

 KeyCite Yellow Flag - Negative Treatment

On Rehearing [Illinois-American Water Company](#), Ill.C.C., June 7, 2017

2016 WL 7325212 (Ill.C.C.), 334 P.U.R.4th 424

Illinois-American Water Company

16-0093

Illinois Commerce Commission

December 13, 2016

**ORDER**

**Synopsis**

Proposed Rate Increases for Water and Sewer Service. (tariff filed on January 21, 2016)

BY THE COMMISSION: Brien Sheahan, Chairman

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## I. INTRODUCTION

### A. Procedural History

\*1 On January 21, 2016, Illinois-American Water Company (“IAWC” or “Company”) filed revised 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”). The Proposed Tariffs were identified as follows: Ill. C. C. No. 5, Seventeenth Revised Sheet No. 37, Sixth Revised Sheet No. 39, Original Sheet Nos. 39.1 & 39.2, Third Revised Sheet No. 40, Original Sheet Nos. 40.1 & 40.2, Sixth Revised Sheet No. 59; Ill. C. C. No. 24, Section No. 1, Table of Contents, Second Revised Page 1, Ninth Revised Sheet No. 1, Eighth Revised Sheet No. 1.1, Seventh Revised Sheet No. 2, Fifth Revised Sheet No. 3, Fourth Revised Sheet No. 3.1, Seventh Revised Sheet No. 3.2, Sixth Revised Sheet No. 7, Seventh Revised Sheet Nos. 7.2 & 7.3, Fifth Revised Sheet Nos. 7.4 - 7.7, Seventh Revised Sheet No. 8, Sixth Revised Sheet Nos. 11.1 & 11.2, Fifth Revised

Sheet Nos. 11.4 & 11.5, Eighth Revised Sheet No. 14.1, First Revised Sheet Nos. 22 & 22.1, Original Sheet Nos. 22.2, 23, 23.1, & 23.2; Section No. 3, Table of Contents, Second Revised Page 1, Seventh Revised Sheet No. 1, Fifth Revised Sheet Nos. 2, 3, & 8, First Revised Sheet Nos. 22 & 22.1, Original Sheet Nos. 22.2, 23, 23.1, & 23.2; Section No. 4, Table of Contents, Second Revised Page 1, Sixth Revised Sheet No. 1, Fourth Revised Sheet Nos. 2 & 3, Sixth Revised Sheet Nos. 7, 7.1, 7.2, & 14.1, First Revised Sheet Nos. 22 & 22.1, and Original Sheet Nos. 22.2, 23, 23.1, & 23.2.

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. Notice of the filing of the Proposed Tariffs was sent to customers, posted in IAWC's business offices, and published in a newspaper of general circulation within each of IAWC's service areas, in accordance with the requirements of Section 9-201(a) of the Act and 83 Ill. Adm. Code 255.

\*2 On February 24, 2016, the Commission entered a Suspension Order suspending the Proposed Tariffs to and including June 18, 2016. Subsequently, the Commission entered a Resuspension Order on June 1, 2016 extending the suspension to and including December 18, 2016.

Appearances or Petitions to Intervene were filed by the Attorney General of the State of Illinois (the "Attorney General" or "AG"); the City of Peoria ("Peoria"); Prairie Farms Dairy, Inc., United States Steel Corporation-Granite City Works, and the University of Illinois, collectively referred to as the Illinois Industrial Water Consumers ("IIWC"); the Village of Tinley Park ("Tinley Park"); the Cities of Champaign, Urbana, and South Beloit and the Villages of St. Joseph, Savoy, Philo, and Sidney (collectively, the "Municipalities"); the Citizens Utility Board ("CUB"); the Village of Bolingbrook ("Bolingbrook"); the Federal Executive Agencies ("FEA"); and Bond-Madison Water Company ("Bond-Madison"). All of the petitions were granted.

Pursuant to due notice, hearings were held in this matter on March 22, 2016, July 26, 2016, and July 28, 2016 before duly authorized Administrative Law Judges ("ALJs") of the Commission at its offices in Chicago, Illinois. Testimony and exhibits filed by IAWC, Commission Staff ("Staff"), the AG, IIWC/FEA/CUB, IIWC/FEA, the Municipalities, and Tinley Park were admitted into evidence at the evidentiary hearing held on July 28, 2016. Thereafter, the record was marked "Heard and Taken."

Initial Briefs and Reply Briefs were filed by IAWC, Staff, the AG, IIWC/FEA/CUB, IIWC/FEA, and the Municipalities on August 31, 2016 and September 19, 2016, respectively. Various motions were filed and briefed by the parties and subsequently ruled on by the ALJs, including Staff's motions to deny requests for a public forum, which were all granted and Staff's motion to strike portions of IAWC's Initial Brief, which was denied. A Petition for Interlocutory Review of the ALJs' rulings on Staff's motions to deny requests for a public forum was filed by the Municipalities on July 12, 2016. The petition was denied.

The ALJs' Proposed Order was served on October 19, 2016. Briefs on Exceptions were filed on October 28, 2016 by IAWC, Staff, the AG, IIWC/FEA/CUB, and IIWC/FEA. Reply Briefs on Exceptions were filed on November 4, 2016 by IAWC, Staff, the AG, and IIWC/FEA/CUB. This Order considers all of the positions and arguments set forth in the Briefs on Exceptions and Reply Briefs on Exceptions.

### **B. Nature of IAWC's Operations**

IAWC is an Illinois public utility that furnishes water and wastewater service to residential, commercial, industrial, and governmental users in its Alton, Cairo, Champaign, Chicago Metro, Hardin County, Interurban, Lincoln, Pekin, Peoria, Pontiac, South Beloit, Sterling and Streator service districts. IAWC is incorporated in Illinois and its principal office is in Belleville, Illinois. IAWC currently employs just under 500 people in Illinois, and serves approximately 310,000 customers.

\*3 IAWC is a wholly-owned subsidiary of American Water Company ("American Water"), a holding company that owns the stock of regulated water and sewer utility subsidiaries operating in multiple states. American Water's service company, American Water Works Service Company, Inc. (the "Service Company") provides support services to IAWC in accordance

with a Commission-approved agreement. IAWC also obtains debt financing through American Water Capital Corporation in accordance with the terms of an approved agreement.

### **C. Test Year**

In this proceeding, the Company's proposed rate increase request is based on a future test year consisting of the 12 months ending December 31, 2017. No party objects to the use of this test year.

### **D. Proposed Revenue Increase**

IAWC is proposing to increase annual revenues by \$42,526,414 over current pro forma revenues. This proposed revenue increase reflects that IAWC agreed with or accepted, in whole or in part, numerous adjustments proposed by the parties. IAWC also updated certain items.

## **II. RATE BASE**

### **A. Resolved Issues**

#### **1. Accrued Liability for OPEB**

The Company agreed to reflect \$1,898,284 in rate base for accrued liability for other (non-pension) post-employment benefits ("OPEB"), which represents the cumulative excess of accrued OPEB costs over actual cash disbursements for OPEB. The Commission notes that this approach is uncontested, and it will be adopted for purposes of this proceeding. IAWC 4.00R at 15; AG Ex. 1.0 at 7.

#### **2. Capitalized Prior Performance Plan Costs**

The AG proposed to remove the 2012 to 2016 capitalized costs of incentive compensation plans that were not included in the revenue requirement in IAWC's last rate case, Docket No. 11-0767. AG Ex. 1.0 at 10. IAWC accepted the portion of this adjustment that removed previously disallowed capitalized incentive compensation costs, and Mr. Effron made additional corrections to the calculation of the adjustment, as agreed by the parties in discovery. IAWC Ex. 4.00R at 16. Staff proposed adjustments to remove incentive compensation expenses that are based on underlying financial goals that primarily benefit shareholders, because ratepayers should not be required to fund incentive compensation plans linked to the financial performance goals of the Company. Staff's adjustments covered capitalized incentive compensation expenses from 2012 through the 2017 test year. Staff Ex. 3.0 at 10-14. The Company included a portion of the AG's proposed capitalized incentive compensation expense adjustment covering 2012 through 2016 in its rebuttal revenue requirement. IAWC Ex. 4.00R at 16; IAWC Ex. 4.04R (Rev.), column "f". The Company included the remainder of the AG's proposed capitalized incentive compensation expense adjustment covering 2012 through 2016 in its surrebuttal revenue requirement. IAWC Ex. 4.04SR (Rev.), column "f". The Company also included the capitalized incentive compensation expense adjustment for 2017 in its surrebuttal revenue requirement. IAWC Ex. 4.04SR (Rev.), column "l" and IAWC Ex. 4.02SR (Rev.) column "u". While Staff's calculation of the adjustment to remove capitalized incentive compensation expenses differs from the adjustments accepted by the Company, to simplify matters, Staff adopted the adjustments as presented by the Company in its rebuttal and surrebuttal revenue requirements.

\*4 In light of the parties' agreement, the Commission finds that Mr. Effron's adjustment, as accepted by IAWC, corrected by Mr. Effron, and agreed to by Staff, is reasonable and approved.

### 3. Cash Working Capital

#### a. Income Available for Return on Equity in Cash Working Capital

IWC/FEA/CUB witness Gorman proposed a correction to the amount of income available for common equity included in cash working capital (“CWC”). IWC/FEA/CUB Ex. 1.0 at 16. Staff presented adjustments to CWC for the Company based on the Gross Lag Approach. Staff Ex. 2.0 at 3. Staff’s schedules reflect adjustments to the test year revenues and expenses for Staff’s revenue requirement presented in its brief. The Company agrees with Staff’s use of the Gross Lag methodology and that the final balance of CWC will be established using the revenue requirement and CWC methodology that is ultimately approved by the Commission in this proceeding. IAWC Ex. 12.00R. Therefore, Staff has no methodology differences from the Company. Staff Ex. 10.0 at 3. The Company accepted IWC/FEA/CUB’s correction. IAWC Ex. 12.00R at 3. The Commission finds that this correction is reasonable and uncontested, and it is approved.

#### b. Tank Painting Amortization

Staff witness Hathhorn and IWC/FEA/CUB witness Gorman proposed corrections to exclude tank painting amortization from the CWC calculations of depreciation and amortization expense and from maintenance-other expense. Staff Ex. 2.0 at 4; IWC/FEA/CUB Ex. 1.0 at 17. IAWC accepted Staff’s corrections in discovery and IWC/FEA/CUB acknowledged that these corrections resolved their concerns. IAWC Ex. 12.00R at 3-4. The Commission notes that this approach is uncontested, and it will be adopted for purposes of this proceeding.

#### c. Rate Case Expense Amortization

IWC/FEA/CUB witness Gorman proposed a correction to remove rate case expense amortization from the CWC calculation. IWC/FEA/CUB Ex. 1.0 at 17. IAWC accepted this correction in discovery. IAWC Ex. 12.00R at 3-4. Because the parties are in agreement, the Commission adopts this approach for purposes of this proceeding.

### 4. Accumulated Deferred Income Taxes

#### a. Deferred Tax Assets for Utility Plant Acquisition Adjustment and Deferred Rate Proceedings

Staff witness Hathhorn proposed to adjust rate base to exclude accumulated deferred income taxes for two accounts that the Company acknowledged it inadvertently included in each rate zone. Accounts for Net Utility Plant Acquisition Adjustment and Deferred Rate Proceedings should not have been included in the deferred tax calculation as the associated assets and liabilities are not included in rate base. Staff Ex. 2.00 at 5. IAWC agreed to these adjustments. IAWC Ex. 4.00R at 3. The Commission finds that these adjustments are reasonable and uncontested; they will be adopted for purposes of this proceeding.

#### b. Restated for Change in State Income Tax Rate

Staff witness Hathhorn and AG witness Effron both accepted IAWC’s proposal to use the 7.75% state income tax rate, which is based on a 100% apportionment factor reflecting IAWC’s activities in Illinois rather than on a five-year average estimate of American Water’s apportionment factor. Staff Ex. 10.0 at 4; AG Ex. 3.0 at 2. Mr. Effron and Ms. Hathhorn proposed to reflect the Company’s State and federal accumulated deferred income taxes (“ADIT”) balances at the 7.75% State income tax rate. Staff Ex. 10.0 at 4; AG Ex. 3.0 at 6-7. IAWC accepted those adjustments. IAWC Ex. 4.00SR at 4, 10. The Commission finds that these adjustments are reasonable and uncontested, and will be adopted for purposes of this proceeding.

## 5. Deferred Charges related to Cairo Filter Project

\*5 In discovery, IAWC agreed to an adjustment to reduce rate base by \$2,162,500 to correct the balance of deferred charges on Schedule B-10 for two filter projects in Cairo that should not be included as deferred maintenance. IAWC Ex. 4.00R at 4. Staff and the AG acknowledged this adjustment in testimony. AG Ex. 1.0 at 10; Staff Ex. 2.0 at 4. The Commission notes that this approach is uncontested, and it will be adopted for purposes of this proceeding.

## 6. Accumulated Depreciation Correction

Staff witness Hathhorn proposed adjustments to the Company's accumulated depreciation correction, "adjust[ing] rate base downward to include accumulated depreciation for two accounts" inadvertently omitted by the Company from each rate zone, as well as corrections to Rate Zone 1 for accumulated amortization and depreciation and amortization expense. Staff Ex. 2.0 at 4-5. IAWC accepted these proposed adjustments. IAWC Ex. 4.00R at 3. The Commission finds that these adjustments are reasonable and uncontested, and they will be adopted for purposes of this proceeding.

### B. Contested Issues

#### 1. Accumulated Deferred Income Taxes Balance / FIN 48

##### a. IAWC's Position

IAWC explains that Financial Accounting Standards Board ("FASB") Interpretation Number 48, or FIN 48, now codified as part of Accounting Standards Codification 740, is FASB's financial accounting guidance related to uncertain tax positions. IAWC explains that FIN 48 prescribes the way in which companies must analyze, quantify, and disclose the most probable outcome that will result from taking a tax position that is uncertain. IAWC Ex. 13.00R at 7.

IAWC states that some of the tax positions that are part of its method of accounting for repairs are uncertain, and it quantified FIN 48 balances accordingly. *Id.* at 8. IAWC understands that the AG argues that the Company has realized tax savings from taking the repairs deduction on its tax returns. AG Ex. 1.0 at 9. Until these deferred tax liabilities are actually paid to the relevant taxing authorities, AG witness Effron contends, they represent non-investor supplied funds that are available to the Company. Mr. Effron proposes the ADIT debit balances related to FIN 48 should be eliminated from the balance of ADIT deducted from plant in service, increasing ADIT and reducing rate base. *Id.* at 10.

IAWC states that it is willing to eliminate an adjusted FIN 48 balance from rate base, but Mr. Effron's adjustment must be revised in two ways. First, IAWC states, the ADIT balance in rate base related to FIN 48 is \$3,432,525, not \$18,343,822, as Mr. Effron initially proposed. The Company explains that \$3,432,525 is the net FIN 48 amount after considering offsets by available net operating losses. IAWC states that this net number is what is included in ADIT. IAWC Ex. 13.00SR (Rev.) at 2.

Second, IAWC states, changes in IAWC's proposed 2015 tax filings will cause a portion of the uncertain tax positions to be realized. Therefore, IAWC explains that with respect to a 2017 test year, a portion of the deferred tax liability associated with uncertain tax positions will have been eliminated when IAWC files its 2015 tax return. IAWC Ex. 13.00R at 8-9. IAWC points out that the adjustment to prior repair deductions has been computed, and the change results in IAWC realizing \$909,707 of its FIN 48 obligation, reducing the amount of the ADIT impact on rate base from \$3,432,525 to \$2,485,188. IAWC Ex. 13.00SR (Rev.) at 2.

\*6 The Company understands that Mr. Effron also proposes that IAWC provide a method for the Commission to verify that the revised FIN 48 amounts are consistent with the filed 2015 tax return. AG Ex. 3.0 at 5. IAWC states that this is not necessary because all ADIT activity estimated by the Company through the 2017 test year has not as yet been reflected on a filed tax

return. IAWC explains that that fact is inherent in using projections and basing rates on a forecasted test year. IAWC states it should not be required to document tax positions that it plans to take with respect to repairs in its 2015 tax return in a manner different than it documents any other tax projection. IAWC states it is willing to provide a confidential disclosure of IRS Form 3115 (Application for Change in Accounting Method) or a copy of IAWC's federal pro forma 2015 tax return as a compliance filing in this docket. IAWC Ex. 13.00SR (Rev.) at 3-4.

#### b. AG's Position

The AG states that the Commission has held and the Illinois Appellate Court has affirmed that “generally, ADIT quantifies the income taxes that are deferred when the tax law provides for deductions with respect to an item, in a year other than the year in which the item is treated as an expense for financial reporting purposes. For regulated entities, ADIT is treated as a no-cost source of capital that reduces rate base.” *Commonwealth Edison Co.*, Docket No. 11-0721, Order at 56 (May 29, 2012), citing *Ameren Ill. Co. v. Ill. Commerce Comm'n*, 2012 IL APP (4th) 100962 at 5. This is because consumers pay rates that include the full tax bill but the utility does not pay some of the tax bill until a later date (the tax payments are deferred), providing the utility with consumer-supplied, no-cost capital.

In this case, the AG argues that IAWC failed to treat certain ADIT as cost-free capital, in violation of basic ratemaking and accounting principles. Specifically, while the Company took tax deductions related to repairs and realized tax savings from the repairs deduction, the Company is treating the deduction as “uncertain” under FIN 48 and not including the ADIT associated with those “uncertain” tax positions in its rate base deduction. However, until these deferred tax liabilities are actually paid to the relevant taxing authorities, the deferred tax liabilities represent non-investor, no-cost funds that are available to IAWC and should be deducted from rate base. The AG points out that the Commission came to this conclusion in IAWC's last rate case, and noted “...the FIN 48 amount represents a source of cost-free capital that should be reflected as a rate base deduction.” *Ill.-Am. Water Co.*, Docket No. 11-0767, Order at 36 (Sept. 19, 2012).

The AG explains that the FIN 48 balance represents the amount of deferred tax liabilities related to uncertain tax positions that may ultimately have to be paid to the government. The FIN 48 balance represents the portion of the repairs deduction taken on IAWC's tax returns that the Company believes is uncertain upon audit by the IRS. The AG asserts that in this regard, the FIN 48 balance is no different from any other ADIT balance.

\*7 AG witness Effron proposes that the ADIT deducted from plant in service not be reduced by the FIN 48 balance. In rebuttal testimony, Mr. Effron stated that the effect is to increase the balance of ADIT by \$18,434,822 and to reduce the rate base by the same amount. AG Ex. 1.0, Sch. B-2; 3.0 at 5; IAWC Ex. 3.1, Sch. B-2.

In rebuttal testimony, the Company agreed that IAWC would eliminate the adjusted FIN 48 deferred tax asset balance from rate base. IAWC Ex. 13.0R at 9-10. IAWC states that it would not be claiming as much in tax repair deductions as previously claimed. IAWC proposes to update the Commission about its claimed FIN 48 and offsetting deferred tax asset in IAWC's surrebuttal testimony.

In surrebuttal testimony, the Company argued that the amount of the FIN 48 adjustment proposed by AG witness Effron in direct and rebuttal testimony (AG Ex. 1.1; AG Ex. 3.1, Sch B-2) was incorrect and provided a much smaller amount of \$3,432,525. The Company claims that the amount of the FIN 48 adjustment should be further reduced to \$2,485,188 to reflect the adjustment to prior repair deductions that IAWC states that it expects to take in filing its 2015 tax return. IAWC Ex. 13.00SR (Rev.) at 2-4. The AG accepts the Company's corrected amount of the FIN 48 adjustment to rate base of \$3,432,525 rather than the original adjustment of \$18,434,822 proposed by AG witness Effron in his direct testimony.

The AG argues that the Company, however, did not reduce rate base by the “corrected” \$2,485,188 amount in the schedules calculating the Company's proposed surrebuttal revenue requirement as the Company promised. The Company seems to have removed the FIN 48 repairs deduction for the 2015-2017 accruals in IAWC Schedules B-9 and 9.1 in IAWC Ex. 4.08SR (Rev.)

at line 5, but did not remove \$2,485,188 from rate base, although Company witness Wilde testified that such an adjustment would be made: “[t]he adjustment to prior repairs deductions has been computed, and the change results in IAWC realizing \$909,707 of its FIN48 obligation, reducing the amount of the ADIT impact on rate base from \$3,432,525 to \$2,485,188” and “[t]he amount to be removed is \$2,485,188.” IAWC Ex. 13.00SR (Rev.) at. 2-3.

In surrebuttal testimony, as support that the rate base deduction should be \$2,485,188 rather than the \$3,432,525, Company witness Wilde offered to provide a confidential disclosure of Form 3115 or a copy of the IAWC federal pro forma tax return as a compliance filing in this docket. The Company's tax returns are filed 8 1/2 months after year end. IAWC Ex. 13.00SR (Rev.) at. 3-4. Thus, the AG points out the filed Form 3115 should be available during the briefing stage of this case and should be provided as evidence to support the lower rate base deduction. The AG adds that, as for the offer of a federal pro forma tax return, it is not the “actual” tax return that will be filed and should not be accepted by the Commission as proof that the Company changed its tax considerations of its repair deductions.

\*8 The AG explains that in IAWC's last rate case the Commission rejected the AG's recommendation to not consider bonus depreciation in the calculation of accumulated deferred income taxes based upon the utility's testimony that American Water Works had decided to not utilize 2011 bonus depreciation. Docket No. 11-0767, Order at 70. The AG argues that it turns out that bonus depreciation was utilized in 2011 as shown in IAWC WPC — 5a. AG Group Ex. Part 2 at 10. That document shows that the Company applied bonus depreciation in 2008-2014 to its taxable income contrary to the Company's assurances in Docket No. 11-0767.

Without IAWC's filed Form 3115 evidence that the Company actually changed its tax method of accounting for repairs in filing its 2015 Corporate Income Tax return, the AG urges the Commission to reject the Company's proposed change in its tax considerations of repair deductions and reduce rate base by the AG's recommended amount of \$3,432,525.

### **c. Commission Analysis and Conclusion**

Both the Company and the AG agree that \$3,432,525 is the net FIN 48 amount after considering offsets by available net operating losses. The Company further argues, however, that due to a revision to its tax method of accounting for repairs the amount of the prior repair deductions has been adjusted. The change results in IAWC realizing \$909,707 of its FIN 48 obligation, reducing the amount of the ADIT impact on rate base from \$3,432,525 to \$2,485,188.

The AG argues that \$3,432,525 should be removed from rate base, and questions the Company's amount of prior repair deductions, because the amount was removed from Schedules B-9 and 9.1 but not rate base. The AG does not appear to have a substantive objection to the Company's modification removing \$2,485,188 from rate base instead of \$3,432,525, but merely questions whether the Company will remove the amount from rate base. The AG requests that the Commission require the Company to file its Form 3115 to show that it actually changed its tax method of accounting for repairs in its 2015 taxes. While the Company agrees to provide Form 3115 or its federal pro forma tax return, the AG states that the pro forma tax return is not the actual form submitted to the IRS and prefers the Form 3115.

The Commission finds that the ADIT impact on rate base from the Company's FIN 48 obligation is \$2,485,188. The AG proposes that the Company make a filing to show IAWC made certain repair deductions. In its Reply Briefs on Exceptions, Attachment A, the Company included its Form 3115 for the parties' review.

## **2. Debt Return on Pension Asset**

### **a. IAWC's Position**

The Company states it has agreed to reflect in rate base a \$1,898,284 accrued liability for (non-pension) OPEB, which represents the cumulative excess of accrued OPEB costs over actual cash disbursements for OPEB. IAWC explains that this has the effect of reducing rate base. IAWC 4.00R at 15; AG Ex. 1.0 at 7.

\*9 IAWC states that it also has a pension asset in the amount of \$6,760,144, which reflects the difference between accrued pension expense and projected cash pension contributions. IAWC explains that when the accrual for pension expense collected from ratepayers exceeds the contribution amounts, the Commission consistently approves a reduction in rate base reflecting the difference. *See, e.g., Ill.-Am. Water Co.*, Docket No. 09-0319, Order, App. A at 2 (Apr. 13, 2010); *Ill.-Am. Water Co.*, Docket No. 07-0507, Order, App. A at 3 (July 30, 2008); *Ill.-Am. Water Co.*, Docket No. 92-0116, Order, App. A (Feb. 9, 1993). *See also Aqua Ill., Inc.*, Order, Docket No. 04-0442, Order, App. at 5 (Apr. 20, 2005); *Consumers Ill. Water Co.*, Docket No. 03-0403, Order, App. A, Sch. 3 (Apr. 13, 2004); *Cent. Ill. Light Co.*, Docket Nos. 01-0465/01-0530/01-0637 (Consol.), Order, App. A, Sch. 3 (Mar. 28, 2002); *Consumers Ill. Water Co.*, Docket Nos. 00-0337/00-0338/00-0339 (Consol.), Order, App. B-K (Jan. 31, 2001).

IAWC argues that the reverse is not true—when pension contributions exceed the pension expense amount IAWC collects through rates, as is projected to occur in this case, the Commission has not approved an increase to rate base. Docket No. 11-0767, Order at 8. It remains IAWC's position, however, that including only pension and OPEB balance sheet liabilities, but not the assets, in rate base is inconsistent. IAWC 4.00R at 15-16. IAWC therefore proposes a middle ground approach, under which IAWC receives a debt return for its pension asset. The Company explains that this is not an unprecedented proposal, because the Commission previously approved a debt return on certain pension contributions for Commonwealth Edison Company (“ComEd”). *Commonwealth Edison Co.*, Docket No. 05-0597, Order on Reh'g at 28 (Dec. 20, 2006). And, IAWC points out, the Illinois Energy Infrastructure Modernization Act (“EIMA”) also allows a debt return on all pension assets. [220 ILCS 5/16-108.5\(c\)\(4\)\(D\)](#). IAWC therefore considers a debt return on its pension asset a reasonable way to balance the deduction of the OPEB liability from rate base. The Company states that such a return would increase the revenue requirement by approximately \$175,000. IAWC Exhibit 4.07SR.

#### b. Staff's Position

In surrebuttal testimony, the Company reflected an adjustment to other revenues to provide for a debt return on its pension asset. IAWC Ex. 4.02SR (Rev.), col. (p). The Company explains that, in agreeing to reduce rate base by the accrued other post-retirement benefits other than pensions liability, it also included the debt return on pension assets. IAWC Ex. 4.00SR at 9. In rebuttal testimony, the Company posits two arguments in support of its position. First, IAWC states that “the Commission permits electric utilities that choose to be regulated under the [EIMA] to include in their cost of service a debt return on pension assets” and argues the Company should be allowed the same treatment. IAWC Ex. 4.00R at 16. Staff notes, however, that the Commission permits the debt return for electric utilities because the General Assembly granted it specific authority to do so pursuant to the EIMA statute, [220 ILCS 5/16-108.5\(c\)\(4\)\(D\)](#). EIMA is not applicable to utilities other than “participating” electric utilities and the Commission has not been delegated authority to permit this treatment for other utilities; thus, the Commission should reject the Company's adjustment.

\*10 Second, Staff notes that IAWC suggests the prevailing argument against including a pension asset in rate base unless it was created with shareholder funds is flawed because “no item in rate base is specifically identified by its source of funding.” *Id.* at 15-16. In fact, the Commission has repeatedly rejected items from rate base due to their source of funding. For example, in Docket Nos. 09-0166/09-0167 (Consol.), the Commission denied inclusion of The Peoples Gas Light and Coke Company's (“Peoples Gas”) pension asset in rate base since there was no evidence in the record that it was created with shareholder funds:

The Utilities have given us no reason to overturn our decision from their last rate case. Although the Utilities state that the pension asset was created with shareholder funds, no evidentiary support was provided. *The*

*Commission finds no support in the record to allow for the inclusion of Peoples Gas' pension asset in rate base which in turn would allow shareholders to earn a return on ratepayer supplied funds.*

*N. Shore Gas Co.*, Docket Nos. 09-0166/09-0167 (Consol.), Order at 36 (Jan. 21, 2010)(emphasis added).

This decision was upheld by the Appellate Court which stated in part:

The central issue before us remains whether the Commission's decision to exclude the pension asset, which it found consisted of consumer-supplied funds, from Peoples Gas' rate base was against the manifest weight of the evidence. Both the Staff's and the People's expert witness testified the pension asset constituted customer-supplied revenues and, therefore, should be deducted from the rate base calculation.

...

Based on the record before us, we find the Commission's decision with regard to the pension asset deduction is not clearly against the manifest weight of the evidence. Accordingly, we see no reason to disturb the Commission's findings.

*People ex rel. Madigan v. Ill. Commerce Comm'n*, 2011 IL App (1st) 100654 at ¶ 69-71.

The Commission has repeatedly denied inclusion of a pension asset in rate base when such asset was paid with ratepayer supplied funds. See *N. Shore Gas Co.*, Docket Nos. 11-0280/11-0281 (Consol.), Order at 33 (Jan. 10, 2012); *N. Shore Gas Co.*, Docket Nos. 12-0511/12-0512 (Consol.), Order at 90 (June 18, 2013); *N. Ill. Gas Co.*, Docket No. 08-0363, Order at 18 (Mar. 25, 2009); *N. Ill. Gas Co.*, Docket No. 04-0779, Order at 22-23 (Sept. 20, 2005); *N. Ill. Gas Co.*, Docket No. 95-0219, Order at 9 (Apr. 3, 1996); *MidAmerican Energy Co.*, Docket No. 14-0066, Order at 12 (Nov. 6, 2014); Docket No. 11-0767, Order at 8. Staff asserts that there is nothing in the record to establish that the Company's pension asset was funded with anything other than ratepayer funds. Further, EIMA does not authorize the Commission to allow the Company a debt return on pension assets.

\*11 Staff notes that the Company mistakenly relies on the Order on Rehearing in Docket No. 05-0597, regarding a debt return on pension contributions. Docket No. 050597, Order on Reh'g at 28. The facts of that case make it unique to the issue of debt return on pension contributions. In that docket, the Commission based its conclusion on the specific details of that proceeding, and the decision was not to be construed as precedent for future proceedings concerning pension plan funding. *Id.* Exelon Corporation, the parent company of ComEd, chose to provide a contribution to the pension asset of ComEd to prefund the pension obligation. Staff continues that is not one of the facts present in this IAWC case. Moreover, in Docket No. 05-0597, the record showed the prefunding contribution to the utility pension plan resulted in a savings to ratepayers. The Commission found that the savings from this prepayment more than outweighed the cost. *Id.* IAWC has not provided sufficient evidence to meet its burden of proof that its proposal for a debt return on its pension asset is warranted or reasonable. Staff recommends that the Commission reject the Company's proposed adjustments.

### c. AG's Position

AG witness Effron recommends that the Commission reduce rate base by the accrued OPEB liability in the amount of \$1,898,284. AG Ex. 3.0 at 7. Mr. Effron explains that Statement of Financial Accounting Standards 106 requires the Company to accrue for the payment of future post-retirement benefits other than pensions and that when the accruals are greater than the actual cash disbursements, accrued liabilities will be reflected on the Company's balance sheets. *Id.* The AG notes that the Commission has consistently applied this rule in IAWC's rate cases. Docket No. 11-0767, Order at App. A, page 4, line 18.

IAWC accepts Mr. Effron's adjustment, but IAWC witness Kerckhove argues that if the Company's rate base is reduced by the accrued OPEB liability, then the Company should be allowed to include in the cost of service a debt return on pension assets. In support of its previously-rejected position, the Company points to formula rates provided to participating utilities under EIMA (220 ILCS 5/16-108.5(c)(4)(D)) and ComEd's rate case in Docket No. 05-0597.

As to EIMA, the AG argues that this statute does not apply to IAWC. IAWC is not a participating electric utility under EIMA and has not satisfied the various provisions required of the participating utilities under EIMA. IAWC is not entitled to, and should not be provided, the various regulatory benefits that result from being a participating utility under that statute. In short, the AG concludes, the formula rate statute is not germane.

\*12 The AG also explains that the facts of Docket No. 05-0597 do not apply to the instant case. In that case, the Commission allowed a debt return on the contribution that Exelon Corporation made to ComEd to fund the latter's pension trust fund. However, the Commission did not allow a debt return on a pension asset, which is what IAWC seeks here. The AG states that the Commission provided a debt return only on the pension contribution made by Exelon to fully fund the pension obligation. Further, the Commission based its conclusions on the specific facts of the case and cautioned that this conclusion should not be used as precedent for future proceedings. The Order stated:

Accordingly, the Commission approves cost recovery of the Pension Asset under Alternative 3 that ComEd proposed on rehearing. However, in doing so, the Commission does not sanction the prefunding of a utility pension plan as a mechanism to increase base rates. Clearly, Exelon chose to prefund ComEd's pension plan with an equity contribution expending a rate of return. *This Commission bases its conclusion on this issue on the specific details of this proceeding, not to be construed as precedent for future proceedings concerning pension plan funding.*

Docket No. 05-0597, Order on Reh'g at 28 (emphasis added). The AG states that contrary to the facts in Docket No. 05-0597, IAWC has provided no evidence here that its pension asset was funded with anything other than ratepayer funds.

The AG argues that the Company has presented no compelling reason for the Commission to change its prior regulatory treatment of the accrued OPEB Liability and pension asset. In the Company's prior rate case, Docket No. 11-0767, the Commission denied the Company's request for a pension asset to be included in rate base while also accepting the Company's rate base deduction for the OPEB Liability. As it did in that case, the Commission should reject IAWC's position and reduce rate base by \$1,898,284.

#### d. Commission Analysis and Conclusion

The Commission declines to make IAWC's requested adjustment. As Staff points out, this Commission has historically not allowed a return on a pension asset when expenses exceed contributions. In IAWC's past three rate cases, and in several other Article IX rate cases for other utilities, the Commission declined to do so. It is well-established law that the Commission is not bound by precedent and is required to look at the facts of each case to make a decision. *Mississippi Fuel Corp. et al v. Ill. Commerce Comm'n*, 1 Ill.2d 509, 513 (1953). While the Commission is not bound by precedent, when the Commission deviates from past practices it must articulate a reasoned basis to do so. *Citizens Utility Bd. v. Ill. Commerce Comm'n*, 166 Ill.2d 111, 132 (1995). Any departure by the Commission from prior orders or decisions must not be arbitrary and capricious. *United Cities Gas Co. v. Ill. Commerce Comm'n*, 235 Ill.App.3d 577, 591 (4th Dist. 1992). Moreover, "...while ordinarily an administrative action taken pursuant to statutory authority is entitled to great deference, an agency action that represents an abrupt departure from past practice is not entitled to the same degree of deference by a reviewing court." *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 180 Ill. App.3d 899, 909 (1st Dist. 1988). The Commission cannot find any new facts provided

by IAWC which warrant a departure from its normal practice in this area. In fact, the 2005 ComEd Article IX rate case cited by IAWC specifically states that it is not to be construed as precedent for future cases. Docket No. 05-0597, Order on Reh'g at 28. IAWC has not demonstrated that the facts in this case are similar to Docket No. 05-0597 because its parent company has not made a contribution to fund IAWC's pension asset, nor has IAWC shown that the excess monies were generated through shareholder funds.

\*13 The Commission also finds the Company's reliance on EIMA misguided. The EIMA allows specific accounting treatment on some rate base issues, such as a debt return on pension asset, provided the utility meets very specific commitments to capital investments. EIMA only applies to utilities that are deemed "participating utilities" under the definitions and law described in Sections 13-108.5 and 108.6 of the Act. Certainly, under the EIMA, water utilities cannot be participating utilities. Under no previous scenarios has this Commission applied the EIMA to any utility other than a participating utility as defined in the law. The Commission declines to do so in this case as well, and will not include \$175,000 in the revenue requirement.

### 3. Cash Working Capital for Deferred Income Tax

#### a. IAWC's Position

IAWC explains that CWC is defined as the funds necessary to finance the day-to-day operations of a utility. IAWC Ex. 12.00 at 2. The necessary level of CWC is determined using a lead-lag study, which IAWC states determines the timing of cash inflows and outflows. IAWC Ex. 12.00 at 3.

The Company states that the two primary components of a lead-lag study are revenue lags and expense leads. The revenue lag represents the period of elapsed time between when a company delivers its product to its customers and when it receives payment from them. *Id.* The expense lead, IAWC states, represents the period of elapsed time between when a good or service is provided to the company and when the company pays its supplier for that good or service. *Id.* IAWC explains that the revenue lag is compared against the expense lead, and the net difference is the company's CWC requirement. *Id.*

IAWC states a dispute arose in this case regarding the CWC requirement associated with deferred income taxes. The Company explains that deferred income taxes are generally deducted from rate base, because they are considered a cost-free source of funds. IAWC Ex. 12.00 at 13; IWC/FEA/CUB Ex. 2.0 (Rev.) at 36. In this case, the Company states it deducted deferred income tax amounts from rate base. The Company states it also assigned a zero-day expense lead to deferred income taxes in the lead-lag study to reflect the fact that there is no current expense associated with the deferred tax amounts. IAWC Ex. 12.00SR at 2.

The Company applied the same revenue lag it applies to all other revenues to the deferred tax amounts. IAWC Ex. 12.00 at 13. IAWC explains that application of the revenue lag reflects the reality that IAWC collects the dollars associated with its deferred tax liability in the same way that it collects all other revenues—by billing and collecting from its customers. IAWC Ex. 12.00SR at 2-3. The Company explains that all of its revenues are subject to a 49.3-day revenue lag, on average. IAWC Ex. 12.00R at 5.

\*14 IAWC points out that Staff did not dispute IAWC's method of calculating CWC associated with deferred income taxes. Staff Ex. 10.0 at 3. However, the Company understands IWC/FEA/CUB propose to eliminate the revenue lag applied to deferred tax amounts—in other words, apply a zero-day revenue lag. IWC/FEA/CUB Ex. 1.0 at 1617. Although the AG offered no testimony on the subject, IAWC notes the AG supports IWC/FEA/CUB's proposal in its briefs.

IAWC states IWC/FEA/CUB witness Gorman makes three arguments in support of his proposal, but none of these arguments withstand scrutiny. First, IAWC notes that Mr. Gorman argued that a zero-day revenue lag was appropriate because "cash received by IAWC in rates for deferred income taxes is not currently paid." IWC/FEA/CUB Ex. 1.0 at 16. He stated that "[e]xpenses such as deferred income tax are recorded ... but do not reflect any payment to a vendor or third party." IWC/FEA/CUB Ex. 2.0 (Rev.) at 36. The Company notes it is clear from these statements that Mr. Gorman has confused the components of the lead-lag study. IAWC states Mr. Gorman's proposal is to modify the revenue lag, yet his argument focuses on when or

whether IAWC incurs an expense for deferred income taxes. IAWC explains that its lead-lag analysis already accounted for the fact that there is no current expense associated with deferred income taxes by applying a zero-day expense lead. IAWC states it also accounted for this by subtracting the deferred taxes from rate base. IAWC points out that, given Mr. Gorman's confusion on this issue, his testimony provides no support for his proposed adjustment.

Second, IAWC states that Mr. Gorman argues that a zero-day revenue lag should be applied to deferred income taxes because the taxes are “a cost-free source of cash.” IWC/FEA/CUB Ex. 1.0 at 16. But IAWC explains that the fact that deferred income taxes are a cost-free cash item has been accounted-for outside of the CWC analysis because IAWC subtracted the deferred taxes from rate base. IAWC Ex. 12.00SR at 3. For purposes of determining the appropriate revenue lag in the CWC analysis, IAWC states that the relevant inquiry is when the Company collects cash from its ratepayers. *Id.* IAWC explains that deferred tax amounts cannot become a “cost-free source of cash” to the Company until the Company actually collects the cash amounts from its customers. *Id.*

Mr. Gorman's third argument is that the deferred income taxes should be considered equivalent to depreciation and uncollectibles expenses, which are assigned a zero-day revenue lag. IWC/FEA/CUB Ex. 1.0 at 16-17. But IAWC points out that its calculation of CWC for depreciation, uncollectibles, and deferred tax expense is consistent with past Commission findings in IAWC cases. IAWC Ex. 12.00SR at 4. The Company maintains that Mr. Gorman has presented no compelling reason to depart from Commission practice, and IWC/FEA/CUB's proposal should be rejected.

#### **b. Staff's Position**

\*15 Staff's testimony states that the Company's Schedules 10.01 ZN, CS, LC and PK present adjustments to CWC for the Company based on Staff's calculation of CWC using the Gross Lag Approach. Staff Ex. 10.0 at 3. These schedules reflect adjustments to the test year revenues and expenses for Staff's rebuttal revenue requirement. The Company agrees 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. 12.00R at 2. Staff states that it agrees with the Company's methodology. Staff Ex. 10.0 at 3.

#### **c. AG's Position**

The AG argues that the Company mischaracterized the purpose of CWC. CWC is not measured by the receipt of cash from ratepayers in relationship to the recording of expenses. Expenses such as deferred income taxes are recorded but do not reflect payment. CWC is necessary to provide the funds required to pay the day-to-day expenses incurred by the utility to provide service to customers. Deferred income taxes are not currently paid and, therefore, do not require any funds to pay the yet-to-be paid taxes. Accordingly, the AG agrees with IWC/FEA/CUB that there is no associated CWC requirement. IWC/FEA/CUB Ex. 2.0 at 36-37.

IAWC witness Walker argued that Mr. Gorman's reliance on the calculation of cash working capital in electric formula rate update filings by Ameren Illinois Company (“Ameren”) and ComEd as not germane because those cases “...involve electric utilities participating in the performance-based formula rate scheme established by the [EIMA].” IAWC Ex. 12.00SR at 5. The AG points out that IWC/FEA/CUB's method for the consideration of deferred income taxes in the calculation of cash working capital has been applied in rate cases other than the electric formula rate annual update proceedings. The method was also adopted by the Commission in the last rate case proceedings of Peoples Gas and North Shore. *N. Shore Gas Co.*, Docket Nos. 14-0224/14-0225 (Consol.), 2nd Amendatory Order, App. A at 9-10 and App. B at 9-10 (Feb. 11, 2015). Consistent with its decision in the recent Peoples Gas and North Shore rate cases, the AG argues that the Commission should adopt the IWC/FEA/CUB adjustment to subtract deferred income taxes from revenues in the CWC calculation.

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

IWC/FEA/CUB explain that a utility's CWC consists of the funds necessary to pay the day-to-day expenses incurred by the utility to provide service for its customers. IWC/FEA/CUB Ex. 2.0 (Rev.) at 36-37. IWC/FEA/CUB argue that the Company overstates its CWC requirement by \$1.1 million by inappropriately accounting for deferred income taxes in its CWC calculation. IWC/FEA/CUB argue that the Commission must adjust these costs to ensure only a just and reasonable amount is included in IAWC's rates.

**\*16** IWC/FEA/CUB reason that deferred income taxes are not currently paid — they are, by definition, “deferred,” which means those taxes are a non-cash item and have no associated CWC requirement. IWC/FEA/CUB Ex. 1.0 at 16. In fact, explain IWC/FEA/CUB, such deferred taxes are a source of cost-free funds, the benefit of which is retained by the Company until the deferred taxes are reflected as a reduction to rate base during a rate case proceeding. IAWC Ex. 12.00 at 13; IWC/FEA/CUB Ex. 1.0 at 17. Other non-cash items like depreciation, uncollectibles expenses, and amortization expenses, which are also cost-free, non-cash capital that are subtracted from rate base, are assigned no CWC requirement. IWC/FEA/CUB Ex. 1.0 at 16-17. IWC/FEA/CUB state that the Company correctly recognized an expense lag of zero for deferred income taxes but did not also subtract deferred income taxes from the revenue side of the CWC calculation. IAWC Ex. 12.00 at 13. Instead, Company witness Walker assigned an average revenue lag of 49.3 days to deferred income taxes in the revenue portion of the calculation. IWC/FEA/CUB Ex. 2.0 (Rev.) at 36. IWC/FEA/CUB conclude that this results in inappropriately including approximately \$1.1 million of CWC (a revenue requirement effect of \$91,784). IWC/FEA/CUB Ex. 1.1 at 2-4.

IWC/FEA/CUB aver that Mr. Walker mischaracterizes the purpose of CWC by stating that Mr. Gorman's proposed adjustment ignores “the lag between IAWC's recorded deferred tax amount, and its collection of that amount from customers.” IAWC Ex. 12.00R at 5. According to IWC/FEA/CUB, Mr. Walker's assertion ignores the fundamental principle that CWC is not measured by the receipt of cash from ratepayers in relationship to the recording of expenses. IWC/FEA/CUB Ex. 2.0 (Rev.) at 36. Expenses such as deferred income tax are recorded (i.e. included in the books and records of the utility), but do not reflect any payment to a vendor or third party. Thus, IWC/FEA/CUB argue that they have no place in CWC. *Id.*

In addition, IWC/FEA/CUB argue that IAWC incorrectly asserts that Mr. Gorman's calculation of CWC is consistent with the gross lag method of calculating CWC. IWC/FEA/CUB point out that in the pending Ameren formula rate case, Docket No. 16-0262, deferred income taxes and depreciation expenses are subtracted from revenues in the revenue portion of the CWC calculation. A similar calculation is reflected in the current annual ComEd formula rate case, Docket No. 16-0259. IWC/FEA/CUB Ex. 2.2 at lines 6 and 7a. IWC/FEA/CUB witness Gorman's proposed calculation is consistent with the approach used in those cases, which has been previously approved by this Commission.

#### e. Commission Analysis and Conclusion

The Commission agrees with the AG and IWC/FEA/CUB. It 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. Utilities have historically excluded deferred income taxes from CWC. As stated by the Supreme Court of Illinois:

**\*17** 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 the stockholders. Where tax accruals actually make funds available, it is error for the Commission to ignore them and fail to offset them against the working capital allowance.

*City of Alton v. Ill. Commerce Comm'n*, 19 Ill.2d 76, 85 (1960). While IWC/FEA/CUB point out that deferred income taxes receive this treatment in the formula rate cases, the Commission prefers to point to other Article IX rate cases as guidance for CWC and deferred income taxes. As the AG notes, IWC/FEA/CUB's method for the exclusion of deferred income taxes in the calculation of cash working capital was also adopted by the Commission in the last rate case proceedings of Peoples Gas and North Shore. Docket Nos. 14-0224/14-0225 (Consol.), 2nd Amendatory Order, App. A at 9-10 and App. B at 9-10. In addition to Docket No. 14-0224/14-0225 (Consol.), two other recent Article IX rate cases also properly excluded deferred taxes in the calculation of CWC. *Ameren Ill. Co.*, Docket No. 15-0142, Order, App. Sch. 8 (Dec. 9, 2015); Docket No. 14-0066, Order, App. at 9.

The Commission adopts the treatment for deferred income taxes in the CWC calculation as proposed by IWC/FEA/CUB and supported by the AG. The Company should reduce both the expense portion and the revenue portion of the CWC calculation for deferred income taxes. This is consistent with Commission policy for the treatment of deferred income taxes and CWC.

### C. Original Cost Determination

IWC accepted Staff's recommendation that the Commission conclude and make a finding in the Final Order in this proceeding that the Company's September 30, 2015 plant balance of \$1,570,415,946 be approved for purposes of an original cost determination. Staff Ex. 2.0 at 14; IWC Ex. 4.00R at 5. The Commission finds that the original cost determination as agreed to by Staff and the Company is reasonable and uncontested. The \$1,570,415,946 original cost of plant for IWC at September 30, 2015, as presented in Staff Exhibit 2.0, is approved as the original cost of plant.

### D. Recommended Rate Base

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

## III. OPERATING EXPENSES AND REVENUES

### A. Resolved Issues

#### 1. State Income Tax Rate

\*18 IWC proposed to revise the effective state income tax rate in developing the gross revenue conversion factor and income tax expense for IWC in this case. The effective state income tax rate that correctly reflects IWC's cost of state income taxes in Illinois is 7.75%, calculated using the Illinois statutory state income rate of 5.25%, plus the Illinois replacement tax rate of 2.5%, multiplied by an apportionment factor of 100%. IWC Ex. 13.00R at 3. IWC determined that it was incorrectly using a five-year average estimate of American Water's apportionment factor when it should have been using the 100% apportionment factor reflecting IWC's activities in the State of Illinois, since all of IWC's sales are sourced to Illinois. *Id.* Using a 100% apportionment for IWC properly represents IWC activities and the amount it will ultimately pay as its share of the American Water combined group. *Id.* Staff witness Hathhorn and AG witness Effron both accepted IWC's proposal to use the 7.75% state income tax rate, based on a 100% apportionment factor. Staff Ex. 10.0 at 4; AG Ex. 3.0 at 2. The Commission finds that the state income tax rate, as agreed to by the Company and Staff, is accurate and will be adopted for purposes of this proceeding.

#### 2. Income Tax Expense

In rebuttal, AG witness Effron stated that while the Company appears to agree with his corrections to the calculation of income tax expenses, the Company still had not made those corrections. AG Ex. 3.0 at 15. In surrebuttal, IAWC witness Kerckhove explained that the current income tax was calculated correctly in the Company's rebuttal testimony. The adjustment to income tax expense used in the Company's rebuttal filing was an error, however, since it used the Company's initial rate case filing as the starting point for the adjustment. The current income taxes in the Company's surrebuttal exhibits match the calculation of income tax expense on Company Pro Forma Present. IAWC Ex. 4.00SR at 11. The Commission finds that the income tax expense, as agreed to by the AG and the Company, is accurate and will be adopted for purposes of this proceeding.

### **3. Advertising Expense**

Schedule C-8 presents IAWC's expenses for advertising that informs consumers how they can conserve water or reduce peak demand, advertising required by law, and advertising regarding service interruptions, safety measures, and emergency conditions. IAWC Ex. 4.00 at 19. Staff witness Kahle proposed an adjustment to reduce the Company's proposed advertising expense level by items he deemed of a promotional, goodwill or institutional nature. Staff Ex. 3.0 at 7, Sch. 3.03 at 1. IAWC accepted that adjustment. IAWC Ex. 4.00R at 4. The Commission finds that IAWC's advertising expense, as adjusted by Staff and agreed to by the Company, is reasonable and will be adopted for purposes of this proceeding.

### **4. Lobbying Expense**

\*19 Schedule C-2.5 presents lobbying expenses that IAWC removed from the test year revenue requirement. IAWC Ex. 4.00 at 14. Staff witness Kahle proposed an additional adjustment for employee expenses related to lobbying that IAWC inadvertently included in test-year operating expenses. Staff Ex. 3.0 at 9, Sch. 3.05. IAWC accepted that adjustment. IAWC Ex. 4.00R at 4. The Commission finds that IAWC's lobbying expense, as adjusted by Staff and agreed to by the Company, is reasonable and will be adopted for purposes of this proceeding.

### **5. Outside Professional Services Expense**

Schedule C-6.2 presents expenses for Outside Professional Services 2014 through 2017. IAWC Ex. 4.00 at 18. Staff witness Kahle and AG witness Effron each proposed an adjustment to remove certain outside professional expenses that IAWC inadvertently included in test year operating expenses. Staff Ex. 3.0 at 10, Sch. 3.06; AG Ex. 1.0 at 25. IAWC accepted that adjustment. IAWC Ex. 4.00R at 4. The Commission finds that IAWC's outside professional services expense, as adjusted, is reasonable and will be adopted for purposes of this proceeding.

### **6. Invested Capital Tax**

Schedule C-2.10 presents an adjustment to the test year forecast for invested capital tax that aligned with IAWC's initially-proposed capital structure balances. IAWC Ex. 4.00 at 15. Staff witness Kahle recommended that the final amount of invested capital tax be based on the average combined long-term debt and common equity from the capital structure adopted by the Commission. Staff Ex. 3.0 at 9. AG witness Effron agreed. AG Ex. 3.0 at 17. In light of the parties' agreement regarding the capital structure balances, IAWC accepted the adjustments to invested capital tax. IAWC Ex. 4.00R at 13; IAWC Ex. 4.00SR at 10. The Commission finds that IAWC's invested capital tax expense, as adjusted, is reasonable and will be adopted the purposes of this proceeding.

### **7. Unaccounted-For Water Expenses**

Staff witness Kahle recommended an adjustment to reduce chemical and power expenses associated with the unaccounted-for water over the maximum allowance in IAWC's tariffs. Staff Ex. 3.0, Sch. 3.02; Staff Ex. 7.0 at 6. IAWC already removed,

however, the excess production costs above the tariff limitations, as shown in workpapers WPC-2.2c and WPC-2.2d. IAWC Ex. 4.00R at 11. Further, Staff's calculations overstated the appropriate adjustment—already included in IAWC's calculations—because they did not reflect the full amount of water not used for billed sales but used for known purposes, and because they included a weighted factor for the lower unaccounted-for water tariff limits in the Chicago Metro district's purchased water areas. *Id.* at 12. Staff witness Sperry did not object to IAWC's calculations and recommended that the Commission accept IAWC's adjustment for unaccounted-for water. Staff Ex. 15.0 at 5. The Commission finds that IAWC's unaccounted-for water expense, as agreed to by the parties, is reasonable and will be adopted for purposes of this proceeding.

## 8. Depreciation/Amortization Adjustment

\*20 IAWC included a depreciation adjustment in its revenue requirement, as shown on IAWC Schedules C-12 and C-2.11. IAWC Ex. 4.00R at 18. AG witness Effron proposed an adjustment to the depreciation expense shown on Schedule C-2, “in the calculation of adjusted operating income under present rates, to comport with the depreciation expense shown on Schedules C-2.11 and C-12.” AG Ex. 1.0 at 22. Mr. Effron's proposal, however, adjusted amortization expense recorded in Accounts 406 and 407. This was also included in IAWC's last three rate cases. IAWC Ex. 4.00R at 18. Mr. Effron agreed and withdrew his proposal. AG Ex. 3.0 at 14. The Commission finds that IAWC's unadjusted depreciation expense is reasonable and uncontested; it will be adopted for purposes of this proceeding.

## 9. Miscellaneous/Other Revenues

IIRC/FEA/CUB witness Gorman proposed an adjustment to IAWC's test year Miscellaneous/Other Revenues to more closely align with 2014 and 2015 Miscellaneous/Other Revenues levels. IIRC/FEA/CUB Ex. 1.0 at 8-9. AG witness Effron also proposed an adjustment to these revenues to reflect actual revenues through September 2015 and proposed revenues for October through December 2015. AG Ex. 1.0 at 11-12. IAWC accepted Mr. Gorman's proposal in part, and proposed that the adjusted level of Miscellaneous/Other Revenues through the 12 months ending May 2016 be used for the 2017 test year. IAWC Ex. 4.00R at 17, 19-20. Mr. Effron accepted this adjustment. AG Ex. 3.0 at 7. Mr. Gorman also accepted the adjustment and recommended an increase in Miscellaneous/Other Revenues for the Chicago-Metro Sewer district, since IAWC's proposed time period did not reflect normal operations in this district. IIRC/FEA/CUB Ex. 2.0 (Rev.) at 22-23. IAWC accepted Mr. Gorman's adjustment. IAWC Ex. 4.00SR at 7-8. The Commission notes that the parties are in agreement regarding this issue. The Commission finds that IAWC's miscellaneous/other revenues, as adjusted, are reasonable and will be adopted for purposes of this proceeding.

## 10. Current Rate Case Expense

IAWC requested rate recovery of \$2,829,388 in rate cases expenses, amortized over two years. IAWC Ex. 4.00 at 19-21. Of that total, \$2,682,915 is the projected cost for outside and affiliate expertise to prepare and litigate this rate case. *Id.* at 19. The remaining \$146,476 is the unamortized balance of Docket No. 11-0767 rate case expense, approved by the Commission as just and reasonable in that rate case.

Section 9-229 of the Act requires the Commission to assess the justness and reasonableness of IAWC's rate case expenses. [220 ILCS 5/9-229](#). In 2015, the Commission adopted the Part 288 rules, which guide this assessment. 83 Ill. Admin. Code, Part 288; *Ill. Commerce Comm'n on Its Own Mot.*, Docket No. 11-0711, Order at 1 (June 3, 2015). The Commission finds that, consistent with that authority, IAWC supplied for the Commission's review documentation supporting the justness and reasonableness of its current rate case expenses, as explained below. The Commission further finds that IAWC has otherwise complied with the requirements of Part 288, as also explained below.

\*21 IAWC states that its \$2,682,915 current rate case expense projection is composed of expenses for the following rate case work, performed by the following professionals, as shown on the Company's Schedule C-10:

- Cash Working Capital Study and support — Harold Walker III, Gannett Fleming;

- Cost of Service Study and support — Paul R. Herbert, Gannett Fleming;
- Demand Study and support — Paul R. Herbert, Gannett Fleming;
- Forecast Audit — Rick Gratza, Kerber, Eck & Braeckel, LLP;
- Rate of Return study and support — Paul R. Moul, Paul Moul & Associates;
- Legal support — Whitt Sturtevant LLP;
- Revenue Requirement support<sup>1</sup> — American Water Works Service Company; and
- Compensation Study and support — Robert V. Mustich, Willis Towers Watson.<sup>2</sup>

In direct testimony, IAWC explained what the anticipated rate case work entailed, why it was prudent to anticipate such rate case work, and why IAWC chose the professionals it did to perform the rate case work, including their qualifications and the reasonableness of their fees. IAWC Ex. 4.00 at 29-45.

IAWC further explained that it engaged the same or similar professionals to prepare and litigate Docket No. 11-0767. The total amount of rate case expense approved in that case for those professional services was \$2,332,541; the total amount actually incurred was \$2,414,670. IAWC Ex. 4.00 at 20. IAWC explained that its current \$2,682,915 rate case expense projection is slightly higher due to moderate increases in consultant costs, including the costs for necessary rate case studies, and the costs to comply with new legal requirements, such as the enhanced customer notice required by recent amendments to the Act. *Id.* at 20-21, 30; [220 ILCS 5/9-201\(a\)](#).

\*22 IAWC otherwise complied with Part 288 of the Commission's rules. Part 288 governs outside and affiliate rate case expenses for which recovery is sought by the utility through rates. [83 Ill. Admin. Code 288.10](#). IAWC also supplied the information required by that rule, related to its current rate case expenses. *See* [83 Ill. Admin. Code 288.40\(a\)](#).

As required by Part 288, IAWC provided in discovery (and in its direct case) this information to assist Staff and other parties in developing a recommended amount of rate case expense:

- requests for production, engagement agreements, and direct testimony describing the terms of engagement between IAWC and outside counsel and technical experts, including their support staff, which describe the nature of the services to be provided, by whom, the attendant hourly rates, and whether specific overhead expenses are excluded from those rates, [83 Ill. Admin. Code 288.30\(a\)\(1\), \(d\)](#); IAWC Ex. 4.00 at 32-45; IAWC Ex. 4.00R at 9; IAWC Ex. 4.00SR at 13; IAWC Ex. 15.01SR at 3-43, 112-13;
- for outside counsel services, which were provided under hourly rate contracts, invoices that clearly indicate the services provided, who provided them, the time spent providing them, and the applicable hourly rates, [83 Ill. Admin. Code 288.30\(a\)\(2\)](#); IAWC Ex. 15.01SR at 91-107, 297-312, 349-64, 380-406, 409-38;
- for outside technical expert services, which were provided under hourly rate contracts, some of which included a not-to-exceed component, invoices that clearly indicate the services provided, who provided them, the time spent providing them, and the applicable hourly rates. [83 Ill. Admin. Code 288.30\(a\)\(3\)](#); IAWC Ex. 15.01SR at 44-80, 108-10, 114-296, 315-48, 367-79, 407-08, 439-47; and
- for the Service Company services, documentation that describes the services provided, the employee number and title of the persons providing those services, the time spent providing the services on a daily basis, the hourly rates, without gross-up for

benefits, like performance pay, and the resultant total amounts charged. [83 Ill. Admin. Code 288.30\(a\)\(6\)](#); IAWC Ex. 15.02SR; IAWC Ex. 15.03SR at 8, 30, 60; IAWC Ex. 4.10SR.

IAWC also provided with its direct case:

- the information required by Part 285.3085 (Schedules C-10 and C-10.1). [83 Ill. Admin. Code 288.30\(b\)\(1\)](#); IAWC Ex. 4.00 at 19-21;
- explanations of the processes, procedures, and controls IAWC uses to ensure that (a) work performed by outside professionals does not duplicate the work of IAWC personnel, and (b) bills from outside professionals are accurate, reasonable, and not redundant, before payment is made. [83 Ill. Admin. Code 288.30\(b\)\(3\)-\(4\)](#); IAWC Ex. 4.00 at 34, 37-38, 40-43;
- \*23 • explanations of the reasonableness of the fees to be paid to outside professionals, considering factors enumerated in [83 Illinois Administrative Code 288.40](#), such as the nature and extent of the work required, the skill required to perform that work, and the professionals' credentials. [83 Ill. Admin. Code 288.30\(b\)\(5\)](#), [288.40](#); IAWC Ex. 4.00 at 29-45; and
- the rationale for IAWC's proposed two-year amortization period—the Company's historical rate case frequency and the effect on rate case timing of the Commission's Order in Docket No. 15-0017, the rulemaking to amend 83 Illinois Administrative Code, Part 656, “Qualifying Infrastructure Plant Surcharge.” [83 Ill. Admin. Code 288.30\(b\)\(6\)](#); IAWC Ex. 4.00 at 19-20.

IAWC also provided with its direct, rebuttal, and surrebuttal cases summary schedules of its rate case expenses, which showed the total projected, total incurred, and total remaining rate case expenses for each professional. [83 Ill. Admin. Code 288.30\(c\)\(1\)-\(4\)](#); IAWC Ex. 4.03 (Rev.); IAWC Ex. 4.12R; IAWC Ex. 4.10SR; IAWC Ex. 15.02SR; IAWC Ex. 15.03SR. IAWC Exhibit 4.10SR also indicates where in IAWC's discovery responses the invoices supporting each expense incurred to date can be found. IAWC Ex. 4.10SR. *See also* IAWC Ex. 15.01SR; IAWC Ex. 15.02SR; IAWC Ex. 15.03SR (collecting those responses).

IAWC also filed the Affidavit of Rich Kerckhove, attesting that the compensation paid or to be paid by IAWC to outside and affiliate professionals for their rate case work is supported by billings or other documentation that are true and accurate; support costs that were reasonable to prepare and litigate the rate case; were reviewed and approved by IAWC management prior to payment; and are not duplicative. IAWC Ex. 14.00SR. Mr. Kerckhove also attested that IAWC has paid, or will pay, the billed amounts for which IAWC requests rate recovery as rate case expense. [83 Ill. Admin. Code 288.30\(e\)\(1\)-\(3\)](#); IAWC Ex. 14.00SR; IAWC Ex. 4.00SR at 15.

Finally, as explained and as required by Part 288, IAWC submitted all of its rate case expense support—including testimony, summary schedules, outside professional requests for proposals, engagement agreements, invoices, and discovery responses—for the evidentiary record to aid the Commission's assessment of the expense. [83 Ill. Admin. Code 288.30\(f\)](#); IAWC Ex. 4.00SR at 12-13; IAWC Ex. 4.11SR; IAWC Ex. 15.01SR; IAWC Ex. 15.02SR; IAWC Ex. 15.03SR. Additionally, the Commission finds that the work product of the professionals that performed the rate case work, including IAWC's testimony, exhibits, and legal filings on the Commission's e-Docket system, further support the justness and reasonableness of IAWC's rate case professionals' expenses.

\*24 In light of the ample record evidence that IAWC has supplied supporting the justness and reasonable of its rate cases expenses and described above, the Company's compliance with Part 288, the recommendation of Staff regarding IAWC's rate case expenses, and the agreement of the parties, the Commission approves IAWC's requested \$2,829,388 level of rate case expense. Specifically, the Commission finds that the compensation for attorneys and technical experts to prepare and litigate this proceeding that are included in the total approved rate case expense amount of \$2,829,388 are just and reasonable pursuant to Section 9-229 of the Act. [220 ILCS 5/9-229](#).

## 11. Unamortized Docket No. 09-0319 Rate Case Expense

IAWC originally requested recovery of unamortized, unrecovered Docket No. 09-0319 rate case expense inadvertently omitted from Docket No. 11-0767. IAWC Ex. 4.00 at 20. Staff witness Kahle and AG witness Effron opposed recovery of the expense, and proposed an adjustment to remove it from the revenue requirement. Staff Ex. 3.0 at 4; AG Ex. 1.0 at 20. To narrow the issues in this case, IAWC accepted that adjustment. IAWC Ex. 4.00SR at 7. In light of the parties' agreement, the Commission finds that Staff and the AG's adjustment is reasonable, and it is approved for the purposes of this proceeding.

## 12. Long-Term Performance Plan Expense

IAWC awards long-term performance pay to attract and retain the critically-skilled employees needed to run its business and to focus those employees on the long-term financial success of the Company. IAWC Ex. 9.00 at 10; IAWC Ex. 9.01 (Rev.) at 8-9; IAWC Ex. 7.00R (Rev.) at 26. *See also* Staff Ex. 3.0, Attach. G at 17-38. IAWC states that its customers benefit when their utility is financially healthy, because this mitigates the costs that customers ultimately pay through rates. *See* IAWC Ex. 7.00R (Rev.) at 2136. For example, IAWC explains, financial success demands attention to operating efficiency; unless the utility controls or reduces its costs, it cannot achieve earnings per share or other financial goals. *Id.* at 24. And, IAWC maintains, a financially healthy utility can secure the debt capital that it needs to operate at reasonable costs—costs that customers pay in rates. IAWC Ex. 7.00R (Rev.) at 26; IAWC Ex. 2.00 at 23.

For these reasons—and because its employees' total compensation, which may include long-term performance pay, is prudent and reasonable—IAWC initially requested recovery of its test year Long-Term Performance Plan expense. However, to narrow the issues in this case and without waiving its right to seek recovery of long-term performance pay costs in future proceedings, IAWC withdrew its request, and accepted Staff's proposed adjustment to its Long-Term Performance Plan expense, as corrected by Staff in discovery. IAWC Ex. 7.00SR (Rev.) at 10-11; IAWC Ex. 4.00SR at 6-7; IAWC-Staff Stip. Cross Ex. 1.00 at 17, 19.

\*25 In light of the parties' agreement, the Commission finds that Staff's adjustment, as agreed to by IAWC, is reasonable and it is approved for the purposes of this proceeding.

### B. Contested Issues

#### 1. Payroll Expense

##### a. IAWC's Position

Payroll expense, the Company explains, is an ordinary and necessary cost of doing business that must be recovered in rates. *Madigan*, 2011 IL App (1st) 100654 at ¶ 49, *citing* *Bus. & Prof'l People for Pub. Interest v. Ill. Commerce Comm'n*, 146 Ill. 2d 175, 247 (1991); *Villages of Milford v. Ill. Commerce Comm'n*, 20 Ill. 2d 556, 565 (1960). IAWC explains that productivity enhancements have allowed it to reduce its employee headcount since its 2011 rate case, saving \$300,000 in test year payroll expense here. IAWC states that the reduction is the result of IAWC's organizational streamlining efforts and technology initiatives, like the Company's Advanced Meter Reading program, which has allowed IAWC to eliminate 16 full-time equivalent positions, and Business Transformation, American Water's system-wide deployment of new, integrated information technology systems to improve technological efficiencies, increase automation and promote more effective business processes. IAWC Ex. 2.00 at 10, 16, 19. IAWC states that these initiatives allow IAWC to complete more work with fewer people than in 2011, but at lower labor and related costs to IAWC's customers. *Id.* at 19. IAWC maintains that any further reductions to employee headcount and payroll expense should be rejected.

IAWC explains that its test year payroll expense reflects the staffing level that IAWC projects it will need to meet its water and sewer service obligations to Illinois customers in 2017—an average of approximately 470 full-time positions. IAWC explains

that total equals 482 average full-time positions (479 full-time permanent positions each month of the test year, and 13 full-time temporary summer positions, June through August), reduced by 2.5% (approximately 12 positions), to account for anticipated position vacancies in the test year. IAWC Ex. 2.00 at 18-19; IAWC Ex. 2.00R (2d Rev.) at 2, 3. IAWC points out that its May 2016 headcount of 442 plus the 24 positions the Company is actively recruiting or planning to hire in 2016—466 total positions—already approximates its test year 470-headcount projection. IAWC states that each position is essential to the core functions of IAWC's operations: construction, operation, and maintenance of IAWC's water distribution and wastewater collection systems, meter testing and repair, customer service, and management of the personnel who perform that critical work. *Id.* at 3; IAWC Ex. 2.01R.

When IAWC staffs its water and sewer operations, it reviews each vacant position for overall need and considers, among other things, whether the position should be transferred, modified, or even eliminated. IAWC explains that it similarly evaluates new positions that it may need to meet changing regulatory requirements, optimize new technology, and most effectively serve customers. IAWC Ex. 2.00 at 19. IAWC maintains that this continuous focus on appropriate staffing needs allows the Company to effectively control labor costs, while maintaining the workforce necessary to meet its service obligations to Illinois customers. IAWC Ex. 2.00R (2d Rev.) at 3-4.

\*26 IAWC states that all of the positions that it is actively recruiting for, or plans to recruit for, in 2016 are critical to serving IAWC's customers. IAWC Ex. 2.00R (2d Rev.) at 3. Therefore, IAWC's President and Vice President of Operations have approved those positions. *Id.* at 4. IAWC maintains that before the end of 2016 and into the 2017 test year, the Company may recruit for additional, but currently unplanned, full-time positions as business circumstances dictate, to meet IAWC's service obligations. *Id.* at 3.

IAWC further explains that test year payroll expense accounts for 2.5%, or 12 anticipated position vacancies. This is because, while IAWC continuously strives to fill all open positions, historically, the Company has been unable to fill all of its staffing needs. First, IAWC notes that the utility workforce is aging and retiring, and IAWC has lost employees due to attrition. *Id.* at 5. Second, IAWC explains that it is difficult to attract new, STEM-qualified (Science, Technology, Engineering, Mathematics) talent to the public utility industry to fill vacancies left by retiring talent. *Id.* Finally, IAWC explains, the Company has recently increased its focus on diversifying its workforce, with great success: in 2014 and 2015, the majority of IAWC's new hires identified with a minority population. But this focus, IAWC explains, means that there may be delays in filling open positions. *Id.*

IAWC emphasizes that no party disputes that IAWC's approach to staffing its operations is reasonable. Further, no party disputes IAWC's current headcount, the need for the 24 full-time positions that IAWC is recruiting for and plans to fill in 2016, or the need for the attendant work. Moreover, IAWC points out, no party disputed that IAWC may need to recruit more positions beyond its current recruitment plans, in 2016 and 2017, to meet its service obligations to Illinois customers. IAWC Ex. 2.00SR at 6.

Despite this, IAWC explains, Staff witness Kahle, AG witness Effron, and IAWC/FEA/CUB witness Gorman proposed to further reduce IAWC's test year headcount and payroll expense, based on nothing more than IAWC's historical position vacancies since 2014, albeit each to varying degrees. *Id.* at 2. Mr. Kahle would reduce the expense by 5.40%; Mr. Effron, by 5.77%; and Mr. Gorman, by 7.59%. Staff Ex. 11.0REV at 11; IAWC Ex. 2.00SR at 7; IAWC/FEA/CUB Ex. 2.0 (Rev.) at 26.

In response, IAWC explains it is already operating with a lean staff, so its historical vacancy experience is not representative of its future staffing needs. IAWC explains that the reduction is one benefit of Business Transformation, which was established in 2013. The Company explains that Business Transformation changed the way IAWC employees work; they perform the same functions, just differently and more efficiently. IAWC explains that the advent of Business Transformation in 2013 meant a period of "right-sizing" for IAWC's workforce—in 2014 and 2015. Thus, IAWC explains, its vacancy experience those years is not a good predictor of its future staffing needs. IAWC Ex. 2.00R (2d Rev.) at 6. IAWC points out that Staff, the AG, and IAWC/FEA/CUB all wholly ignored this key context for IAWC's 2014 and 2015 staffing levels.

\*27 IAWC also emphasizes that, at a minimum, any payroll expense adjustment requires an offsetting adjustment for increased overtime expense—something the AG and IWC/FEA/CUB ignore or dismiss. IAWC explains that when it cannot fill a budgeted position, current employees must perform the work—at time-and-a-half pay—in addition to their other responsibilities, so IAWC can meet its service obligations to Illinois customers. IAWC Ex. 2.00R (2d Rev.) at 7; IAWC Ex. 2.00SR at 2, 3-4. Therefore, IAWC explains, where historical headcount vacancies have exceeded budget, IAWC's historical overtime expenses likewise have exceeded budget—by \$742,000 in 2013; by \$808,000 in 2014; and by \$459,000 in 2015. IAWC Ex. 2.00R (2d Rev.) at 7. As of May 2016, IAWC states, its 2016 overtime expense was 69% over budget. IAWC Ex. 2.00SR at 4. In other words, on average, 2013 to date, IAWC's overtime expenses have exceeded budget by 43%, offsetting budgeted payroll expense reductions those years.

IAWC points out that IWC/FEA/CUB ignore this. The AG, however, recognizes that overtime expenses can be attributable to the need to compensate for headcount vacancies. But rather than recognizing any offset to its payroll expense adjustment for this, IAWC explains, the AG argued that “[o]vertime can be the result of many factors.” IAWC notes that the AG then cited only one: American Water's stated need in 2014 for increased overtime labor to remedy main breaks resulting from harsh winter weather. Yet this does not aid the AG's position, IAWC explains. If IAWC had the workforce sufficient to respond to unanticipated circumstances, like an increased number of main breaks, its overtime expenses would be less. IAWC Ex. 2.00SR at 6. IAWC affirms that the AG's example simply highlights IAWC's need for flexibility to add headcount beyond its June 2016 recruitments, to ensure the workforce necessary to respond to unanticipated circumstances. *Id.*

IAWC explains that some overtime is expected and appropriate, and therefore IAWC includes overtime expense in its annual budget. IAWC Ex. 2.00SR at 5. IAWC explains that excessive overtime, however, is not desirable. Overtime hours are taxing on employees. IAWC explains that these hours affect employee satisfaction and risk the Company's ability to maintain the stable workforce it needs to serve Illinois customers. *Id.* And excessive overtime hours are not sustainable, IAWC continues. Although IAWC remains focused on safety, it notes that excessive overtime can foster safety concerns. Most IAWC employees who put in overtime hours are field personnel, and an 8-hour shift becomes a 12-hour shift. Simply put, IAWC states, it is better for IAWC to fill planned full-time positions than for IAWC's current workforce to continue to do the work of those positions by working overtime hours. *Id.*

\*28 IAWC notes that Staff recognized that forecasting payroll expense is more dynamic than the AG and IWC/FEA/CUB presume, because Staff's adjustment accounted for the overtime labor that must compensate for unfilled headcount positions. IAWC explains that its projected test year overtime expense is \$1,311,710. IAWC Ex. 2.00SR at 4. IAWC explains that applying the Company's historical average overtime expense variance of 43% to the test year expense level produces an increase in overtime expense of \$559,444. *Id.* IAWC explains that Staff witness Kahle agreed that that increase appropriately offsets his \$702,756 payroll expense adjustment, and he reduced the amount of his adjustment to \$143,312. IAWC-Staff Stip. Cross Ex. 1.0 at 18, 20.

IAWC remains concerned, however, that Staff's adjustment, while more reasonable than the AG's and IWC/FEA/CUB's because it appropriately recognizes overtime expense, is overstated. IAWC notes that Staff argued that IAWC's staffing plans as of June 2016 produce a vacancy rate of 4.36%. Staff didn't dispute the need for any of the planned positions. Yet, IAWC notes, Staff proposed a higher test year vacancy rate - 5.4% - which would remove some of those undisputed planned positions. IAWC explains therefore that, by Staff's own calculation, Staff's proposed vacancy rate is overstated.

IAWC concludes that it has already significantly reduced its workforce, which has mitigated the payroll expense that customers pay through rates. IAWC maintains that the Commission should support such efforts, not constrain payroll expense—and, consequently, IAWC's ability to fill necessary positions with talented, diverse personnel—further. IAWC urges the Commission to reject any adjustment to IAWC's forecasted 2017 test year payroll expense. That expense reasonably reflects the future staffing that IAWC needs to meet its service obligations to Illinois customers. IAWC states that if, however, the Commission adjusts IAWC's forecasted payroll expense for historical vacancies, the Commission must also recognize the consequent increase in overtime expense, which offsets those vacancies.

### b. Staff's Position

Staff states that the Commission should adopt its proposed adjustment to reduce test year payroll expense in order to reflect the Company's history of unfilled budgeted positions. During 2014, 2015 and the first two months of 2016, the Company left unfilled 5.4% of their budgeted positions, on average, but allowed only for a vacancy rate of 2.5% in the test year. Staff's adjustment increases the test year vacancy rate to the Company's historical actual average vacancy rate of 5.4%. Staff Ex. 3.0 at 14-15. In rebuttal, Staff modified its position to divide its proposed adjustment between expensed and capitalized payroll rather than reflect the entire adjustment as an operating expense. Staff Ex. 11.0 at 10-11. Staff further reduced its proposed adjustment to reflect the offsetting effect of additional overtime expense associated with unfilled positions. The overtime expense estimate was supplied by the Company. IAWC-Staff Stip. Cross Ex. 1.00 at 18 and 20. Staff's modified adjustment continues to reflect a vacancy rate of 5.4%.

\*29 The Company argues that its vacancy rate for the test year should not be reduced because the Company plans to fill several vacant positions. IAWC Ex. 2.00R at 2-5. The Company, however, did not present a plan that supports this argument. The Company proposes a 4.36% vacancy rate. Staff Ex. 11.0 at 11-12.

Staff notes in briefs that the Company alleges three reasons why it has been unable to fill its full-time positions, but Staff points out that none of these reasons support the Company's claim that its ability to fill positions will be better in the test year than demonstrated by its recent history. The Company gives no explanation of how it will improve on its history of filling vacant positions as the available workforce is reduced. The Company does not explain why the Commission should accept as a given that there are not enough available graduates with STEM-related degrees. Finally, Staff states that the Company does not explain why hiring minorities may result in delays in filling open positions.

According to Staff, the Company's proposed vacancy rate is out of line with its historic vacancy rates and is not supported by the Company's plan. Staff maintains that its adjustments to the vacancy rate to reflect the Company's average historical rate over the past three years of 5.4% should be adopted.

### c. AG's Position

The AG notes that IAWC's actual vacancy percentage since 2014 has been consistently higher than the vacancy percentage assumed by the Company in forecasting the test year headcount. For May 2016, the most recent month in which data was available, the actual vacancy rate was 10.34%; for the months between July 2015 and April 2016 the highest and lowest monthly vacancy rates ranged from 7.10% to 9.41%, and the average actual monthly vacancy rate for 2014 was 4.79%. AG Ex. 3.1, Sch. C-2.

Company witness Smyth asserted in rebuttal that if positions are unfilled, current IAWC employees and/or temporary employees must do the required work, increasing IAWC's overtime and temporary labor expenses. He also claimed that IAWC's increased overtime and temporary labor expenses since 2013 are due to IAWC's unfilled planned full-time positions. IAWC Ex. 2.00R at 2-10. The AG argues that Mr. Smyth's contention regarding temporary labor expense is contradicted by the fact that its actual temporary labor expense from January through May, 2016 of \$23,000 is below the budgeted year-to-date amount of \$35,000. AG Group Ex. Part 3 at 8-9.

Moreover, the AG asserts that the Company's argument that its overtime expense would increase with a higher vacancy rate is unfounded. There can be many reasons for increased overtime and temporary labor expenses. Overtime can be the result of many factors, and only a percentage of IAWC's overtime can be attributable to its actual vacancy rate. AG Group Ex. Part 3 at 38-39. The AG cites page 45 of the Form 10-K for December 31, 2014 for American Water Works which states that there was "...an increase in salaries and wages expense in 2014 as a result of annual wage increases and *increased overtime expense*

*attributable to an increased number of main breaks as a result of the harsh winter weather conditions* and increases in severance expense as a result of the restructuring of certain functions....” AG Ex. 3.0 at 9 (emphasis added). The AG claims that the Company has not provided any evidence of the percentage of the increased overtime costs that is attributable to the increased vacancy rate, so the Commission should not consider the incremental overtime costs in its determination of an adjustment to recognize the Company's increasing vacancy rate.

**\*30** The AG adds that IAWC has not provided any data that would permit the Commission to calculate a percentage of the increased overtime costs that might be attributable to the increased vacancy rate. Clearly, the percentage of the increased overtime costs attributable to the increasing vacancy rate is not 100%. Unless the Commission chooses to arbitrarily select a percentage of overtime that might be attributable to the Company's increasing vacancy rate, the Commission should not consider the incremental overtime costs in its determination of an adjustment. Applying the vacancy rate proposed by AG witness Effron rather than the higher vacancy rate proposed by IWC/FEA/CUB witness Gorman would provide a fair compromise.

The AG argues that in addition to adopting the adjustment to recognize the Company's increasing vacancy rate it should also adopt the derivative adjustments proposed by AG witness Effron: (1) FICA payroll tax also proposed by Staff witness Kahle and IWC/FEA/CUB witness Gorman; (2) 401K expense and group insurance adjustments also proposed by Mr. Gorman; (3) defined contribution plan that provides all employees hired after 1/1/2006 a 5.25% base pay defined contribution plan (AG Group Ex. Part 3 at 12); (4) capitalized 2017 payroll as proposed by Staff witness Kahle; and (5) capitalized 2016 payroll as the capitalized 2016 payroll represents a forecast and is not the actual capitalized 2016 payroll.

The AG says that in response to IAWC's claim that Mr. Effron had improperly applied certain benefits to the vacancy positions, including the employee benefits of pension, OPEB, retiree medical, and the Employee Stock Purchase Plan, Mr. Effron removed those items from his calculation of his proposed adjustment in his rebuttal testimony.

#### **d. IWC/FEA/CUB's Position**

IAWC seeks recovery of a level of payroll expense based on a budgeted/authorized employee level of 482. IWC/FEA/CUB Ex. 1.0 at 9. IWC/FEA/CUB argue that IAWC's recent budgeted levels of employees have proven to be very inaccurate when compared to actual levels. *Id.* at 9-10. IWC/FEA/CUB point out that on a rolling 12-month basis, since December 2014, IAWC's budgeted number of average employees has been 20 to 38 employees (or 4% to 8%) higher than its actual employee levels. IWC/FEA/CUB Ex. 2.0 (Rev.) at 25 Table 1. Using the most recent available data, updated through May 2016, the disparity between budgeted and actual employee levels has increased each month for a full year. IWC/FEA/CUB Ex. 2.0 (Rev.) at 24-25.

IWC/FEA/CUB reason that, given the Company's recent history of overestimating its employee levels, its 2017 estimate is likely inflated. Mr. Gorman made adjustments to IAWC's employee level to reflect more accurate recent historic levels. To calculate his adjustment, Mr. Gorman used the last known average level of employees for calculating salaries and wages, payroll taxes, and benefits. IWC/FEA/CUB Ex. 1.0 at 10.

According to IWC/FEA/CUB, the Company's claims that its estimated employee levels will be realized are undermined by its recent historical experience, its attrition rates versus new hire rates, and the length of some vacancies (as long as 297 days). IWC/FEA/CUB Ex. 2.0 (Rev.) at 27. While IAWC witness Smyth attempted to show that the Company is in the process of filling its vacant positions, only two of the 24 employees listed in IAWC Ex. 2.01R accepted offers as of the filing of Staff and Intervenor rebuttal testimony in this proceeding. Additionally, IWC/FEA/CUB state that even if those two employees are hired, they are offset by two employee departures since May 2016. IWC/FEA/CUB Ex. 2.0 Rev. at 27. In fact, of the 60 full-time employees hired by IAWC in 2015 and 2016, all 60 of those hires have been offset by 60 resignations during the same time period. *Id.* at 27. IWC/FEA/CUB argue it is simply unrealistic to assume that these trends will drastically change, and that IAWC will begin to hire employees at a pace that far exceeds employee attrition.

\*31 IWC/FEA/CUB recommend that the Commission adopt Mr. Gorman's adjustment as discussed in his rebuttal testimony and use the last known average level of employees. IWC/FEA/CUB state that this more reasonable and realistic approach would result in a revenue requirement adjustment of \$1,430,877.

#### e. Commission Analysis and Conclusion

The Commission finds that the Company's estimate of 470 full-time employees is reasonable. The Company projected 482 hires and reduced the projected head count by 2.5%, or 12 positions, to account for vacancies. IAWC's test year staffing level in this case is 26 positions less than IAWC's approved staffing level in Docket No. 11-0767, including anticipated vacancies, and its payroll expense is \$300,000 less. IAWC Ex. 2.00 at 19. IAWC cites some of its business initiatives from 2013 which streamlined much of its work and eliminated 16 full-time equivalent positions in 2014 and 2015. No party disputed IAWC's current headcount, or the need for the 24 positions that IAWC seeks to fill. IAWC identified the positions and explained why each is essential to the core functions of IAWC's operations: construction, operation, and maintenance of IAWC's water distribution and wastewater collection systems, meter testing and repair, customer service, and management of the personnel who perform that critical work. IAWC Exhibit 2.01R. The dispute between the parties on this issue is over the vacancy rate. Staff proposes reducing the expense by 5.40%; the AG by 5.77%; and IWC/FEA/CUB by 7.59%, using the Company's historical vacancy rates since 2014. AG Ex. 1.0 at 12-14; AG Ex. 3.0 at 7-10; IWC/FEA/CUB Ex. 1.0 at 9-11; IWC/FEA/CUB Ex. 2.0 at 23-28; Staff Ex. 3.0 at 14-15; Staff Ex. 11.0 (Rev.) at 10-12.

The Commission finds that the Company's vacancy estimate is reasonable, due in part to the technological improvements affecting the Company's workforce since its last rate case. The Commission notes that neither IWC/FEA/CUB nor the AG considered any offsetting overtime expense in its adjustment. If the Company cannot fill a budgeted position, current employees must perform the work in overtime, in addition to their other responsibilities. Certainly, any adjustment to the vacancy rate must account for an offset in the amount of overtime paid to employees. The AG and IWC/FEA/CUB adjustments are rejected, for that reason. Moreover, the AG and IWC/FEA/CUB adjustments are based on only one month of data, the June 2016 vacancy rate. The Commission agrees with the Company that staffing decisions are much more dynamic than the Company's needs in one month of the year. The Company must have flexibility to hire staff as circumstances demand, to meet service obligations to customers, or deal with unexpected staffing needs, such as main breaks and other emergencies.

Staff witness Kahle's final proposed adjustment did consider an offset for overtime and considered more than one month of vacancy rate data. Staff's proposed adjustment that accounts for overtime also looks at historical vacancy rates since 2014, but it does not consider the recent changes the Company has made to staffing due to the Company's technological advancement projects in 2014 and 2015 which impacted the Company's employee headcount. The Commission finds IAWC's estimate reasonable, because it examines a more recent picture of the Company's vacancy rate.

\*32 The AG cites the 2014 American Water Form 10-K in support of its argument that any payroll expense adjustment should not be offset by overtime. The Form 10-K cites main break work due to harsh weather conditions as leading to overtime, and the AG intimates that these main breaks may be part of the reason for increased overtime, not necessarily the vacancy rate. The Commission finds that unanticipated demands on staffing, due to unexpected main breaks, for example, and increased overtime because of fewer employees, go hand in hand. The Company states that it needs to hire additional employees, specifically citing a need for a Field Services Technician, which may have reduced overtime hours in the cases of unanticipated main breaks because there would be more employees overall.

The Commission agrees with the Company that reducing the Company's payroll expense may hinder its ability to successfully recruit and hire qualified individuals. For these reasons, the Staff, AG and IWC/FEA/CUB adjustments to payroll expense are rejected.

## 2. Annual Performance Plan Expense (Resolved between IAWC and Staff)

### a. IAWC's Position

IAWC explains that part of its Annual Performance Plan (“APP”) successfully encourages its employees to achieve IAWC’s operational goals—safety, customer satisfaction, environmental leadership, and operational efficiency—with pay that depends on their annual performance as well as that of the Company’s. From 2013 to 2015, IAWC states that it reduced safety incident rates and increased customer satisfaction rates, under annual performance pay metrics. IAWC points out that it has so increased its operational efficiency that its overall operating expenses in this case reflect a 3% decrease from those in the Company’s 2011 rate case. IAWC asserts that Illinois customers have benefitted from these operational successes.

IAWC notes it initially requested full recovery of its APP expense. However, to narrow the issues, IAWC accepted Staff’s proposed adjustment to allow only the portion that encourages IAWC’s operational successes. Therefore, IAWC notes, Staff, IAWC, and IWC/FEA/CUB agree that that portion of the APP expense is recoverable.

IAWC explains that the AG would disallow IAWC’s entire APP expense, including the portion that encourages IAWC’s operational successes. But, IAWC explains, Mr. Effron does not dispute that IAWC reasonably compensates its employees, or that the APP encourages their operational achievements, or that those achievements benefit Illinois customers. Rather, IAWC points out that the AG focuses on one feature of the APP that ensures that IAWC can fund the plan before payouts are made, and from this alone, the AG claims that the plan expense should be disallowed in its entirety.

IAWC states that when part of the compensation a utility pays its employees is at risk (like incentive or performance pay), recovery of the expense generally hinges on whether it benefits customers. *See, e.g., N. Shore Gas Co.*, Dockets 07-0241/0242 (Consol.), Order at 66 (Feb. 5, 2008) (“The main and guiding criterion is that the [incentive pay] expense be prudent, reasonable and operate in a way to benefit the utility’s customers.”); *Madigan*, 2011 IL App (1st) 100654 at ¶¶ 51, 55 (affirming the Commission’s customer benefit standard). IAWC further explains that the Commission has consistently found that performance pay that promotes safety, increases customer satisfaction, and controls operating expenses benefits utility customers and is rate recoverable. *See* Docket No. 15-0142, Order at 44-46; Docket Nos. 12-0511/12-0512 (Consol.), Order at 130 (“One of the goals that the Commission encourages public utilities to incentivize through [incentive pay] plans is the control and reduction of operating costs since ... this should have the effect, all else being equal, of lowering the costs to be recovered in future rate cases.”).

**\*33** IAWC explains that it prudently and reasonably compensates its employees. Like its industry peers, IAWC explains, the Company compensates employees with a mix of base pay, overtime pay, and short- and long-term performance pay. IAWC states that performance pay is pay that varies depending on the individual employee’s and the broader Company’s performance. IAWC Ex. 9.00R at 4; IAWC Ex. 2.00 at 20. Docket Nos. 07-0241/07-0242 (Consol.), Order at 66 (“Being a large utility means that management depends on the dutiful work performance of its employees. To motivate and maintain high standards, a utility may reasonably offer incentive compensation, as the best way to match both employer and employee interests and to ensure quality work performance.”). IAWC further explains that, also like its peers, to compete for talented employees, IAWC targets its employees’ total compensation (base pay plus performance pay) at the market median for comparable positions. IAWC Ex. 9.00 at 4-5.

IAWC explains that in 2015 the total compensation it paid its employees was somewhat below both the national and Midwest market medians, by 16% and 15%, respectively. IAWC Ex. 9.00 at 8. IAWC notes that its employees’ 2015 base pay alone was substantially below those market medians, by 28% and 25%, respectively. In other words, IAWC maintains that its employees are not overcompensated. IAWC further maintains that if its employees did not receive their performance pay—and received base pay alone—they would be significantly underpaid relative to their peers. *Id.* at 9; IAWC Ex. 7.00R (Rev.) at 23; *Commonwealth Edison Co.*, Docket No. 14-0312, Order at 49-50 (Dec. 10, 2014) (finding the utility should be allowed to recover close to market-level employee compensation, including incentive pay).

IAWC states that it awards its employees short-term performance pay under the APP. IAWC Ex. 2.00 at 20, 22-23; Staff Ex. 3.0, Attach. G at 4-16 (Plan document). The Company explains that payouts under the APP depend 50% on financial performance, assessed via earnings per share metrics, and 50% on operational performance, assessed via safety, customer satisfaction, environmental leadership, and operational efficiency metrics. IAWC Ex. 2.00R (2d Rev.) at 12; IAWC Ex. 9.01 (Rev.) at 7-8. The plan, IAWC states, also requires that IAWC have the financial resources to fund it, assessed as attaining 90% of an earnings per share goal, before payouts can be made. IAWC Ex. 9.00 at 10. IAWC explains, however, that this is not a performance metric under the plan on which employees are paid. *Id.*

IAWC asserts that the APP's operational goals benefit IAWC's customers. In 2013, 2014, and 2015, IAWC explains, its employees achieved incremental and sustained operational successes, under its short-term performance pay Plans. IAWC Ex. 2.00R (2d Rev.) at 12-13.

**\*34** IAWC asserts that safety incidents decreased, and customer satisfaction and service quality increased. And, IAWC asserts, operational efficiency increased such that the total test year operating expenses that IAWC initially requested in this case—\$98.7 million—were 3% less than in its last rate case, despite inflation and despite that, in this case unlike Docket No. 11-0767, IAWC requested recovery of its performance pay expenses. IAWC Ex. 2.00 at 5; IAWC Ex. 2.00R (2d Rev.) at 11; IAWC Ex. 7.00SR (Rev.) at 11. The Company maintains that this reduction has not only mitigated the operating costs that IAWC's customers ultimately pay through rates, but also delayed the time between IAWC's rate cases. IAWC Ex. 2.00R (2d Rev.) at 11-12, 14.

IAWC states that the AG's position to disallow 100% of the APP expense ignores the record evidence and the law and would unfairly disallow the cost of operational metrics that the AG does not dispute benefit customers. First, the AG's position wholly ignores all of IAWC's operational successes, which the APP incentivizes and which unquestionably benefit customers. IAWC Ex. 9.00 at 10. Second, IAWC maintains, the AG's position ignores the structure of the APP itself. IAWC explains that the financial viability aspect of the APP is not a performance metric on which participants are paid.

IAWC also notes that the AG argued that payout under the plan depends on corporate “financial success.” As IAWC explained in testimony, 50% of the plan depends on financial performance, and 50%, on operational performance. The 50% financial performance portion of the plan does depend on financial success, IAWC states, measured by achievement of earnings per share goals at threshold, target, and maximum levels. But the 50% operational performance portion does not. And, IAWC states, that is the only portion of the plan at issue here. IAWC reiterates that there is a “financial viability” aspect to the plan: 90% of an earnings per share goal must be attained to ensure IAWC has the financial resources to fund the plan. IAWC explains, however, that is something different than attaining the earnings per share goal itself. In other words, 90% of the target earnings per share target goal falls well below even the threshold earnings per share goal that must be attained for payout under the 50% financial performance portion of the plan. Put simply, IAWC maintains, ““financial viability” is not the same as “financial success.”

IAWC notes that, nevertheless, from the financial viability aspect of the APP alone, the AG summarily concluded that “[s]ince payment of the APP is dependent on the achievement of American Water to achieve a threshold financial performance level, the APP primarily benefits shareholders, not ratepayers.” IAWC states that the AG, however, never explained why this primarily benefits shareholders, despite all of IAWC's operational successes under the plan, which provide clear and undisputed ratepayer benefits. The Company explains that even if the financial viability aspect of the plan depends on threshold financial success, earnings per share goals only benefit shareholders if those goals are not fixed. IAWC Ex. 7.00R (Rev.) at 28. A utility must reduce or control its operating expenses (which benefit customers) to reach its earnings per share goals. If the utility's expenses are excessive, IAWC explains, it simply cannot realize the profits necessary to satisfy its investors. *Id.*

**\*35** IAWC points out that the AG's position also ignores that, despite the financial viability aspect of its short-term performance pay plans, IAWC's employees have consistently received performance pay under the plans every year, for at least the last seven years. IAWC-AG Stip. Cross Ex. 2.00 at 2. In fact, IAWC states, on average, payouts have exceeded the target level—the level at which IAWC set performance pay in its revenue requirement in this case. *Id.*; IAWC Ex. 2.00 at 21. IAWC explains that

this means that IAWC employees can reasonably be expected to meet or exceed their APP operational goals in the test year; IAWC can reasonably be expected to award them for that performance; and customers can reasonably be expected to benefit, the financial viability aspect of the plan aside. *See N. Shore Gas Co.*, Docket Nos. 07-0241/07-0242 (Consol.), Order at 67 (Feb. 5, 2008).

IAWC also states that the Commission consistently approves cost recovery for performance pay operational metrics that benefit customers, such as safety, customer satisfaction, and operational efficiency. *See* Docket Nos. 07-0241/07-0242 (Consol.), Order at 66 (when incentive pay tied to “matters of customer service, customer satisfaction, the reduction of operating expenses, and the like is at hand, it is incumbent upon the Commission to take a close and considered view”). IAWC points out that these are the very goals that the APP incentivizes, to the undisputed benefit of IAWC's customers in 2013, 2014, and 2015.

Moreover, IAWC continues, in recognizing that operational performance pay metrics benefit customers, the Commission has approved cost recovery even when the governing plan includes a financial feature, to avoid an unjust and disproportionate result. *See* Docket No. 14-0312, Order at 48-51. IAWC explains that in Docket No. 14-0312, the Commission approved partial recovery of ComEd's Annual Incentive Plan, which consisted of eight operational metrics on which ComEd employees received annual incentive pay as well as a “Shareholder Protection Feature” that relied on a reference to Exelon's earnings per share performance. *Id.* IAWC explains that like the financial viability feature of IAWC's APP, ComEd's Annual Incentive Plan's Shareholder Protection Feature could limit the amount of annual incentive compensation paid, but it was not a metric on which ComEd employees earned their annual incentive compensation. *Id.* at 29. IAWC explains that in Docket No. 14-0312, like here, no party disputed that ComEd's Annual Incentive Plan metrics incited employees to meet goals that are beneficial to ratepayers. *Id.* And in that case, like here, the record showed that if employees did not receive their annual incentive pay, they would receive below market wages. *Id.* In light of this, IAWC explains, the Commission found that ComEd should recover its Annual Incentive Plan costs, at 102.9% payout, which the Commission concluded “insures that ComEd recovers the market-based salary for their employees plus a reasonable bonus which further serves to encourage employees continued achievement of the operational goals to the benefit of ratepayers, without allowing for excess cost recovery.” *Id.* at 50. IAWC explains that the Commission rejected the AG's proposed 100% disallowance of ComEd's Annual Incentive Plan in Docket No. 14-0312—based only on the existence of the Shareholder Protection Feature—as disproportionate. *Id.* at 49.

\*36 Besides ignoring the Docket No. 14-0312 Order, IAWC argues that the AG disregards that the operational portion of the APP depends on operational successes, not on financial goals. IAWC notes that the AG cited, in support of its argument, the Commission's order from IAWC's 2007 rate case, where the Commission found: “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 (emphasis added).

Still, IAWC notes, rather than recognizing all of the customer benefits that IAWC's APP provides, the AG faulted IAWC for its inability to show that its reduced operating expenses are not the result of something else, like declining usage or investments in innovative technology. IAWC explains that showing that performance pay is “directly responsible” for operational successes like reductions in operating expenses, however, as the AG advocates, is not the Commission's cost recovery standard. To avoid a disproportionate result, IAWC states the Commission should accept Staff's adjustment to allow 50% recovery of the APP expense.

#### b. Staff's Position

Staff's proposed adjustments remove incentive compensation expenses that are based on underlying financial goals that primarily benefit shareholders. Staff states that ratepayers should not be required to fund incentive compensation plans linked to the financial performance goals of the Company. Staff's adjustments cover operating expenses for the 2017 test year. Staff Ex. 3.0 at 10-14.

The Company accepted Staff's proposed adjustment for test year operating expenses with the only caveat being the adjustment for payroll taxes. IAWC Ex. 7.00SR (Rev.) at 10-11. Staff later modified its adjustment to reflect the correct amount of payroll taxes as supplied by the Company. IAWC-Staff Stip. Cross Ex. 1.00 at 17 and 19. The Company included the 2017 test year operating expense adjustment in its surrebuttal revenue requirement. IAWC Ex. 4.02SR (Rev.), column "t". Staff adopts the Company's surrebuttal calculation for the adjustment to the non-capitalized portion of incentive compensation expense.

### c. AG's Position

The AG recommends that 100% of the cost of IAWC's performance plans be disallowed because no payment can be made to any participant in the APP, or short-term variable compensation program, unless the corporate financial performance of IAWC's corporate parent achieves at least 90% of the targeted earnings per share. According to the AG, therefore, the payout of APP to its participants is dependent upon the financial success of each of the affiliates of IAWC, not just IAWC. Since payment of the APP is dependent on the achievement of American Water to achieve a threshold financial performance level, the APP primarily benefits shareholders, not ratepayers. AG Ex. 1.0 at 14-15.

\*37 The AG argues that the Commission has consistently and routinely found that it is inappropriate to include in rates the costs associated with incentive compensation programs that condition payment on corporate financial goals. *Id.* For example, in the Company's prior rate case, Docket No. 11-0767, IAWC did not oppose a Staff adjustment to remove a portion of the cost of the performance plan that the Company inadvertently had not removed. Docket No. 11-0767, Order at 48. And in a prior IAWC rate case, the Commission disallowed all costs of the performance plans, finding that:

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.

... In no way does the Commission mean to suggest that IAWC should not be using an incentive compensation plan. On the contrary, if use of the APP helps IAWC meet its financial goals as well as minimum statutory and regulatory requirements, the Commission has no objection to its continued use. The Commission, however, does object to the notion that ratepayers should have to help encourage IAWC's employees to meet goals benefitting shareholders and meet minimum service obligations.

Docket No. 07-0507, Order at 25-27.

The AG argues that IAWC's reliance on the Commission's Order in Docket No. 14-0312 as support for its position that it should be allowed to recover incentive compensation costs for a plan that requires the attainment of certain financial goals for employees to receive payment is misplaced. The AG points out that the Commission's Order in that case shows that the Commission does not consider conditioning incentive compensation costs on the attainment of financial goals as prudent or reasonable.

The AG notes that in its Order in Docket No. 14-0312, the Commission directed ComEd to develop an incentive compensation plan that was not based on the earnings per share or any other financial performance metric of ComEd's corporate parent, Exelon. The Commission ordered a revised plan to be presented in ComEd's next formula rate update or the Company would run the risk of continued disallowance of such expenses. The AG further states that Docket No. 14-0312 is unlike this case in fundamental ways. Docket No. 14-0312 was a ComEd formula rate update case. ComEd's formula rates under Section 16-108.5 of the Act differ from IAWC's rates determined under [Section 9-201](#). For example, formula rates are only in effect for one year while IAWC's rates will be in effect for an unknown period of time. Moreover, there has been no analysis to determine the differences between ComEd's incentive pay plan considered by the Commission in Docket No. 14-0312 and IAWC's plan under consideration in the instant proceeding.

\*38 The AG points out that the Company has not shown any link between the APP tied to financial goals and any identified reduction in operation and maintenance expenses or delay in the filing of rate cases or, further, that these efficiencies would not have been achieved in the absence of incentive compensation based on financial goals. Mr. Effron argued that many factors, such as weather, water usage, and technology, can affect changes in expenses or the time between rate cases. AG Ex. 3.0 at 10-11. In addition, rate changes, such as the use of a Qualifying Infrastructure Plant (“QIP”) rider, may affect the frequency of rate cases. Other than general assertions, the AG asserts that the Company has provided no evidence that the incentive compensation program has affected the results of operations or its revenue increase request.

Moreover, the AG notes that other IAWC witnesses identified reasons for reduced expenses that have nothing to do with the existence of the APP. Company witness Roach stated: “Over the long term, *reduced usage per residential customer has helped lower operating costs*, and has helped avoid some capacity-related needs. These savings and avoided costs have benefitted customers through the ratemaking process.” IAWC Ex. 8.00 at 14 (emphasis added). Mr. Roach added: “As a result of ... ongoing reductions in water usage, the water utility industry has avoided the need to build supply, treatment, and transmission facilities to meet those now avoided additional usage demands.” *Id.* at 14-15. Company witness Hauk stated:

And our water efficiency efforts are demonstrated by investments in new metering and innovative data collection technologies, and by improved business processes that help us work smarter and more efficiently and, by extension, contribute to our cost control efforts. Our ability to reduce O&M from the level approved in our 2011 rate case proves the effectiveness of these efforts, and the consequent cost benefit to our customers.

IAWC Ex. 1.0 at 12.

The AG concludes that the Commission should adopt the AG's adjustment to remove the remaining 50% of the APP because the Company has not established that the APP has been directly responsible for any reduction in operation and maintenance expenses or a delay in the filing of the current rate case or that these cost reductions would not have been achieved in the absence of incentive compensation based on financial goals.

#### **d. Commission Analysis and Conclusion**

At issue is whether the Company may recover 50% of its expenses paid to fund its APP. IAWC initially sought recovery of 100% of its expenses related to its incentive compensation program; however, after Staff questioned the portion of the Plan which is based on financial goals and metrics, the Company withdrew its request for full recovery. IAWC Ex. 2.00R (2d Rev.) at 12; IAWC Ex. 9.01 (Rev.) at 7-8; Staff Ex. 3.0 at 10-14. The remaining 50% of the metrics in the Plan are tied to operational outcomes, and no party disputes that they are not related to financial goals. The AG requests that the Commission remove all expenses related to the Company's APP because no payment can be made to any participant in the APP unless the corporate financial performance of IAWC's corporate parent achieves at least 90% of the targeted earnings per share. Because of this overall requirement, the AG argues that the Plan is completely tied to financial goals, which the Commission does not consider prudent or reasonable. AG Ex. 1.0 at 14-15.

\*39 A utility's incentive compensation plan is often one component of employee salaries, with pay depending on both employee and utility annual performance. Generally, reasonable and prudent expenditures for salaries paid by the utility should be recoverable from ratepayers and should be included in the utility's rate base. *Madigan*, 2011 IL App. 1st 100654 at ¶ 52. Under certain circumstances, however, it has been held that the cost of salaries should be apportioned between shareholders and ratepayers. *Commonwealth Edison Co.*, 398 Ill.App.3d at 517, citing *Du Page Utility Co. v. Ill. Commerce Comm'n*, 47 Ill.2d 550, 560-61, (1971), *Candlewick Lake Utilities Co. v. Ill. Commerce Comm'n*, 122 Ill.App.3d 219, 226 (1983). For example,

the Commission has required that the utility must demonstrate a sufficient nexus between the earnings per share portion of the employee incentive compensation plan and a benefit to ratepayers. *Commonwealth Edison Co.*, 398 Ill.App.3d 510 at 515.

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/North Shore 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 (Consol.) Order at 58.

In this case, however, the Company is only including the expenses associated with operational metrics. Fifty percent of the goals in IAWC's APP are related to safety, customer satisfaction, technology, and operational efficiency. Staff Ex. 3.0, Attachment G at 9 (Conf.). The remaining 50% are associated with the Company's financial growth, targeting a specific earnings per share. The Commission notes that no party disputes that the APP's operational component is designed to benefit ratepayers. Certainly benchmarks that require reducing OSHA injuries, meeting drinking water quality standards and increasing customer satisfaction survey results directly benefit IAWC's ratepayers. *Id.* This is the crux of the analysis concerning whether a utility can recover its expenses related to incentive compensation plans. While it is true that there is a financial aspect to the plan in that 90% of an earnings per share goal must be attained to ensure IAWC has the financial resources to fund the plan, the Commission agrees with IAWC that this is something different than attaining the earnings per share goal itself.

\*40 This case can be distinguished from ComEd's formula rate case, Docket No. 14-0312, which is governed by EIMA, Section 16-108.5 of the Act. Section 16-108.5 specifically permits recovery of incentive compensation that:

is based on the achievement of operational metrics, including metrics related to budget controls, outage duration and frequency, safety, customer service, efficiency and productivity, and environmental compliance. *Incentive compensation expense that is based on net income or an affiliate's earnings per share shall not be recoverable under the performance-based formula rate;*

220 ILCS 5/16-108.5(c)(4)(A). As stated earlier in this Order, Section 16-108.5 does not apply to this rate case. EIMA, and specifically Section 108.5(c)(4)(A), does not govern IAWC, because it is not a “participating utility” under the Act. EIMA's specific language disallowing expense that is “based on net income” or “earnings per share” is not relevant to this case. EIMA expressly disallows incentive compensation expenses based on financial indicators. For this case, the Commission is bound by Article IX and the Illinois Courts' prior discussion of incentive compensation. The Commission finds that since IAWC's APP is reasonable, and the recovery of the expense is limited to only the operational metrics benefitting ratepayers, such recovery is appropriate.

Finally, the Commission points out a reluctance to disallow 100% of the incentive compensation expense because the APP payout is a component of market value employee salaries that would typically be recoverable. As IAWC notes, it currently pays its employees below market value. By disallowing recovery of 100% of employees' incentive compensation, the Company may decide it can no longer offer an APP to its employees, bringing IAWC's employee compensation even lower than its competitors and making it difficult for the Company to attract and retain qualified personnel.

### 3. Purchased Power Expense

#### a. IAWC's Position

IAWC explains that it relies on electricity to power its buildings, pumping stations, and treatment plants. Like many large consumers of electricity, the Company hedges its electricity costs by entering into power supply agreements. IAWC Ex. 2.00R

(2d Rev.) at 15. IAWC explains that rates under these agreements are based on the wholesale price of energy and capacity in the PJM Interconnection LLC (“PJM”) and Midcontinent Independent System Operator (“MISO”) regions. IAWC further explains that the capacity component is based on annual auctions. *Id.*

IAWC states that its test year purchased power expense is based on two power supply agreements (one each for MISO and PJM), which the Company entered into during September of 2015. IAWC Ex. 4.00 at 13. IAWC adjusted its original 2017 forecast, prepared before September 2015, by \$219,000, to account for these agreements, including MISO capacity cost increases. IAWC explains that capacity costs account for 15-20% of total retail power costs under the September 2015 power supply agreements. *Id.*

\*41 IAWC explains that after it filed this case, MISO announced lower capacity costs for MISO's June 1, 2016 through May 31, 2017 planning year. Based on this alone, IAWC notes that the AG argued that purchased power expense should be reduced by the entire \$219,000 adjustment that IAWC made, to account for these new capacity prices. AG Ex. 1.0 at 20-21.

IAWC argues that the AG's adjustment is overstated in two ways. First, IAWC explains, lower capacity prices will go into effect only in the MISO region, and only then for half of the test year—through May 2017. IAWC Ex. 2.00R (2d Rev.) at 16. Second, IAWC states, the AG's proposed adjustment to reflect a capacity cost decrease does not account for increases in other components of IAWC's purchased power costs, including increases in Ameren and ComEd distribution rates, which comprise its \$219,000 adjustment. IAWC Ex. 2.00R (2d Rev.) at 17.

IAWC also maintains that the AG's adjustment is too narrow. The AG's adjustment simply assumes that capacity prices for the final seven months of the 2017 test year will continue at the level announced for the first half of 2017, but IAWC maintains that there is no reason to believe that this will be the case. IAWC Ex. 2.00R (2d Rev.) at 16. IAWC explains that recent history shows that MISO capacity prices have been extremely volatile: costs for the 2013-2014 planning year were \$1.05/megawatt day; they rose to \$16.75/megawatt day in 2014-2015; prices rose again, significantly, to \$150/megawatt day in 2015-2016; and then fell to \$72/megawatt day for the 2016-2017 planning year. *Id.* at 15; AG Ex. 1.0 at 20-21. IAWC states that these dramatic swings highlight the likelihood that capacity charges will increase again in the latter seven months of 2017. And if that happens, IAWC explains, the AG's adjustment would shortchange IAWC's full recovery of purchased power costs. IAWC Ex. 2.00R (2d Rev.) at 16-17.

IAWC maintains that the Commission should reject the AG's adjustment and approve recovery of IAWC's purchased power expense, as adjusted by IAWC to reflect its September 2015 power supply contracts.

#### **b. AG's Position**

The AG states that IAWC included electricity capacity charges in its purchased power expense. In 2015-2016 the capacity charges in the MISO area that serves some IAWC facilities jumped from \$16 to \$150 for June 1, 2015 through May 30, 2016. In 2016-2017, the capacity charge dropped to \$72. AG Ex. 1.0 at 20-21. Despite the more than 50% decrease in capacity costs for the 2016-2017 period, IAWC increased the MISO capacity charge in its test year. AG witness Effron removed the part of the Company's pro forma adjustment to fuel, power, and chemical expense that increased production costs from the high \$150 capacity charge in 2015-2016. Mr. Effron testified that the Company's pro forma adjustment to increase the purchased power costs over the 2017 projected level was not supported and using the 2015-16 capacity charge of \$150 would likely overstate IAWC's purchased power costs. AG Ex. 1.0 at 20; AG Ex. 3.0 at 13.

\*42 The AG points out that Company witness Smyth testified that he “...agrees that, due to the capacity price flow-through, if viewed in isolation, IAWC will temporarily benefit from the reduction in capacity prices in the [MISO] territory from June 1, 2016 through May 30, 2017.” Mr. Smyth argued that there is no assurance that prices will not swing up again in the second half of the test year when MISO holds its capacity auction for the 2017-2018 planning year. IAWC Ex. 2.0 at 14-17. AG witness Effron agreed that while there is no assurance that prices will not swing up in the second half of 2017, there is also no assurance

that the prices will go down in the second half of 2017. AG Ex. 3.0 at 13. Moreover, the AG points out that Mr. Effron's adjustment did not change the Company's original forecast for 2017 power costs that considered several factors including the \$150 per megawatt-day passed through MISO capacity price that was in effect through May 30, 2016.

The AG adjustment is conservative in that it only removes the Company's pro forma adjustment to increase the costs greater than the projected 2017 power costs that were based on the \$150 per megawatt-day pass through MISO capacity price, despite the fact that, as noted above, MISO capacity prices have decreased by more than 50% to \$72 per megawatt/day for 2016-2017. The AG recommends that the Commission adopt the AG adjustment to reduce the test year power costs \$219,035.

### c. Commission Analysis and Conclusion

The Commission agrees with the Company that the AG's adjustment would not allow IAWC to recover its purchased power costs. The Commission also agrees that MISO's dramatic price swings over the last few years indicate a likelihood that prices will continue to fluctuate significantly. Therefore, the Commission declines to make the AG's proposed adjustment.

## 4. Test Year Sales Level

### a. IAWC's Position

The Company explains that because utility rates incorporate a volumetric charge, the total sales volumes must be forecasted to ensure that rates will recover the total revenue requirement. IAWC explains that the objective in a future test year case is to forecast sales as accurately as possible, so that the forecast reflects actual conditions in the test year, and the utility can set rates that allow it to earn its authorized revenues.

The Company states that it is undisputed that its sales volumes are declining. IAWC Ex. 8.00SR at 6, Table 8.02. IAWC estimates that the decline in use per residential customer is approximately 2.03% per year while use among commercial customers is declining at a rate of 0.4% per year. IAWC Ex. 8.00 at 6.

IAWC explains that the decline in residential and commercial usage is driven by customers' installation of new low-flow fixtures and appliances, as well as customer awareness of water conservation and efficiency initiatives. IAWC Ex. 8.00 at 9-11. IAWC further asserts that federal law mandates water efficiency standards for fixtures and appliances, which have been growing more stringent over time. *Id.* at 11. IAWC states that more than 87% of homes in Illinois were constructed before federal water efficiency standards took effect, and were constructed with more water-intensive fixtures. The Company explains that as customers replace older water-intensive fixtures with fixtures that meet the federal mandates, their demand for water declines. *Id.* at 11-12. IAWC states that, therefore, usage will likely continue to decline through the 2017 test year— and beyond. IAWC Ex. 8.00R (Rev.) at 4.

\*43 The Company states the decline is significant, both in terms of gallons and in terms of revenue dollars. From 2006 through 2015, IAWC states it sold 17.8 billion fewer gallons than was used to determine its Commission-approved revenue requirements. IAWC Ex. 8.00 at 15. IAWC explains that while over 60% of IAWC's revenues are variable— recovered via per-gallon volumetric charges— over 90% of the Company's costs are fixed. IAWC Ex. 7.00 at 6-7. IAWC states that when customer usage and sales volumes decline, as IAWC's have, and its rate structure relies heavily on volumetric charges, as IAWC's does, the rates do not produce enough revenue to cover the utility's costs. *Id.* at 5. Because IAWC's rate structure relies heavily on volumetric charges, IAWC explains, this shortfall in gallons sold led IAWC to under-recover its approved revenue requirements by approximately \$51 million between 2006 and 2015. *Id.* at 6; IAWC Ex. 8.00 at 15.

IAWC states that it developed its forecasted test year sales volumes by conducting a statistical regression analysis using base usage data. IAWC Ex. 8.00 at 5-6. The Company explains that a regression analysis is the best method for modeling a trend in data, because the analysis estimates the relationship between variables—in this case, time and usage per customer. IAWC Ex.

8.00SR at 3. IAWC explains further that a regression analysis calculates a trend line that best matches and incorporates singular data points—in this case, data points representing usage per customer at particular points in time. *See* IAWC Ex. 8.01; IAWC Ex. 8.02. The Company points out that both IWC/FEA/CUB witness Gorman and IWC/FEA witness Collins agreed that a regression analysis is the appropriate method for calculating a trend in data. IAWC Ex. 8.00SR at 3.

IAWC states that its regression analysis relied on a robust data set and produced reliable results. The data set, IAWC explains, includes the average usage per customer per day in each month, for each customer in the residential and commercial classes, over the 10-year period 2006 through 2015. IAWC Ex. 8.00 at 5. IAWC states the 10-year period is appropriate because, in statistics, a greater number of observations — a larger data set — yields more significant explanatory values. IAWC Ex. 8.00R (Rev.) at 10.

For purposes of conducting the regression analysis, IAWC states that it excluded weather-dependent usage from its data set. IAWC Ex. 8.00 at 7-8. IAWC explains that it is necessary to separate weather-sensitive usage from base usage in order to ensure that the result of the analysis (the trend line) measures only trends that exist independently from fluctuations in weather. IAWC Ex. 8.00SR at 4. In addition, IAWC states that unlike an analysis based on weather normalization, which requires an assumption that weather in the forecasted period will be equal to “normal” weather, an analysis of base usage does not require the Company or the Commission to make any assumptions regarding weather during the forecasted period because it considers only usage that is not driven by weather. *Id.* at 7.

**\*44** The Company opines that the results of IAWC's regression analysis are reliable. IAWC explains that the trend line that resulted from the regression has a 99.5% chance of correctly predicting usage in the test year. *Id.* at 2. In other words, IAWC explains that there is a 0.05% chance that usage in the test year will be significantly different than usage predicted by IAWC's regression analysis.

IAWC notes that although all parties agree that IAWC's residential sales volumes are trending down, the parties disagree about how the decline should be forecasted into the test year. IAWC understands that Mr. Gorman and Mr. Collins argue that residential usage in the test year should be assumed to be equal to average usage over the 2011-2015 period, while commercial usage in the test year should be set equal to usage in 2015. IAWC states that, despite IWC/FEA/CUB's agreement that a regression analysis is an appropriate method for analyzing trends in data, and their presentation of a regression analysis in briefs, IWC/FEA/CUB argue that a simple average of monthly usage over the five-year period 2011-2015 is a suitable predictor of residential usage in the test year, and that the entire regression analysis should be ignored when forecasting commercial usage. IAWC states that these contentions must be rejected.

IAWC explains that an average cannot account for a trend in the data being averaged. Consider the example provided by IAWC witness Roach: the simple number set 12, 11, 10, 9, 8 represents a trend. “Given the trend, the next number in the set would logically be 7. But if one were to average the data points, as Mr. Gorman and Mr. Collins did, the result would be 10.” IAWC maintains that this same logic holds true here. IAWC states that usage has already declined below the level Mr. Gorman and Mr. Collins proposed to incorporate into the forecast.

IAWC states that because the data Mr. Gorman and Mr. Collins relied upon in developing their average includes weather-sensitive usage, it requires acceptance of the inherent assumption that weather in the forecasted period will be similar to weather in the averaged period. IAWC explains that because water usage is driven in large part by precipitation, rather than primarily by temperature (like electric and natural gas usage), there is no generally-accepted weather normalization methodology in the water industry. IAWC Ex. 8.00 at 8. Therefore, IAWC states, Mr. Gorman's technique of averaging five years of usage as an attempt to normalize for weather is arbitrary.

In addition, IAWC states, Mr. Gorman's contention that weather during the 2011-2015 period was “relatively close to normal” is incorrect, based on data. IWC/FEA/CUB Ex. 1.0 at 7. The Company explains that during 2012, weather in Illinois was unusually hot and dry; it was between 25 and 30% warmer than the 40-year average and between 34 and 60% drier than the 40-

year average. IAWC Ex. 8.00R (Rev.) at 6. But, IAWC points out, data from 2012 represents one-fifth of the data upon which Mr. Gorman's analysis relied. IAWC states that Mr. Gorman's approach is unreasonable because it assumes that weather in the test year will correspond to weather during the five-year period he averaged, but that period includes extraordinary weather. In contrast, the Company states its analysis, which relied on data regarding base usage, requires no such assumptions regarding weather in the forecasted period. IAWC Ex. 8.00SR at 7. As such, IAWC argues, its approach is a far more reliable basis for a forecast. IAWC Ex. 8.00 at 8.

#### **b. Staff's Position**

\*45 Staff states in testimony that it reviewed the Company's methodologies for forecasting annual use per residential customer and the number of residential customers per month. Staff agrees with the Company's methods for forecasting the number of customers per month but was less certain about the method used to forecast the declining sales trend. Staff states that IAWC's method is unnecessarily complex and relies on some assumptions that may or may not be valid. Staff witness Brightwell noted that he used alternative methods which lead to qualitatively similar results. Based on the data provided by the Company, Staff states the evidence supports a hypothesis of a downward trend in average monthly use per residential customer. Staff Ex. 8.0 at 5.

#### **c. IWC/FEA/CUB Position**

IWC/FEA/CUB witness Gorman plotted a trend using average data from five full years' worth of water usage data and concluded that, though residential base water use has declined over the past ten years, the rate of decline has slowed in recent years. IWC/FEA/CUB Ex. 2.0 (Rev.) at 2. Mr. Gorman explains that a forecast based on the most recent five years of usage is more likely to be accurate than a forecast based on ten years of usage because the decline in residential base water use per customer has not been as steep over the past five years as compared to the five years prior to that. IWC/FEA/CUB also observe that Commercial water use has not declined at all in the past ten years — it has been stable, or even slightly increasing. IWC/FEA/CUB Ex. 2.0 (Rev.) Figure 3 at 6.

It is IWC/FEA/CUB's position that the Company's analysis of residential and commercial sales trends is flawed. The result of IAWC's analysis was considerably lower than the most recent five-year average for both residential and commercial customer classes. *Id.* at 7. It is the opinion of IWC/FEA/CUB that it is a more reasonable approach to use an averaging of the most recent five years of data than the most recent ten years of data because the trends show that conservation actions and economic conditions that may have had a greater impact five-to-ten years ago have largely leveled off in the last five years. IWC/FEA/CUB Ex. 2.0 at 8.

IWC/FEA/CUB note that Company witness Roach claims that the weather patterns during 2011-2015 were not representative of test year weather. To justify this conclusion, however, IAWC examined Heating Degree Day (“HDD”) and Cooling Degree Day (“CDD”) data only for June, July and August at Champaign and Springfield. IAWC Ex. 8.00R at 8. This limited data is not representative of normalized weather conditions for Illinois, according to IWC/FEA/CUB. IWC/FEA/CUB witness Gorman reviewed the historical HDD and CDD data for all months of the year, which showed that the weather and rainfall for 2011-2015 was in fact more representative of normalized weather conditions for Illinois than Mr. Roach's data. IWC/FEA/CUB Ex. 2.0 (Rev.) at 7.

\*46 Furthermore, though IAWC witness Roach criticized Mr. Gorman's use of data from the whole State of Illinois as being skewed toward the cooler Chicago region (IAWC Ex. 8.00SR at 12), IWC/FEA/CUB claim it is Mr. Roach's analysis that improperly excludes large areas of IAWC's service territory.

IWC/FEA/CUB witness Gorman calculated an increase in residential and commercial revenue from the Company's estimation at current rates of \$3.335 million and \$1.15 million, respectively, net of variable chemical and power expenses, which increase with increased sales. IWC/FEA/CUB Ex. 1.0 at 8.

#### **d. Commission Analysis and Conclusion**

No party disputes that water usage is declining. The parties dispute how to forecast the total customer sales level in 2017. Though the parties appear to agree that a regression analysis is the best way to plot large data sets of water usage, only the Company used such an analysis. Despite IWC/FEA/CUB's acknowledgment that a regression analysis is the proper tool for modeling such data, it used an average of the last five years of usage data. IWC/FEA/CUB Ex. 2.0 (Rev.) at 2. In testimony, Staff questioned the Company's methodology, but Staff's analysis produced estimates similar to that of the Company. Staff Ex. 8.0 at 5. Staff did not brief this issue.

The Commission agrees with the Company that a regression analysis using the last ten years of data is the most appropriate method to calculate customer usage. The trend line that resulted from its regression analysis has a 99.5% chance of correctly predicting usage in the test year. The Commission notes that IWC/FEA/CUB's use of a five-year analysis produces an average that is higher than any actual usage during that five-year period, which is not reasonable. Moreover, the Commission agrees with the Company that separating weather sensitivity from its initial analysis ensures that the trend lines only measure trends that exist independently from fluctuations in weather.

The Commission agrees with the Company that IWC/FEA/CUB's analysis using weather includes a year (2012) where weather was abnormally hot and dry. IAWC then claims IWC/FEA/CUB incorrectly samples weather data from only certain areas of the State, ignoring locations where it serves significant portions of its ratepayers, such as downstate or in Central Illinois. IWC/FEA/CUB criticizes the Company's subsequent analysis only using weather data from the summer months, when discretionary summer outdoor usage is variable. The Commission finds both these analyses flawed.

For these reasons, the Commission finds the Company's initial analysis which ignores weather trends and examines only usage data produces the most reasonable estimate of test year sales level. As for commercial usage, the Commission disagrees with IWC/FEA/CUB that using the 2015 actual usage rate among commercial users is more appropriate than the regression analysis the Company performed. Again, the Company's regression analysis which captures the declining usage over the last ten years, albeit smaller than the decline among residential customers, provides a more reasonable estimate for the future test year. The adjustments proposed by IWC/FEA/CUB are not adopted.

### **5. Uncollectible Rate in Lincoln**

#### **a. IAWC's Position**

\*47 IAWC states that, to provide a reasonable, consistent approach across its service territories, the Company used a 0.95% uncollectible rate for its four districts: Zone 1, Chicago Metro-Wastewater, Lincoln and Pekin. IAWC understands that AG witness Effron, however, proposes a separate uncollectible rate of 0.92% for the Lincoln district only. AG Ex. 1.0 at 5. IAWC explains that maintaining separate uncollectible rates for each rate zone adds to the complexity of preparing a rate case and preparing the Company's annual business plan. IAWC Ex. 4.00R at 15. The Company states it also, for example, used one set of depreciation rates for all rate zones, rather than preparing multiple costly depreciation studies. The Company states its use of one uncollectible rate to forecast uncollectibles for the entire Company is similarly reasonable, and the use of one uncollectible rate, and one gross revenue conversion factor, for all tariff groups is consistent with the Company's last rate case, Docket No. 11-0767, and previous rate cases, Docket Nos. 07-0507, 02-0690, and 00-0340.

IAWC states that Mr. Effron's proposal is also unnecessary, as it reduces the Lincoln rate zone revenue requirement by less than \$1,500, or \$0.01 per typical residential customer bill. IAWC Ex. 4.00R at 15. The Company maintains that Mr. Effron's proposal should be rejected.

### **b. AG's Position**

The AG states that IAWC applied a uniform Gross Revenue Conversion Factor (“GRCF”) to all of its divisions to avoid the complexity of maintaining separate uncollectible rates for each zone. The AG argues that the Company has a history of maintaining separate uncollectible rates for its various divisions. For the projected 2017 test year, the calculated uncollectible rate for Lincoln was 0.92% while the uncollectible rate for the other divisions were 0.95%. For projected 2016, the calculated uncollectible ratio for Chicago Metro-Wastewater was 0.880% while the uncollectible ratios for the other divisions were 0.900%. The AG notes that for 2014 and 2015, the actual uncollectible ratios differ for all divisions. AG Group Ex. Part 1 at 61, IAWC Schedule C-16 Line 23.

The AG asserts that a separate GRCF for each district is appropriate. Having four GRCFs rather than one GRCF adds little complexity for a rate case when there are already separate revenue requirements for each district. Moreover, doing so would be consistent with the Commission's finding in a prior IAWC rate case, Docket No. 09-0319, where the Commission concluded that the uncollectible factor used in the GRCF should be different for each district. The Order stated:

The Commission also finds convincing [AG's] assertion that its proposal to calculate a district-specific uncollectibles factor produces a more accurate estimate of the district specific revenue requirement.

\*48 Docket No. 09-0319, Order at 60.

The AG concludes that the Commission should approve the use of a separate GRCF for the Lincoln division so that consumers in that division can benefit from the lower uncollectible rate in that area.

### **c. Commission Analysis and Conclusion**

The Commission agrees with the AG that IAWC's Lincoln customers should benefit from the lower 2017 test year estimated GRCF, regardless of the small impact it will have on customers' bills. This is consistent with past Commission practice. The Commission disagrees that district-specific uncollectibles rates are unnecessarily complex. The Company is directed to use the 0.92% uncollectible rate for the Lincoln water district.

## **6. Demand Study Costs**

### **a. IAWC's Position**

IAWC states that the Company and the AG agree that IAWC's direct measurement demand study be discontinued. The AG recommends that the Company's revenue requirement be reduced by approximately \$69,000 for test year demand study costs. AG Ex 2.0 at 16-17; AG Ex. 4.0 at 1-2. IAWC states that this adjustment is unnecessary. IAWC notes that Mr. Rubin is correct that IAWC expects to incur this amount for demand study data collection and analysis in 2017. IAWC Ex. 4.00R at 19; IAWC Ex. 4.00SR at 11. But, IAWC states, these costs are accounted for as deferred expenses, so they are not reflected in the test year revenue requirement, and IAWC is not seeking to recover them in the current rate case. IAWC Ex. 4.00R at 19; IAWC Ex. 4.00SR at 11-12. As a result, IAWC points out that Mr. Rubin has proposed to disallow costs that are already not in the test year. IAWC states that no adjustment is needed to remove an amount that is not reflected in the test year. IAWC Ex. 4.00SR at 12.

### **b. AG's Position**

In direct testimony, AG witness Rubin testified that he agrees with IAWC's request to discontinue collecting demand data, stating that the demand data the utility has gathered for this case should be usable for many years going forward. AG Ex. 2.0 at 16. Accordingly, Mr. Rubin recommends that the Company's revenue requirement be reduced by \$69,460. *Id.* at 16-17; AG Ex. 2.7.

In rebuttal testimony, AG witness Rubin explained that in a response to discovery, IAWC stated the amount it would save by no longer collecting demand data. The \$69,460 number is the basis for Mr. Rubin's proposed reduction to the revenue requirement. However, in its rebuttal testimony, the Company did an about-face and claimed that there are no savings associated with discontinuing collecting demand data because the expenses are deferred, and not considered a current cost of service. IAWC should be held to its first position, that is, that \$69,460 should be removed from its revenue requirement request. In its direct case, Company witness Kaiser testified that "IAWC would accept an adjustment to test year expenses to remove the cost related to the collection and compilation of the direct measurement data if the Commission approves discontinuance of the data collection." IAWC Ex. 3.00 at 31-32. And, in responding to the AG's data request, the Company quantified the amount associated with collecting the demand data that should be removed from the revenue requirement.

\*49 The AG argues that the Company's change in position in rebuttal testimony responded to no party. No party opposed IAWC's proposal to discontinue collecting demand data and to remove the associated costs from its proposed revenue requirement. Therefore, the AG requests that \$69,460 be removed from the revenue requirement approved in this case.

### c. Commission Analysis and Conclusion

The parties all agree that IAWC's demand study be discontinued. The AG recommends \$69,460 be removed from the revenue requirement because IAWC initially stated that this is the amount that would be saved by discontinuing the study in 2017. AG Ex. 2.0 at 16-17; AG Ex. 4.0 at 1-2. IAWC states that since these are deferred expenses, they would not be recoverable in the current rate case. The Commission agrees that no adjustment is needed to remove an amount that is not reflected in the test year. The Commission declines to make the AG's proposed adjustment.

## C. Recommended Operating Revenues and Expenses

Upon giving effect to the determinations above, the Commission finds that the operating statements for IAWC's respective districts are hereby approved as shown in the schedules contained in the Appendices to this Order.

## IV. CAPITAL STRUCTURE AND RATE OF RETURN

### A. Resolved Issues

#### 1. Capital Structure

The parties agree that the following average test year capital structure is reasonable for setting rates in this proceeding:

CAPITAL COMPONENT	BALANCE	WEIGHT
Short-term Debt	\$17,060,924	1.90%
Long-term Debt	\$433,176,118	48.30%
Common Equity	\$446,559,694	49.80%
<b>Total</b>	<b>\$896,796,736</b>	<b>100.00%</b>

Staff Ex. 12.0 at 2, Sched. 12.01; IAWC Ex. 6.00SR at 2; IAWC Ex. 6.01SR; IAWC-IIWC/FEA/CUB Stip. Cross Ex. 1.00 at 4; AG Ex. 3.0 at 3; AG Ex. 3.1 at Sched. A-3. The Commission finds this test year capital structure is appropriate for the purposes of this proceeding and it is hereby approved.

## 2. Cost of Debt

The parties agree that 0.74% and 5.34% are reasonable average costs of short-term debt and long-term debt, respectively, for IAWC in the test year. IAWC Ex. 6.00R at 3-6, 7-8; IAWC Ex. 6.01R; Staff Ex. 12.0 at 3-4, Sched. 12.01; IAWC-IIWC/FEA/CUB Stip. Cross Ex. 1.00 at 4; AG Ex. 3.1 at Sched. A-3. The Commission finds these test year costs of debt are reasonable and they are hereby accepted.

## B. Contested Issues

### 1. Cost of Common Equity

#### a. IAWC's Position

\*50 IAWC proposes a return on equity ("ROE") of 10.75%. The Company notes that Staff proposes an ROE of 8.12% and a downward adjustment of eight basis points if Rider VBA is adopted. IIWC/FEA/CUB propose an ROE of 9.00%.

The Company asserts that the differences in the recommended ROEs sponsored by the parties in this case are considerable and significant. It states that although the IIWC/FEA/CUB recommendation is low, Staff's recommendation is unprecedented and if adopted, it would cause alarm in the investment community. IAWC Ex. 10.00R at 6. The Company alleges that the Commission has not imposed an ROE as low as Staff proposes in the more than 40 year history that it has been keeping track of ROEs and publishing them. *Id.* at 2-3; IAWC Ex. 10.04R.

IAWC adds that Staff's ROE recommendation is well below the recently-authorized ROEs for other utilities in the country as well as the ROEs for the water companies used in the Company's ROE analyses and the Company's affiliates. IAWC Ex. 10.00R at 3-4, 5. IAWC also contends that the companies in Staff's water sample, which as described below, includes all water utilities within Standard & Poor's ("S&P") Utility Compustat II that have publicly traded stock, have authorized returns averaging 9.65%. IAWC Ex. 10.00R at 4. Moreover, the Company asserts that it already has the lowest authorized ROE of any utility in the American Water system which is problematic because the subsidiaries with competitive rates of return are much more likely to attract the capital necessary to address aging water infrastructure in a more pro-active, accelerated fashion. IAWC Ex. 1.00R at 7; *see also* IAWC Ex. 3.00R at 2-10.

The Company urges the Commission to reject the ROEs recommended by Staff and IIWC/FEA/CUB. It is the Company's position that its witness Mr. Moul's recommended ROE of 10.75% is the most reasonable and should be adopted. IAWC explains that Mr. Moul's cost of equity recommendation is based on analyses using the discounted cash flow ("DCF") model and the capital asset pricing model ("CAPM") and that the risk premium and comparable earnings models were used as a check on reasonableness.

The Company notes that it does not have market-traded common stock, so a proxy group is utilized to conduct the parties' common equity analyses. The proxy group is composed of publicly traded companies comparable, but not identical in risk, to IAWC. IAWC Ex. 10.00 (Rev.) at 3. IAWC witness Moul developed his estimate of the Company's cost of capital using a proxy group of nine water companies ("Water Group"), all of which are contained in the Value Line Investment Survey ("Value Line"); have stock that is publicly traded; and are not currently the target of an announced merger or acquisition. *Id.*

### *DCF Analysis*

The Company states that Mr. Moul used the constant DCF model in his analysis of the cost of equity. IAWC Ex. 10.00 (Rev.) at 21-32. He testified that he generally disfavors a multi-stage or non-constant DCF model because there is no recognized source for analysts' long-term growth expectations. IAWC Ex. 10.00R at 8. He also testified that it is not widely used in regulatory proceedings. *Id.* IAWC states that the underlying theory of the DCF model is that an investment in a utility's stock is worth the present value of future dividends, discounted at a rate commensurate with the risk of the investment. The inputs of this model are current stock price, expected dividend and expected growth rate. IAWC Ex. 10.00 (Rev.) at 17-18. *See also* IAWC/FEA/CUB Ex. 1, App. B at 22-23.

\*51 IAWC explains that Mr. Moul's DCF analysis is based on five-year forecasts of earnings growth for each company in his sample. IAWC Ex. 10.00 (Rev.) at 24. The Company asserts that a leverage adjustment to the DCF results was necessary in order to account for the fact that the Company has more debt in its capital structure than the companies in the Water Group, and is therefore subject to more risk. *Id.* at 27-29.

### *CAPM Analysis*

IAWC states that Mr. Moul also used the CAPM in his analysis of the cost of equity. The Company explains that the theory behind the CAPM is that an investor's return equals a risk free rate, plus an associated risk premium. Staff Ex. 5.0 at 15-16. IAWC further explains that the required inputs for this model are an estimate of the 30-year Treasury risk-free rate, beta (a measurement of the systemic risk associated with a stock), and a market risk premium. *Id.*; *see also* IAWC Ex. 10.00 (Rev.) at 37. Like the DCF, IAWC states that the CAPM is sensitive to the variables used, especially the risk-free rate and market risk premium.

The Company asserts that Mr. Moul chose a forecasted interest rate for 10-year Treasury notes as his proxy for the long-term risk-free rate of return in his CAPM because he believes it is more indicative of "the universal consensus" that interest rates will increase in the future. IAWC 10.00R at 11-13. IAWC explains that Mr. Moul uses Value Line to calculate his beta.

IAWC explains that Mr. Moul applied a leverage and size adjustment to its CAPM results. The Company argues that a size adjustment is warranted because IAWC is smaller than the other companies in the Water Group and therefore it faces an increased level of risk that should be reflected in its ROE. IAWC also argues that Mr. Moul has demonstrated that a leverage adjustment is necessary to properly reflect the fact that the Company carries more financial risk, meaning more debt, than the other companies in the Water Group. IAWC Ex. 10.00 (Rev.) at 28.

### *Risk Premium and Comparable Earnings Analyses*

The Company asserts that while its DCF and CAPM analyses indicate a cost of equity ranging from 9.89% to 10.93%, with an average of 10.41%, additional analyses using the risk premium and comparable earnings models suggest an ROE toward the higher end of this range. IAWC Ex. 10.00 (Rev.) at 2, 4-5, 46. Mr. Moul testified that his recommendation of 10.75% is validated by his risk premium analysis showing a required return of 11.25% and his comparable earnings analysis suggesting a return as high as 13.05%. *See* IAWC Ex. 10.00 at 32, 46.

### *Response to the Parties' Criticism of IAWC's Common Equity Analysis*

IAWC observes that Staff, IAWC/FEA/CUB, the AG, and the Municipalities argue that the Company's ROE estimate is inflated because it includes size and leverage adjustments as well as the risk premium and comparable earnings approaches. IAWC asserts that this argument is not persuasive and it should be rejected.

\*52 IAWC notes that these parties state that the Commission has consistently rejected most of these adjustments in prior proceedings. The Company argues that these orders, like all other Commission orders, are not binding on the Commission's determination in this proceeding. *Citizens Util. Bd.*, 166 Ill.2d 111, 132. Further, IAWC notes that the Commission included model results that reflected size and leverage adjustments in its calculation of ROE in two recent cases. See *Aqua Ill., Inc.*, Docket No. 14-0419, Order at 46 (March 25, 2015); Docket Nos. 12-0511/12-0512 (Consol.), Order at 208.

Additionally, the Company asserts that IAWC witness Moul established that the size and leverage adjustments are necessary. The Company states that Mr. Moul testified that a leverage adjustment needed to be added in the Company's DCF analysis because it has more debt in its capital structure than the companies in the Water Group and therefore it is subject to more risk. IAWC Ex. 10.00 (Rev.) at 27-29. Moreover, Mr. Moul testified that a size adjustment is warranted because IAWC is smaller than the other companies in the Water Group and therefore it faces an increased level of risk that should be reflected in its ROE.

Further, the Company argues that its risk premium and comparable earnings analyses provide extrinsic evidence to support the reasonableness of its proposal. The Company asserts, however, that Staff and IWC/FEA/CUB cannot point to any extrinsic evidence to support their proposals.

#### *Criticism of Staff's and IWC/FEA/CUB's Common Equity Analyses*

IAWC states that the ROEs recommended by Staff and IWC/FEA/CUB are low primarily due to their low DCF results. The Company asserts that this is particularly true for Staff. These DCF results, in IAWC's view, are depressing the cost of equity estimates of these parties' to uncharted depths. It argues that the current low interest rate environment does not adequately explain these DCF results. Instead, the Company maintains that the fact that the ROEs recommended by these parties exceeds the highest ROE indicated by their DCF results shows that the DCF understates investor requirements. IAWC explains that the record shows that the ROE estimates by means other than the DCF consistently produce greater returns which indicates that the DCF generally understates the ROE estimates of the witnesses' in this proceeding, especially Staff's. Staff Ex. 5.0 at 14, 26; IWC/FEA/CUB Ex. 1.0, App. B at 36, 44.

IAWC asserts that although the DCF and CAPM analyses should not be expected to predict the exact same cost of equity, the significant differences between the results derived from these two models in this case should raise serious questions. IAWC argues that ignoring this disparity by simply averaging the results produces a figure that is less likely to represent investor expectations and calculating an average with a below-average figure necessarily yields a below-average "average."

\*53 While the Company challenges Staff's and IWC/FEA/CUB's DCF results, it specifically addresses several flaws in Staff's analyses. First, IAWC points out that Staff decided to use a non-constant or multi-stage growth DCF model because the constant growth DCF typically relies on forecasts of dividend growth for the proxy companies and Staff surmised that the analysts' growth rates of 6.7% to 7.6% are unreasonably high and would result in calculations that overstate ROE if used in a constant growth DCF. Staff Ex. 5.0 at 7-8; Staff Ex. 13.0 at 13. IAWC argues that if Staff had actually performed a constant growth calculation with these growth rates, there would be a basis for comparison of the two methods for the Commission's consideration. The Company also states that it is notable that Staff characterizes the results of a study it did not perform as overstating ROE, but never questions whether the study it performed understates ROE.

Second, the Company asserts that the principal flaw in Staff's DCF analysis is its reliance on a forecasted gross domestic product ("GDP") growth rate of 4.2%. The Company states that Staff's claim that growth rates in excess of projected GDP growth should not be used in DCF calculations is not supported by market data. Staff Ex. 5.0 at 7. It is the Company's position that in a stable business such as public utilities, analysts' forecasts can be used directly in the DCF model without injecting GDP growth. IAWC Ex. 10.00R at 30. IAWC takes issue with Staff's argument that an assumption that utilities could experience dividend growth in excess of GDP means that utilities would eventually overtake the entire U.S. economy. IAWC witness Moul explained that such a claim only holds true if one runs the calculations to infinity. *Id.* at 9. The DCF model mathematically

assumes an infinite stream of earnings, but in reality, no financial instrument pays an income stream forever, and IAWC's rates are not going to be in effect forever and the utility sector is only one segment of the economy. *Id.* Therefore, IAWC states that there is no realistic scenario of the water industry, or IAWC in particular, overtaking the entire U.S. economy, regardless of what growth rate is used in a DCF analysis.

Additionally, IAWC notes that Staff asserts that its growth rate is more reasonable because water utilities will experience “below average” growth. Staff Ex. 5.0 at 9. The Company maintains that this assertion is contrary to published analysts' growth rates as well as evidence that the looming need to replace aging infrastructure will drive growth at a faster rate than GDP. IAWC Ex. 10.00R at 10-11.

Third, the Company maintains that the essential flaw inherent in Staff's CAPM analysis is that Staff witness Kight-Garlisch used a Treasury bond yield, which is a spot yield on a single day, instead of looking at available market data for trends in Treasury yields. IAWC Ex. 10.00R at 12. IAWC argues that Staff's CAPM result is understated because it does not reflect the expected increase in interest rates that is indicated in all of the recognized forecasts. Additionally, IAWC contends that it is not impossible to predict the impact of an increase in interest rates as Staff suggests. *Id.* at 13. IAWC points out that Mr. Moul's rebuttal testimony includes a list of five sources that have done so.

#### **FERC Order 531**

\*54 IAWC urges the Commission to consider the Federal Energy Regulatory Commission's (“FERC”) new approach for establishing DCF-based equity returns for utilities under its jurisdiction. *Mass. Att'y Gen. v. Bangor Hydro-Elec. Co.*, 147 FERC 61, 234 (June 19, 2014) (“FERC Order 531”) at ¶ 158. The Company states that FERC recently re-evaluated its approach due to the same anomalies in DCF results that the Company highlights. FERC recognized in that order that an ROE based on a “mechanical application” of the DCF “could undermine the ability of the [utilities] to attract capital for new investment” and impose a “competitive disadvantage” relative to other utilities. *Id.* at ¶ 150. IAWC states that FERC responded to this concern by changing its DCF method to reflect the realities of anomalous markets and bring the results in line with other models. It is the Company's position that FERC's conclusions deserve attention since it is an institution of considerable technical skill and prestige.

IAWC states that both Staff and FERC use the non-constant or multi-stage DCF model (with FERC using two growth stages and Staff using three), but the disparity in results is explainable by the assumed rates of growth and their weighting. IAWC explains that, like the FERC analysis, Staff uses analysts' five-year forecasts for initial stage growth and GDP for final stage growth. Staff Ex. 5.0 at 7-9. However, Staff adds an intermediate growth stage represented by the average of the first and third stage growth rates, and gives each of the three stages equal weighting. *Id.* IAWC further explains that FERC gives the short-term forecast a two-thirds weighting and it gives the long-term forecast a one-third weighting.” *Id.* at ¶ 17. IAWC claims that FERC's approach of weighting short-term projections more heavily than long term projections is consistent with the growth rate evidence produced in this proceeding.

According to IAWC, if Staff's variables for growth rates are plugged into the FERC two-stage DCF model, the implied investor required return is 10.51%, which the Company argues fits comfortably within the range of results indicated by IAWC witness Moul. IAWC posits that the Commission is entitled to give this information the weight it believes it deserves.

The Company also asserts that although its DCF model estimates the cost of equity using the single-stage or constant growth rate and includes a leverage adjustment unlike the FERC approach, its DCF results are the only results within the range of the DCF estimate that would be achieved under the FERC approach. IAWC states that the similarity of results confirms that both approaches represent different methods of arriving at similar results for the investor-required ROE. The Company also notes that the average of its DCF and CAPM results are remarkably close to what it believes the ROE would be if this issue were before FERC.

\*55 IAWC argues that rather than simply take the DCF-implied returns at face value, the Commission should take into account the evidence regarding low interest rates, how those interest rates depressed the ROE midpoint, and how interest rates will rise in the near-term. *See* FERC Order 531 at ¶ 130. The Company asserts that the Commission has broad discretion to consider the DCF studies produced in this case and decide for itself how the results should factor into its decision. *People ex. rel. Madigan v. Ill. Commerce Comm'n*, 2015 IL 116005 at ¶ 23, *citing City of Chicago v. Ill. Commerce Comm'n*, 281 Ill. App. 3d 617, 622, 666 N.E.2d 1212 (1st Dist. 1996). Therefore, the Commission may decide to address the phenomenon by adopting the FERC DCF approach, or it may consider other options such as disregarding the DCF studies performed in this case, or giving the CAPM studies more weight than the DCF studies.

### ***Rider VBA Adjustment***

IAWC insists that Staff's recommendation that the Company's ROE should be reduced by eight basis points if Rider VBA is approved is baseless and it should be rejected. *See* Staff Ex. 13.0 at 3. The Company understands that Staff claims Rider VBA would reduce volatility in the Company's cash flows and improve its credit rating, thereby decreasing risk and lowering investors' required ROE. Staff Ex. 5.0 at 35, 37. However, IAWC states that this argument ignores the fact that the estimate of the Company's cost of equity is derived from market information on the cost of common equity for other comparable water utilities. IAWC Ex. 10.00R at 19. Moreover, since it has become increasingly common for utility companies in the water, electric, and natural gas industries to employ alternative rate design and ratemaking mechanisms, the approval of trackers, riders, adjustment clauses, forecast test years, and other mechanisms by regulatory commissions is widespread in the utility business and already largely embedded in financial data. *Id.* IAWC argues that therefore it would be inappropriate and result in double counting to include a further adjustment to the extent that the market-derived cost of common equity for other utility companies already incorporates the impacts of these or similar mechanisms.

IAWC notes that five of the nine companies in the Water Group utilize alternative ratemaking mechanisms. *Id.* at 20; *see also* IAWC Ex. 10.02, Sched. 3 at 2. Thus, IAWC states, the existence, approval, and impact of these alternative ratemaking mechanisms is embedded in the data the parties used to develop their ROE analyses, including the stock prices, bond ratings, and business risk scores. IAWC Ex. 10.00R at 21. As a result, the Company maintains, the existence, approval, and impact of the alternative ratemaking mechanisms is embedded in the results of those analyses.

\*56 Additionally, IAWC states that its position is well-supported by empirical studies. The Company points to a couple of studies recently published by the Brattle Group which find that there is no statistically significant evidence of a decrease in the cost of capital following adoption of a decoupling mechanism such as Rider VBA. *Id.* at 21-22; IAWC Ex. 10.07R.

In conclusion, IAWC argues that it has provided American Water's customers in Illinois with exceptional service but in order to continue to provide such exceptional service and efficient operations, it must have sufficient funding. The Company asserts that the evidence shows that a range of 9.89% to 10.93% is reasonable, and that qualitative factors such as management performance justify an authorized ROE above the midpoint of this range. Accordingly, IAWC contends that the Commission should approve the Company's proposed ROE of 10.75%.

### **b. Staff's Position**

Staff recommends an ROE for the Company of 8.12%. Staff also suggests a downward adjustment of eight basis points if the Company's proposed Rider VBA is approved by the Commission.

Staff argues that the disparity between its recommended ROE and the Company's proposed ROE stems largely from the Company's inclusion of additional adjustments based on size and leverage. Staff asserts that these adjustments have been repeatedly rejected by the Commission and are not appropriate in this instance. Further, they would result in an ROE recommendation that is out of line with required returns for utilities in general and water utilities specifically.

Staff avers that when the Company's results are corrected to remove these adjustments, the resulting average of the Company's unadjusted ROE analyses is 8.84%, 191 basis points below the 10.75% ROE the Company recommends. Thus, Staff states the recommendations offered by Staff and IAWC are similar after these adjustments are properly removed.

Staff explains that its ROE recommendation is based on the results of its witness Kight-Garlich's DCF and CAPM analyses. Ms. Kight-Garlich utilized two proxy groups. The first is a water sample consisting of all S&P utilities that have publicly traded stock and data necessary for analysis. Staff Ex. 5.0 at 3. This water sample consists of six companies, all of which are included in the Company's Water Group. Staff states that Ms. Kight-Garlich also developed a larger utility sample because she believes smaller samples are prone to increased measurement error. This sample consists of the nine electric and water utilities closest in risk to IAWC based on a comparable risk analysis. *Id.* at 5.

#### DCF Analysis

Staff indicates that Ms. Kight-Garlich used a non-constant or multi-stage growth DCF model with three stages of dividend growth. Ms. Kight-Garlich rejected the constant growth DCF model because she believes it would have required use of unreasonably high growth rates that would be assumed to apply into perpetuity. Staff Ex. 5.0 at 7.

\*57 Staff explains that for the first stage, which lasts five years, Ms. Kight-Garlich used three to five year earnings growth expectations estimated by financial analysts. Staff Ex. 5.0 at 10; Sched. 5.02. In the five-year transitional stage, the growth rate applied was the average of the growth rate for the first and third stages. The long-term growth rate for the third stage, which Staff states begins at the end of the tenth year, was calculated, in part, using the average of the Energy Information Administration and IHS Global Insight forecasts of long-term GDP growth. Staff asserts that this number was combined with the estimate of long-term expected inflation to arrive at the long-term growth estimate of 4.2%. Then, an expected stream of dividends was estimated by applying these stages of growth to the current dividend for each company in the two proxy groups. The discount rate that equates the present value of this expected stream of cash flows to the company's current stock price equals the market-required ROE estimate for each company according to Staff. Staff Ex. 5.0 at 9.

Staff states that Ms. Kight-Garlich's non-constant DCF estimates of the ROE for the Water Sample and Utility Sample are 7.24% and 7.51%, respectively. *Id.* at 14.

#### CAPM Analysis

Staff states that Ms. Kight-Garlich considered U.S. Treasury bonds and U.S. Treasury bills as a proxy for the risk-free rate of return in her CAPM analysis. After considering the pluses and minuses of each of these securities, Ms. Kight-Garlich determined that the U.S. Treasury bond yield of 2.54% is the best proxy for the long-term risk-free growth rate. *Id.* at 19. Staff contends that it is generally accepted that current interest rates are the best predictor of future interest rates.

Staff asserts that Ms. Kight-Garlich then estimated the rate of return on the market by conducting a DCF analysis on the firms composing the S&P 500 Index ("S&P 500") as of March 30, 2016. *Id.* at 20. Growth rate estimates were obtained primarily from Zacks and secondarily from Reuters. *Id.* Staff explains that firms were eliminated from the analysis if they did not pay a dividend as of March 30, 2016 or for which neither Zacks nor Reuters growth rates were available. *Id.* The estimated weighted average expected rate of return for the remaining 418 firms, composing 81.25% of the market capitalization of the S&P 500, equaled 12.03%.

According to Staff, there is no one "true" beta for a company, because betas are forward-looking measures of investors' expectations of market risk. *Id.* at 24. Thus, Ms. Kight-Garlich used multiple approaches to estimate beta in order to mitigate the effects of measurement error. *Id.* at 25. Staff explains that for the beta parameter, Ms. Kight-Garlich combined adjusted

betas from Value Line, Zacks, Reuters, Morningstar and a regression analysis. *See generally, id.* at 20-23. The Water Sample's average Value Line, Zacks, Reuters, Morningstar and regression beta estimates were 0.75, 0.57, 0.58, 0.58 and 0.57 respectively. Since both the Zacks, Reuters, Morningstar and regression beta estimates are calculated using monthly data, unlike Value Line which uses weekly data, Staff notes that Ms. Kight-Garlich averaged those results to avoid over-weighting that approach. The average was 0.58 which Ms. Kight-Garlich then averaged with the Value Line estimate to produce a beta for the Water Sample of 0.66. *Id.* at 24.

\*58 Staff states that Ms. Kight-Garlich undertook the same analysis for the Utility Sample. The average of the Zacks, Reuters, Morningstar, and regression beta estimates was 0.57 which Ms. Kight-Garlich averaged with the Value Line beta to produce a beta for the Utility Sample of 0.67.

Staff points out that by inputting the risk-free rate of return, the estimated market rate of return, and the beta into the CAPM, Ms. Kight-Garlich calculated a cost of common equity of 8.80% for the Water Sample and 8.90% for the Utility Sample.

#### ***Rider VBA Adjustment***

Staff recommends a downward adjustment of eight basis points to the Company's ROE if the Commission adopts Rider VBA. Staff Ex. 13.0 at 3. Staff argues that this adjustment should be made because Rider VBA will reduce the risk faced by the Company since it will reduce the volatility in the Company's cash flows by decoupling the recovery of fixed cost from its volume of water sales. Staff Ex. 5.0 at 32.

#### ***Response to IAWC's Criticism of Staff's Common Equity Analysis***

Staff argues that the Company's comparison of Staff's recommended ROE to other companies' allowed ROEs is not the appropriate benchmark and it only serves to undermine the validity of the Company's ROE analyses. Moreover, Staff states that the arguments advanced by the Company concerning Staff's DCF and CAPM results are unconvincing.

Staff observes that the Company argues that the essential flaw in Staff's CAPM analysis is that Ms. Kight-Garlich's Treasury bond yield does not reflect the expected increase in interest rates. Staff states that this argument should be rejected for the reasons noted below in Staff's critique of the Company's CAPM results.

Staff further notes that the Company argues that Staff's ROE recommendation is low primarily because of its DCF results. Staff asserts that its ROE recommendation is not based solely on its DCF results but rather it is derived from its DCF and CAPM analyses. Therefore, the Company's focus on Staff's DCF analysis in isolation misconstrues Staff's recommendation. Staff argues that it has presented evidence that shows, that regardless of the analysis, returns have fallen compared to the Company's last rate case. IAWC Ex. 10.00R at 4. Staff points to the fact that the Company's own unadjusted analyses show a recommended ROE below its currently authorized ROE.

#### ***Criticism of IAWC's Common Equity Analysis***

Staff challenges IAWC's common equity analysis for several reasons, including the Company's use of adjustments based on size and leverage as noted above. Staff argues that the Company's DCF analysis is overstated because it uses unreasonable growth rates. Staff states that the Company's long-term growth rate of 6% is not a reasonable estimate of long-term sustainable growth. Staff argues that while it is a commonly accepted practice to use three to five year growth rates in a constant growth DCF analysis, at least as a starting point, use of that growth rate is appropriate only if it is sustainable for the long term. In this instance, Mr. Moul's growth rate of 6% is 43% above the estimated long-term growth rate of the economy as a whole. Staff notes that Mr. Moul defends his growth rate, stating that "no financial instrument pays an income stream forever, and IAWC's rates are not going to be in effect forever." IAWC Ex. 10.00R at 9. Staff argues that Mr. Moul's assertion may be true,

however, it is a necessary assumption in DCF analysis that the growth rate will continue in perpetuity and Mr. Moul's estimate is mathematically impossible to sustain to infinity.

**\*59** Staff states that Mr. Moul's DCF analysis also incorporates a clearly aberrant growth rate. Staff explains that Mr. Moul's Water Group includes a company that has a forecasted short-term growth rate of 14.00% which is a clear outlier and unsustainable over the long term. IAWC Ex. 10.02R, Sched. 7. Staff notes that Ms. Kight-Garlich's DCF analysis included this same initial stage outlier, but she also used intermediate and long-term growth estimates for this company that are consistent with expected growth in these stages (9.20% for the intermediate stage and 4.20% for the long-term stage) which decreased the significance of this one company in the proxy group.

Staff argues that the Company's CAPM analysis is also overstated, primarily because it uses a forecasted interest rate, a single source to calculate its beta, and size and leverage adjustments. Staff takes issue with Mr. Moul's use of a forecasted interest rate in his CAPM analysis. Staff does not believe there is evidence to support his assertion that there is a "universal consensus" that interest rates will increase in the future. IAWC 10.00R at 11-13. Thus, Staff disagrees with Mr. Moul's use of the forecasted interest rate for 10-year Treasury notes as his proxy for the long-term risk-free rate of return. Staff argues that Mr. Moul's calculations, which show that his risk-free rate of return estimate decreased from his direct testimony to his rebuttal testimony, demonstrate that his assumption is tenuous. IAWC Ex. 10.02R, Sched. 1. Staff asserts that it is impossible to predict the impact of any increase in interest rates because the economy could grow or slow depending on the size of the increase and how it is perceived. Further, Staff maintains that the best indicator of long-term interest rates is the current interest rate, which Staff has proposed. Staff Ex. 13.00 at 16-18.

Staff contends that Mr. Moul's use of a single source, Value Line, to calculate his beta in his CAPM analysis is also problematic. In Staff's view, the more estimates used, the less possibility that a beta is unduly affected by a random or one-off event. Additionally, Staff questions the accuracy of Value Line's beta because its weekly beta was significantly higher than the four other betas that Ms. Kight-Garlich used in her CAPM analysis. Staff Ex. 5.0 at 24.

Staff further argues that the leverage and size adjustments included in Mr. Moul's CAPM analysis are inappropriate and unreasonable. Staff notes that Mr. Moul testified that a leverage adjustment is necessary when a firm's capitalization as measured by market value differs from its book value capitalization, because the potential exists for a financial risk difference. IAWC Ex. 10.00 at 27. Staff contends that this assertion does not aid IAWC for numerous reasons. First, the Company does not have a market value since it is not publicly traded. But, assuming for the sake of argument that its market value exceeds book value, the Company offers no evidence that this in turn leads to increased risk that is not already accounted for by the various other components of ROE calculation methods. Second, the change in risk that Mr. Moul addresses is actually the result of fluctuating debt to equity ratios over time. Third, the Company presents no evidence that it faces unusual risk necessitating a leverage adjustment. Fourth, Mr. Moul has presented this adjustment before and the Commission has rejected the exact same adjustment in previous cases. *See N. Shore Gas Co.*, Docket Nos. 14-0224/14-0225 (Consol.), Order at 132, 134 (Jan. 21, 2015); Docket Nos. 09-0166/09-0167 (Consol.), Order at 128; Docket Nos. 07-0241/07-0242 (Consol.), Order at 96.

**\*60** Staff also takes issue with Mr. Moul's claim that a size adjustment is necessary. First, Staff contends that there is no theoretical basis for the adjustment and to the extent there is any correlation between firm size and return, that relationship is likely the result of some other related factors, such as liquidity and information costs, rather than a direct relationship between size and return. Staff Ex. 5.0 at 43. Second, even if one were to accept as a general proposition that smaller companies are riskier than larger companies, IAWC offers no evidence that a size premium should be applied to utilities. *Id.* at 44. Third, since the common equity of IAWC is obtained indirectly from investors through American Water, a much larger organization, neither IAWC nor American Water incur the additional costs allegedly associated with smaller companies. Staff Ex. 13.00 at 21.

IAWC's ROE analysis is also overstated, in Staff's view, because it incorporates the risk premium and comparable earnings approaches. Staff argues that Mr. Moul's equity risk premium estimate contains many flaws. It is derived from historical data, which Staff believes is inappropriate because the S&P 500 is riskier than utilities generally, therefore its investor required rate

of return exceeds the cost of common equity for water utilities. Mr. Moul's estimate is based on the average spread between earned returns and interest rates but there is no way, in Staff's opinion, to know whether the earned rate of return is higher or lower than the rate of return investors required at some point in the past. Staff Ex. 5.0 at 48-49. In addition, Staff states that utilizing a forecasted base yield instead of a yield based on current interest rates, inappropriately increases Mr. Moul's risk premium results by 0.79%. Staff Ex. 5.0 at 49.

Staff maintains that IAWC's use of the comparable earnings approach also distorts the Company's ROE analysis. Staff explains that the cost of common equity is the market-driven rate of return demanded by investors. In contrast, comparable earnings analysis is a book-based methodology that incorrectly implies that the earned rate of return on book equity is equivalent to the investor-required market rate of return. Staff Ex. 5.0 at 51. Staff asserts that it should not be used to assess investor expectations because the market price of a common stock reacts to forces in the marketplace while the book value remains constant whether the market goes up or down. *Id.* Staff notes that the Commission has routinely rejected the use of comparable earnings methodology in rate cases for this reason. *See* Docket Nos. 14-0224/14-0225 (Consol.), Order at 134; *Cent. Ill. Light Co.*, Docket Nos. 06-0070/06-0071/06-0072 (Consol.), Order at 141 (Nov. 21, 2006); *Aqua Ill., Inc.*, Docket No. 04-0442, Order at 43-44 (Apr. 20, 2005); Docket No. 03-0403, Order at 41; *Cent. Ill. Pub. Serv. Co.*, Docket No. 99-0121, Order at 68 (Aug. 25, 1999); *Ill. Bell Tel. Co.*, Docket Nos. 92-0448/93-0239 (Consol.), Order at 173 (Oct. 11, 1994); *Ill. Bell Tel. Co.*, Docket No. 89-0033, Order on Remand at 15 (Nov. 4, 1991).

### **FERC Order 531**

\*61 Staff argues that it is highly questionable if FERC Order 531 is relevant. Staff states that while the Company suggests FERC Order 531 must be considered because FERC “is an institution of considerable technical skill and prestige,” the Company makes no effort to explain why the “technical skill” of a federal commission charged with regulating interstate electric transmission and power markets has any import in determining the ROE for an Illinois water company. Staff also argues that the Commission should consider FERC Order 531 in its entirety if it determines that it is relevant in this proceeding. Additionally, Staff asserts that the order undermines the Company's ROE recommendation in several ways.

First, FERC Order 531 establishes that, once a range of reasonable ROEs is established for companies in the proxy group, the ROE for the subject company must fall within that range. Staff notes that Mr. Moul did not present ROEs for the individual companies in his proxy group, nor did he establish a DCF range for the companies in his proxy group, both of which are required by the FERC methodology.

Second, the FERC methodology, like Staff's analysis, considers both short and long-term growth rates while the Company considers only a short-term, five-year growth rate. IAWC Ex. 10.00 (Rev.) at 24. Staff points out that FERC Order 531 states that: “To the extent a high DCF estimate is based on [a] five-year projection, that result is inconsistent with the theory underlying the constant growth DCF model, which requires an estimate of dividend growth extending into the indefinite future.” FERC Order 531 at ¶ 37. FERC also noted that five-year growth projections like the one utilized by Mr. Moul are “limited to too brief a time period to meet the requirements of the DCF model.” FERC Order 531 at ¶ 19 (internal citations omitted). Staff also notes that FERC addresses the limitations inherent in speculating about long-term investment by crafting a method to weight long-term growth but Mr. Moul “addresses” it by simply ignoring long-term growth. Further, the FERC analysis uses a two-stage non-constant growth rate and the Company's witness specifically rejected anything other than a constant growth rate DCF analysis.

Third, FERC Order 531 states that additional methodologies such as CAPM or a risk premium analysis are useful for determining where in the DCF range the final ROE should fall but the ROE must still be within the DCF range. Staff asserts that this is contrary to Mr. Moul's approach of determining an ROE using DCF and CAPM analyses and then adding on adjustments which he attempts to justify through additional methodologies.

Additionally, Staff notes that FERC Order 531 establishes the long-term growth rate as the forecasted GDP of the economy as a whole, which is 4.2%. Mr. Moul, however, testified that he disagrees with the use of the forecasted GDP as an appropriate

indicator of long-term growth and he used a future growth rate of 6% in his analysis. IAWC 10.00R at 10. Staff asserts that Mr. Moul's DCF results would therefore be lower under the FERC's methodology because the long-term growth rate would be based on the forecasted GDP of 4.2% instead of the Company's rate of 6%.

\*62 Finally, Staff notes that the Company erroneously asserts that Staff's DCF results would be higher “[i]f Staff's variables for growth rates are plugged into the FERC two-stage DCF model.” Staff states that this assertion completely ignores the fact that the FERC Order adopts a new methodology to calculate growth rates for use in a DCF model. *Id.* at 13. Therefore, an analysis using FERC's methodology would not involve the use of any of the party's growth rate numbers.

### c. AG's Position

The AG asserts that it supports Staff's ROE recommendation and strongly opposes IAWC's proposed ROE which it states is an outlier that must be rejected. The AG contends that IAWC witness Moul's recommended ROE is grossly inflated because it relies on several methodologies that have the singular effect of driving the proposed ROE higher. The AG notes that Staff witness Kight-Garlich testified that these tactics have been repeatedly and consistently rejected by the Commission, yet Mr. Moul failed to provide any response or offer an explanation as to why the Commission should deviate from its past decisions rejecting these ROE-inflating methods. Staff Ex. 5.0 at 42, 46, 50, 52. The AG points out that Ms. Kight-Garlich also testified that when the effects of two of these tactics are removed, Mr. Moul's proposed ROE is reduced to a range of 8.89% to 9.00%, which is much closer to Ms. Kight-Garlich's proposal, and at the high end, identical to IAWC/FEA/CUB witness Gorman's recommendation. Staff Ex 5.0 at 40; IAWC/FEA/CUB Ex. 1.0 at 4.

The AG notes that the size adjustment that Mr. Moul added to his CAPM results has been rejected in numerous cases, including in IAWC's penultimate rate case, Docket No. 09-0319. IAWC Ex. 10.00 (Rev.) at 41-42; *see* Docket No. 09-0319, Order at 113; Docket Nos. 11-0280/11-0281 (Consol.), Order at 123; *Aqua Ill., Inc.*, Docket No. 110436, Order at 38 (Feb. 16, 2012).

Next, Mr. Moul used a leverage adjustment in his DCF analysis, but the AG notes that the Commission has also repeatedly declined to adopt leverage adjustments in previous cases, including at least three in which Mr. Moul proposed this adjustment. The AG points to the Commission's decision in Docket Nos. 14-0224/14-0225 (Consol.), in which the Commission stated that Mr. Moul's CAPM result was inappropriately inflated because he “appl[ie]d a Commission rejected leverage adjustment technique to the beta measurement.” Docket Nos. 14-0224/14-0225 (Consol.), Order at 133. The AG also notes that the Commission rejected Mr. Moul's leverage adjustment in Docket Nos. 09-0166/09-0167 (Consol.) and Docket Nos. 07-0241/07-0242 (Consol.). Docket Nos. 09-0166/09-0167 (Consol.), Order at 127; Docket Nos. 07-0241/07-0242 (Consol.), Order at 96.

\*63 The AG explains that Mr. Moul also boosted his ROE by employing a risk premium model which is another tactic that the Commission has repeatedly found to be improper. IAWC Ex. 10.00 (Rev.) at 32-37. The AG states that on five separate occasions, Mr. Moul recommended that the Commission use this model as part of his ROE analysis, but in each case, the Commission declined to do so. *See* Docket Nos. 14-0224/14-0225 (Consol.), Order at 134; Docket Nos. 12-0511/12-0512 (Consol.), Order at 208; Docket Nos. 11-0280/11-0281 (Consol.), Order at 139; Docket Nos. 09-0166/09-0167 (Consol.), Order at 139; and Docket Nos. 07-0241/07-0242 (Consol.), Order at 93.

The AG also criticizes Mr. Moul's use of a comparable earnings analysis to augment his recommended ROE. IAWC Ex. 10.00 (Rev.) at 42-46. The AG explains that like Mr. Moul's other adjustments and methodologies, the Commission has on several occasions refused to include a comparable earnings analysis as part of its ROE determination. *See* Docket Nos. 14-0224/14-0225 (Consol.), Order at 134; Docket Nos. 06-0700/06-0071/06-0072 (Consol.), Order at 141-142; Docket No. 04-0442, Order at 43-44; and Docket No. 03-0403, Order at 41.

In addition to the various adjustments and alternative measurement methods Mr. Moul employed, the AG argues that Mr. Moul dedicated significant portions of his testimony to comparisons of Staff's and IAWC/FEA/CUB's ROE recommendations to ROEs

approved by other public utility commissions around the country. IAWC Ex. 10.00R at 3-6; IAWC Ex. 10.00SR at 3-4, 6-7. The AG asserts that the Commission has consistently rejected this tactic also. *See Commonwealth Edison Co.*, Docket No. 05-0597, Order at 153 (June 6, 2006); Docket Nos. 07-0241/07-0242 (Consol.), Order at 90-91.

Finally, the AG notes that Mr. Moul testified that the return generated by his various analyses was 10.70% and he rounded up the 10.70% “to the nearest one-quarter percentage point, or 10.75%.” IAWC Ex. 10.00R at 30. Mr. Moul did not provide any other reason or explanation for adding five basis points to his recommended return. The AG asserts that the ease with which he increased his result raises serious questions regarding the credibility of Mr. Moul's testimony and his recommendations.

For these reasons, the AG concludes that the Commission should reject IAWC's proposed ROE and adopt Staff's recommended ROE instead.

#### **d. IWC/FEA/CUB's Position**

\*64 IWC/FEA/CUB witness Gorman recommended an ROE of 9.00% for IAWC. IWC/FEA/CUB argue that IAWC's proposed ROE of 10.75% is excessive and the Company's analyses are severely biased, or reflect inappropriate data.

IWC/FEA/CUB state that Mr. Gorman's cost of equity recommendation is based on analyses of several versions of the DCF model and the CAPM. IWC/FEA/CUB state that Mr. Gorman relied on two proxy groups to estimate IAWC's cost of capital: the water utility proxy group developed by Mr. Moul and a gas utility proxy group. IWC/FEA/CUB claim that these two proxy groups together provide the most reasonable estimate of IAWC's investment risk for several reasons. IWC/FEA/CUB Ex. 1.0, App. B at 20. First, a gas proxy group's securities are more widely followed by securities analysts than are water utility stocks, and therefore the estimated cost of equity from a gas proxy group provides a more robust estimate of IAWC's current market cost of equity. *Id.* Second, the asset capitalization and operations of gas utilities and water utilities are very similar. *Id.* Third, the two groups are reasonably comparable to IAWC in investment risk. *Id.* at 21.

#### **DCF Analysis**

IWC/FEA/CUB assert that Mr. Gorman used the following versions of the DCF model to develop his ROE recommendation: (i) the constant growth DCF model using analysts' growth rate data, (ii) a sustainable growth DCF model, and (iii) the non-constant or multi-stage growth DCF model. IWC/FEA/CUB Ex. 1.0, App. B at 19.

IWC/FEA/CUB explain that Mr. Gorman included a quarterly compounding adjustment to his DCF return estimate because it is the Commission's standard practice to include this quarterly compounding return in DCF estimates. They caution, however, that replicating reinvestment of quarterly dividends over a year can overstate a fair ROE for setting rates. IWC/FEA/CUB Ex. 1.0, App. B at 23.

In his constant growth DCF analysis, IWC/FEA/CUB assert that Mr. Gorman used the average of the weekly high and low stock prices of the proxy groups over a 13-week period ended April 29, 2016. For dividends, IWC/FEA/CUB state that Mr. Gorman used the most recently paid quarterly dividends from Value Line of March 4, 2016. *Id.* at 24. IWC/FEA/CUB point out that Mr. Gorman relied on a consensus, or mean, of professional security analysts' earnings growth estimates as a proxy for the investor consensus dividend growth rate expectations. He then used the average of three sources of analysts' growth rate estimates: Zacks, Yahoo! Finance, and Reuters. *Id.* at 25. IWC/FEA/CUB state that the average and median constant growth DCF returns for the water utility proxy group are 9.12% and 8.00%, respectively. The average and median constant growth DCF returns for the gas utility proxy group are 9.12% and 9.27%, respectively. *Id.*

\*65 In his sustainable growth rate DCF analysis, IWC/FEA/CUB state that Mr. Gorman based his estimate of the long-term sustainable growth rate on the proxy group companies' current market to book ratios and on Value Line's three to five year

projections of earnings, dividends, earned returns on book equity, and stock issuances for each company. *Id.* at 28. IWC/FEA/CUB state that Mr. Gorman calculated a sustainable growth DCF analysis for the water utility proxy group to produce average and median DCF results of 8.05% and 8.30%, respectively. The average and median DCF results for the gas utility proxy group are 9.48% and 9.46%, respectively.

In his multi-stage growth DCF analysis, IWC/FEA/CUB state that for the shortterm growth period, Mr. Gorman relied on the consensus analysts' growth projections described above in relationship to his constant growth DCF model. For the transition period, the growth rates were reduced or increased by an equal factor, which reflects the difference between the analysts' growth rates and the GDP growth rate. *Id.* at 30. For the long-term growth period, IWC/FEA/CUB explain that, Mr. Gorman assumed each company's growth would converge to the maximum sustainable growth rate for a utility company as proxied by the consensus analysts' projected growth for the U.S. GDP of 4.2%. *Id.* at 30-32.

IWC/FEA/CUB observe that Mr. Gorman developed his long-term sustainable growth rate based on the latest issue of Blue Chip Economic Indicators, which published a consensus economists GDP growth rate outlook of 4.2% over the next 5 and 10 years, respectively. *See id.* at 27, citing Blue Chip Economic Indicators, March 10, 2016 at 14. Mr. Gorman used the midpoint of the consensus economists' projected 5 and 10 year GDP consensus growth rate of 4.2% as an estimate of long-term sustainable growth. *Id.* at 32. IWC/FEA/CUB note that Mr. Gorman also used the same 13-week stock price, dividend, and growth rates that he used for his constant growth DCF analysis. *See id.* at 35. Using this model, the average and median multi-stage growth DCF returns on equity are 7.09% and 6.82%, respectively, for the water proxy group. The average and median returns are 7.64% and 7.53% for the gas proxy group. *Id.* at 35. IWC/FEA/CUB note that Mr. Gorman testified that he included this additional model in his analyses to reflect the outlook of changing growth expectations.

IWC/FEA/CUB state that the DCF studies performed by Mr. Gorman support an ROE of 8.80%, which is the midpoint of his DCF range of 8.3% to 9.3%.

#### CAPM Analysis

As noted above, IWC/FEA/CUB witness Gorman also used the CAPM to estimate the Company's required ROE.

IWC/FEA/CUB note that the Blue Chip Economic Indicators' projected 30 year Treasury bond yield of 3.50% was used for Mr. Gorman's CAPM analysis, because longterm Treasury bonds are considered to have negligible credit risk. *Id.* at 38. Mr. Gorman used the beta values for the water and gas utility proxy groups' average Value Line beta estimates of 0.71 and 0.79, respectively. *See* IWC/FEA/CUB Ex. 1.0, App. B, Ex. 1.10.

\*66 IWC/FEA/CUB point out that Mr. Gorman developed two versions of a prospective market risk premium estimate because they believe the Commission prefers prospective market risk premiums. IWC/FEA/CUB Ex. 1.0, App. B at 42. Mr. Gorman offered a risk premium method of estimating a prospective return on the market. This methodology produced a return on the market of 11.4%, which was reduced by Mr. Gorman's risk-free rate estimate of 3.5%, resulting in a prospective market risk premium estimate of 7.9%. *Id.* Mr. Gorman's second prospective market risk premium estimate was based on a DCF return on the market. *Id.* at 43. This methodology produced a DCF return on the market of 10.53%, which was reduced by Mr. Gorman's risk-free rate estimate of 3.5%, resulting in a market risk premium of 7.0%. *Id.* at 43-44.

IWC/FEA/CUB conclude that Mr. Gorman's CAPM study estimated an ROE for IAWC in the range of 8.50% to 9.80% with a midpoint of 9.15%, which Mr. Gorman rounded to 9.2% for purposes of this proceeding. *Id.* at 44. Mr. Gorman's estimate reflects a risk-free rate of 3.5%, a market risk premium in the range of 7.0% to 7.9%, and proxy group betas of 0.71 to 0.79 for his water and gas proxy groups, respectively. *Id.* at 44.

***Criticism of IAWC's Common Equity Analysis***

IWC/FEA/CUB state that IAWC's DCF return estimate is overstated because IAWC witness Moul unjustifiably added a leverage adjustment to the results of his DCF study. IWC/FEA/CUB argue that Mr. Moul's leverage adjustment is nothing but a market-to-book ratio adjustment and it should be rejected. *Id.* at 51. IWC/FEA/CUB opine that it is not just and reasonable because it is designed to inflate market prices, rather than provide a fair rate of return on investment in utility plant and equipment. *Id.* at 51. Moreover, the Commission has rejected earlier versions of Mr. Moul's leverage adjustment in previous cases. IWC/FEA/CUB submit that removing Mr. Moul's leverage adjustment from his recommended DCF return of 9.72% produces a reasonable DCF return for IAWC of 8.78% or 8.8%.

IWC/FEA/CUB also complain that Mr. Moul's CAPM analysis includes a leverage adjustment to the beta estimate and a size adjustment to his proxy group CAPM return estimate. IWC/FEA/CUB aver that Mr. Moul's proposed leverage adjustment is unreasonable and should be rejected. They argue that the leverage adjustment to the beta estimate reflects only one element of risk that should be captured in a beta estimate. Further, adjusting the observed market beta as published by Value Line results in a CAPM return estimate that is not consistent with independent market participants' risk assessment and published data for the proxy group companies. *Id.* at 60.

IAWC's size adjustment is without merit and should also be rejected, in IWC/FEA/CUB's view. They assert that IAWC is not a stand-alone small utility company. Rather, it is a subsidiary of one of the largest publicly traded water utility companies in the U.S. *Id.* at 61. The Company's customers pay for the affiliation with its parent company through increased Service Company fees. IWC/FEA/CUB Ex. 2.0 (Rev.) at 14. This affiliation with a large water company and the payment of Service Company fees, IWC/FEA/CUB argue, mitigates IAWC's risk and provides it economies of scale, and support. Further, IWC/FEA/CUB claim that Mr. Moul's size adjustment does not correctly follow Ibbotson data used to develop his CAPM risk premium. IAWC Ex. 10.00 (Rev.) at 35. Ibbotson recommends CAPM adjustment for company size and also industry risk. However, IWC/FEA/CUB note that Mr. Moul did not include a CAPM adjustment for industry risk in his analysis. This adjustment, IWC/FEA/CUB state, would have resulted in a return below the 8.9% produced by the traditional CAPM on the Water Group. IWC/FEA/CUB Ex. 1.0, App. B at 61-65. IWC/FEA/CUB note that excluding Mr. Moul's leverage adjustment and small size adjustment from Mr. Moul's CAPM study produces an ROE estimate of 8.9% for IAWC. IAWC Ex. 10.02R at 1 of 12, Sched. 1.

\*67 IWC/FEA/CUB contend that Mr. Moul's use of a risk premium study should also be rejected because it produces overstated estimates. They argue that the Commission has continually rejected the use of this methodology because it is not a reliable methodology for estimating a fair ROE for a utility. They note that IWC/FEA/CUB witness Gorman concluded that Mr. Moul's estimate of this 6.5% equity risk premium is arbitrary and has not been shown to be an appropriate risk premium for a below-market risk utility investment like IAWC. IWC/FEA/CUB Ex. 1.0, App. B at 56-57. IWC/FEA/CUB contend that adjusting the 6.5% market risk premium estimated by Mr. Moul for IAWC's below-market risk would support a risk premium of approximately 4.5% using Mr. Moul's methodology. *Id.* at 58-59. Further, IWC/FEA/CUB argue that including a more appropriate risk-adjusted risk premium of 4.5%, and a current observable bond yield of 4.1% would produce a more reasonable estimate of a fair ROE for IAWC of 8.6%. *Id.*

IWC/FEA/CUB also oppose the use of Mr. Moul's comparable earnings analysis in this proceeding. They note that Mr. Gorman explained that Mr. Moul's comparable earnings analysis is fundamentally flawed and unreliable for at least three reasons. First, it does not measure a return investors require in order to assume the investment risk of a company like IAWC. IWC/FEA/CUB Ex. 1.0, App. B at 66-67. Second, it compares companies that have not been shown to have comparable risk to that of IAWC. *Id.* at 67. Finally, it is tied to non-regulated companies which may have different accounting standards, and earned returns that may not be directly comparable to the earned return for a regulated company. *Id.*

**FERC Order 531**

IWC/FEA/CUB believe the Commission should completely disregard the Company's reliance on FERC Order 531 to support a higher DCF result for several reasons. First, since IAWC did not advance its late argument based on this Order until its Initial Brief, it has not been established in the record whether this Order, which concerns electric transmission utilities and not water utilities, is relevant. Second, the parties have not had an opportunity to cross examine IAWC witness Moul regarding the conflict between his preference for a constant growth DCF approach and the two stage DCF approach used in FERC Order 531. Third, the Company's assertions and inferences regarding this Order have no record support since they have not been tested in an evidentiary hearing. Finally, IWC/FEA/CUB argue that the Company's analysis suffers from many infirmities, including the Company's use of incorrect data.

#### e. Municipalities' Position

The Municipalities argue that the Commission should reject IAWC's proposed ROE and adopt Staff's ROE recommendation. The Municipalities opine that Staff's recommendation properly includes a downward adjustment of eight basis points if the Commission approves the Company's proposed Rider VBA since the rider reduces the Company's business risk associated with a decrease in sales.

\*68 The Municipalities believe IAWC's proposed ROE is faulty for the same reasons asserted by Staff and the AG. They state that Staff witness Kight-Garlich's testimony clearly demonstrates that the Company's proposal is based on adjustments that the Commission has consistently rejected in past cases and that the Company has presented no valid reasons to support its argument that the Commission should accept these adjustments in this case. Staff Ex. 5.0 at 40.

Additionally, the Municipalities state that in an attempt to gloss over these flaws, IAWC cites FERC Order 531. The Municipalities assert that they agree with Staff that the applicability of a FERC decision regarding electric transmission companies to an Illinois water utility case is questionable. They urge the Commission to rely on its own prior cases and reject IAWC's unsupported 10.75% ROE.

#### f. Commission Analysis and Conclusion

The Commission observes that estimating the cost of common equity is perhaps one of the most challenging aspects of a rate case proceeding. The Commission has relied primarily on the data derived from financial models that attempt to quantify the cost of attracting capital investment during the time period for which the rates will be in effect. Historically, the Commission has given substantial weight to the results of the DCF and CAPM analyses of the parties' expert witnesses. The Commission has discretion to consider other factors when weighing its decision.

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 Water Works & 398 Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). These decisions establish that a regulatory body such as the Commission must consider whether the authorized return will allow a return that 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. *Bluefield*, 262 U.S. at 692-93; *Hope*, 320 U.S. 591 at 603. The Company must be able to provide safe, reliable service at just and reasonable rates. *Bluefield*, 262 U.S. at 693; *Hope*, 320 U.S. 591 at 603. The return 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.

IAWC, Staff, and IWC/FEA/CUB presented witnesses who testified concerning their recommendations for the Company's cost of common equity. While all of the witnesses performed their analyses using the DCF and CAPM analyses, their recommendations differ considerably. IAWC witness Moul proposed an ROE of 10.75%; Staff witness Kight-Garlich proposed an ROE, if Rider VBA is adopted, of 8.04%; and IWC/FEA/CUB witness Gorman proposed an ROE of 9.00%. While the

Commission believes results derived from the DCF and CAPM analyses should not be expected to produce the exact same cost of equity, there were significant differences between both the methodologies employed and the results derived by the parties in this case. IAWC Initial Brief at 2-3; IAWC Reply Brief at 1-4.

\*69 The Company argues that the ROE estimates proposed by Staff and IWC/FEA/CUB are low in large part because their DCF results are uncharacteristically low which is depressing their overall estimates. IAWC Initial Brief at 12. Additionally, the Company argues that the disparity between the CAPM results and DCF results offered by these parties shows that the DCF analysis understates investor requirements. IAWC Initial Brief at 11-12. However, Staff, IWC/FEA/CUB, the AG, and the Municipalities argue that the difference is due to the Company's inclusion of additional adjustments and methodologies that have been rejected by the Commission in past proceedings. Staff Ex. 5 at 40; IWC/FEA/CUB Ex. 1.0, App. B at 50-52; Municipalities Initial Brief at 3-4. See generally AG Initial Brief.

The Commission agrees with the Company that Staff's proposed ROE of 8.04% is anomalous.<sup>3</sup> An authorized rate of return that is not competitive will deter continued investment in the State of Illinois. IAWC Ex. 1.00R at 5; IAWC BOE at 5. 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. IAWC Ex. 1.00R at 7; see also IAWC Ex. 3.00R at 2-10.

In order to address the abovementioned concerns, the Commission finds that an average of the ROE results recommended by IAWC and IWC/FEA/CUB, which is 9.87%, should be used to calculate the Company's ROE in this proceeding. The parties have pointed out various flaws in each parties' analyses. However, the Commission believes an average of these results will minimize many of the shortcomings identified by the parties.

The Commission acknowledges that IAWC's DCF and CAPM results contain size and leverage adjustments. IAWC Reply Brief at 15-18; IAWC Ex. 10.00R at 15-18. However, the ROE approved by the Commission in the instant docket is an average of IAWC's and IWC/FEA/CUB's ROE recommendations and not an endorsement of every input of every aspect of the methodologies performed by these parties. See Docket No. 14-0419 at 44.

\*70 The Commission agrees with both Company and Staff that the adoption of Rider VBA will reduce IAWC's operating risk. IAWC Ex. 10.00R at 21; Staff Ex. 5.0 at 2, 32. Staff's recommended adjustment ranges from an 8 to 28 basis point reduction. Staff Ex. 13.0 at 3; Staff Ex. 5.0 at 2, 32. Overall, the record supports a downward adjustment, and the Commission finds it reasonable to reduce the ROE by eight (8) basis points. Accordingly, the Commission deducts eight basis points from the average of IAWC's and IWC/FEA/CUB's proposed ROEs for a final ROE of 9.79%.

Finally, the Commission will not consider FERC Order 531 in this proceeding. The Commission agrees with Staff, IWC/FEA/CUB, and the Municipalities that the Company failed to establish that this Order, which concerns electric transmission utilities and not water utilities, is relevant to this proceeding. Moreover, the Commission notes that the Company should have proposed the new methodology that it appears to be advocating in post-hearing briefs earlier in this proceeding to allow the parties an opportunity to develop a full record on this issue.

For the reasons stated above, the Commission concludes that IAWC's cost of common equity is 9.79%. This number reflects an average of IAWC's and IWC/FEA/CUB's proposed ROEs, which is 9.87%, and deducts eight (8) basis points due to the adoption of Rider VBA for a final ROE of 9.79%. The Commission finds that this ROE is reasonable, supported by the record, and consistent with the governing legal standard. The Commission's analysis in this case is not indicative of how the Commission will review and decide upon ROE in future rate cases, nor shall this decision obligate the Commission to apply the same or similar analysis in future proceedings.

### C. Recommended Capital Structure and Rate of Return

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 7.47%. The rate of return incorporates an ROE of 9.79%. The Company's rate of return was derived as follows:

CAPITAL COMPONENT	WEIGHT	COST	WEIGHTED COST
Short-term Debt	1.90%	0.74%	0.01%
Long-term Debt	48.30%	5.34%	2.58%
Common Equity	49.80%	9.79%	4.87%
<b>Total</b>	<b>100.00%</b>		<b>7.47%</b>

## V. RIDERS

### A. Resolved Issues

#### 1. Pension/OPEB Rider

\*71 IAWC initially proposed a rider to recover pension OPEB costs. IAWC Ex. 1.00 (Rev.) at 18; *see also* IAWC Ex. 7.00 at 20-25; IAWC Ex. 7.00R (Rev.) at 17-21. In order to narrow the issues, however, IAWC withdrew this proposed rider. IAWC Ex. 7.00SR (Rev.) at 10. IAWC asserts that it reserves the right to propose a Pension/OPEB rider in future cases. *Id.* The Commission makes no findings regarding the terms of the proposed rider and it has not been considered for approval by the Commission.

### B. Contested Issues

#### 1. Rider VBA

##### a. IAWC's Position

IAWC asserts that most of its costs are fixed and it is experiencing both declining and variable usage. The Company explains that the Commission and the Illinois Supreme Court have found that decoupling a utility's sales and revenues—by truing up rates to approved revenues—addresses these cost recovery problems. The Company, therefore, states that it is proposing a decoupling mechanism, Rider VBA, to resolve its cost recovery concerns.

IAWC reiterates that like gas utilities, most of its costs are fixed, and do not vary with usage. IAWC Ex. 7.00 at 4-5. However, under traditional ratemaking, it relies on volumetric charges (which are based on the number of gallons of water a customer consumes), to recover the majority of its costs. *Id.* at 5. Thus, IAWC states that its cost recovery is heavily dependent on water sales volume which can be a source of fiscal stress for the Company because declining usage, weather, or both, can push IAWC's sales volumes, and so revenues, below the point where the utility has a reasonable opportunity to recover its costs. The Company also states that its dependence on volumetric sales for revenue creates an incentive to sell more water and a disincentive to promote water efficiency. *Id.*

According to IAWC, its proposed Rider VBA would address these issues. The Company states that Rider VBA is designed to ensure that it collects the revenues authorized by the Commission, independent of changes in sales volume. *Id.* at 8. Rider VBA, IAWC explains, would compare 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.* at 11-12. Netting production costs will ensure that customers pay only those production costs for the actual amount of water delivered. *Id.*

at 12. The Company further explains that under Rider VBA, prices will increase and decrease as sales volume changes between rate cases but it will hold revenues at authorized levels. *Id.* at 9.

Additionally, IAWC states that Rider VBA removes the incentive to sell more water and any disincentive to promote water efficiency, reduces the adverse impacts of weather variability for both IAWC and its customers, and supports revenues for programs and investments that improve water efficiency. *Id.* at 10. IAWC explains that Rider VBA also allows for periodic adjustments (credits and surcharges) in between rate cases and therefore IAWC will not need to file frequent rate cases to recover revenue shortfalls resulting from declining sales. *Id.* at 11. IAWC asserts that customers will benefit from a reduction in contested issues in rate cases, a reduction in the frequency of rate cases, and as a result, reduced rate case expense. *Id.*

\*72 The Company notes that the Commission has previously approved the Rider VBA decoupling mechanism to address concerns about declining and variable usage. IAWC points to the Rider VBA proposed by North Shore and Peoples Gas (“North Shore/Peoples Gas Rider VBA”) which was approved by the Commission as a pilot in Docket Nos. 07-0241/07-0242 (Consol.) in 2008 and permanently in Docket Nos. 110280/11-0281 (Consol.) in 2012. *See* Docket Nos. 07-0241/07-0242 (Consol.), Order at 150; Docket Nos. 11-0280/11-0281 (Consol.), Order at 164. The Company also points to the Rider VBA proposed by Ameren Illinois Company d/b/a Ameren Illinois (“Ameren Rider VBA”) in Docket No. 15-0142 which the Commission recently approved in 2015. Docket No. 15-0142, Order at 109. IAWC elaborates that the Ameren Rider VBA is very similar to the North Shore/Peoples Gas Rider VBA and it was approved by the Commission as an uncontested issue. The Company further notes that its Rider VBA is modeled after the North Shore/Peoples Gas Rider VBA.

IAWC highlights that the Rider VBA decoupling mechanism is legally sound. To support its point, the Company notes that the Illinois Supreme Court recently affirmed that the North Shore/Peoples Gas Rider VBA approved in the Commission's Order in Docket Nos. 11-0280/11-0281 (Consol.) is lawful, holding that the rider did not violate either the prohibition against single-issue ratemaking or the rule against retroactive ratemaking. *People ex rel. Madigan v. III. Commerce Comm'n*, 2015 IL 116005 at ¶ 3.

Finally, the Company notes that IAWC, Staff, the AG and IAWC/FEA are now in agreement that Rider VBA should be adopted and that it should reflect Staff witness Brightwell's proposal to recover only volumetric costs through the rider as well as Dr. Brightwell's rider formula. The Company asserts, however, that the AG continues to propose additional modifications to IAWC's Rider VBA. Specifically, the AG recommends that a separate Rider VBA should be created for Zone 1 purchased water areas (Chicago Lake and South Beloit) and that Rider VBA should be eliminated for Chicago Wastewater. IAWC opposes the AG's proposals and maintains that they should be rejected.

With respect to the first recommendation, IAWC contends that a separate Rider VBA for purchased water areas will cause the rider to become administratively burdensome, which the AG does not dispute. Moreover, IAWC asserts that the AG unconvincingly argues that it would be unfair to the customers of the purchased water areas to reject the AG's proposal because the variable costs for customers in these areas are not recovered through base rates and there are rate impacts of 0.3 - 2.0% that AG witness Rubin claims are significant.

\*73 IAWC takes issue with this argument for several reasons. First, the Company states that it is not true that all purchased water customers' variable costs are excluded from base rates. IAWC explains that Chicago Metro Lake and South Beloit have production costs for power used to pump water through the system that are not included in the purchased water charges. IAWC Ex. 7.00R (Rev.) at 9. IAWC points out that Mr. Rubin acknowledged as much in his rebuttal testimony. AG Ex. 4.0 at 4. Because of this, IAWC states, Chicago Metro Lake and South Beloit are no different from a rate consolidation perspective than other areas in the consolidated Rate Zone 1, as costs vary from area to area. Therefore, creating a separate Rider VBA for these purchased water areas would effectively undo the consolidation of these areas into Zone 1. IAWC Ex. 7.00SR (Rev.) at 5. Second, the Company states that, contrary to the AG's assertion, there will not be any material impact on customer bills from separating purchased water areas. IAWC argues that Mr. Rubin's assessment of ratepayer impact of 0.3 - 2.0% is overstated. IAWC Ex. 7.00SR (Rev.) at 6. According to the Company, the impact to a customer's monthly bill is 0.309% and 0.506% for

Chicago Lake and South Beloit, respectively. *Id.* at 7-8. IAWC concludes that there is little point to the AG's proposal since there is not a significant difference in customers' bills from separating purchased water customers. IAWC Ex. 7.00R (Rev.) at 7-8.

With respect to the second recommendation, IAWC contends that Rider VBA is needed for Chicago Wastewater. The Company states that, like its water rate areas, its sewer rate area's fixed revenues do not recover the full amount of fixed costs, therefore its fixed cost recovery in its sewer rate area is also dependent on usage volumes. *Id.* at 13. IAWC points out that 92% of the costs in the Chicago Wastewater district are fixed; however, fixed wastewater revenues proposed in this case are only 81.8%. *Id.* The Company argues that since the fixed costs are not recovered by the fixed revenues, Rider VBA is needed here to ensure the Company recovers the fixed costs of service.

#### **b. Staff's Position**

Staff observes that both Staff witnesses Brightwell and Hathhorn proposed revisions to the Company's Rider VBA proposal. Staff asserts that Staff witness Brightwell proposed limiting revenue reconciliations to differences between actual distribution delivery charge revenues and rate case distribution delivery charge revenues and opined that adjustments to production costs should be based on the average rate case production cost multiplied by the difference between actual sales and rate case sales in each rate zone. Staff Ex. 8.0 at 7-8. Staff notes that the Company agreed to these changes (IAWC Ex. 7.00SR at 2) and provided suggested language for the rider as Exhibits 7.01SR and 7.02SR.

Staff states that Ms. Hathhorn proposed changes to the proposed Rider VBA concerning customer acquisitions, internal audit, reports and reconciliations, and corrections to the formula and the water production costs definition in the wastewater tariff. Staff notes that the Company also accepted these changes. IAWC Ex. 7.00R at 3.

\*74 Staff mentions that Ms. Hathhorn also recommended that the Company present proposed language and/or a separate tariff in its rebuttal testimony to address the fact that Chicago Metro Lake customers do not pay production costs through base rates. Staff Ex. 2.0 at 13. However, Staff states that it withdrew this recommendation based on the Company's explanation that its IAWC Exhibit 7.01R does not segregate the Chicago Metro Lake or South Beloit customers into separate tariffs because the Company believes this would cause the Rider VBA to become administratively burdensome. IAWC Ex. 7.00R at 8; Staff Ex. 10.0 at 5-6.

Staff concludes that it supports the Company's Rider VBA with these agreed upon modifications. Staff notes that the traditional rate-setting paradigm was established at a time when utilities experienced regular and predictable customer and sales growth; however, an increased focus on energy efficiency and conservation efforts has caused this paradigm to shift somewhat. Staff asserts that, while there is nothing wrong with the traditional method of rate setting, the Company has identified many problems it is facing within the traditional paradigm due to sales variability and the Company has established that Rider VBA alleviates many of these problems.

#### **c. AG's Position**

The AG states that it does not oppose the Company's proposed Rider VBA in concept, but it recommends changes to the tariff. The AG notes that it reached an agreement with IAWC, as reflected in IAWC-AG Stipulated Cross-Exhibit 2.00, to accept Staff witness Brightwell's proposal that the Company should recover only volumetric charges through Rider VBA and use Dr. Brightwell's suggested tariff formula. IAWC-AG Stip. Cross-Ex. 2.00 at 1. The AG notes that, like Dr. Brightwell, AG witness Rubin testified that the rider, as originally proposed, would inappropriately recover certain variable costs and that these variable costs should not be recovered through Rider VBA. AG Ex. 2.0 at 14. The AG submits that this change is perhaps the most significant change.

While the AG agrees with Staff and IAWC on those points, the AG states that it recommends two additional changes to the Company's Rider VBA. The AG argues that IAWC's Rider VBA should be modified to require the Company to calculate separate Rider VBA charges for the South Beloit and Chicago Metro Lake areas of Zone 1. The AG notes that Mr. Rubin testified that the Company's proposal is unfair to the South Beloit and Chicago Metro Lake regions because the variable costs for customers in these areas are not recovered through base rates like the customers in all of the other areas in Zone 1. Mr. Rubin explained that customers in the South Beloit and Chicago Metro Lake areas pay their variable costs (consisting of purchased water) through a separate rider and, as a result, pay lower fixed charges than other Zone 1 customers. AG Ex. 2.0 at 15. The AG also notes that, in response to an AG discovery request to IAWC, the Company agreed that it is appropriate to calculate a separate Rider VBA charge for the South Beloit and Chicago Metro Lake regions. AG Ex. 4.0 at 3; AG Ex. 4.1. However, the AG asserts that IAWC witness Watkins later testified in rebuttal testimony that the administrative burdens would be too great, and the rate impacts too small, to justify separate Rider VBA charges for these areas. IAWC 7.00R at 9-11.

\*75 The AG challenges Mr. Watkin's characterization that the rate impacts are insignificant. The AG states that Mr. Rubin's calculations of the percentage of fixed charges for these areas show that IAWC's proposed rate for 100 gallons of water for customers in the portions of Zone 1 that do not purchase water (that is, areas other than South Beloit and Chicago Metro Lake) would change by as much 2%. AG Ex. 2.6; AG Ex. 4.0 at 3-4. Mr. Rubin's analysis also shows, in the AG's view, that the rate adjustments for the South Beloit and Chicago Metro Lake areas would be 1.9% and 0.3% of base rates in 2013, respectively. *Id.* at 4; AG Ex. 4.3. The AG contends that, contrary to Mr. Watkins' assertion, such impacts on base rates are significant and justify separate Rider VBA calculations for the purchased water areas of Zone 1. AG Ex. 4.0 at 4-5.

The AG also argues that wastewater customers should be exempt from the tariff. The AG asserts that there is no reason to apply Rider VBA to wastewater customers because unlike water revenues, approximately 85% of the Company's wastewater revenues are fixed, therefore these customers pay a flat rate that varies very little from month-to-month. AG Ex. 2.0 at 15-16.

For these reasons, the AG recommends that the Commission accept its recommendation to modify Rider VBA to require IAWC to: (1) calculate separate Rider VBA charges for the South Beloit and Chicago Metro Lake areas of Zone 1; and (2) exclude wastewater customers from the tariff.

#### **d. IAWC/FEA's Position**

IAWC/FEA state that, in the interest of narrowing the issues in this case only, they do not oppose the Company's proposal to accept Staff witness Brightwell's proposal to recover only volumetric revenues through Rider VBA and his formula methodology for Rider VBA. IAWC Ex. 7.00SR at 2.

#### **e. Municipalities' Position**

The Municipalities observe that IAWC has modified its proposed Rider VBA based on changes suggested by Staff which limit the rider's impact on ratepayers. *Id.* The Municipalities state that they do not oppose the adoption of Rider VBA, provided that Staff's changes are included as part of the rider.

#### **f. Commission Analysis and Conclusion**

The Company proposes a Rider VBA decoupling mechanism to address its cost recovery concerns. Staff witnesses Hathorn and Brightwell proposed several modifications to the Company's Rider VBA, including a proposal that the rider should only recover volumetric charges and that it should use the rider formula proposed by Dr. Brightwell. The Company accepts these modifications and Staff supports the rider with these modifications. The AG, IAWC/FEA, and the Municipalities do not oppose the Company's Rider VBA as revised by Staff; however, the AG proposes additional modifications which the Company opposes.

The Commission finds that IAWC's Rider VBA is reasonable and appropriate in these circumstances. The record supports the Company's assertion that most of its costs are fixed and that it is experiencing both declining and variable usage. Additionally, IAWC has established that both weather and declining usage per customer has caused its sales volumes and revenues to vary from approved levels. While there is nothing wrong with traditional ratemaking, the Commission has determined in Docket Nos. 07-0241/07-0242 (Consol.), Docket Nos. 11-0280/11-0281 (Consol.), and recently in Docket No. 15-0142, that decoupling mechanisms such as Rider VBA address these cost recovery issues.

**\*76** The Commission notes that under traditional ratemaking, the Company relies on volumetric charges to recover the majority of its costs. Thus, IAWC's cost recovery is heavily dependent on water sales volume which can be problematic because declining usage can drive IAWC's sales volumes, and therefore revenues, below the point where the utility has a reasonable opportunity to recover its costs. The Company's dependence on volumetric sales for revenue creates an incentive to sell more water and a disincentive to promote water efficiency.

The Commission believes Rider VBA resolves these issues by producing a determined amount of revenue regardless of how much water a utility delivers, and therefore it ensures that the utility can recover its Commission-authorized revenue requirement. Rider VBA also removes the incentive to sell more water and any disincentive to promote water efficiency, reduces the adverse impacts of weather variability for both IAWC and its customers, and supports revenues for programs and investments that improve water efficiency. The rider also benefits IAWC's customers because it allows for periodic adjustments (credits and surcharges) in between rate cases therefore the Company will not need to file frequent rate cases to recover revenue shortfalls resulting from declining sales. IAWC customers will also benefit from reduced rate case expense because there will be a reduction in contested issues in rate cases and a reduction in the frequency of rate cases.

Finally, the Commission observes that the Company's Rider VBA is modeled after the North Shore/Peoples Gas Rider VBA. The Illinois Supreme Court has affirmed the Commission's Order in Docket Nos. 11-0280/11-0281 (Consol.) adopting this Rider VBA decoupling mechanism permanently and it found that it is lawful. For these reasons, the Commission approves the Company's Rider VBA as modified by Staff.

The Commission, however, declines to adopt the modifications proposed by the AG. The AG recommends that a separate Rider VBA should be created for Zone 1 purchased water areas (Chicago Lake and South Beloit) and that Rider VBA should be eliminated for Chicago Wastewater. The Commission finds that the Company has shown that the AG's first recommendation is administratively burdensome, contrary to the Commission's recent decision in IAWC's last rate case to consolidate Zone 1, and it appears that it will have little impact on customers' bills. The Commission also finds that the Company has shown that the AG's second recommendation should be denied because IAWC's sewer rate areas face the same issue as its water rate areas since the fixed revenues for these areas do not recover the full amount of fixed costs either. Therefore, Rider VBA will help ensure that the Company recovers the fixed costs of service in the sewer rate areas also.

## 2. Rider QIP Recommendation

### a. IAWC's Position

**\*77** IAWC notes that it included in its rate base investments that would qualify as QIP investments under 83 Ill. Admin. Code 656 ("Part 656"). The Company states that it agreed with Staff witness Hathhorn's proposal to attach the QIP amounts as an appendix to the Commission's final Order, with the caveat that the information would no longer be accurate if new rules are approved since the information is based on the Commission's Part 656 Rules in effect in January 2016. IAWC Ex. 4.00R at 5.

IAWC observes that new rules were approved by the Commission in Docket No. 15-0017 and they became effective as of July 1, 2016 in Docket No. 15-0017. *See* Part 656; *Aqua Ill., Inc.*, Docket No. 15-0017, Order at 2 (June 29, 2016). Therefore, IAWC states, in its Reply Brief, that it is unnecessary to attach the information because it is outdated and no longer accurate. The Company explains that updated information regarding the QIP investments will be available after the first quarter of 2017.

### **b. Staff's Position**

Ms. Hathhorn recommended, for purposes of a complete record and possible use in future proceedings, that the QIP amounts provided by IAWC should be attached as an appendix to the Commission's final Order in this case. Staff Ex. 2.0 at 6. Ms. Hathhorn testified in her rebuttal testimony that the Company agreed with her recommendation. Staff Ex. 10.0 at 4-5.

In its Brief on Exceptions, Staff states that it withdraws its recommendation because the recently revised Part 656 now requires a post-rate case filing of the calculation of updated QIP plant and depreciation amounts, rendering its recommendation moot.

### **c. Commission Analysis and Conclusion**

The Commission concurs with Staff that its recommendation is now moot. Both IAWC and Staff agree that Part 656 now requires a post-rate case filing of QIP information. Moreover, Staff has withdrawn its recommendation since it was based upon the prior Part 656 Rules. Therefore, the Company does not need to attach the QIP amounts as an appendix to this Order.

## **VI. RATE DESIGN AND COST OF SERVICE**

### **A. Resolved Issues**

#### **1. Declining Block Usage Charge for Non-Residential Customers in Chicago Metro Sewer**

Staff witness Boggs recommended that IAWC continue to apply a declining block usage charge to Collection Only and Collection and Treatment customer classes in the Chicago Metro Sewer District, as had been approved in prior cases. Staff Ex. 6.0 at 22. IAWC accepted this proposal. IAWC Ex. 11.00R at 5. The Commission finds that Staff's proposal to apply a declining block usage charge to Collection Only and Collection and Treatment customer classes in the Chicago Metro Sewer District is reasonable and it is hereby approved.

#### **2. Public Fire Charges**

\*78 Staff witness Boggs recommended that the Public Fire Protection rate for each of IAWC's three water districts be set so that the revenues recovered are equal to the cost to serve the respective district. Staff Ex. 6.0 at 29. Staff's proposed adjustments increase the Public Fire Protection rates in Zone 1 and Lincoln and decrease the rates in Pekin. *Id.* at 29-30. IAWC did not object to Staff's proposal. IAWC Ex. 11.00R at 5. The Commission finds that the adjustments to the Public Fire Protection rates proposed by Staff and agreed to by the Company, are reasonable and they are hereby adopted for the purposes of this proceeding.

#### **3. Certain Large User**

IIRC/FEA witness Collins and IIRC/FEA/CUB witness Gorman recommended that IAWC include a certain customer in the Large Industrial class in its cost of service study ("COSS") that IAWC originally excluded from the study. IIRC/FEA Ex. 1.0 at 7; IIRC/FEA/CUB Ex. 1.0 at 6. Mr. Collins testified that, although the customer's usage had "declined due to economic circumstances," the customer "did not intend to cease all operations at its facilities served by IAWC." IIRC/FEA Ex. 1.0 at 7. IAWC proposed to account for the decline in the customer's usage by utilizing the customer's most recent 12-month usage level. IAWC Ex. 4.00R at 21-22. Mr. Collins and Mr. Gorman agreed that this revised usage is reasonable. IIRC/FEA Ex. 2.0 at 3; IIRC/FEA/CUB Ex. 2.0 (Rev.) at 2-3. The Commission finds that the use of the large customer's usage from the most recent 12-month period in IAWC's COSS is appropriate and it is hereby accepted for the purposes of this proceeding.

#### 4. Distribution Main Allocation to Large Users

AG witness Rubin proposed to modify IAWC's Factor 4, which allocates costs associated with distribution mains for purposes of the COSS. AG Ex. 2.0 at 5-7. According to IAWC, its proposed Factor 4 excludes usage from the Large Commercial, Large Industrial, Competitive Industrial, Large Other Public Authority, Other Water Utilities, and Large Other Water Utilities classes because generally, these customers are served from transmission mains, rather than distribution mains. IAWC Ex. 11.00R at 11. Mr. Rubin testified that the usage from eleven of the thirty-four customers excluded from the allocation of distribution main costs should be added to IAWC's Factor 4 calculation because he determined that they are served by distribution mains. AG Ex. 2.0 at 5-7. IAWC witness Herbert, however, testified that he determined that six of the eleven customers at issue were served by short stub distribution-diameter mains, and should not be considered connected to distribution mains. IAWC Ex. 11.00R at 11. Mr. Herbert further testified that the remaining five customers could be considered served from a distribution main, and added their consumption into the calculation of Factor 4. *Id.* The AG agreed with IAWC's revised Factor 4. AG Ex. 4.0 at 7. The Commission finds that revised Factor 4, as agreed upon by the AG and IAWC, is reasonable and it is hereby adopted for the purposes of this proceeding.

### B. Contested Issues

#### 1. Purchased Power Cost Allocation

##### a. IAWC's Position

\*79 IAWC states that its COSS properly allocates purchased power costs using Factor 1, which is based on average daily usage. The Company urges the Commission to reject IAWC/FEA's recommendation that IAWC's purchased power costs should be allocated using Factor 6, which is based on maximum day and hour demands. IAWC/FEA Ex. 1.0 at 17.

IAWC notes that IAWC/FEA witness Collins testified that Factor 6 allocation is appropriate because that factor "recognizes the base and extra capacity components of purchased power costs, and is consistent with the allocation of IAWC's other pumping expenses and the allocation of rate base associated with electric pumping equipment." IAWC/FEA Ex. 1.0 at 17. IAWC contends that Mr. Collins' assertion, which is the basis for IAWC/FEA's recommendation, is flawed.

First, the Company asserts that contrary to Mr. Collins' assertion, Factor 6 does not accurately account for the base and extra capacity components of IAWC's purchased power costs. IAWC explains that electric rates are structured to include three components: a customer charge, a demand charge, and commodity charges. IAWC Ex. 11.00R at 7. The Company observes that the American Water Works Association Manual M1 ("AWWA Manual") provides that "the demand portion of power costs should be allocated to extra capacity to the degree that it varies with the demand pumping requirements." *Id.* IAWC states its electricity bills include a demand charge, even when the Company is at its lowest demand for power, and explains this is the base component of IAWC's purchased power costs. The Company further explains that the extra capacity component of purchased power costs is the amount by which the demand charge varies with the demand pumping requirements. IAWC points out that its witness Mr. Herbert determined that only 1.25% of IAWC's total purchased power expense is attributable to extra demand. *Id.* IAWC states that if Factor 6 was applied to purchased power costs, as Mr. Collins proposes, 42.6% of IAWC's power costs would be allocated to extra demand. *Id.* Thus, IAWC maintains that the application of Factor 6 clearly does not accurately account for the base and extra capacity components of IAWC's electric demand costs.

Second, the Company states that even though Factor 6 is used to allocate non-power pumping costs, it is not an appropriate allocator for purchased power costs. IAWC notes that purchased power is conceptually similar to other costs allocated using Factor 1, such as purchased water, treatment chemicals, and sewer disposal. IAWC Ex. 11.00 (Rev.) at 6. IAWC also points out that Factor 6 is appropriate for the "capital and associated O&M costs because the system is designed to meet average demand and as well as maximum day and hour demands." IAWC Ex. 11.00R at 6. However, IAWC states that unlike the capital and O&M costs, the power that runs the pumping facilities "varies with the amount of water being pumped, and varies only

minimally with peak usage.” *Id.* at 7. IAWC argues that because purchased power varies only minimally with peak usage, Factor 1, which is based on average daily consumption, is a more reasonable and appropriate allocator.

\*80 Finally, IAWC asserts that IWC/FEA also argue, for the first time in their Initial Brief, that class contributions to peak water demands vary, particularly for the residential class, and that variation in peak power demand among the rate classes is not accounted for in Factor 1. IAWC contends that this argument also fails to withstand scrutiny. IAWC points out that IWC/FEA never mentioned residential class power demand costs in the testimony they offered in this case, let alone establish that class contributions to peak power demand vary between winter and summer months due to residential and commercial irrigation demands. Thus, IAWC asserts that there is no record evidence to support this late argument.

For these reasons, IAWC concludes that the Commission should reject IWC/FEA's recommendation to utilize Factor 6 rather than Factor 1 to allocate IAWC's purchased power costs.

### b. Staff's Position

It is Staff's position that the Commission should reject IWC/FEA's proposal to allocate purchased power costs using Factor 6 instead of Factor 1 in the Company's COSS. Staff argues that IWC/FEA's proposal is untenable because it fails to recognize that, unlike the other costs associated with pumping water, purchased power costs vary with the amount of water being pumped and vary only minimally with peak usage.

Staff observes that IAWC witness Herbert explained in his testimony that, while using Factor 6 as an allocator for capital costs and O&M costs associated with pumping equipment is appropriate, using Factor 6 as an allocator for the power costs associated with pumping is not. IAWC Ex. 11.00R at 6-7. He testified that Factor 6, which uses average flow and maximum day and hour requirements, aligns with the purposes of the pumping system because the pumping system is designed to meet average demand as well as maximum day and maximum hour demands. *Id.* Staff notes that Mr. Herbert concluded that, because the power to run the pumps varies with the amount of water being pumped, it only varies minimally at peak usage. Mr. Herbert asserted that Factor 1 is therefore appropriate in IAWC's COSS because it is based on average daily usage. *Id.* at 7.

Staff also observes that Mr. Herbert supported his allocation method by quoting the AWWA Manual which states that “the demand portion of power costs should be allocated to extra capacity to the degree that it varies with the demand pumping requirements.” IAWC Ex. 11.00R at 7. Mr. Herbert explained that the AWWA Manual does not suggest that the total demand portion of power costs should be allocated to extra capacity, rather it should be allocated only to the degree that it varies with pumping requirements. *Id.*

Additionally, Staff notes that Mr. Herbert testified that he analyzed the Company's power bills and determined that they show that the difference between the minimum demand charge for the lowest demand month and the demand charges in the remaining months result in approximately 1.25% of the total purchased power expense being attributable to extra demand. *Id.* On the other hand, he testified that using Mr. Collins' Factor 6 proposal would allocate about 42.6% of power costs to the extra demand functions. *Id.* Staff highlights that Mr. Herbert also stated that an accurate refinement to the Company's COSS based on the power bill analysis would allocate only 1.25% of purchased power costs to the extra capacity function. *Id.* Staff notes that Mr. Herbert further stated that an adjustment should not be made because such a small refinement (1.25%) would have an insignificant impact on the COSS. *Id.* at 8.

\*81 Staff avers that Mr. Herbert's testimony supports IAWC's use of Factor 1 to allocate purchased costs instead of Factor 6 as IWC/FEA recommend. Staff argues that IAWC's method better reflects cost of service and it is based on the AWWA Manual's procedures which are commonly used in COSSs and rate designs. Moreover, Staff contends that IWC/FEA failed to provide convincing reasons or data that would justify the need to deviate from the previously approved process. Accordingly, Staff asserts that the Commission should approve the Company's proposal to use Factor 1 to allocate purchased power costs instead of Factor 6.

### c. IWC/FEA's Position

While IWC/FEA generally agree with the cost classifications and allocations contained within the Company's COSS in this proceeding, IWC/FEA disagree with the allocation of purchased power costs through the use of Factor 1. IWC/FEA recommend that IAWC allocate these costs using Factor 6 instead.

IWC/FEA argue that Factor 6 is more appropriate because this allocation factor recognizes the base and extra capacity components of purchased power costs, and is consistent with the allocation of IAWC's other pumping expenses and the allocation of rate base associated with electric pumping equipment.

IWC/FEA assert that it is important to note that all of the costs associated with pumping, except for purchased power, have been allocated based on Factor 6 and purchased power costs are the only costs associated with pumping to be allocated on the basis of Factor 1. IWC/FEA state that Factor 6 recognizes the Company's rate classes' contribution to peak water demands. They argue that the Company's allocation of purchased power cost associated with pumping is inconsistent with the treatment of other expenses and rate bases associated with pumping. This inconsistency is unreasonable according to IWC/FEA because purchased power costs are not all driven by average daily water consumption upon which Factor 1 is based. IWC/FEA note the other costs (both expenses and capital) associated with pumping have been recognized by the Company to have both a base component as well as an extra capacity component and have been allocated appropriately on Factor 6. IWC/FEA Ex. 1.0 at 16.

It is IWC/FEA's position that the Company's arguments fail to recognize the class contributions to purchased power costs which are driven by class peak demands for water. IWC/FEA opine that under the Company's logic, if total Company demand costs are the same each month and do not vary, all demand costs would be allocated to customers based on average daily usage or Factor 1. IWC/FEA aver that the Company's arguments ignore the fact that class contributions to peak water demands vary, particularly for the residential class.

IWC/FEA state that while the total system demand costs may not vary materially in IAWC's opinion, the reality is that residential class water demands that contribute to these total purchased power costs do vary materially and should be recognized in the allocation of purchase power costs. This recognition of class contributions to system peak water demand is accomplished by Factor 6. IWC/FEA explain that Factor 6 recognizes the class contributions to peak demand for water which in turn drive the Company's total purchased power costs. IWC/FEA assert that it is inappropriate that the Company has recognized these class peak demand contributions to all pumping costs except for purchased power costs.

**\*82** According to IWC/FEA, electric power demand costs are driven by IAWC's monthly peak electric demand; therefore, the electric power demand costs should be classified as extra capacity costs. IWC/FEA Ex. 2.0 at 5. IWC/FEA argue that with the use of Factor 1, the Company fails to properly differentiate between the purchased power cost it incurs on the basis of classes' average daily usage and the purchased power cost incurred on the basis of classes' peaking requirements. With the use of Factor 1, IWC/FEA claim the Company ignores the effect that class contributions to peak demand have on purchased power costs. IWC/FEA note that this effect varies particularly between winter and summer months due to residential and commercial irrigation demands. The variation in purchased power costs is based in part on customer class peak demands for water and should be allocated accordingly. Consequently, IWC/FEA believe their proposal is more appropriate and should be adopted by the Commission.

### d. Commission Analysis and Conclusion

IAWC and IWC/FEA dispute whether the Company should allocate its purchased power costs in its COSS using Factor 1, which is based on average daily usage, or Factor 6, which is based on maximum day and hour demands. The Commission believes the Company provided compelling evidence that demonstrates that Factor 6 is not an appropriate allocator for purchased

power costs and it does not accurately account for the base and extra capacity components of the Company's electric demand costs. Additionally, the Company's allocation method better reflects the cost of service and it is based on the AWWA Manual's procedures which are commonly used in COSSs and rate designs. The Commission also notes that the method used by the Company was approved previously in IAWC's last rate case, Docket No. 11-0767, and IWC/FEA do not provide any convincing reasons or evidence to justify the need to deviate from this previously approved method. Finally, the Commission agrees with the Company that there is no evidence in the record to support IWC/FEA's argument in their Initial Brief regarding the variations among classes' contributions to peak water demand. Accordingly, the Commission finds that IAWC's proposal to allocate purchased power costs using Factor 1 is reasonable and it is adopted.

## 2. Simplification of Metered Large User Water Tariff

### a. IAWC's Position

IAWC argues that the Commission should disregard IWC/FEA's proposal to simplify IAWC's Metered Large User Water Service tariff. IAWC explains that this tariff is available to customers that use at least 187 million gallons of water per year. ILL.C.C. No. 24, Sec. 1, Eight Rev. Sheet 14.1. Charges to customers under the tariff are equal to the customer's maximum day demand ratio, multiplied by approximately \$0.19. *Id.* The Company states that the maximum day demand ratio is the customer's maximum day demand divided by the customer's average day demand. *Id.* IAWC claims that the maximum day demand ratio serves two important purposes. First, it incentivizes customers to smooth their demand so that their maximum day demand is as close as possible to their average day demand, because it increases charges when the maximum demand is higher than average demand. IAWC Ex. 11.00SR at 8. Second, IAWC explains, the maximum day demand ratio variable in the current tariff ensures that customers' rates are determined individually, and customized to match their usage. *Id.*

\*83 The Company notes that in his direct testimony, IWC/FEA witness Collins proposed that IAWC's Metered Large User Water Service tariff "should be simplified . . . to provide more cost certainty to customers" served under the tariff and attract additional customers to the tariff. IWC/FEA Ex. 1.0 at 18. However, IAWC argues that Mr. Collins did not offer any substantive suggestion as to how the tariff should be simplified, or explain why such simplification is desirable. IAWC states that although Mr. Collins did not specify which portion of the existing formula he proposed to eliminate, IAWC witness Herbert surmised that Mr. Collins' concern is rooted in the fact that the current tariff includes a variable for customers' Maximum Day Demand Ratio. As discussed above, IAWC states that the maximum day demand ratio serves important purposes, provides appropriate incentives, and should not be eliminated.

IAWC states that IWC/FEA's alternative proposal that the Commission should order the parties to participate in a workshop to discuss possible revisions to this tariff should be rejected. The Company argues that there is no reason to hold a workshop on this matter since IWC/FEA have not made a specific, substantive suggestion in this proceeding. IAWC argues that IWC/FEA had multiple opportunities to put forth a substantive proposal in this proceeding, yet failed to do so. It is IAWC's view that the Company and other parties to a workshop would be burdened to develop the proposal IWC/FEA should have developed during the course of this proceeding.

Moreover, IAWC maintains that the rationale IWC/FEA offer in support of their proposed simplification is fallacious. Mr. Collins noted that only two customers currently take service under the Metered Large User Water Service tariff and he stated that simplifying the tariff would be beneficial because it would "attract additional customers to take service under this tariff." *Id.* IAWC states, however, that if Mr. Collins' proposal is adopted and successful in attracting additional customers to the tariff, there may well come a point at which it is more efficient to use a formula, which IAWC's tariffs currently utilize, than to calculate rates at the cost of service. IAWC Ex. 11.00R at 8-9. IAWC states that this further supports its position that there is no need to make unspecified and unsupported changes to the tariff. Therefore, IAWC asks that the Commission reject IWC/FEA's proposal.

### b. Staff's Position

Staff asserts that the Commission should reject IWC/FEA's proposal to simplify IAWC's Metered Large User Water Service tariff. Staff agrees with IAWC that IWC/FEA witness Collins did not provide a specific proposal regarding eliminating the rate formula in the Metered Large Water Service tariff. Rather, he simply indicated the rate should be based on the cost of providing service to customers. Staff states that while it generally supports setting cost-based rates, it must be able to review specific descriptions and/or calculations of a cost-based rate design to determine whether the recommended design is one that can be usefully developed to recover costs and mitigate rate impacts for a specific customer class. Without a specific rate design proposal for these customers, Staff maintains that there is insufficient information to assess the merits of IWC/FEA's recommendation and therefore it should not be adopted.

### c. IWC/FEA's Position

\*84 IWC/FEA recommend that IAWC simplify its Metered Large User Water Service tariff by eliminating the rate formula in the tariff. IWC/FEA Ex. 1.0 at 18. IWC/FEA argue that IAWC should instead base the rate on the utility's cost of providing service to customers served under the tariff. *Id.*

IWC/FEA observe that currently only two customers receive service under this tariff and IWC/FEA argue that simplification of the tariff will encourage other eligible customers to take this service. Moreover, IWC/FEA believe simplification is possible and will provide more revenue certainty to the Company and more cost certainty to customers at a time when IAWC claims the need for a new rider due to uncertain cost recovery.

IWC/FEA disagree with the Company's argument that their proposal will not simplify the tariff or the rate charged to customers under the tariff and that IWC/FEA do not describe how IAWC would charge customers under this proposal. IWC/FEA state that their witness Mr. Collins did in fact offer a specific proposal. *Id.*

IWC/FEA take issue with the Company's argument that, assuming Mr. Collins is correct and the modification does attract additional customers, at some point a rate formula may be more efficient. IWC/FEA state that while this may be a future concern for IAWC, any changes necessary to the rate could and should be made in the next rate case based on the customer situation at that time. The Company should not keep a less efficient tariff because at some point in the future the current less efficient method may be more appropriate. IWC/FEA argue that they have shown the benefits of revenue certainty, customer cost certainty, and the incentive for more customers to apply for service under this proposed tariff, outweigh the concern that another method might be more efficient at some point in the future.

It is IWC/FEA's position that the Company can ably modify the tariff as recommended noting, in general, utility companies routinely create new tariffs and modify existing tariffs outside rate cases. Should the Commission reject the IWC/FEA recommendation, IWC/FEA assert that it would be prudent to establish a workshop among the parties involved in this rate case, and any other interested stakeholders, to discuss possible revisions to this tariff to both simplify it and to attract additional customers to take service. IWC/FEA suggest the workshop begin 45 days after the final Order in this docket is issued and conclude 90 days thereafter. They also suggest that Staff file a report 45 days after the conclusion of the workshop that includes a description of the positions of the workshop attendees and Staff's recommendation as to if or when the modified tariff should be filed.

### d. Commission Analysis and Conclusion

The Commission observes that IWC/FEA propose that IAWC simplify its Metered Large User Water Service tariff by eliminating the rate formula in the tariff. IWC/FEA argue that IAWC should instead base the rate on the utility's cost of providing service to customers served under the tariff. They assert that this modification will provide more cost certainty to customers served under the tariff and encourage more eligible customers to use the tariff. In the alternative, IWC/FEA propose

that the Commission order a workshop to facilitate discussion regarding possible revisions to the tariff if the Commission does not adopt IWC/FEA's initial proposal.

\*85 The Commission finds that IWC/FEA did not present a sufficiently detailed proposal for consideration in this proceeding or in a workshop. The proposal does not specify which portion of the existing formula IWC/FEA seek to eliminate or any specific descriptions or calculations of the recommended rate design. IWC/FEA also failed to present a convincing argument to support the need for their proposal. However, IAWC established that the maximum day demand ratio that appears in its current ratio serves important purposes and provides appropriate incentives. Specifically, IAWC witness Herbert explained that the maximum day demand ratio provides incentives to very large users of water to smooth their demand in a way that minimizes the need for costly extra capacity and peak facilities. For these reasons, the Commission declines to adopt IWC/FEA's proposal to modify IAWC's Metered Large User water tariff and their alternative proposal to require the parties to participate in a workshop on this issue.

### 3. Customer Records, Collection Labor, Uncollectible Accounts

#### a. IAWC's Position

IAWC notes that AG witness Rubin recommended that customer accounts and uncollectibles expenses should be recovered through volumetric charges, rather than fixed customer charges so that residential customers contribute “an equivalent percentage of their bill to support billing, collections, and uncollectible accounts,” rather than an equal dollar amount. AG Ex. 2.0 at 8; AG Ex. 4.0 at 6. Mr. Rubin argued that, although “there is no single ‘right way’ to collect these funds from customers,” his methodology “is fairer to all residential customers.” AG Ex. 4.0 at 6.

IAWC responds that Mr. Rubin's proposal is not fairer to customers since “there is no difference in the cost to generate and collect a water bill for \$40, and the cost to generate and collect a water bill for \$80 (or \$100, \$500, or \$1000).” IAWC Ex. 11.00SR at 3. IAWC explains that it incurs customer accounts and uncollectibles expenses on a per-bill basis, not based on the dollar amount of the bill. IAWC asserts that the AG has offered no evidence that the cost to IAWC varies according to the dollar amount of bills, only conclusory statements by its witness with no underlying analysis. *Id.* IAWC notes that Staff agrees that the AG has not provided any evidence that the uncollectible accounts expenses vary with usage or the amount of the bill.

IAWC states that its proposal would collect the same amount from each customer for collections and uncollectible accounts expenses. On the other hand, IAWC notes, the AG's proposal would result in a customer with an \$80 water bill paying double the amount of collections and uncollectibles expense that a customer with a \$40 water bill would pay, even though the underlying costs to the Company are the same. Thus, IAWC argues that the AG's proposal would cause higher-use customers to subsidize lower-use customers with respect to collections and uncollectibles expenses. IAWC claims that the AG failed to explain why this subsidy is just and reasonable, or why it is fairer. IAWC maintains that the AG's proposal is not fairer, and notes that Staff agrees it is not fair to have high-volume users pay a larger portion of the uncollectible accounts expense than a low-volume user. The Company concludes that the Commission should reject Mr. Rubin's proposal.

#### b. Staff's Position

\*86 Staff disagrees with AG witness Rubin's recommendation that collection expenses and uncollectible accounts expenses should be excluded from the calculation of the customer charge. Staff concurs with IAWC witness Herbert's assessment that Mr. Rubin has not provided evidence that the uncollectible accounts expenses vary with the usage or the amount of the bill. IAWC Ex. 11.00R at 10. Moreover, Staff argues that since collection efforts and expenses to the Company are the same regardless of the amount of the delinquency, it is not fair to require high-volume users to pay a larger portion of the uncollectible accounts expenses than low-volume customers. Staff Ex. 14.0 at 6-7. Staff further argues that in addition to being unfair, requiring high-volume users to contribute more to the recovery of these expenses would not reflect cost causation. *Id.* It is Staff's position that all customers should share equally in the recovery of these expenses. Therefore, Staff supports the Company's rate design

proposal which includes collecting these expenses on a per-customer basis through the customer charge and recommends that the Commission reject the AG's proposal.

### c. AG's Position

The AG notes that IAWC proposes collecting collection expenses and uncollectible accounts expenses through the customer charge, making all customers responsible for an equal amount of the expenses. The AG recommends excluding these expenses from the calculation of the customer charge.

AG witness Rubin testified that it is unfair to charge all customers the same amount for these costs because collection expenses and uncollectibles are a function of bill size, which is primarily a function of usage. AG Ex. 2.0 at 8. Mr. Rubin further testified that these costs should be apportioned based on customer usage; that is, customers using greater amounts of water should be responsible for a larger share of collection expenses and uncollectibles than customers using less water. *Id.*

The AG challenges IAWC's argument that Mr. Rubin's proposal should be rejected because "there is no difference in the cost to generate and collect a water bill for \$40, and the cost to generate and collect a water bill for \$80 (or \$100, \$500, or \$1000)." IAWC Ex. 11.00SR at 3. The AG asserts that IAWC's argument misses the point because Mr. Rubin took no issue with the cost the Company incurs to issue a bill. Rather, while conceding that there is no "right" answer as to how to recover these costs, Mr. Rubin testified that because there is a relationship between water usage and non-payment, it is fairer that all residential customers pay an equal percentage of their bills toward this cost item, resulting in higher-use customers paying a greater amount of collection expenses and uncollectibles. AG Ex. 4.0 at 6-7. For these reasons, the AG states that the Commission should adopt its proposal to remove collection expenses and uncollectible accounts expenses from the calculation of the customer charge.

### d. Commission Analysis and Conclusion

\*87 The Commission finds that the record does not support the AG's proposal to recover customer records, collection labor, and uncollectible accounts expenses through volumetric charges rather than customer charges. The AG did not offer any analysis to support its position that these expenses vary based on the size of customers' bills. The Company, however, provided testimony to establish that the collection efforts and expenses to the Company are the same regardless of the size of the delinquent bills. The Company showed that these expenses vary based on the number of customers and therefore all customers should share equally in the recovery of these expenses. Thus, it would be unfair and inconsistent with principles of cost causation to require customers with larger bill amounts to contribute more to the recovery of these expenses than those with smaller bills. Accordingly, the Commission concludes that the Company's rate design proposal which includes collecting these expenses on a per-customer basis through the customer charge is approved and the AG's proposal is rejected.

## 4. Zone 1 5/8 Meter Charge

### a. IAWC's Position

IAWC notes that, as a corollary to his proposed adjustment for customer records, collection labor and uncollectible accounts expenses discussed above, AG witness Rubin proposed an additional adjustment to set the customer charge for Zone 1 customers with 5/8-inch meters to no more than \$18.50. IAWC states that Mr. Rubin arrived at this figure by removing the customer records, collection, and uncollectible accounts expenses from IAWC's proposed customer charge. IAWC asserts that the AG offered no compelling support in testimony for its proposal to limit the customer charge to \$18.50 and no argument in support of its proposal in its Initial Brief. Therefore, based on these reasons and the reasons explained above, IAWC argues that Mr. Rubin's proposal to remove these expenses from the customer charge should be rejected.

### **b. Staff's Position**

Staff asserts that AG witness Rubin's proposal to limit the monthly Zone 1 charge for a 5/8-inch meter customer to \$18.50 due to his proposed adjustments to the customer cost analysis discussed in Section VI.B.3 above is unfounded and should be rejected by the Commission. Staff Ex. 14.0 at 6. Staff argues, as it does in Section VI.B.3 above, that this proposal would not reflect cost causation and it would unfairly require high-volume users to pay a larger portion of the uncollectible accounts expense than low-volume customers. It is Staff's position that uncollectible accounts expense should be recovered on a per-customer basis through the customer charge and therefore the Commission should approve the Company's proposed \$20.00 monthly Zone 1 5/8 Meter Charge.

### **c. AG's Position**

As stated in Section VI.B.3 above, AG witness Rubin recommended that the Commission exclude collection expenses and uncollectible accounts expenses from the calculation of the customer charge. Mr. Rubin testified that the result of this proposed adjustment would be an additional adjustment to reduce the customer charge for Zone 1 customers with 5/8-inch meters to no more than \$18.50. AG Ex. 2.0 at 8-9. He noted that the Company currently proposes a \$20.00 monthly Zone 1 5/8 Meter Charge. Mr. Rubin advanced the same arguments stated above in Section VI.B.3 to support this recommendation. *Id.*

### **d. Commission Analysis and Conclusion**

\*88 The Commission declines to adopt AG witness Rubin's proposal to limit the monthly customer charge for Zone 1 customers with 5/8-inch meters to \$18.50 due to his recommendation discussed in Section VI.B.3 above to exclude collection expenses and uncollectible accounts expenses from the calculation of the customer charge. As discussed above, the Commission believes the uncollectible accounts expense should be recovered on a per-customer basis through the customer charge and therefore the Commission approves the Company's proposed monthly customer charge of \$20.00 for Zone 1 customers with 5/8-inch meters.

## **5. Limitation of Increase by Class**

### **a. IAWC's Position**

IAWC notes that AG witness Rubin proposed that rate increases for all customer classes should be limited so that no class receives an increase of more than 1.5 times the system-average increase, and no class receives an increase that is less than 0.5 times the system-average increase. AG Ex. 2.0 at 10. IAWC states that Mr. Rubin based this proposal on the ratemaking principles of gradualism and rate continuity. *Id.* Although IAWC agrees that generally rate increases should be gradual and continuous, and that the increase limitation is generally reasonable, the Company states that it cannot accept Mr. Rubin's proposal to apply this limitation to all customer classes. IAWC explains that applying this limitation to all rate classes would result in increases to customers that are served under contract. IAWC Ex. 11.00R at 12. IAWC further explains that its contractual rates are fixed in the contracts, which provide the specific provisions for how the rates can be increased. The Company states that the contracts simply do not allow for the increases Mr. Rubin proposes.

IAWC states that it is proposing an overall increase of approximately 21.6% in its rates. Therefore, under Mr. Rubin's proposed limitations, IAWC notes, no class would receive a rate increase of less than 10.8% or more than 32.4%. AG Ex. 2.0 at 10. But in applying these limitations, IAWC states that Mr. Rubin did not account for IAWC's limited ability to increase rates for the customer classes served under contract, which include the Large Commercial, Competitive Industrial, and Large Other Water Utility customer classes. The Company emphasizes that Mr. Rubin's proposal would result in the maximum increase of 32.4% for these customer classes. However, IAWC states, the rates for those classes are set by contract, and the contractual rates cannot be increased as Mr. Rubin proposes. IAWC Ex. 11.00R at 12.

IAWC observes that the AG did not offer any argument in support of this proposal in its briefs. Additionally, IAWC points out that Staff agrees with the theory underlying the AG's proposal — that rate increases should be gradual and continuous, and that the 0.5-1.5 times system-average limitation is generally reasonable. However, both Staff and IAWC agree that the limitation cannot be applied to customer classes that are served under contract. Thus, IAWC concludes that the Commission should reject the AG's proposal.

#### **b. Staff's Position**

\*89 Staff explains that its witness Mr. Boggs testified that the increase limitations recommended by AG witness Rubin should promote gradualism in rate increases and mitigate any potential for increases that could become burdensome to specific rate classes. Staff Ex. 14.0 at 8. Staff also acknowledges that IAWC witness Herbert testified that the rates for Large Commercial, Competitive Industrial and Large Other Utility are set by contract so the increase limitations proposed by Mr. Rubin would not and could not apply to these customer classes. IAWC Ex. 11.00R at 12.

In light of this testimony, Staff asserts that the Commission should approve Mr. Rubin's recommendation to limit the increase for each customer class so that no class receives a percentage increase that is more than 1.5 times the system average percentage increase or less than 0.5 times the system average increase, but only for those customers who are not bound by the terms of a contract that sets the rates for that respective class.

#### **c. AG's Position**

AG witness Rubin recommended that the rate increase for all customer classes be limited so that no class receives an increase of more than 1.5 times the system-average percentage increase, and no class receives an increase that is less than 0.5 times the system-average percentage increase. AG Ex. 2.0 at 4, 10. Mr. Rubin testified that this proposal reflects the principle of gradualism which is an important principle of rate design and cost allocation. Mr. Rubin further testified that under his proposal, each class would receive an increase between 10.8% and 32.4%. *Id.*

#### **d. IWC/FEA's Position**

IWC/FEA state that they generally agree with the Company's proposed class revenue allocation. IWC/FEA Ex. 2.0 at 4. However, IWC/FEA express concern about the Company's proposal for an above system average increase for the Industrial class. IWC/FEA acknowledge that most increases are difficult for any customer, but IWC/FEA argue such increases are especially difficult for industrial customers that continuously face competitive pressures in their respective industries throughout the region, the U.S., and the world. *Id.* at 4. IWC/FEA note such competitive pressures make industrial customers sensitive to even the slightest increases. They argue that while these customers understand such increases are part of doing business, an increase above the system average increase, as is the situation here, is cause for concern which can be alleviated by a more accurate measure of the class cost of service.

IWC/FEA argue that even with the exemption of the contractual rate customers, the Company's COSS includes several flaws, such as the previously discussed allocation of purchased power expense, which inhibit the Company from accurately measuring the class cost of service. IWC/FEA assert that, as a result of these inaccuracies, the actual cost of service for the Industrial and Large Other Public Authority classes is lower than the cost of service calculated by the Company in its COSS. *Id.* at 4-5.

\*90 Additionally, it is IWC/FEA's view that application of the AG increase limitation to a flawed COSS still results in increases that are difficult for these classes to sustain. Accordingly, IWC/FEA believe the Commission should reject the AG's proposal. Instead, IWC/FEA state that the Industrial and Large Other Public Authority classes should receive increases no higher than those recommended by IAWC witness Herbert, which are 24.5% and 20.7%, respectively. IAWC Ex. 11.00R at 2, 62.

### e. Commission Analysis and Conclusion

The Commission notes that the Company proposed an overall increase of approximately 21.6% in its rates which is set forth in detail on page two of IAWC Exhibit 11.01R. In its direct testimony, the AG recommends that the rate increase for all customer classes should be limited such that no class receives an increase of more than 1.5 times the system-average increase, and no class receives an increase that is less than 0.5 times the system-average increase.

The Commission agrees with Staff, IAWC, and the AG that gradualism is an important principle of rate design and cost allocation. However, the Commission declines to adopt the AG's proposal at this time. The AG did not respond to IAWC's or Staff's assessments of the proposal in its rebuttal testimony or briefs and it failed to provide any legal argument in its briefs to support its proposal. Notably, the AG has not presented evidence to demonstrate that its proposal is needed in this proceeding. It also appears that applying the limitation to non-residential classes, including those served under contracts that set their rates, may be problematic. Further, it also appears that many of the customer classes would experience more significant rate increases under the AG's proposal than they would under the Company's proposal. Accordingly, the Commission adopts the Company's proposed percentage increases by class as specified on page two of IAWC Exhibit 11.01R, which will be adjusted based on the Company's final revenue requirement.

## 6. Demand Factors

### a. IAWC's Position

IAWC states that consistent with the Commission's directives in Docket No. 110767, the Company conducted a direct measurement demand study in preparation for this case, in which the Company directly measured the demand of a sample group of customers between May 2011 and October 2015. *See* Docket No. 11-0767, Order at 113-114. IAWC used the results of that demand study to develop the demand factors it proposes in this case. IAWC Ex. 11.00R at 3. IAWC notes that Staff and AG witnesses accepted the proposed demand factors, but IWC/FEA witness Collins recommended that the Commission ignore the results of the demand study, and rely instead on demand factors developed and approved in IAWC's last rate case in Docket No. 11-0767. IWC/FEA Ex. 1.0 at 15. IAWC notes that IWC/FEA also recommend that the Commission order the Company to continue its demand study. IAWC argues that the Commission should reject Mr. Collins' proposal and approve the updated demand factors the Company proposes here, and which Staff and the AG support.

\*91 IAWC asserts that its proposed demand factors reflect the most recent available actual data regarding its customers' demand. IAWC Ex. 11.00R at 3. In contrast, IAWC notes that the demand factors Mr. Collins advocates are based on very limited direct measurement data collected prior to the filing of IAWC's rate case in 2011. *Id.* In the years since Docket No. 11-0767, IAWC states that it has collected more comprehensive data, and its proposed demand factors are based on that more recent, more comprehensive data. *Id.*

The Company contends that the Commission has expressed a preference for demand factors based on the most recent available data. *See, e.g.,* Docket No. 09-0319, Order at 149-150; Docket No. 07-0507, Order at 121; Docket No. 02-0690, Order at 119-120. Additionally, IAWC argues that Mr. Collins has not offered a compelling reason to reject the Company's more recent, more comprehensive data, or to reconsider the Commission's preference for more recent data. Tellingly, IAWC points out, Mr. Collins did not respond in testimony to IAWC's criticisms of his proposal. *See* IWC/FEA Ex. 2.0 at 4-7.

IAWC takes issue with IWC/FEA's argument that IAWC has failed to provide any evidence to explain why the demand factors for some customer classes differ from those adopted in IAWC's last rate case. The Company reiterates that its proposed demand factors reflect the most recent available data about customers' actual demand. Therefore, IAWC maintains, there is no need to provide evidence explaining why the demand factors have changed. Nevertheless, IAWC notes that its witness Mr. Herbert explained that the demand factors differ because the data used to calculate the demand factors in preparation for Docket No. 11-0767 was much more limited in scope than the data collected for this case. IAWC Ex. 11.00R at 3. IAWC argues that IWC/

FEA's proposal would require IAWC to rely on the obsolete data, simply because the results of the recent, lengthy, and in-depth study differ from the older and more cursory data collection efforts.

IAWC states that the Commission should also reject IWC/FEA's request that the Company be ordered to continue its demand study. IAWC notes that IWC/FEA argue, for the first time in their briefs, that they do not believe the demand study is complete and therefore the Company should continue to monitor the situation. IAWC argues that all of the record evidence shows that an ongoing demand study is not cost-effective and is unnecessary. IAWC elaborates that IWC/FEA did not offer testimony that the demand study should be continued. However, IAWC states that every other party that offered testimony on the subject — Staff, the AG, and IAWC — agreed that IAWC's demand study will be valid for ten years, and that it is not cost-effective to continue the demand study. IAWC Ex. 11.00R at 3; Staff Ex. 6.0 at 35-36; AG Ex. 2.0 at 16.

\*92 Further, IAWC explains that the Company and Staff agreed that the Company should only conduct a demand study once every ten years, and the Company should use the less resource intensive AWWA-method rather than direct measurement. IAWC Ex. 11.00R at 3-4. IAWC contends that IWC/FEA's assertion that the Company should continue to monitor the situation ignores IAWC's agreement with Staff to conduct AWWA-method demand studies once every ten years and submit evidence in future rate cases that there has not been a significant change in the ratio of peak to average demand. Staff Ex. 6.0 at 36; IAWC Ex. 11.00R at 4.

#### **b. Staff's Position**

It is Staff's position that the Commission should reject IWC/FEA's proposal to use the demand factors that were approved in the Company's last rate case and its proposal that the Company continue its demand study.

Staff notes that IWC/FEA assert that they are concerned that the Company's proposed demand factors are flawed and used inappropriately in the COSS. IWC/FEA Ex. 1.0 at 15. They contend that the Company has excluded a large industrial user and an entire rate class from the COSS and that the Company understated usage for its Residential and Commercial classes in the COSS. *Id.* Staff also notes that IAWC states that the demand study that it conducted in preparation for this case is the result of collecting direct measurement data over the most recent five year period. IAWC Ex. 11.00R at 3. IAWC further states that the demand factors used in Docket No. 11-0767 included very little direct measurement data and all of it is now outdated because that study reflected data leading up to the filing of the rate case in 2011. *Id.*

Like IAWC, Staff contends that IWC/FEA have failed to provide a convincing argument to support their recommendation to use outdated demand data when more recent, direct, and comprehensive data is available. Staff Ex. 14.0 at 12. Staff asserts that it agrees that IAWC's demand study will be valid for ten years. Thus, Staff submits that the Commission should reject IWC/FEA's recommendation that IAWC continue its demand study. Staff explains that its witness Mr. Boggs testified that IAWC should be allowed to conduct a AWWA-method demand study every ten years and submit evidence in future rate cases that there has not been a significant change in the ratio of peak to average demand. Staff Ex. 6.0 at 36. Therefore, Staff recommends that the Commission approve the Company's proposed direct demand study data and that it allow the Company to conduct AWWA-method demand studies once every ten years provided that the Company submits evidence in future rate cases that there has not been a significant change in the ratio of peak to average demand.

#### **c. AG's Position**

AG witness Rubin testified that the Company should not be required to continue its demand study. Mr. Rubin opined that it is not cost-effective for the Company to continue collecting individual customer demand data for study purposes. AG Ex. 2.0 at 16. He agreed with Staff and IAWC that the demand study provided in this case can be used for many years in the future, therefore he concluded that there is no need to conduct such a study for each rate case. *Id.*

#### d. IIRC/FEA's Position

\*93 IIRC/FEA state that they believe the demand study the Company conducted in preparation for this case is incomplete, and they recommend that the Company continue to monitor the situation. IIRC/FEA Ex. 1.0 at 14. IIRC/FEA argue that the Company has mischaracterized their opposition to ending the monitoring as ignoring the results of the study IIRC prepared for this case. IIRC Ex. 11.00R at 2. IIRC/FEA claim that they recommend that monitoring continue due to some significant changes in the demand factors since the last IIRC rate case. IIRC/FEA explain that a comparison of the demand factors for Zone 1 from this case with those used in the last case indicate that some classes' factors have significantly changed. IIRC/FEA Ex. 1.0 at 14. IIRC/FEA note that they presented this comparison in IIRC/FEA Exhibit 1.2.

IIRC/FEA also argue that the Company failed to provide any evidence as to why certain classes would see such a change in demand ratios between rate cases and they failed to adequately explain why this has occurred. *Id.* IIRC/FEA state that they are not attempting to ignore the results of the Company's study but rather they are using the collected information to show that continued monitoring is necessary. Additionally, IIRC/FEA acknowledge that the Company has incurred significant costs to conduct the study, but they claim the cost to certain customer classes, in the form of interclass subsidies, will likely be much more expensive if the demand factors are incorrect.

IIRC/FEA indicate that the Company has addressed some of the concerns they raised in this proceeding, due to the significant changes in some classes' demand factors, however, IIRC/FEA remain concerned that the Company's proposed demand factors are flawed and inappropriate for use in the COSS. IIRC/FEA argue that the use of flawed factors will not result in appropriate cost allocation to classes. As a result, IIRC/FEA recommend that the Company use the existing demand factors approved in the last rate case for Zone 1 and that it continue to monitor the situation. IIRC/FEA Ex. 1.0 at 14-15.

#### e. Commission Analysis and Conclusion

The Commission notes that IIRC/FEA question whether the demand study prepared by the Company in preparation for this proceeding is complete. They believe the Company has not sufficiently explained the difference between the demand factors for some customer classes in IIRC's last rate case and the demand factors it proposes in this proceeding. Due to these perceived shortcomings, IIRC/FEA recommend that the Company use the existing demand factors approved in the last rate case for Zone 1 instead and that the Company continue its direct demand study.

Staff, the AG, and the Company agree that the Commission should approve the use of IIRC's proposed demand factors and permit the Company to discontinue its demand study. Staff and IIRC agree that the Company should be allowed to conduct AWWA-method demand studies every ten years, provided that the Company submits evidence in future rate cases that there has not been a significant change in the ratio of peak to average demand. The AG agrees that the current demand study can be used for some time and that it is unnecessary for the Company to conduct a demand study for each rate case.

\*94 The Commission concurs with Staff and IIRC. The Company complied with the Commission's prior directive in Docket No. 11-0767 by conducting a direct demand study in preparation for this case and using the collected data to develop the Company's proposed demand factors. The Company's proposed demand factors reflect the most recent and comprehensive available data concerning its customers' demand. IIRC explains that there is a difference between the demand factors proposed in this case and in the Company's last rate case because the direct demand study measures customers' actual demand over the most recent five year period and the data used to calculate the demand factors in the Company's last rate case was more limited in scope than the data collected in preparation for this proceeding. Moreover, as stated by Staff and the Company, IIRC/FEA failed to provide a compelling reason to support the use of demand factors based on older data instead of the most recent and comprehensive data available. Finally, the record supports Staff's and IIRC's position that the Company should be allowed to conduct AWWA-method demand studies every ten years. Staff, the AG, and IIRC all agree that the Company's current demand

study will be valid for ten years and that direct measurement demand studies are resource-intensive, unlike the AWWA-method which is more commonly used for determining demand factors.

Accordingly, the Commission rejects IWC/FEA's proposal and adopts the Company's proposed demand factors. The Commission also adopts the proposal by Staff and IAWC that the Company only conduct a demand study using the AWWA-method once every ten years, and submit evidence in future rate cases indicating that there has not been a significant change in the ratio of peak to average demand.

## VII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) IAWC is in the business of furnishing water and sewer service to the public in various areas in the State of Illinois and is a public utility as defined in the Act;

(2) the Commission has jurisdiction 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, 2017; this test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, IAWC's net original cost rate bases are set forth in Appendices A through E;

(6) the \$1,570,415,946 original cost of plant for IAWC at September 30, 2015, as presented in Staff Exhibit 2.0, should be approved as the original cost of plant;

\*95 (7) a just and reasonable rate of return which IAWC should be allowed an opportunity to earn on its net original cost rate base is 7.47%; this rate of return incorporates an ROE of 9.79%;

(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) IAWC's rates which are presently in effect for water service and sewer service are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; the currently effective rates should be permanently canceled and annulled;

(10) the rates proposed by IAWC would produce a rate of return in excess of a return that is fair and reasonable; IAWC's Proposed Tariffs should be permanently canceled and annulled;

(11) IAWC should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendices A through E, such tariff sheets to be applicable to service furnished on and after their effective date; the terms and conditions in these tariff sheets should be consistent with Finding (13) below;

(12) the cost of service, interclass revenue allocation, rate design, and tariff terms and conditions found appropriate in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted; and

(13) the new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than five working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary, except as is otherwise required by Section 9-201(b) of the Act as amended.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the Proposed Tariffs proposing a general increase in rates, filed by Illinois-American Water Company on January 21, 2016, 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 (13) of, and other determinations in, this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that upon the effective date of the new tariff sheets to be filed pursuant to this Order, the tariff sheets presently in effect for water and sewer service rendered by Illinois-American Water Company which are replaced thereby are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that the \$1,570,415,946 original cost of plant for Illinois-American Water Company at September 30, 2015, as presented in Staff Exhibit 2.0, is approved as the original cost of plant.

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.

**\*96** 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 13<sup>th</sup> day of December, 2016.

#### Footnotes

- 1 IAWC explained that “Revenue Requirement” support is Service Company personnel assistance in preparing revenue requirements, testimonies and exhibits, data request responses, analyses, as necessary, and final tariffs. It also includes the expense for Service Company personnel to attend hearings. IAWC Ex. 4.00.
- 2 Schedule C-10 also shows IAWC’s projected \$250,000 “Internal Demand Study Costs.” IAWC explained that this represents the costs for utility personnel to continue the data collection and analysis required for the Demand Study the Commission ordered in Docket No. 11-0767, through final resolution of this case. IAWC-AG Stip. Cross Ex. 2.00 at 6; IAWC Ex. 15.03SR at 11, 33, 63. Schedule C-10 also includes \$200,000 in “Other” costs for customer communications related to the rate case, \$110,000 of which IAWC explains it had incurred at the time of its surrebuttal filing. IAWC-AG Stip. Cross Ex. 2.00 at 6; IAWC Ex. 4.00SR at 14; IAWC Ex. 4.11SR.
- 3 See IAWC Initial Brief at 2-3; IAWC Reply Brief at 1-4; IAWC Ex. 10.00R at 2-5; see also Docket Nos.: 14-0419; 11-0436; 11-0767; 10-0194; 09-0319; 07-0507; 06-0285; 05-0071/72; 04-0442; 03-0403; 00-0340.