes "the costs to be incurred (new environmental laws and regulations) are predictable, the Company's actions (capital investments) necessary to respond to the event are unpredictable because they depend on factors not yet known." AG Ex. 4.0 at 28. As Mr. Larkin-Connolly pointed out, however, it is true that "the Company cannot know all of the factors that may affect a future decision, but this is no different from any other decision utility management faces." AG Ex. 4.0 at 28. All water and sewer utilities need to make decisions regarding the capital investments that are necessary to provide safe and reliable service, taking into consideration factors such as "source water characteristics, environmental factors, distribution system characteristics, wastewater receiving streams, and climate impacts." *See* IAWC Ex. 14.00 at 8. Because these are investments that any such utility would need to make in the ordinary course of business, "it would be difficult, if not impossible, to distinguish between costs that are eligible for recovery through Rider ESR and costs that are simply normal costs IAWC incurred to satisfy its obligation to provide safe and affordable water and wastewater service." AG Ex. 3.0 at 30.

In addition to being largely predictable, the AG explains how the "non-QIP eligible capital investments" of the type the Company seeks to recover under Rider ESR are also within the Company's control. In defending Rider ESR, the Company states that "[i]t is difficult to determine what level of investments, techniques, or treatments will be needed until regulations are finalized and a [MCL] is established." IAWC Ex. 14.00 at 8. Thus, the Company admitted that once a new regulation or standard is finalized, it is the Company who will determine what approach to take. AG Ex. 4.0 at 30. This is to be expected; the determination of how to comply with applicable regulations and standards "is a key attribute of utility management." *Id*. As Mr. Larkin-Connolly testified, "[t]he mere fact that the Company must decide on how to implement or respond to a new regulation shows that it has some level of control over the costs." *Id*. The Company cannot claim that capital investments are outside of its control simply because it does not know what they are yet.

Similarly, the AG argues that "investments made to advance state and federal environmental regulatory policy objectives" are not costs that are beyond the Company's control that would be appropriate for recovery under Section 220.2(a) of the Act. IAWC Ex. 3.00 at 25. The Company attempted to use a broad definition of "regulatory policy

objectives" by including "increasing use of renewable energy and increasing [its] alternative-fuel fleet." In addition to the lack of limitation as to what types of regulatory policies are relevant to IAWC as a water and wastewater utility, IAWC has failed to show that its response to, and investments in response to, purported regulatory goals are beyond the Company's control. Similarly, it has not shown that the associated costs would be exceptionally volatile or unpredictable. *See* IAWC Ex. 6.00 at 26. Thus, the AG argues, IAWC has not shown that its proposed Rider ESR meets the standards for approval.

The AG also explains that the Company incorrectly claims that similar riders have not been approved for other utilities. IAWC cites two cases to support its claim that "[s]imilar mechanisms have been approved for Illinois energy utilities." IAWC IB at 120-121. However, neither of the mechanisms approved in the cited dockets are similar to IAWC's proposal. In Docket No. 05-0597, the Commission approved a rider for ComEd to recover the costs of environmental clean-up and remediation costs for specific sites related to historic manufactured gas plants ("MGP") because the Commission had previously approved cost-tracking riders for MGP site remediation costs and such costs could no longer be recovered through base rates. Docket No. 05-0597, Order at 212. The Commission denied recovery for non-MGP site cleanup, because ComEd "failed to demonstrate that non-MGP costs [were] reasonable, prudently incurred, related to delivery costs and are as volatile as MGP costs." *Id*. at 213. The Commission further pointed out that "there is no precedent for recovery of non-MGP costs through a rider." *Id*. In Docket No. 20-0722, the Commission approved a limited rider to allow Nicor to facilitate the connection of renewable natural gas facilities to its distribution system. Docket No. 20-0722, Order at 15-16.

In contrast to both of these dockets, IAWC's proposed rider is based on potential future "changes to drinking water and wastewater standards." IAWC IB at 118. IAWC claimed that it anticipates spending "approximately $88 million over the next [five] years to address new and emerging regulations and standards through the construction of new facilities and equipment," and "additional investment" to address other environmental concerns. *Id*. In other words, IAWC's proposal is not limited to environmental cleanup at specific historic plant sites or a narrow interconnection pilot project, but instead is a large-scale capital investment rider that would provide the Company with authority to heavily invest in new infrastructure to address vague environmental concerns, without rate case oversight. The AG argues that the Commission should reject IAWC's proposal because it is significantly broader in scope and costs than either the ComEd or Nicor proposals the Company cited as support.

The Company claims that its ability to recover costs under Rider ESR would benefit its customers and Illinois more broadly. These include the health benefits of safe drinking water, environmental benefits associated with compliance such as a reduction in nutrient enrichment and pollution in source waters, and economic benefits of infrastructure spending. But, the AG notes, compliance with environmental regulations and prudent investment in its systems are the baseline expectations of a utility. Thus, customers will recognize these benefits regardless of the cost recovery mechanism.

While there is no benefit to ratepayers, the AG explains that there are several risks if the Commission were to approve Rider ESR. The use of riders as a cost recovery

mechanism "eliminates the regulatory incentive to control costs between rate cases and undermines the principle that the utility must manage its aggregate costs to keep rates just and reasonable." AG Ex. 3.0 at 28. Mechanisms like Rider ESR "can increase rates and revenues even when a regulated utility company achieves its rate of return and does not have a revenue deficiency." *Id*. at 29. Moreover, allowing the Company to recover the proposed expenses through Rider ESR would simply incentivize the Company "to favor compliance steps that involve investment in new capital over possibly less expensive operating cost measures." AG Ex. 2.0 at 28. The AG explains that the only party that stands to benefit from a reduction in regulatory lag and oversight is the Company's shareholders.

As Staff witness Pearce stated, "the rider is unnecessary because the Company may file a rate increase whenever it believes revenues are no longer sufficient to cover operating costs and provide a reasonable return to its investors." Staff Ex. 9.0 at 13. On the other hand, the AG explains how the proposed rider would reduce regulatory lag and oversight, to the sole benefit of the Company's shareholders. It is a well-settled principle that the "rate making process . . . involves a balancing of the investor and consumer interests." *Ill. Bell Tel. Co*., 414 Ill. at 287 (1953), *citing Fed. Power Comm'n*, 320 U.S. at 603. The AG demonstrates that Rider ESR would upend that traditional balance because it is completely unnecessary and would allow the Company to immediately recover costs, including the return to investors, that can be adequately covered through general rates. Therefore, the AG requests that the Commission reject Rider ESR.

**d. Municipalities' Position**

The Municipalities agree with Staff and the Intervenors that IAWC's proposed Rider ESR should be rejected. The Company seeks the rider to cover what it claims are unpredictable capital costs it might incur to comply with changes in environmental regulations and standards. However, the rider is not necessary because the Company has failed to show that there is a reasonable expectation that such costs will occur. Indeed, the Company in its own briefs listed known rules, regulations, and standards and acknowledged the costs to comply with them. Therefore, the Company has not demonstrated that its costs "are difficult to predict" as required for approval of a rider under Section 9-220.2(a)(iii) of the Act.

Moreover, the Municipalities agree with AG witness Larkin-Connolly that the core function of water and wastewater utilities is:

> to comply with environmental and clean water laws and regulations to assure safe drinking water and a clean environment. Environmental compliance costs are not unique or unpredictable; and compliance should be an ordinary, ongoing utility function. A rider surcharge mechanism is not appropriate for costs that are a part of the utility's fundamental responsibility.

AG Ex. 2.0 at 22.

Because IAWC's request for Rider ESR does not meet the statutory requirements for a rider and because IAWC is seeking to recover costs associated with its "fundamental

responsibility" as a water and wastewater utility, the Municipalities assert that the rider should be rejected.

#### e. Commission Analysis and Conclusion

IAWC seeks approval of a new rider that will allow the Company to recover the revenue requirement associated with non-QIP eligible capital investments made to "comply with new and emerging state and federal environmental standards or to advance state and federal environmental regulatory policy objectives." IAWC IB at 3; *see also* IAWC Ex. 3.00 at 25.

Compliance with state and federal regulations is a requirement for all public utilities and is not unique to IAWC. As parties indicate, these regulations are on some level always in flux. Regulations governing the treatment of contaminants in water do change, as do federal and state environmental policy objectives. While specific changes themselves may be unpredictable, they are not unexpected. As the AG notes, two of the 'emerging contaminants' that IAWC refers to have been under consideration by the EPA for over a decade.

The Commission agrees with Staff, the AG, and the Municipalities that the challenges that IAWC faces in complying with new and emerging regulations or regulatory policy objectives is typical of any of the challenges faced by any utility management. The Commission finds it unreasonable to approve a rider mechanism that would arguably place greater risk on the ratepayer for the benefit of stakeholders because IAWC would be able to immediately recover costs, including a return to investors, under the rider subject to a reconciliation. Should IAWC's management find in the future that its existing rates are insufficient to comply with any environmental rules or regulations, the Company may elect to file a rate case.

Also concerning is the potential scope of the qualifying costs under Rider ESR. IAWC states that investments under Rider ESR would represent a significant portion of the Company's annual capital budget. As Staff correctly notes, Rider ESR is a broad capital investment rider that would provide IAWC with authority to make large capital investments in new infrastructure to address vague environmental concerns. While investments in infrastructure provide positive economic results that benefit ratepayers, that does not mean that such investments are reasonable or prudent, especially considering the broad scope and ambiguity of Rider ESR. Accordingly, the Commission rejects IAWC's proposed Rider ESR.

Because the Commission rejects Rider ESR, assuming arguendo it is properly allowable pursuant to Section 9-220.2(a) of the Act, the Commission need not address the statutory interpretation arguments raised by parties as to whether such a rider is permissible under the Act.

### 2. Bad Debt Expense Rider ("Rider BDE")

#### a. IAWC's Position

IAWC states that the Commission has the authority to, and should, approve Rider BDE on a permanent basis. IAWC notes that Staff witness Alan recommends the Commission reject the Company's proposal to make its current Rider BDE permanent. IAWC notes that Section 9-220.2 of the Act provides that a water or sewer utility may "file

a surcharge which adjusts rates and charges to provide for recovery of… other costs which fluctuate for reasons beyond the utility's control or are difficult to predict….” 220 ILCS 5/9-220.2(a). IAWC states that it filed its original Rider BDE, effective December 20, 2020 “to recover incremental bad debt expense that fluctuates for reasons beyond the Company’s control or are difficult to predict given the ongoing COVID-19 pandemic.” *See* IAWC Tariff filing SRM #20-045, Cover Letter (Nov. 5, 2020). As stated in the tariff, “[t]he purpose of this Rider is to recover or credit the amount by which the Company’s actual annual bad debt expense in a fiscal year ending in February exceeds or is less than the bad debt amount included in the Company’s rates in effect for the reporting year… Costs subject to this Rider are those costs that are classified as bad debt expense in Account 670. IAWC explains that such adjustments will be the incremental difference between the amount of bad debt expense in Account 670 and the bad debt expense included in base rates and as allocated by customer class in the [COS] study for that case.” ILL.C.C. No. 24, Section No. 1, First Revised Sheet No. 29 (Canceling Original Sheet No. 27).

IAWC explains that Rider BDE is consistent with Section 9-220.2, including its provisions for reconciliations that will compare revenues collected under these riders during the effective period with the anticipated amount of revenues that were to be recovered or refunded under the riders. IAWC Tariff filing SRM #20-045, Cover Letter (Nov. 5, 2020). IAWC explains that Rider BDE was extended through December 2023 by the Commission in Docket No. 20-0309. *Ill. Commerce Comm’n,* Docket No. 20-0309, Order on Reopening and Stipulation (Mar. 18, 2021).

With these approvals, IAWC notes, the Commission has found that Rider BDE is a proper and reasonable mechanism for recovering fluctuating bad debt expense as a result of the pandemic through 2023. But as IAWC explained, bad debt expense is expected to continue to fluctuate after 2023.

IAWC notes that, as Company witness Selinger testified, there are a variety of factors, both on a macro and micro level, that cause fluctuations in uncollectible expense. For example, IAWC states, the current elevated level of inflation is at a level not seen in decades. Furthermore, IAWC states, contrary to Staff’s opinion, due to the ongoing and uncertain impacts of the COVID-19 pandemic, the ability to forecast the level of uncollectible expense in base rates continues to be challenging, and the historical approach utilized for setting a level of uncollectible expense in base rates carries risks for both customers and the Company. Additionally, IAWC states, the variability in uncollectible expense is not only related to severe events such as the pandemic. IAWC maintains that changes in economic conditions in general can drive these balances to significantly change from year to year. Further, the impact of new customer assistance programs is uncertain at this time and establishing IAWC’s current Rider BDE on a permanent basis would ensure that customers receive the benefit of such reductions if they were to occur. IAWC explains that Staff’s opposition to Rider BDE ignores a key element of IAWC’s proposal – because proposed Rider BDE will adjust for the variance between the actual uncollectible expense incurred and the level of expense authorized in this case. The Company notes that should uncollectible expense go down (for example due to the impact of customer programs, such as the Low-Income Household Water Assistance Program), customers would receive a credit for that reduction.

According to IAWC making Rider BDE permanent is consistent with Section 9-220.2 of the Act, as the level of bad debt expense remains beyond IAWC's control and difficult to predict. Without question, the impact of the pandemic on bad debt costs is outside IAWC's control. But IAWC anticipates other impacts will continue to affect bad debt expense as well.

If costs are difficult to predict, as Section 9-220.2 contemplates, so inherently is the timeframe for that unpredictability. As such, Section 9-220.2 permits a Commission approved surcharge without a time limit. For example, not only was it unforeseen that Illinois would face COVID-19, but it was also unforeseen that it would last for multiple years. As such, making Rider BDE permanent is not only reasonable and beneficial to the Company and its customers, but consistent with Section 9-220.2.

IAWC points out that Staff witness Alan disregards that Illinois' energy utilities currently operate uncollectible ("bad debt") rate adjustment mechanisms on a permanent basis. IAWC notes that energy utilities have statutory bad debt riders. *See, e.g.,* 220 ILCS 5/16-111.8 (authorizing an uncollectible rider for electric utilities). The Company explains that water utilities experience the same fluctuations and unpredictability for bad debt expense as other types of utilities. Establishing Rider BDE on a permanent basis simply puts IAWC on the same footing as the energy utilities in terms of the ability to address these fluctuations and unpredictability in a manner that allows IAWC to recover its costs if bad debt expense goes up and protects customers if the expense goes down – as Section 9-220.2 intends.

Staff witness Alan claims that because the current Rider BDE is set to expire December 31, 2023, the Company has minimal risk associated with fluctuations in its uncollectible expense. However, IAWC states, contrary to Staff's opinion, as stated above, the expiration date of December 31, 2023 is not a reliable factor in predicting the end of unpredictable fluctuations in the Company's uncollectible expense. IAWC notes that Staff does not demonstrate that the same circumstances affecting IAWC's bad debt expense now will not be present in December 2023 and beyond. Further as explained above, there are other impacts to bad debt costs that qualify bad debt costs for recovery under Rider BDE pursuant to Section 9-220.2. IAWC explains that the unpredictability is the precise reason why Rider BDE should be made permanent.

IAWC also states that Staff's claims that "[t]here is no [] provision in the Act authorizing permanent uncollectible riders for water or wastewater companies" and characterizes Rider BDE as a rider "that do[es] not have a basis in statute but impact[s] the revenue requirement…", is clearly incorrect as a matter of law, as Rider BDE does have a basis in statute – in Section 9-220.2(a) of the Act. 220 ILCS 5/9- 220.2(a). IAWC states that Staff's own logic regarding Rider ESR, that "the statute referencing 'other costs' refers to expenses rather than capital investments of new infrastructure, equipment, and technologies", would suggest that Rider BDE is exactly the type of rider authorized by Section 9-220.2. IAWC states that in short, Rider BDE is authorized by statute, and the standard is whether its recovers costs "which fluctuate for reasons beyond the utility's control or are difficult to predict."

The Company states that Section 9-220.2 of the Act is the correct legal standard and that the record evidence shows that IAWC's bad debt expense "fluctuate[s] for

reasons beyond the utility's control or [is] difficult to predict…." For this reason, IAWC states, Staff's reliance on *People ex rel. Madigan*, where the court cites to a 2010 Appellate Court decision, *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 405 Ill. App. 3d 389 (2d Dist. 2010), is misplaced. IAWC explains that nevertheless, even if those cases do apply, they establish essentially the same standard: whether the expenses in question are unexpected, volatile, fluctuating or outside the utility's control. As explained above, Rider BDE meets this standard. The Commission has previously approved an extension to Rider BDE, demonstrating that it is a proper and reasonable mechanism for recovering fluctuating bad debt expense through 2023.

IAWC contends that Staff's own adjustment to test year uncollectible expense confirms that the expense fluctuates. Staff developed a revised test year level of uncollectible expense using a "normalization" approach of a three-year average of 2019-2021 expense. IAWC explains that this use of a multiyear average of actual data suggests a desire to smooth out annual variability in uncollectible expense – in other words, that the expense fluctuates. IAWC also explains that the fluctuation can be seen in IAWC's data on annual uncollectible rates by rate zone, which show, for example, uncollectible percentages for Central wastewater ranging from 1.66% to 3.66% over the 2019-2021 time period, and for Central water from 0.49% to 0.74% over that same period.

Accordingly, IAWC concludes, the Commission should approve Rider BDE on a permanent basis.

**b. Staff's Position**

Staff argues that the Commission should reject the Company's proposal to make Rider BDE permanent. First, the Company has failed to provide evidence that the fluctuations in uncollectibles expense is exceptional to demonstrate that the rider is necessary. When reviewing riders that do not have a basis in statute but impact the revenue requirement, the Commission has looked to the courts for guidance. The Appellate Court decision, *Commonwealth Edison Co.,* 405 Ill. App. 3d 389, noted that "exceptional circumstances" exist such that it finds that the expenses in question are unexpected, volatile, fluctuating or outside the utility's control. The Company has the burden of showing that the costs are fluctuating, unexpected, or volatile.

Staff argues that IAWC has failed to provide evidence that the costs are fluctuating, unexpected, or volatile. Staff witness Alan calculated the Company's three-year Company average of uncollectible expense percentage for years 2019 through 2021 as 0.73%, with 2021 being 0.77%. Staff Ex. 3.0 at 15-16. The Company's stated necessity for the rider is not supported by the data; specifically, the lack of significant fluctuation in the data provides only further support that the costs are not fluctuating, unexpected, or volatile. Further, uncollectible expenses are not unique to IAWC; rather, they are costs common to all water and wastewater utilities and operating expenses fluctuate year to year. *Id*. at 16. According to Staff, adopting Company witness Selinger's rationale regarding fluctuation would lead to the unreasonable conclusion that the Company should be allowed to recover any, and all of its costs through various riders because the argument could be applied to any expense that fluctuates at all, even a minimal fluctuation. *Id*.

Second, Staff states that the Company's argument that because Illinois' energy utilities have permanent uncollectible expense riders, water and wastewater companies should be given the same treatment, is unpersuasive. The Commission granted uncollectible riders for gas and electric utilities through specific authority provided in the Act. *See*

220 ILCS 5/16-111.8(a);

220 ILCS 5/19-145(a).

There is no such provision in the Act authorizing permanent uncollectible riders for water or wastewater companies. If the General Assembly intended for water and wastewater companies to have uncollectible riders, it would have explicitly stated so as it did for electric and gas utilities. The best evidence of legislative intent is the language used in the statute itself, which must be given its plain and ordinary meaning. *People v. Bywater*, 223 Ill. 2d 477, 481 (2006). "No rule of construction authorizes us to declare that the legislature did not mean what the plain language of the statute imports, nor may we rewrite a statute to add provisions or limitations the legislature did not include." *See Zahn v. North Am. Power and Gas, LLC*, 2016 IL 120526, ¶ 15. The Commission is a creature of statute, and when granting energy utilities' uncollectible riders, it looked to the Act authorizing such an action. Staff asserts there is no such authority here, and the Company's arguments that water/wastewater utilities should be authorized to have uncollectible riders simply because energy utilities have them, are unpersuasive and should be rejected by the Commission.

Third, Staff states it is important to note that the Commission chose not to make the uncollectible rider permanent in Docket No. 20-0309, but instead extended the rider through December 2023 due to the COVID-19 pandemic. The Commission recognized that the pandemic was an unusual circumstance, which is why the Company was permitted to utilize Rider BDE on a temporary basis only.

In rebuttal testimony, the Company disagreed with Staff's recommendations due to the following factors: elevated level of inflation and continued uncertainty regarding the economic consequences of the COVID-19 pandemic, aligning the Company with its peer Illinois energy utilities, and the differences the parties have had in this case recommending the amount of uncollectible expense to include in base rates. Staff Ex. 11.0 at 13; IAWC Ex. 17.00 at 39. With regard to inflation, Staff notes that the Company has minimal risk of significant fluctuations in uncollectible expense due to its current Rider BDE being extended to December 31, 2023, and its estimated length for rates to be effective from this case. The possible effect on the Company's uncollectibles will not occur until 2024 at the earliest. *Id*. at 14. Company witness Selinger also stated that new customer programs and other customer bill assistance funds may result in reduced uncollectible expense for the Company. *Id*. (*citing* IAWC Ex. 17.00 at 39). As to aligning with its peer energy utilities, Staff stands on its argument that there is no statutory authority for uncollectible riders for water/wastewater utilities as there is for energy utilities. Most notably, there is not a water/wastewater utility that currently has a permanent uncollectible rider. Thus, Staff argues that the Company's comparison ultimately fails.

Staff notes that the Company argues that Section 9-220.2 is a basis for approving proposed Rider BDE. IAWC IB at 144. However, Rider BDE is not consistent with Section 9-220.2 of the Act, which states:

> (a) 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.

220 ILCS 5/9-220.2(a) (emphasis added).

Staff disagrees with the Company that the level of bad debt expense is "beyond IAWC's control" and "difficult to predict given the [COVID]-19 pandemic" in December 2023 and beyond. IAWC IB at 144-45. Aside from mere generalized statements that fluctuations are expected to continue past 2023, the Company fails to provide any actual evidence to support its claim that the costs are significantly fluctuating, unexpected, or volatile to justify making Rider BDE permanent.

The Company also argues that Staff has not demonstrated that Rider BDE should not be permanent. Staff argues that the Commission should reject this assertion. The burden of proof is on IAWC to prove that Rider BDE is just and reasonable on a permanent basis, not Staff. 220 ILCS 5/9-201(c). The Company argues that Staff witness Alan has not demonstrated that the same circumstances affecting IAWC's bad debt expense now will not be present in December 2023 and beyond. *Id*. However, according to Staff, IAWC's attempt to shift the burden of proof is inappropriate. Moreover, IAWC's attempt to deflect and shift the burden of proof only further demonstrates the Company's failure to prove that fluctuations and unpredictability will continue beyond December 2023.

Lastly, with regard to the Company's rebuttal argument that the different uncollectible expense amounts recommended by parties in this case supports the Company's proposal to make Rider BDE permanent is unconvincing. The Company accepted the AG's correction in its rebuttal position, and Staff concurred with the AG's correction. *Id*. at 15. Therefore, the uncollectibles amount in base rates is no longer contested and there is only one position in the record; however, this is not an argument in support of making Rider BDE permanent. *Id*.

Staff concludes that the Commission should reject the Company's proposal to make Rider BDE permanent.

#### c. Commission Analysis and Conclusion

The Commission does not find that IAWC has provided sufficient evidence that fluctuations in uncollectibles expense are unexpected or volatile so as to support permanent approval of Rider BDE. The Company asserts Rider BDE is necessary due to the ongoing impacts of the COVID-19 pandemic making it difficult for the Company to forecast the level of uncollectible expense. The Commission extended the effective date of Rider BDE through 2023. Other than general assertions made by IAWC, nothing in the

record indicates that fluctuations in uncollectibles expense due to the ongoing COVID-19 pandemic will continue beyond that date, let alone supports permanent adoption of Rider BDE. Moreover, as Staff notes, IAWC's claim that costs are fluctuating, unexpected or volatile is not supported by the data. Staff Ex. 3.0 at 15-16.

The fact that Illinois energy utilities have uncollectibles expense riders is not persuasive to justify approving a permanent rider for IAWC, especially considering that the energy utilities' uncollectibles riders were specifically authorized by the Act. *See* 220 ILCS 5/16-111.8(A); 220 ILCS 5/19-145(a). Accordingly, the Commission rejects IAWC's request to adopt Rider BDE on a permanent basis.

## VII. LOW-INCOME TARIFF

### A. Contested Issues

#### 1. Eligibility Threshold

##### a. IAWC's Position

IAWC proposes new low-income discount tariff pricing to make water and wastewater service more affordable for customers with demonstrated income at or below 150% of the Federal Poverty Level ("FPL"). IAWC states that the affordability of water and wastewater service is essential. It is IAWC's position that everyone should have access to clean, safe, and reliable water and wastewater service, a priority that no party disputes. IAWC explains that in an effort to achieve this goal, IAWC's proposed low-income discount tariff is designed to assist customers with the affordability of their service by providing a rate that lowers their monthly bill and makes service more affordable. IAWC explains that its proposed tariff has the following features:

- The Company's proposed tariff will be available to all water and wastewater residential customers with household incomes at or below 150% of the FPL.
- The tariff will offer a 70% discount on the base volumetric charges to any qualifying water or wastewater customer for all usage during the month.
- There is no proposed cap on monthly usage for any qualifying customer.
- Total discounts provided the customers will be recovered from all customers through the Company's existing Volume Balancing Adjustment ("VBA") mechanism.
- IAWC's proposed low-income rate will not limit the amount of time a customer can take service through this tariff as long as the customer demonstrates household income at the qualifying level.

IAWC notes that while no party disputes the benefit of the Company's proposed low-income tariff, and Staff and the AG generally recommend that the Commission approve the Company's proposed tariff, Staff objects to the Company's proposed eligibility threshold, the Company's decision to not place a usage cap on the amount of service that can be taken under the tariff, and the method by which the Company should recover the shortfall in revenue resulting from the low-income discount. IAWC argues that Staff's criticisms of IAWC's low-income tariff prioritize consistency with another

utility's tariffs over the best interest of IAWC's customers, ignores detailed analyses performed at a community level, and should be rejected.

IAWC proposes to make its low-income discount tariff available to any residential customer with a demonstrated income at or below 150% of the FPL. IAWC explains that this threshold is based on extensive research into the Company's residential customer population, which provides the estimated number of customers by multiple of FPL and the expected Balance-to-Income ("BTI") ratios for each of those groups based on the Company's proposed rates.

IAWC estimates that there are approximately 46,000 residential water customers and approximately 9,000 residential wastewater customers in its service territory with household incomes at or below 150% of the FPL that would be eligible for the Company's proposed low-income tariff. IAWC explains that for customers in the income group at or below 150% of the FPL, the discounts offered under this tariff would reduce a typical bill for Basic Water Service (40 gallons per day per household member for a family of three) from $64.20 per month under proposed rates to $41.31 per month, which is a discount of 36% on the total bill and is less than what these customers would pay for basic water service under the Company's current rates. IAWC notes that the BTI ratio for this customer group would be reduced from approximately 7% to approximately 5% under the proposed discounts.

IAWC states that Staff opposes the Company's proposed eligibility threshold, arguing that IAWC should be bound to the 100% of FPL threshold approved for PPWC in Docket No. 21-0198, because "[t]here is no reason that the Commission should approve different income level thresholds for two water/wastewater utilities in the same state and whose territories and customer makeup is similar." Staff Ex. 15.0 at 4. IAWC contends that Staff offers no evidence or support for the assertion that the Company's territory and customer makeup is similar to that of PPWC (let alone why any similarities would justify mandating implementation of an identical low-income program). Instead, IAWC notes, it is clear that Staff's objection to the Company's proposed eligibility threshold is based on nothing more than a desire to avoid inconsistent eligibility criteria for residential customers. IAWC argues that this is not a reasonable justification for rejecting the Company's data-driven proposal, and that this approach assumes that IAWC must somehow overcome or disprove the standards implemented in the PPWC rate case, while simultaneously ignoring the substantial evidence presented by IAWC in this proceeding.

IAWC explains that of the approximately 46,000 residential water customers and approximately 9,000 residential wastewater customers in IAWC's service territory with household incomes at or below 150% of the FPL, IAWC has determined that approximately 20,000 of those customers (43%) are in the 100-150% FPL group that Staff's proposal would exclude from eligibility in the tariff based on the tariff program approved for PPWC. And, for the approximately 20,000 customers that Staff's proposal would exclude from eligibility for the low-income tariff, IAWC has estimated that bills resulting from the Company's proposed rates are expected to take up approximately 2.8% of household income – above the 2% BTI threshold that is generally regarded as being "affordable" for non-low-income customers. IAWC states that as acknowledged by the AG, the Company's proposed low-income eligibility threshold is supported by substantial community-level data - the Company's geospatial poverty analysis comprehensively

assesses the prevalence of poverty in its service areas through a specific service territory analysis of customers and income data available at the zip code level and does not rely on state-level averages. IAWC points out that in contrast, per Staff witness Boggs' explanation, the threshold level established for PPWC in Docket No. 21-0198 was done without actual data, including information supporting how many households would be eligible.

IAWC argues that it is well-established that "any finding, decision or order made by the Commission shall be based exclusively on the record for decision in the case." 220 ILCS 5/10-103. IAWC asserts that Commission practice is clear on this point – the Commission must have the power to "deal freely with each situation that comes before it, regardless of how it may have dealt with a similar or even the same situation in a previous proceeding." *Commonwealth Edison Co*., 405 Ill. App. 3d at 407-408; *citing Miss. River Fuel Corp*, 1 Ill. 2d at 513. Therefore, "[a] record containing new evidence or argument that implicates past decisions compels reconsideration on the new record and may require a different result." *Commonwealth Edison Co.*, 405 Ill. App. 3d at 408. IAWC notes that the AG also acknowledges this point, stating that the Commission is not required to approve the same program for IAWC that it approved for PPWC.

IAWC notes that Staff offers no other justification for why the Company's proposed eligibility threshold should not be adopted. IAWC argues that binding it to another utility's rate design, simply because the other utility suggested it first, is unreasonable and ignores the reality of the Company's distinct and separate customer base, service territory, and proposed low-income program. IAWC concludes that the Company's proposed eligibility threshold of 150% of the FPL is reasonable, supported by evidence, and should be adopted.

**b. Staff's Position**

Staff states that the Company proposes low-income discount tariff pricing to make water and wastewater service more affordable for customers with demonstrated income at or below 150% of the FPL. IAWC Ex. 7.00 at 34-35. The tariff discount will be a 70% discount on all applicable base rate volumetric charges for qualifying customers. *Id*. at 35. The Company's proposal does not include any limits (or caps) on the number of participants in the program, the dollar amount of discounts provided to eligible customers, or the amount of monthly water or wastewater service that a qualifying customer can use under the discounted tariff. *Id*. at 35-36. The Company proposes to recover the costs of the discounts provided to customers through the Company's Rider VBA. *Id*. Staff objects to the Company's proposed eligibility threshold, the lack of inclusion of usage caps and its approach to cost recovery. Staff recommends the Commission approve the Company's low-income discount tariff with Staff's proposed modifications to the eligibility criterion, usage caps, and cost recovery. Staff Ex. 7.0 at 57.

Staff argues that the Commission should reject the Company's proposal to offer its low-income tariff to any water or wastewater customer whose household income is at or below 150% of the FPL. Staff Ex. 7.0 at 51. Staff recommends the tariff be available to all customers with demonstrated income at or below 100% of the FPL. *Id*. Mr. Boggs explained in testimony that the Commission recently approved this criterion for a discounted volumetric rate provided by PPWC. *Id*. at 51-52. In that docket, the company,

Staff, and the AG all agreed that the 100% threshold was "reasonable" and should be adopted.

As this is a new proposal from IAWC and the low-income rate approved in Docket No. 21-0198 is still in its infancy stage, Staff does not see a compelling reason to allow a different income eligibility threshold to be approved in two different water/wastewater utilities in Illinois. *Id*. at 52. Thus, to remain consistent, Staff recommends the Commission approve IAWC's low-income discount tariff to all customers with demonstrated income at or below 100% of the FPL. *Id*. Staff is unaware of any compelling reason that the Commission should approve different income level thresholds for two water/wastewater utilities in the same state and whose territories and customer makeup is similar. *Id*. at 52-53. Although Staff's recommendation may reduce the amount of IAWC customers that are eligible for the low-income discount rate tariff, this will also mitigate the reduced revenue from offering lower rates that will have to be recovered from customers that do not qualify for the discounted tariff. *Id*.

The Company argues that Staff's concerns regarding inconsistent eligibility criteria are not reasonable justifications for rejecting the Company's "data-driven" proposal. Staff argues that the Company's arguments are meritless. Staff has explained that both customer bases are made up of a combination of smaller, former municipal systems that were consolidated into a larger water and sewer utility system over time, and that both IAWC and PPWC's customer classes are spread across several counties in Illinois. IAWC's proposal could result in a customer being eligible in one community, but not in a neighboring community. Staff states that at this early stage of the low-income program, there is no reason for two Illinois water and wastewater utilities to offer different eligibility parameters for water and wastewater customers. Staff asserts that the Commission should approve Staff's recommended eligibility threshold that the tariff should be available to customers with demonstrated income at or below 100% of the FPL.

**c. AG's Position**

The AG argues that the Commission is not required to approve the same program for IAWC that it approved for PPWC. AG witness Larkin-Connolly pointed out, "Given the magnitude of the rate increases the Company proposes . . . , I view the adoption of this discount rate as an important affordability measure." AG Ex. 2.0 at 29-30. When compared with the Low-Income Home Energy Assistance Program ("LIHEAP"), Staff's proposed eligibility threshold is very low for a discount rate program and would thus omit many struggling ratepayers from participation in a program that would otherwise provide help to cover IAWC's increasingly unaffordable rates. Raising the eligibility threshold for certification to 150% gives greater opportunity for low-income customers to avoid being overburdened by IAWC's rate increases and allows a greater number of struggling ratepayers to participate in its program.

The AG shows that Staff's reliance on the PPWC program is also misplaced because the service areas of the two utilities are very different. USI has approximately 15,000 water customers and 4,000 wastewater customers spread over 22 districts. Docket. No. 21-0198, Order at 11, 36. In contrast, IAWC has 375,000 customers in more than 60 municipalities. *See* IAWC Municipality List; IAWC Ex. 1.00 at 4. IAWC's estimates show that approximately 46,000 of its residential water customers and

approximately 9,000 of its residential wastewater customers make less than 150% FPL—meaning that the number of customers eligible for IAWC's program is more than double USI's entire customer base. If the Commission caps IAWC's eligibility threshold at 100% FPL, then it would exclude approximately 20,000 customers from this program. Further, IAWC serves many Illinois cities (*e.g*. Peoria, Pekin, Champaign, ESL) as well as more suburban (Chicago area) and rural areas. The cost of living in these areas may be higher than in PPWC's service territory. As a result, the populations served by the two utilities are not comparable. The AG maintains that more flexible eligibility criteria that more closely mirrors eligibility in the Energy Assistance Act and the Water and Sewer Assistance Act is more appropriate for a utility of IAWC's size. *See, e.g.,* 305 ILCS 20/6 (Energy Assistance Act); 305 ILCS 21/20 (Water and Sewer Assistance Act).

The AG requests that the Commission reject Staff's proposal to lower IAWC's discount rate eligibility threshold to 100% FPL.

#### d. Commission Analysis and Conclusion

While Staff's 100% FPL eligibility threshold is reasonable, IAWC's proposed eligibility threshold of 150% of the FPL for participation in its low-income tariff is also reasonable and supported by substantial evidence that analyzes the Company's residential customer population, including the estimated number of customers by multiple of FPL and the expected BTI ratios for each of those groups based on the Company's proposed rates. Staff claims the Commission should make IAWC's low-income tariff consistent with the low-income tariff approved for PPWC in Docket No. 21-0198 in part because having consistent State-wide eligibility parameters places Illinois customers on a level playing field. Low-income tariff programs are relatively new. While uniformity among low-income tariff programs may be an appropriate goal in the future, the Commission must make a decision based on the evidence in this record. IAWC has a different service area than PPWC, including many more ratepayers in very different communities, and limiting the eligibility threshold to 100% of the FPL unnecessarily excludes struggling ratepayers from participating in the program. The Commission adopts IAWC's proposed eligibility threshold of 150% of the FPL.

### 2. Usage Caps

#### a. IAWC's Position

IAWC states that its proposed low-income discount tariff will be available to all customers in all pricing zones and will provide a 70% discount on all base rate volumetric charges in each district. IAWC notes that the Company has determined that it is in the best interest of IAWC customers to not impose a cap on the amount of water that can be used each month under the discounted rates because there is a strong positive correlation between the number of people living in a home and the amount of water used for basic water service in the home. In other words, the more people that reside in a household, the more water one can expect that household to use. IAWC explains that because the definition of FPL takes into account both household income and the number of people living in a home, and households with as many as six or seven people can qualify under the 150% of FPL provision for the proposed low-income tariff, it is appropriate to ensure that the potential benefits of the tariff are available to larger families that would qualify under the tariff's income guidelines. IAWC notes that the AG agrees

with this approach, acknowledging that "the variability in the size of low-income households makes it appropriate to forego a volumetric bill usage cap on discounted water," and given that "application of the discount to a specific usage cap had the potential to undermine the program's goal to keep water and sewer rates affordable for low-income households." AG Ex. 2.0 at 31.

IAWC states that Staff objects to this approach and argues that usage under the low-income tariff should be capped using "a similar usage forecast and calculations…as the Commission approved in Docket No. 21-0198." Staff Ex. 7.0 at 54. IAWC explains that Staff's justification for the usage cap is based, again, on a preference for consistency and a desire to bind IAWC to the tariffs approved for an unrelated utility with separate geographical service areas and customer base. Again, similar to Staff's objection to the Company's proposed eligibility threshold, there is no data or evidence supporting this proposal. IAWC maintains that Staff has not offered any analysis of how a cap on usage under the low-income rate may impact participation, customer bills, or affordability, not has Staff demonstrated why PPWC's usage forecast and calculations are reasonable or appropriate for use by IAWC. Staff also argues a usage cap is necessary to ensure that low-income customers are incentivized to conserve water in the same way as non-low-income customers. Again, IAWC notes, there is no evidence that low-income customers (who necessarily have lower income levels than the non-low-income customers) may lack incentives to conserve water or may otherwise use water and wastewater service indiscriminately. Neither has Staff demonstrated what factors may drive water conservation for non-low-income customers, such that they will conserve water whenever possible. IAWC further notes that under Staff's proposal (assuming an eligibility threshold of 150% of FPL), more than a quarter of potential eligible customers will see significant differences of anywhere between 16% and 78% depending on the size of the threshold.

**b. Staff's Position**

The Company's proposed low-income discounted tariff does not include any limit (or cap) on the amount of water/wastewater service that a low-income customer can use under the discounted tariff. IAWC Ex. 7.00 at 35. Staff objects to this aspect of the Company's proposal. Staff Ex. 7.0 at 53.

Staff witness Boggs recommends IAWC use a similar usage forecast and calculations for both its water and wastewater low-income tariff proposal as the Commission approved in Docket No. 21-0198. Staff Ex. 7.0 at 54. In that case, PPWC developed a low-income usage forecast model based on a bill frequency analysis of its residential bills and, from that model, PPWC estimated that the average low-income usage on a bill would be 2.299 kilogallons, equal to a 67% factor for low-income usage. *Id*. The Commission approved using this 67% factor to forecast total low-income sales for rate design purposes, which addressed the concerns of the AG regarding bill distribution effects of using the residential class average usage to forecast low-income sales. Docket No. 21-0198, Order at 105. Staff recommends that IAWC use a similar usage forecast and calculations for both its water and wastewater low-income tariff proposal. Staff Ex. 7.0 at 54. Staff asserts that since the low-income tariff rate proposals are in their infancy stage, having two different low-income tariff programs running simultaneously with different rules and eligibility requirements between similar utilities could lead to fairness concerns between the two customer bases. *Id*.

Staff witness Boggs calculated a usage cap for water and wastewater service for IAWC's proposed discounted tariff using the method approved by the Commission in Docket No. 21-0198. *Id*. Based on IAWC's usage calculations provided by the Company and the approved USI model described previously, the overall average water usage for IAWC customers is 4,130 gallons per month. The average usage among IAWC customers who do not use the average amount of water in a month is 2,314 gallons. In this IAWC proceeding, the usage adjustment would calculate to 56%. Staff Ex. 7.0 at 54-55, Att. 7.06.

Staff states that the Commission should reject the Company's proposal of no cap on the amount of monthly water or wastewater service that a low-income customer can use under the discounted tariff. Staff Ex. 7.0 at 55. Customers that qualify for the discounted tariff should have the same incentive to conserve water as the IAWC customers that do not qualify for the discounted tariff. The Company's calculated average water and wastewater usages among all customers includes all non-low-income and low-income users. Staff Ex. 7.0 at 55. Staff states that the Company has not provided information or documentation to illustrate that the family size differs among customers that qualify for the discounted tariff and customers that are ineligible for the discounted tariff. Staff's recommendation should provide all water and wastewater customers an incentive to conserve water whenever possible. *Id*.

**c. AG's Position**

The AG requests that the Commission deny Staff's proposal for a usage cap because the Commission is not required to approve the same discount rate program for multiple utilities. The AG notes that Staff's usage cap would arbitrarily limit the discounted service available to low-income ratepayers without regard to family size or location. Indeed, the poverty rate explicitly recognizes the higher costs associated with larger families, and the AG contends such families, while qualifying for the program, should be able to satisfy basic health and sanitation needs by using the amount of water appropriate to the number of people in the household. A usage cap based on an average family size would unreasonably limit the benefit available to larger families. The AG maintains that if the Commission were to approve Staff's proposal, then it would unreasonably force low-income ratepayers to ration their water use to avoid paying the full cost of IAWC's unaffordable service for any amount of water or wastewater used above the proposed caps. The AG thus requests that the Commission reject Staff's proposal to impose a cap on water and wastewater usage subject to IAWC's discount rate.

**d. Commission Analysis and Conclusion**

The Commission is not persuaded by Staff that a usage cap is necessary. As the Company points out, there is no evidence that low-income customers will use unreasonable amounts of water due to the reduced rates. Moreover, there is a strong positive correlation between the number of people living in a home and the amount of water used for basic water service in the home. As IAWC notes, it is appropriate to ensure that the potential benefits of the tariff are available to larger families that would qualify under the tariff's income guidelines.

Staff claims that having two different low-income tariff programs running simultaneously with different rules and eligibility requirements between similar utilities

could lead to fairness concerns is misplaced. Utilities offer many different products to their customers, some which are required by law and some which are not. Utilities are not required to offer low-income tariffs to their customers and therefore, are not required to mimic other utilities' nonstandard services.

### 3. Revenue Recovery

#### a. IAWC's Position

IAWC states that because it is unclear how many customers might avail themselves of the low-income rate to recover the cost of the 70% discount on volumetric rates provided to eligible customers through the low-income tariff, the Company proposes to use its VBA mechanism to recover the cost of the discount on volumetric rates provided through its low-income tariff. The VBA Rider, which is reconciled every year in a docketed Commission proceeding, allows the Company to recover shortfalls in volumetric revenues or provide credits from an overcollection of volumetric revenues to customers based on approved volumetric revenue requirements in this proceeding. Under this approach, IAWC explains, if all customers who were eligible for the tariff participated at full usage, the cost of the low-income program would be approximately $10.2 million. The associated increase in the VBA to recover this cost would be approximately $0.03 per hundred gallons, which for a low-income household of two person would equate to $0.78 per month. Because the typical discount for that low-income customer is approximately $16 per month, the associated increase in the VBA represents less than 5% of the total discounts available to low-income customers. IAWC argues that this approach is reasonable, avoids imprecise estimates of potential customer participation in the tariff, and ensures that any revenue shortfalls that accrue from the low-income program are reflected in the VBA calculation rather than guaranteeing the Company cost recovery based on a predetermined estimated level of cost.

IAWC notes that Staff objects to IAWC's proposal to recover the exact amount of its revenue shortfall through Rider VBA, arguing that Rider VBA was not established as a mechanism to recover loss of revenue as the result of offering a low-income rate through a discounted tariff, and that IAWC's proposal would potentially set a dangerous precedent by allowing the Company to reduce rates for an unlimited amount of water for a particular customer class knowing that there will be guaranteed recovery of that revenue somewhere else. Instead, Staff recommends that IAWC assume 100% participation in its low-income rate to develop a rate that recovers any revenue shortfalls from the low-income tariff through the volumetric rate in each respective water and wastewater division.

Again, IAWC contends, Staff's recommendation is designed to remain consistent with the method approved in Docket No 21-0198. And, again, IAWC states, Staff offers no evidence as to why this approach or Staff's proposed assumptions are appropriate or reasonable for IAWC. In fact, IAWC notes, Staff acknowledges the inexactitude of this proposal, recognizing that it is unlikely that the Company will get 100% participation from all customers who qualify. To address this imprecision, Staff simply recommends that the Company engage in annual reporting (excluding first-year statistics) to estimate the volumes of water and wastewater used by the number of low-income ratepayers and determine how to set non-low-income volumetric rates in future rate filings.

IAWC states that Staff has not provided any evidence demonstrating why this approach is reasonable, nor any justification for its application to IAWC beyond ensuring consistency with PPWC. IAWC explains that developing a volumetric rate that assumes a relatively large assumption of tariff participation into rate design will inevitably increase rates for customers with no ability to reduce those rates until the next rate case if there is less than 100% participation in the low-income tariff by eligible customers. In contrast, IAWC notes that its proposal results in lower rates for customers, and only recovers the cost of discounts offered through the tariff when those discounts are used; those costs are recovered in the next year, which further reduces the cost of the program for nonparticipants.

Further, IAWC states, Staff's concern that Rider VBA was not designed to recover revenue shortfalls resulting from a low-income rate is irrelevant, and that Staff offers no case law, evidence, or contradictory tariff language to support this view. IAWC points out that the first low-income rate for water and wastewater utilities was approved just nine months ago in Docket No. 21-0198 (which Staff has repeatedly cited). Therefore, IAWC states, indisputably, the Company's VBA Rider was approved by the Commission when a low-income discount tariff had not yet been contemplated, let alone litigated. Nevertheless, IAWC states, recovery of revenue shortfalls resulting from a low-income rate is consistent with the original purpose of the VBA Rider – to allow the Company to recover its approved volumetric revenue requirement, no more or less.

IAWC explains that as designed, its VBA tariff reconciles rate case volumetric revenues generally. IAWC asserts that in order for low-income discounts to not be recovered through the VBA, the tariff language of Rider VBA and the calculation of the factor itself would have to be amended to specifically exclude rate case revenues and actual revenues associated with low-income discounts. IAWC asserts that its VBA tariff carries the force of law, and Staff has not proposed any changes to the tariff language or to the VBA calculation that would specifically exclude the reconciliation of revenues associated with a low-income tariff. Without such changes, IAWC's VBA tariff would capture shortfalls in revenue associated with the low-income tariff in its revenue calculation. *See Sheffler v. Commonwealth Edison Co*., 2011 IL 110166, ¶28 ("Once the Commission approves a tariff, the tariff is a law, not a contract, and has the force and effect of a statute"); *citing Adams v. N. Ill. Gas Co*. *d/b/a Nicor Gas Co.*, 211 Ill. 2d 32, 55 (2004).

IAWC also asserts that under Staff's approach, which would adjust volumetric rates to account for assumed participation levels, IAWC would still be required to use its VBA mechanism to reconcile total actual fiscal year volumetric revenues; thus, any deviation from Staff's assumptions about low-income discounts would cause a fluctuation in actual fiscal year volumetric revenues, which would again be recovered through the normal VBA process. Therefore, unless IAWC's VBA Rider is changed to specifically exclude fluctuations in revenues due to low-income tariff participation, any changes in revenues from Rate Case volumetric revenue due to differences between actual and forecasted low-income participation will flow through the VBA no matter what assumptions are initially made.

IAWC argues that Staff's additional objections to the use of Rider VBA to recover revenues associated with the low-income tariff are similarly unsupported. While Staff

maintains that Rider VBA was not intended to recover anticipated lost volumetric revenue, IAWC notes that this argument ignores that, in Docket No. 16-0093, the Commission approved Rider VBA and acknowledged its myriad benefits for the Company's customers, including that Rider VBA "supports revenues for programs and investments that improve water efficiency." Docket No. 16-0093, Order at 72. Thus, IAWC asserts, while the Commission did not directly address Rider VBA's relationship to low-income rates (nor would it, given that none would be proposed in Illinois for another five years), the Commission clearly anticipated reduced volumetric revenues resulting from Company-implemented programs. And, although Staff argues that the Company's proposed use of Rider VBA could somehow set an inappropriate precedent, Staff disregards the clear laws and regulations in place that prevent utilities from, on their own accord and independent of Commission oversight, setting (or decreasing) rates for specific groups based on an assumption that the VBA will reconcile the difference.

IAWC states that under Staff's proposal, the Company would be guaranteed this level of cost recovery automatically in rates every year, even for eligible customers that do not participate in the program, and those increased revenues would accrue to the Company's benefit rather than guaranteeing the Company full funding every year regardless of customer participation levels. IAWC asserts that such an approach will increase rates for customers with no ability to reduce those rates until the Company's next rate case, if there is anything less than 100% participation in the low-income tariff by the Company's estimated 46,070 eligible customers.

IAWC states that its proposed low-income tariff rate design is designed with the long-term best interest of its customers in mind, maximizes benefits to as many eligible customers as possible, and mitigates the cost of the program for all IAWC customers. IAWC argues that it should be adopted. In contrast, IAWC states, Staff's proposal reduces eligibility, reduces benefits, and increases costs to non-participating customers beyond what is necessary to fund the program. IAWC argues that Staff's reliance on the low-income tariff approved in Docket No. 21-0198 is inappropriate, unsupported, and should be rejected.

**b. Staff's Position**

Staff recommends the Commission reject the Company's proposal to recover the costs of the discounts provided to customers under the proposed low-income tariff through the Company's Rider VBA.

Rider VBA was established to ensure the volumes and revenues used in the rate case are trued up to the actual amounts of revenue if consumption drops or rises. Staff Ex. 7.0 at 57. Rider VBA is not an appropriate mechanism to recover loss of revenue as the result of offering a low-income rate through a discounted tariff for low-income customers as proposed by IAWC in this docket. *Id*. IAWC admits as much, stating that Staff "may very well be correct that Rider VBA does not contemplate revenue losses as a result of low-income rates because that Rider was developed at a time when low-income discount rates did not exist and were not proposed." IAWC Ex. 18.00 at 20. However, IAWC argues that Rider VBA does not address any specific cause of revenue fluctuation and does not distinguish between causes of revenue fluctuation. *Id*. The Company also asserts that Staff's concern that "Rider VBA was not designed to recover revenue

shortfalls resulting from a low-income rate is irrelevant." IAWC IB at 156. Staff asserts that the Commission should reject these arguments; Staff argues that the purpose of Rider VBA is exceedingly relevant. When the Commission approved IAWC's Rider VBA in Docket No. 16-0093, utilizing Rider VBA for the circumstances in this proceeding, as a mechanism to recover anticipated lost volumetric revenue, was not contemplated. Specifically, Rider VBA was designed to ensure that it collects the revenues authorized by the Commission, independent of changes in sales volume. Docket No. 16-0093, Order at 68. Rider VBA, as implemented since Docket No. 16-0093, compares the rate case authorized amount of volumetric revenues to actual volumetric revenues, net of production expenses (power, chemicals, and water waste disposal) that vary directly with sales levels, and provide a credit (if revenues exceed the authorized level) or a volumetric surcharge (if revenues are below the authorized level). *Id*. Netting production costs ensures that customers pay only those production costs for the actual amount of water delivered. *Id*. Under Rider VBA, prices will increase and decrease as sales volume changes between rate cases, but it will hold revenues at authorized levels. *Id*. Utilizing Rider VBA as proposed by the Company in this proceeding could set an inappropriate precedent for the use of Rider VBA in future proceedings and allow for recovery of items that are outside the scope of what is deemed appropriate for recovery under the rider. Staff states that IAWC would seemingly have the Commission ignore that Rider VBA should only recover volumetric charges, and instead, utilize Rider VBA as a mechanism to recoup, improperly, revenue shortfalls from the proposed low-income tariff.

Instead of improperly utilizing Rider VBA, Staff recommends the Company recover the revenue shortfall from customers that do not qualify for the discounted tariff through the Usage Charge. The Commission recently approved a similar approach in Docket No. 21-0198. Docket No. 21-0198, Order at 107. Consistent with the Commission's Order in that case, Staff recommends that IAWC use the 67% factor to estimate usage forecasts for water and wastewater customers who are at or below 100% of the FPL and would be eligible for the low-income discount tariff. To calculate rates in this case, the Company should assume 100% participation from all customers that are eligible by virtue of having annual income at or below 100% of the FPL. The Company should recover revenue shortfalls from non-low-income customers separately through the volumetric rate in the respective water and wastewater divisions. *Id*. To remain consistent with the method approved in Docket No. 21-0198 the Commission should approve IAWC using a 67% factor (2,767 gallons per month for water customers and 2,675 gallons per month for wastewater customers) to forecast its total low-income sales for rate design purposes. *Id*. It is also Staff's contention that a pitfall to recovering the revenue shortfall through Rider VBA is that revenue shortfall will be recovered from all customers, which could greatly reduce the benefits to low-income customers if large amounts of the revenue shortfall would need to be recovered from all customers.

The Company asserts that Staff's recommendation is designed to remain consistent with Docket No. 21-0198, and "offers no evidence as to why this approach or Staff's proposed assumptions are appropriate or reasonable for IAWC." IAWC IB at 155. This is false. Staff states that the Commission should remain consistent with the low-income tariff approved in Docket No. 21-0198, and Staff has provided several reasons as to why this is important.

Staff also recommended certain reporting requirements related to the Company's proposed low-income discount tariff. Mr. Boggs explained that, at the onset of offering this discount tariff, it is unlikely that the Company will get 100% participation from all customers who qualify. Staff Ex. 7.0 at 59. To estimate the volume of water discounted by the low-income tariff in future years, Staff recommends the Company provide an annual report documenting the percentage of eligible low-income ratepayers who have signed up to take advantage of the low-income tariff offering. *Id*. Staff recommends eliminating the first-year statistics for eligible customers and the volumes of water and wastewater used at the discounted rate because it is unknown how the low-income rate will be communicated to customers and how likely those customers will provide the income documentation to prove eligibility. After the tariff has been established for a year and the Company has had adequate opportunity to communicate the availability of the program, the Company's low-income statistics should be averaged for all subsequent years until the Company's next general rate case. *Id*. Upon that filing, the Company should have enough data to more accurately estimate the volumes of water and wastewater used by the number of low- income ratepayers that have proven eligibility and participated in the program. The data compiled should include the number of customers that have taken rates under the low-income tariff and the average volume of water used at the discounted rate. This data will aid in determining how to set non-low-income volumetric rates in future rate filings so the shortfall of revenues collected at the discounted low-income rate can be recovered through the volumetric rates paid by non-low-income ratepayers. *Id*. at 59-60. Staff made a similar recommendation in Docket No. 21-0198, which the Commission approved. Docket No. 21-0198, Order at 111.

For the foregoing reasons, Staff recommends the Commission adopt a low-income discount tariff for IAWC water and wastewater customers with the following modifications: the tariff should be available to customers with demonstrated income at or below 100% of the FPL and the tariff should include usage caps on the amount of monthly water or wastewater service that customers can use under the discounted tariff of 2,771 gallons for water customers and 2,675 gallons for wastewater customers. Additionally, Staff asserts that the Commission should reject the Company's proposal to recover the costs of the discounts provided to customers under the low-income tariff through Rider VBA. Staff argues that the Commission should approve Staff's recommendation that IAWC recover the revenue shortfall from non-low-income customers in the respective water and wastewater service areas as the customers using the discounted tariff rate. Staff also recommends the Company provide, in its next general rate case, an annual report documenting the percentage of eligible low-income ratepayers who have signed up for the low-income tariff offering. Staff also states the Commission should approve Staff's reporting requirements.

#### c. AG's Position

Staff proposed that IAWC assume 100% of eligible customers will enroll in the program and charge other ratepayers the costs of that participation upfront, rather than have IAWC recover the actual costs of participation through the Rider VBA. Staff Ex. 7.0 at 58. In contrast, IAWC proposed that it refrain from assuming the participation level upfront, and instead recover the actual costs of the program annually through its Rider

VBA. The AG supports IAWC's proposal because it is a more accurate measure of program participation and cost.

The AG demonstrates that assuming that 100% of eligible customers will participate is unreasonable and will inevitably result in costs that do not reflect the actual number of program participants. The AG offers LIHEAP, a statewide opt-in energy assistance program, as an example. LIHEAP experienced 13% to 25% participation from 2014 to 2020. *See* Docket No. 21-0198, Order at 109. The AG maintains that it is unreasonable to expect 100% of eligible customers to participate in IAWC's program when only 25% of eligible ratepayers participated in an established statewide program with similar opt-in application criteria. IAWC will recoup the full costs of the program through both proposals, but the AG contends that it is better to recover these costs through the Rider VBA after the Company and Commission know the actual participation levels. This will avoid creating large swings for Rider VBA to fill and prevent overcharging ratepayers upfront and then having to potentially refund them later through Rider VBA. The AG asserts that the Commission should not require customers to pay more for a program based on an unreasonable and unrealistic participation estimate.

The AG also points out that Staff failed to reconcile the fact that Rider VBA will be used to adjust the costs of recovery either way. According to the AG, the Commission is presented with two choices on this issue, either require ratepayers to pay Staff's unrealistic and inflated estimated costs of the program upfront and refund ratepayers for these excessive charges through the Rider VBA later; or permit the Company to charge ratepayers the actual costs of the program through the VBA, after the actual number of customers who participate in the program is known. The AG maintains that the second option is preferable because it is based on actual participation—not an unreasonable and unrealistic participation estimate.

For these reasons, the AG requests that the Commission adopt the revenue recovery mechanism proposed by IAWC.

#### d. Commission Analysis and Conclusion

Staff recommends that the Commission approve revenue recovery under the low-income tariff based on the process approved in Docket No. 21-0198. Staff also argues that using Rider VBA for cost recovery is counter to the purpose behind the approval of Rider VBA. Staff therefore suggests using 100% participation from all eligible customers to calculate rates in this case. Staff states the Company should recover revenue shortfalls from non-low-income customers separately through the volumetric rate in the respective water and wastewater divisions.

The Commission agrees that Rider VBA was not approved with a low-income tariff in mind. The VBA tariff, however, reconciles rate case volumetric revenues generally. "Rider VBA is designed to ensure that it collects the revenues authorized by the Commission, independent of changes in sales volume." Docket No. 16-0093, Order at 68. The Commission agrees with IAWC that Rider VBA benefits the Company's customers, and "supports revenues for programs and investments that improve water efficiency." *Id.* at 72.

Using 100% eligible participation for estimating purposes surely overstates the costs of the program. The Commission agrees with the AG that based on its experience with LIHEAP, there is never 100% participation among eligible customers.

The Commission further agrees with the AG that Rider VBA will eventually be used to adjust the costs of recovery. Ratepayers can pay Staff's overestimated costs of the program upfront and later be refunded through Rider VBA or, the Company can charge ratepayers the actual costs of the program through the VBA. The Commission finds that the second option is preferable because costs are based on actual participation. The Company's cost recovery proposal, supported by the AG, is approved.

Staff makes several recommendations on reporting the results of the low-income tariff. It does not appear any party objects to those; they are adopted.

## VIII. OTHER

### A. Uncontested Issues

#### 1. Depreciation Study

IAWC states that Staff noted the depreciation study used for this case was calculated as of December 31, 2016. IIWC/FEA also recommend that IAWC be required to conduct an updated demand study. The Company has agreed to conduct a depreciation study prior to its next rate case. The Commission finds this is reasonable and it is approved.

#### 2. Original Cost Determination

IAWC accepts the proposed original cost determination as of December 31, 2021 of $2,455,743,929. This issue is uncontested. The Commission finds this is reasonable and it is approved.

#### 3. Gross Revenue Conversion Factor

IAWC explains that the Company's original filing applied a uniform gross revenue conversion factor ("GRCF") based on the total company average uncollectible rate provided in the Company's Schedule C-16. Staff and the AG proposed to apply a GRCF calculated using a zone-specific uncollectible rate. Staff proposed Schedules 9.07 for GRCF. Staff Ex. 9.0 at 2. IAWC did not contest Staff's Schedules.

The Company has updated its GRCF calculation based on the Company's proposed individual rate zones uncollectible percentage. These updates can be found in the Company's revised A-2.1 schedule. The Commission finds IAWC's updated GRCF is reasonable and it is approved.

#### 4. Demand Study

IAWC notes that IIWC/FEA recommend that the Company be required to conduct a new demand study which includes load characteristics of the fifteen newly acquired water systems and the fourteen wastewater systems in this case in addition to any additional systems the Company acquires before the next rate case so that peaking factors updated for these acquisitions can be included in the next COS study provided by the Company, and Staff agreed with that recommendation. IAWC states that the Company agrees that it would be useful to update its capacity study in the next rate case

to reflect the acquisitions the Company has made and might make before the filing of the next rate case. The Commission finds this is reasonable and it is approved.

### 5. Typographical Errors

Staff identified typographical errors included in the Company's proposed Standby Water Usage Charges for its Central Division customers and the Company's proposed Metered Water Usage Charge for the Central Division (Pontiac District). Staff Ex. 8.0 at 3. Staff recommended that the Company correct those errors identified in Schedule E-1. IAWC Ex. 15.00 at 14. IAWC agreed to update and correct its proposed rates in its tariff pages filed in compliance with the final Order in this proceeding. *Id*. The Commission finds this is reasonable and is approved.

## IX. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the record herein, is of the opinion and finds that:

(1) Illinois-American Water Company 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 Public Utilities Act;

(2) the Commission has jurisdiction over 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 E 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 December 31, 2023; this test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, Illinois-American Water Company's net original cost rate bases are set forth in Appendices A through E;

(6) the $2,455,743,929 original cost of plant for Illinois-American Water Company as of December 31, 2021 should be approved as the original cost of plant;

(7) a just and reasonable rate of return which Illinois-American Water Company should be allowed an opportunity to earn on its net original cost rate base is 7.01%; this rate of return incorporates a return on equity of 9.78%;

(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 E based on the test year herein approved;

(9) Illinois-American Water Company'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 Illinois-American Water Company would produce a rate of return above a return that is fair and reasonable; Illinois-American Water Company's Proposed Tariffs should be permanently canceled and annulled;

(11) Illinois-American Water Company should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendices A through E, such tariff sheets to be applicable to service furnished on and after their effective date; with compliance tariffs to be filed annually which reflect the re-allocation stage of the Central Zone's wastewater revenue requirement; the terms and conditions in these tariff sheets should be consistent with Finding (17) below;

(12) the cost of service, interclass revenue allocation, wastewater revenue reallocation, 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;

(13) the 2021 actual and projected 2022 and 2023 QIP amounts for Central Water included in base rates are comprised of Utility Plant in Service of $215,171,408; $305,495,156 and $418,193,512, respectively; related accumulated depreciation of $8,686,824; $14,559,772 and $19,654,797, respectively; related accumulated deferred income tax of $22,060,880; $45,701,157, and $53,280,959, respectively, for NetQIP – Rate base of $184,423,704 for 2021, $245,234,227 for 2022 and $345,257,756 for 2023 and $3,920,937; $5,873,284; and $10,490,886 in annualized depreciation expense, respectively;

(14) the 2021 actual and projected 2022 and 2023 QIP amounts for Pekin Water included in base rates are comprised of Utility Plant in Service of $9,161,804; $15,111,206 and $21,086,089, respectively; related accumulated depreciation of $445,061; $751,144 and $1,037,664, respectively; related accumulated deferred income tax of $1,062,931; $2,230,519 and $2,907,895, respectively, for NetQIP – Rate base of $7,653,813 for 2021; $12,129,543 for 2022 and $17,140,530 for 2023 and $219,004; $229,479 and $240,146 in annualized depreciation expense, respectively;

(15) the 2021 actual and projected 2022 and 2023 QIP amounts for Lincoln Water included in base rates are comprised of Utility Plant in Service of $4,601,999; $15,539,951 and $31,414,074, respectively; related accumulated depreciation of $176,882; $445,963 and $746,579, respectively; related accumulated deferred income tax of $458,960; $1,624,459 and $1,724,395, respectively, for NetQIP – Rate base of $3,966,158 for 2021; $13,469,530 for 2022 and $28,943,100 for 2023 and $84,147; $88,586 and $93,105 in annualized depreciation expense, respectively;

(16) the 2021 actual and projected 2022 and 2023 QIP amounts for Chicago Metro Wastewater included in base rates are comprised of Utility Plant in

Service of $21,545,373; $32,916,397 and $41,425,245, respectively; related accumulated depreciation of $737,814; $1,441,240 and $1,604,755, respectively; related accumulated deferred income tax of $1,507,322; $2,794,412 and $3,005,914, respectively, for NetQIP – Rate base of $19,300,238 for 2021; $28,680,745 for 2022 and $36,814,575 for 2023 and $413,662; $703,427 and $329,170 in annualized depreciation expense, respectively;

(17) 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;

(18) the Commission has considered the estimated costs to be expended by Illinois-American Water Company to compensate attorneys and technical experts to prepare and litigate rate case proceedings and assesses that the amount included as rate case expense in the total revenue requirement of $594,000 is just and reasonable pursuant to Section 9-229 of the Act

(19) Illinois-American Water Company is directed to conduct a depreciation study and demand study prior to its next rate case;

(20) Illinois-American Water Company is directed to provide updated COS studies in accordance with the conclusions herein; and

(21) Illinois-American Water Company should be directed to conduct a new demand study that includes load characteristics of the fifteen newly acquired water systems and the fourteen wastewater systems in this case, and any additional systems the Company acquires before the next rate case, so that peaking factors updated for these acquisitions can be included in the next cost of service study provided by the Company.

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 February 10, 2022, are hereby permanently canceled 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 (17) 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 the $2,455,743,929 original cost of plant for Illinois-American Water Company at December 31, 2021, is approved as the original cost of plant.

IT IS FURTHER ORDERED that Illinois-American Water Company comply with the requirements in Findings (19), (20) and (21) above.

IT IS FURTHER ORDERED that Illinois-American Water Company's 2021, 2022, and 2023 Qualifying Infrastructure Plant costs included in rate base in this proceeding for each rate zone are subject to review in the Illinois-American Water Company's annual Qualifying Infrastructure Plant reconciliation proceedings and the costs related to such Qualifying Infrastructure Plant are subject to adjustments for prudence and reasonableness in the annual Qualifying Infrastructure Plant reconciliation and future base rate proceedings.

IT IS FURTHER ORDERED that all motions, petitions, and objections which have not been disposed of are hereby deemed to be disposed of in a manner consistent with the conclusions herein.

IT IS FURTHER ORDERED that pursuant to Section 10-113(a) of the Public Utilities Act and 83 Ill. Adm. Code 200.880, any application for rehearing shall be filed within 30 days after service of the Order on the party.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities 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 15th day of December, 2022.

(SIGNED) CARRIE ZALEWSKI

Chairman