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STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN WATER COMPANY, )  
 INC. FOR AUTHORITY TO INCREASE ITS RATES AND )  
 CHARGES FOR WATER AND SEWER UTILITY SERVICE, )  
 FOR APPROVAL OF NEW SCHEDULES OF RATES AND ) CAUSE NO. 43680  
 CHARGES APPLICABLE THERETO, FOR APPROVAL OF )  
 CHANGES TO RULES AND REGULATIONS APPLICABLE )  
 TO SUCH SERVICE, AND FOR AUTHORIZATION TO ) APPROVED: APR 30 2010  
 DEFER IN A PENSION/OPEB BALANCING ACCOUNT )  
 OVER- AND UNDER-RECOVERIES FOR PASS THROUGH )  
 TO CUSTOMERS. )

**BY THE COMMISSION:**  
**David E. Ziegner, Commissioner**  
**Angela Rapp Weber, Administrative Law Judge**

On April 30, 2009, Indiana-American Water Company, Inc. (“Petitioner,” “Indiana American,” or “Company”) filed its *Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements* (“Petition”) with the Indiana Utility Regulatory Commission (“Commission”), seeking authority to increase its rates and charges for water and sewer utility service, for approval of new schedules of rates and charges applicable thereto, for approval of changes to rules and regulations applicable to such service, and for authorization to defer in a Pension/OPEB balancing account over- and under-recoveries for pass through to customers. Petitioner’s notice of its intent to file in accordance with the Commission’s rules on minimum standard filing requirements (“MSFRs”) was given pursuant to 170 IAC 1-5-1 *et seq.*<sup>1</sup>

Pursuant to notice as provided in 170 IAC 1-1.1-15, a Prehearing Conference was convened in this Cause on May 27, 2009 at 9:30 A.M. in Room 224 of the National City Center, 101 W. Washington Street, Indianapolis, Indiana. Proofs of publication of notices of the Prehearing Conference were incorporated into the record and placed in the official files of the Commission. Petitioner, the Office of Utility Consumer Counselor (“OUCC” or “Public”) and Intervener Town of Schererville (“Schererville”) participated in the Prehearing Conference. The procedural, scheduling, and other matters determined at the Prehearing Conference were memorialized in the Commission’s Prehearing Conference Order approved and issued on June 3, 2009.

Petitions to Intervene in this Cause were filed on May 21, 2009 by the Town of Schererville; on June 17, 2009 by the Ramsey Water Company, Inc. (“Ramsey”); on July 2, 2009, by a group of Indiana American’s industrial customers (“Industrial Group”); on July 15,

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<sup>1</sup> Since Petitioner filed its Petition, case-in-chief, and supporting workpapers prior to the promulgation of new regulations concerning the MSFRs, the prior version of the MSFRs have continued to apply to this Cause. References to the regulations promulgating the MSFRs herein are to the version of those regulations that was in effect when Petitioner filed its case-in-chief and supporting workpapers.

2009 by the City of Crown Point (“Crown Point”); on August 5, 2009 by the City of West Lafayette (“West Lafayette”); on August 27, 2009 by the Town of Clarksville (“Clarksville”); on August 27, 2009 by the City of Jeffersonville (“Jeffersonville”); and on August 27, 2009 by the City of Noblesville (“Noblesville”). Schererville’s Petition to Intervene was granted at the Prehearing Conference held on May 27, 2009. The Petitions to Intervene of Ramsey, Industrial Group, and Crown Point were granted by Docket Entries issued on August 10, 2009 and July 22, 2009. The Petitions to Intervene of West Lafayette, Clarksville, Jeffersonville, and Noblesville were granted at the Evidentiary Hearing held on September 2, 2009. Thus, all the entities requesting intervention were made parties to this Cause.

Pursuant to notice published as required by law, a public Evidentiary Hearing commenced on September 2, 2009 at 9:30 A.M. in Room 222 of the National City Center, 101 W. Washington Street, Indianapolis, Indiana. Proofs of publication of the notices of such Hearing were incorporated into the record of this proceeding by reference. During the Evidentiary Hearing conducted on September 2 through 4, 2009, evidence constituting Indiana American’s case-in-chief was offered and admitted into the record, and its witnesses were offered for cross-examination.

The Commission took administrative notice of its following Orders: Indiana-American Water Co., Cause No. 43320 (IURC 1/30/08) (“Preapproval Order”); Indiana-American Water Co., Cause No. 43187 (IURC 10/10/07) (“2007 Rate Order”); Indiana-American Water Co., Cause No. 42520 (IURC 11/18/04) (“2004 Rate Order”); Indiana-American Water Co., Cause No. 42029 (IURC 11/6/02) (“2002 Rate Order”); Indiana-American Water Co., Cause No. 40703 (IURC 12/11/97) (“1997 Rate Order”); and Indiana-American Water Co., Cause No. 40103 (IURC 5/30/96) (“1996 Rate Order”).

Pursuant to IC 8-1-2-61(b), a public Field Hearing was conducted on September 15, 2009 in the City of Gary, which is the largest municipality in Petitioner’s service area. During this public field hearing, members of the public provided oral and/or written testimony in this Cause. On October 5, 2009 and October 26, 2009, Field Hearings were conducted in Muncie and Jeffersonville, respectively, at which times members of the public provided oral and/or written testimony in this Cause.

On September 4, 2009, the Evidentiary Hearing was continued to October 21, 2009, which is the date established in the Prehearing Conference Order for the parties to present any settlement and evidence in support thereof. The parties advised the Presiding Administrative Law Judge that they had not reached any settlement. Pursuant to a Docket Entry dated October 20, 2009, the Evidentiary Hearing was continued to December 15, 2009. During the Evidentiary Hearing conducted on December 15 and 16, 2009, evidence constituting the respective cases-in-chief of the Public and the intervening parties was offered and admitted into the record, and their witnesses were offered for cross-examination. In addition, Petitioner’s rebuttal evidence was offered and admitted into the record, and Petitioner’s rebuttal witnesses were offered for cross-examination.

Having considered all of the evidence presented in this proceeding, based on the applicable law and being duly advised in the premises, the Commission now finds:

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

2. **Petitioner’s Characteristics.** Petitioner is a public utility corporation organized under the laws of the State of Indiana and is engaged in the provision of water utility service to the public in and around numerous communities and counties throughout the State of Indiana. Petitioner also provides sewer utility service in Wabash and Delaware Counties. Petitioner has charter power and authority to engage in the business of providing such water and sewer utility service under indeterminate permits, franchises, licenses, and permits heretofore duly acquired. Petitioner renders such water and sewer utility service by means of utility plant, property, equipment, and related facilities owned, leased, operated, managed, and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution, and sale of water for residential, commercial, industrial, public authority, and sale for resale purposes, for the provision of public and private fire service, and for the provision of sewer service. Petitioner provides utility service to approximately 283,000 customers.

3. **Existing Rates.** Petitioner’s existing basic rates and charges for water and sewer service were established pursuant to the 2007 Rate Order. Two Distribution System Improvement Charge (“DSIC”) filings have been approved since the conclusion of the 2007 Rate Order. The first DSIC was authorized in Cause No. 42351-DSIC-4 pursuant to the Commission’s Order dated April 2, 2008. Petitioner applied for an additional DSIC surcharge that was authorized in Cause No. 42351-DSIC-5 in a Commission Order dated April 15, 2009.

4. **Relief Requested.** Petitioner originally proposed that its rates be increased by 28.86%. Prior to the September 2 Evidentiary Hearing, Petitioner filed supplemental direct testimony and exhibits reflecting the updated rate base permitted by 170 IAC 1-5-5 and Paragraphs 2 and 6 of the Prehearing Conference Order. These updates would revise Petitioner’s requested increase to 29.32%. In addition, Petitioner proposed the completion of its transition to single tariff pricing (“STP”) in all categories except volumetric rates for general water service. For general water service, Petitioner proposed to reduce the number of water tariffs to two: Area One and Area Two. In conjunction with the further move to STP, Petitioner requested that future DSICs be implemented on a single tariff basis and that the eight remaining municipalities which have not yet adopted ordinances pursuant to IC 8-1-2-103 be moved to fire protection surcharges by meter size in lieu of directly billed hydrant charges. Petitioner also sought authority to defer under-collection and over-collection of revenues for pension and other post-employment benefits (“OPEB”) in a Pension/OPEB Balancing Account for future recovery or refund, as the case may be. Finally, Petitioner proposed a modification to its tariff, which would require that customers who pay for service during a twelve-month period twice with a check that is dishonored be required to pay their bills in cash for the following twelve months.

5. **Test Year.** As provided in the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and *pro forma* operating revenues, expenses, and operating income under present and proposed rates is the twelve months ended November 30, 2008, adjusted for changes that are fixed, known, and measurable for ratemaking purposes and that will occur within twelve months following the end of the test year. The financial data for this test year, when adjusted for changes as provided in the Prehearing Conference Order, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

6. **Overview.** David K. Baker, President of Indiana American, provided an overview of Petitioner's case and identified the most significant drivers of the need for a rate increase. Mr. Baker recognized that this will be one of the largest total increases that the Company has ever requested, but he stated that this increase is directly traceable, for the most part, to five categories of cost increases that Indiana American has experienced since its last general rate case. Petitioner's Exhibit DKB at 6. Mr. Baker testified that these five components constitute roughly 86% of the total rate increase request and stated that while the increase is significant, it is needed because that is how much the costs of providing water service to the Company's customers have increased. Mr. Baker stated that without the increase, the Company's ability to attract on reasonable terms the capital it needs to continue delivering service to its customers would be hindered. He pointed out that even with the increase, the price for water is still quite reasonable, representing a cost of pennies more than \$1 per day for the average customer. Petitioner's Exhibit DKB at 6. On Cross-examination, Mr. Baker acknowledged that this cost refers to the average residential customer. Mr. Baker stated that the Company's water will still provide the greatest value for almost any consumable that its customers might purchase.

Mr. Baker then discussed the five most significant drivers of Petitioner's rate increase request: 1) significant additions of new rate base (beyond that reflected in Petitioner's intervening DSICs); 2) higher cost of debt; 3) higher cost of equity; 4) dramatic increase in the cost of chemicals, uncollectibles expense, and labor; and 5) higher cost to maintain pension and other OPEB obligations. Mr. Baker testified that in total, the increases in costs caused by these drivers represent approximately \$40.4 million, or more than 86% of the request. Petitioner's Exhibit DKB at 6.

Several of the consumer parties discussed the economic burden of such a large rate increase during the existing economic downturn. They presented testimony challenging Petitioner's costs and made numerous recommendations as to how to reduce the overall impact of Petitioner's requested rate increase. Also, all of the parties raised many issues in this Cause, some of which have been resolved by the parties, and therefore, the Commission accepts the resolution of such issues. The Commission will focus its discussion and findings primarily on the issues where disagreement still exists between the parties.

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

A. **Original Cost.** In its case-in-chief, Petitioner first presented its utility plant in service balances as of November 30, 2008. Petitioner updated those balances to the June 30, 2009 actual balances pursuant to 170 IAC 1-5-5. Petitioner also updated its rate base to reflect four major projects. With respect to each major project: (1) the major project was identified in

the Petition; (2) estimates of Petitioner's investment were included in Petitioner's case-in-chief; (3) the amount to be included in rate base does not exceed such estimates; (4) monthly investment updates were filed; (5) each was declared to be used and useful at least ten business days before the final Evidentiary Hearing; and (6) the estimated and actual cost of each was more than 1% of Petitioner's proposed rate base. The four major projects are:

West Lafayette Improvements. This project includes the construction of a new 3.0 million gallons per day ("MGD") water treatment facility and associated improvements for the Happy Hollow Station location and removal of Wells Nos. 8 and 12 from service. This project also includes the purchase of property for the Davis Ferry water treatment facility, construction of a 9.0 MGD source of supply and water treatment facility to meet the remaining demand in the West Lafayette service area, and installation of an additional finished water main to connect the Davis Ferry water treatment facility to the existing distribution system. Expenditures for this project were preapproved in the Preapproval Order.

London Road Improvements. This project includes the design and installation of new wells to produce 3-4 MGD, construction of the new 3.0 MGD London Road water treatment facility, and the acquisition of easements for and installation of approximately 35,300 feet of 24" transmission main to connect to the Johnson County Operation. Expenditures for this project were preapproved in the Preapproval Order.

Northwest Cleveland Street Transmission Main and Pump Station Improvements. This project includes the construction of approximately 20,200 feet of 30" transmission main and a new pump station within the Gary and Glen Park pressure zones to meet the demands in the Northwest Operation. Demands in the southern part of the Northwest service area have exceeded transmission main capacity. The new transmission main and pump station along with other improvements that have been completed and or are being completed will meet the growing demands over a fifteen-year planning horizon.

Northwest Indiana Odgen Dunes Backwash Recycle Improvements. This project includes the construction of two backwash clarifiers along with recycle pumps, piping, and controls to recycle backwash water. Due to Indiana Department of Environmental Management ("IDEM") requirements, Petitioner must discontinue discharging to its existing residuals lagoon. In order to discontinue such discharge, Petitioner was required to install the new backwash recycle system. Backwash water will be directed to the new backwash clarifiers rather than to the residuals lagoon. Backwash water will be clarified and recycled to the head of the plant at a controlled rate.

Of those four major projects, all except the Cleveland Street Main and Pumping Station and a small piece of the West Lafayette Improvements were in service as of June 30, 2009 and therefore were reflected in Petitioner's actual plant in service figures as of that date. The Cleveland Street Main was in service by the September Hearing. The Cleveland Street Pumping Station and the remaining pieces of the West Lafayette Improvements (a maintenance garage and a section of main) were placed in service by November 30, 2009. Ten business days before the final Evidentiary Hearing, Petitioner filed its final actual costs on the major projects, which had not been included in the June 30, 2009 balances. To the extent these costs included amounts for

which December invoices had not yet been received, Petitioner included estimated invoice amounts supplied by the contractors.

Petitioner also originally included in rate base the amount that it anticipated to defer in its proposed Pension/OPEB Balancing Account (to be discussed later) from January 1, 2009 through June 30, 2009. As will be described later, Petitioner proposed in this case to defer amounts by which its actual pension and OPEBs differ from the amounts recovered in rates, pursuant to Statement of Financial Accounting Standards (“SFAS”) 106. Petitioner originally proposed to commence the deferral as of January 1, 2009 and to include the deferred amounts as of June 30, 2009 in its actual rate base in this Cause. The inclusion in rate base in this Cause was opposed by the OUCC, the Industrial Group, and Schererville. On rebuttal, Petitioner modified its proposal, and one of the modifications was to exclude any deferred amounts from rate base in this Cause. With the modification to the Pension/OPEB Balancing Account, Petitioner’s proposed net original cost rate base as of June 30, 2009 and adjusted for the actual cost of the major projects is \$656,248,955.

OUCC Witness Margaret Stull testified that the net original cost rate base equaled \$657,268,279. Public’s Exhibit No. 1 at 9, Table MAS-2. The OUCC adjusted for amounts that Petitioner did not include in its original calculation of contributions in aid of construction (“CIAC”), customer advances, and a discrepancy for capitalized tank painting. These adjustments were accepted by Petitioner. The OUCC also proposed to exclude from rate base one high service pump in the Southern Indiana Operations and Treatment Center (“SIOTC”) and 50% of Muncie meter replacements. Finally, the OUCC proposed to change the Commission’s policy of allowing depreciation expense on CIAC by also amortizing it. The Commission will now proceed to address the contested rate base issues.

(1) SIOTC pumps. The 2004 Rate Order disallowed \$753,378 in SIOTC rate base because it found that Indiana American failed to present sufficient evidence necessary to find that the clear water reservoir isolation design was used and useful. 2004 Rate Order at 15–16. The Commission identified five categories of information that would be necessary to support inclusion of the clear water reservoir isolation design. While this issue was subsequently raised in Cause No. 43187, for purposes of settlement Indiana American agreed to an equivalent disallowance without prejudicing its opportunity to justify the need for the clear water reservoir isolation design in its next case. Petitioner’s Exhibit AJD at 5.

(a) Petitioner’s Position. Petitioner’s Witness Alan J. DeBoy testified regarding the need for the clear water reservoir and pumping capacity at the SIOTC. Mr. DeBoy also explained how IDEM regulations require that the reservoir be designed with two compartments. According to Mr. DeBoy, 327 IAC 8-3-8 contains IDEM construction permit requirements for public water supplies, and the conditions within Article 8 must be satisfied to obtain an IDEM construction permit. Petitioner’s Exhibit AJD at 5. Mr. DeBoy stated that Article 8 incorporates by reference the Recommended Standards for Water Works, commonly referred to as the “Ten State Standards,” which IDEM uses as a reference document during construction permit application review. Petitioner’s Exhibit AJD at 5. According to Mr. DeBoy, the Ten State Standards section 7.1.2.d states that “[a] minimum of two clearwell compartments shall be provided.” He stated that each clearwell needs a pumping configuration to meet system demand. A five-pump configuration provides optimal pumping capacity configurations for the

SIOTC system demands and when one clearwell is out of service. Petitioner's Exhibit AJD at 5–6.

Mr. DeBoy specifically responded to the 2004 Rate Order's identification of additional information necessary to establish the need for the two compartment design:

- **The frequency that the reservoir maintenance occurs** – Mr. DeBoy testified that reservoir maintenance can be categorized as either planned or unplanned. Planned or scheduled inspection and follow-up maintenance would likely occur at a five-year frequency, whereas unplanned maintenance, as its name implies, cannot be predicted with respect to frequency. Petitioner's Exhibit AJD at 6. Mr. DeBoy explained that natural events or structural failures could happen at any time, which is why the Ten State Standards requires the two compartment feature. Indiana American can never know when the unplanned maintenance will occur and so the system must be designed to accommodate such an event. Petitioner's Exhibit AJD at 6.
- **The amount of time necessary to carry out the maintenance of the reservoir** – Mr. DeBoy testified that maintenance event duration is highly variable and that concrete or other structural repairs could be significant and take several days to a few weeks to address. Petitioner's Exhibit AJD at 6–7.
- **The time of year when Petitioner plans to carry out the maintenance of the reservoir** – Mr. DeBoy stated that unplanned maintenance would occur when circumstances necessitate. Planned inspection and maintenance would be scheduled during periods when lower system demand is anticipated, although he noted that high demand can occur unexpectedly. Petitioner's Exhibit AJD at 7.
- **Whether Petitioner could implement the reservoir maintenance during non-peak months** – Mr. DeBoy testified that maintenance needs resulting from unforeseen circumstances may or may not be scheduled during a non-peak system demand. The nature of a maintenance need could require immediate action independent of the time of year or system demand conditions. Petitioner's Exhibit AJD at 7.
- **Whether Petitioner needs five pumps at the SIOTC if the reservoir's maintenance could be implemented during non-peak months** – According to Mr. DeBoy, it cannot be anticipated that all maintenance can occur during non-peak system demand periods. Therefore, the five pump configuration is necessary to provide a reasonable level of redundancy in delivering reliable customer service. Petitioner's Exhibit AJD at 7.

Mr. DeBoy emphasized that Indiana American cannot always schedule outages to coincide with off-peak demand periods because a water utility does not always know when its high demands are going to occur and cannot always schedule infrastructure and treatment equipment removal from service during a time when higher demands will not occur. Petitioner's Exhibit AJD at 7. In addition, equipment sometimes fails at unexpected, inconvenient times.

Petitioner's Exhibit AJD at 7–8. If such an event were to occur, Indiana American would be forced to take action to limit the water use of its customers because it would be unable to meet peak demands. Petitioner's Exhibit AJD at 8.

Mr. DeBoy stated that another significant problem is that Indiana American can never know for sure when high demands will occur. For example, the Shelbyville System experienced a peak demand in the middle of February 2007 because of a fire at a large industrial facility. Petitioner's Exhibit AJD at 8. This is typically not a peak demand period for this system and may well have been a reasonable time to take infrastructure off-line for repairs, maintenance, or cleaning. Mr. DeBoy recognized that such scenarios are not the norm, but he stated that customers facing boil water advisories or unavailable water supplies would probably disagree that the savings on their bills justify not having such facilities. Petitioner's Exhibit AJD at 8.

Mr. DeBoy testified that the reservoirs were designed with two pumps on one side and three on the other to afford sufficient flexibility in meeting the wide range of system demands that occur throughout the year. Petitioner's Exhibit AJD at 8. Pumps can be sized to produce different flows and either pump a set amount of water or vary the amount of water pumped (within certain ranges). Based on this analysis, Mr. DeBoy concluded that all three pumps are necessary on the west side of the storage structure.

The three pumps drawing water from the storage structure's west pumping well are necessary because using any two of the pumps on this side results in flows 4.7 to 3.7 MGD less than the maximum day demand of 21.7 MGD. Mr. DeBoy provided the pump combination capacities measured on June 5, 2007. The capacity of the three pumps on the west reservoir is between 21–22 MGD, while different combinations of two pumps produce a capacity of 16–18 MGD. He then concluded that three pumps are necessary on the west pumping well and noted that the two pumps on the east side of the reservoir produce a combined output of approximately 20 MGD.

(b) OUC's Position. Roger A. Pettijohn, a Senior Utility Analyst for the OUC's Water/Wastewater Division, maintained that the Petitioner does not need to have five high service pumps at the SIOTC. Public's Exhibit No. 6 at 6. Mr. Pettijohn noted that the issue of excess capacity at the SIOTC was first raised by the OUC in Cause No. 42520. Assuming a peak demand of approximately 22 MGD at the SIOTC, the Commission stated in that Cause that with the largest pump out of service, the remaining four pumps could pump 37.7 MGD.

Mr. Pettijohn noted that the crux of Mr. DeBoy's testimony in this Cause is his assertion that with either of the two cells out of service the remaining cell of the clearwell must be able to meet peak demand. Mr. Pettijohn testified that Petitioner cites no requirement or standard that a utility must be able to meet peak demand from one cell of a clearwell. Mr. Pettijohn stated that according to the Ten States Standards, when any pump is out of service a utility's remaining pump or pumps shall meet peak demand. Public's Exhibit No. 6 at 6–7. Mr. Pettijohn also acknowledged that bifurcating a clearwell of this size makes sense. Public's Exhibit No. 6 at 8. However, Mr. Pettijohn disagreed with a suggestion that there is a requirement that each individual cell of a bifurcated clearwell must meet peak day demand.

Mr. Pettijohn further noted that based on Petitioner's peak demand of 21.7 MGD, the

Petitioner's other cell, the east cell, could not meet a peak day demand since it has a pumping capacity of only 20 MGD. Mr. Pettijohn noted, however, that there has not been any suggestion in this Cause or earlier Causes that Indiana American has failed to meet any standard with respect to the east cell. Thus, Mr. Pettijohn maintained it is not necessary for either cell to provide peak day capacity while the other is out of service. Public's Exhibit No. 6 at 6–8.

Mr. Pettijohn then described generally how Petitioner's clearwell would be maintained. Mr. Pettijohn stated that Indiana American's clearwell is normally in-service and is rarely taken out of service except for cleaning or inspection; thus the cells should be thought of as one unit normally in operation. Public's Exhibit No. 6 at 8. Mr. Pettijohn stated that maintenance in the form of cleaning or inspection would take place during low production periods such as winter months or on a weekend. He added that clearwells can be readily taken out of service and put back into service. Public's Exhibit No. 6 at 8. Mr. Pettijohn further stated that, in the unlikely event of sudden demand during a time when one of the cells is out of service such as with a major fire or main break (*e.g.*, a major fire or main break), the elevated storage tanks would provide a reserve until such time as the cell could be put back on line and service normalized. Public's Exhibit No. 6 at 8–9.

During cross-examination by Petitioner, Mr. Pettijohn acknowledged that the design of the clearwell was appropriately bifurcated given its size. Mr. Pettijohn also acknowledged that IDEM would have approved the plans for the SIOTC prior to its construction. (Tr. At F-43–44). During redirect by the OUCC, Mr. Pettijohn noted that the clearwell had been designed to hold only four high service pumps. (Tr. at F-45–46). Based upon Mr. Pettijohn's recommendations, the OUCC reduced utility plant by \$753,378 and accumulated depreciation by \$479,192 for a net reduction to rate base of \$274,186. Public's Exhibit No. 1 at 16.

(c) Petitioner's Rebuttal. Mr. DeBoy clarified that Mr. Pettijohn was not challenging the need for two clear water reservoirs at SIOTC. Mr. Pettijohn's criticism related to whether the isolation of one side of the reservoir would be necessary during high demand events. His criticism also related to whether the design of the clearwell reservoir with pumps that allow either side to independently approximate the peak system demands is unnecessary and imprudent. Petitioner's Exhibit AJD-R at 13.

Mr. DeBoy testified that the OUCC's proposal is flawed because a water utility does not always know when its high demands are going to occur and cannot always perform infrastructure maintenance and repairs during a low demand period. Petitioner's Exhibit AJD-R at 13. Mr. DeBoy stated that Mr. Pettijohn asks Indiana American to assume that it will never be necessary to drain one of the reservoir compartments during a time of high demand, which is a gamble. If he is wrong, Indiana American will be forced to take action to limit the water use of its customers because it will be unable to satisfy demands. Petitioner's Exhibit AJD-R at 13.

Mr. DeBoy disagreed with Mr. Pettijohn's assertion that the elevated storage tanks would provide a reserve if one of the clearwells had to be removed from service during a peak period. Mr. DeBoy explained that Mr. Pettijohn is assuming that distribution system storage can be utilized for conditions for which it was not designed without risk to the system. Petitioner's Exhibit AJD-R at 14–15. Distribution system water storage is designed with fire protection and equalization in mind, not in meeting demand if one of the clearwells is out of service. While Mr.

DeBoy stated that the system might be able to handle this type of stress for a short period of time, Mr. Pettijohn's implicit assumption that one of the two clearwells would only be out of service for a short period of time is unrealistic. Petitioner's Exhibit AJD-R at 15. Mr. DeBoy explained that structural repairs and disinfecting the clear water reservoir after maintenance may take the reservoir out of service for between forty-eight hours to a week or more. Petitioner's Exhibit AJD-R at 15.

Mr. DeBoy agreed that the Ten State Standards does not contain an explicit statement that each of the clearwell reservoirs must be able to meet maximum day demand, but he believed installing pumps that allowed each reservoir to independently meet the approximate maximum demand was consistent with the redundancy contemplated in the Ten State Standards. Petitioner's Exhibit AJD-R at 16. According to Mr. DeBoy, the concept of redundancy embodied in the Ten State Standards is to ensure that failure of a critical system does not result in a shortage of supply; the clearwell is one of the critical components in assuring adequate service. Petitioner's Exhibit AJD-R at 17. Mr. DeBoy stated that the redundancy built into the Ten State Standards is not intended for instances of planned maintenance like cleanings or inspections, but rather are intended to protect against loss of supply during unforeseen events or repairs that are too lengthy or immediate to be planned around non-peak periods. Petitioner's Exhibit AJD-R at 17-18.

Mr. DeBoy disagreed with Mr. Pettijohn that clearwells can be readily taken out of service and put back into service. He testified that Mr. Pettijohn provided no support for this statement and it is simply not true. For example, repairing a leak in a clearwell would not allow the clearwell to be readily taken out of service and returned to service. Petitioner's Exhibit AJD-R at 18. The repair could take several weeks, and refilling the clearwell before the repair is complete could require the work to be redone or put the clearwell at risk of further damage.

Finally, Mr. DeBoy explained the considerations that factored into installing three pumps to serve the west clearwell reservoir. He noted the three pumps provided flexibility in varying the amount of flow from the SIOTC based upon the wide range of system demands that occur throughout the year. Petitioner's Exhibit AJD-R at 18. Mr. DeBoy again pointed to the June 5, 2007 pump combination capacities and stated that any two of the pumps acting together fall short of the maximum day demand making all three pumps necessary on the west side of the storage structure. Mr. DeBoy stated that Mr. Pettijohn's proposal to remove one of the pumps is completely arbitrary because he does not explain why he believes two pumps per clearwell, regardless of their capacity, is appropriate. Petitioner's Exhibit AJD-R at 19. Mr. DeBoy further stated that Mr. Pettijohn's testimony lacks any discussion of the capacity he believes would be appropriate or the design he believes the Company should have used.

(d) Commission Discussion and Findings. In the Commission's Final Order in Cause No. 42520, we reduced Indiana American's rate base by \$753,378 and accumulated depreciation by \$232,248 as a result of excess capacity at the SIOTC. In that Cause, the OUCC maintained that Petitioner had an excess pumping capacity of 15.7 MGD with the largest pump out of service because it had five pumps and need only four. Indiana American testified that design and construction characteristics at the SIOTC warranted the use of five pumps so that Petitioner could meet its peak day demand with one clearwell out of service. Therefore, the Commission focused on whether Indiana American's two-compartment clearwell

system at the SIOTC was used and useful and listed the type of information needed to make that determination.

In this Cause, Petitioner provided information in response to the questions contemplated by the Commission in the 2004 Rate Order to support the contention that the two clearwell design at the SIOTC is necessary to meet peak day capacity. However, Indiana American focused on the bifurcated design of the clearwell only. The Commission notes that no party opposed the basic design of the clearwell. The issue in this Cause is whether the bifurcated clearwell design *with five pumps* is used and useful.

In his testimony, Mr. DeBoy provides various hypothetical situations where he asserts that the redundant pumping capacity would prove to be reasonable. Mr. DeBoy testified concerning the occurrence of planned and unplanned maintenance. As a result of the unpredictability of outages and demand levels, Mr. DeBoy concluded that the two well configuration and five pumps are necessary at the SIOTC.

The Commission agrees with Indiana American and the OUCC that the bifurcated well design is necessary at the SIOTC. The Commission also agrees with the OUCC that Indiana American has failed to prove that the five pump design is necessary. Specifically, Petitioner has failed to prove that the fifth pump is used and useful at the SIOTC at this time. As noted by Mr. Pettijohn and acknowledged by Mr. DeBoy, neither the Ten State Standards nor the IDEM regulations required the installation of the fifth pump at the SIOTC. Mr. Pettijohn also noted that his review of documents provided by Petitioner indicated that the SIOTC plans provided for four high service pumps, not the five currently in place.

No standard or regulation cited by Indiana American and the OUCC require that both cells be able to independently meet maximum day demand. Even if both cells were required to independently meet peak day demand, the Commission notes that the fifth pump serves the west cell only. Therefore, Petitioner would fail to meet this requirement when its west cell is out of service since the east well has pumping capacity of 20 GPD, 1.7 GPD less than the peak day demand.

The data provided to support the necessity of the fifth pump discussed pumping capacities for only the west well and for only one day—June 5, 2007. In addition, Petitioner failed to explain whether the measured flow data was the result of peak demand or simply pump testing. If the data provided was the result of peak flows and the duration of the flows was short, elevated tank storage could have provided sufficient reserve capacity, as suggested by Mr. Pettijohn. Information specific to the SIOTC such as design operating points utilizing the combination of standard drives and variable frequency drives, the specific events that different pumping configurations are designed to meet, and the specific pumping configurations used to meet the different demand levels that occur would have been helpful in determining the fifth pump's necessity. Without more specific and actual information and data, the Commission is unable to determine that fifth pump at the SIOTC is used and useful.

For the foregoing reasons, the Commission reaffirms our prior finding that Petitioner's SIOTC has excess capacity that should not be considered used and useful in the provision of water service and therefore should be excluded from rate base at this time.

(2) Muncie Meter Replacement.

(a) OUCC's Position. Margaret A. Stull, a Utility Analyst in the OUCC's Water/Wastewater Division, recommended that the Commission exclude 50% of the costs associated with purchasing new meters in the Muncie District. Public's Exhibit No. 1 at 17. Ms. Stull explained that the Commission in Cause No. 42520 agreed with the OUCC regarding Petitioner's meter replacement policy in the Muncie District and excluded 50% of the costs associated with purchasing new meters during calendar years 2002 and 2003. Public's Exhibit No. 1 at 17. Ms. Stull therefore reduced utility plant by \$193,000 and accumulated depreciation by \$150,748 for a net reduction to rate base of \$42,252.

(b) Petitioner's Rebuttal. In rebuttal, Petitioner's Witness Gary M. VerDouw explained that this adjustment was originally made because the OUCC disputed the meter replacement timeline that the Petitioner was using relative to meters changed out in the Muncie District in 2002 and 2003. Petitioner's Exhibit GMV-R at 5. Mr. VerDouw stated that these meters are in service and are used and useful and are providing a very necessary service to Indiana American. He explained that meters enable Petitioner to bill its customers in the Muncie district correctly. Mr. VerDouw noted that no witness submitted testimony disputing inclusion of these meters in Petitioner's last rate case, Cause No. 43187. However, Mr. VerDouw added that the OUCC's proposed adjustment is immaterial and its impact on Petitioner's revenue requirement would be small. Petitioner's Exhibit GMV-R at 5.

(c) Commission Discussion and Findings. Petitioner has asked the Commission to depart from our decision in Cause No. 42520 with respect to the Muncie Meters. However, Indiana American did not provide an adequate explanation of what new facts have been developed that should lead to a different conclusion. Accordingly, the Commission accepts the OUCC's proposed disallowances.

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

<u>Utility Plant In Service:</u>	
Utility Plant in Service as of 12/31/08	\$ 970,603,177
Net Additions January - June, 2009	89,900,952
Major Project Additions After 6/30/09	15,440,000
Capitalized Tank Painting	346,651
Deferred Depreciation	3,669,204
Post-in-Service AFUDC	5,577,073
Less: Southern Indiana Pump	753,378
Less: Muncie Meters	193,000
Total Utility Plant in Service	<u>1,084,590,679</u>
<u>Accumulated Depreciation</u>	
Utility Plant in Service	272,176,156
Plant in Service - Amortization	45,229
Capitalized Tank Painting	301,790
Deferred Depreciation	1,090,305
Post-in-Service AFUDC	1,795,845
Less: Southern Indiana Pump	479,192
Less: Muncie Meters	150,748
Total Accumulated Depreciation	<u>274,779,385</u>
Net Utility Plant in Service	<u>809,811,294</u>
<u>Deductions</u>	
CIAC	90,320,116
Accum. Amortization of CIAC	-
Customer Advances for Construction	65,990,888
Somerset Capacity Adjustment (Cause No. 36448)	178,005
Total Deductions	<u>156,489,009</u>
<u>Additions</u>	
Acquisition Adjustment (net)	586,468
Other Regulatory Deferrals	-
Materials and Supplies (13 mo. avg.)	2,023,764
Total Additions	<u>2,610,232</u>
Total Original Cost Rate Base	<u>\$ 655,932,517</u>

**C. Indiana Cities Acquisition Adjustment.**

(1) Petitioner's Position. Petitioner's Witness Gary M. VerDouw reviewed the history of the Commission's ratemaking treatment with respect to the investment made by Indiana American to acquire Indiana Cities Water Corporation ("Indiana Cities") and the

resulting acquisition adjustment. Mr. VerDouw stated that on August 31, 1993, Indiana American acquired the common stock of ICWC Holdings Inc. (“ICWC”), which owned all of the common stock of Indiana Cities. Petitioner’s Exhibit GMV at 40. ICWC was subsequently dissolved, making Indiana Cities a direct subsidiary of Indiana American. Indiana American’s total investment to acquire Indiana Cities was \$37,072,008. The book value of Indiana Cities’ common equity at the acquisition date was \$19,659,999. The difference between the investment to acquire Indiana Cities and the book value of Indiana Cities was \$17,412,009, which was recorded on Indiana American’s balance sheet as an acquisition adjustment (“Indiana Cities AA”). Petitioner’s Exhibit GMV at 40–41.

Mr. VerDouw next summarized the Commission’s ratemaking treatment of the Indiana Cities AA through four litigated rate cases subsequent to the acquisition. Petitioner’s Exhibit GMV at 41–48. All four Orders were included in the list of those of which we took administrative notice. Mr. VerDouw explained that the Commission has ordered a treatment for the Indiana Cities AA that (a) provides Indiana American with compensation for its investment to acquire Indiana Cities through a fair value increment over an original cost return through informed fair value ratemaking, (b) excludes the annual amortization of the Indiana Cities AA from the Company’s recoverable expenses, and (c) excludes the Indiana Cities AA from the interest synchronization calculation used to determine income tax expense. Petitioner’s Exhibit GMV at 49. Mr. VerDouw stated that he has computed and reflected in this case a fair value increment consistent with the treatment provided in Cause Nos. 40103, 40703, 42029, and 42520. The amount of the fair value increment has been thus calculated at \$991,468. Petitioner’s Exhibit GMV at 49.

(2) OUCC’s Position. The Commission notes that as a result of a review of the OUCC’s submitted schedules, the OUCC included the Indiana Cities AA in its calculation of Petitioner’s revenue requirement. The OUCC did not dispute the inclusion of a fair value increment in Indiana American’s revenue requirement, but the OUCC included \$822,377 for Petitioner’s fair value increment, which is \$169,090 less than Petitioner’s request (\$991,467 - \$822,377 = \$169,090). The difference is attributed to the weighted costs of capital used by the OUCC and Petitioner to calculate the fair value increment.

(3) Industrial Group’s Position. Industrial Group Witness Michael P. Gorman did not dispute the manner of calculating the fair value increment of \$991,468, but he recommended that the Commission now depart from past practice by no longer including it in Indiana American’s cost of service in this case and from this point forward. Industrial Group’s Exhibit No. 2 at 68. Mr. Gorman argued that this adjustment is tied to the difference between the fair value of rate base and the original cost rate base for the Indiana Cities districts. Mr. Gorman also stated that the original cost rate base that existed at the time of the 1993 acquisition no longer reflects the original cost rate base for service today in these districts. Industrial Group’s Exhibit No. 2 at 68. Mr. Gorman noted that the original cost of the utility assets have been depreciated over the sixteen-year period following the acquisition and that additional capital additions and improvements have almost certainly been made to these districts over this same time period. Industrial Group’s Exhibit No. 2 at 68.

Thus, opined Mr. Gorman, those capital additions and cost recoveries have significantly altered the plant that was originally purchased relative to the cost of service and plant providing

service to that district today. Industrial Group's Exhibit No. 2 at 69. Furthermore, Mr. Gorman stated that Petitioner's financial statements indicate that it has recorded substantial impairment charges over the last several years, which Mr. Gorman suggested was the financial reporting equivalent to a ratemaking acquisition adjustment. Industrial Group's Exhibit No. 2 at 69. Because the Company has been writing off its goodwill assets, Mr. Gorman testified that an acquisition adjustment related to Indiana Cities' acquisition sixteen years ago is no longer appropriate. Industrial Group's Exhibit No. 2 at 69.

(4) Petitioner's Rebuttal. In rebuttal, Petitioner's Witness VerDouw testified that Mr. Gorman ignores the Commission's purpose for adopting the treatment which has been in place since the Commission's 1996 Rate Order and fails to cite persuasive reasons for eliminating the regulatory treatment of the Indiana Cities AA. Petitioner's Exhibit GMV-R at 49–50. Mr. VerDouw stated that as a result of the 1996 Rate Order, Indiana American was able to recognize its entire investment in rates through its fair value rate base; the issue of confiscation did not need to be addressed. In addition, the 1996 Rate Order permitted Petitioner to be compensated for its investment using the fair value in its fair value rate base determination. Petitioner's Exhibit GMV-R at 50.

Mr. VerDouw testified that there have been no regulatory changes that would warrant Mr. Gorman's proposed elimination of this regulatory treatment. Petitioner's Exhibit GMV-R at 50–51. Mr. VerDouw stated that the acquisition adjustment for the 1993 purchase of ICWC is being amortized at a rate that will have the acquisition adjustment fully amortized forty years after the August 31, 1993 purchase. Mr. VerDouw further stated that accumulated amortization was taken into consideration when calculating the fair value increment on the Indiana Cities acquisition, as shown on Petitioner's Exhibit GMV-1 Schedule 4. Petitioner's Exhibit GMV-R at 51. According to that schedule, the fair value increment was calculated by taking the acquisition adjustment relative to the 1993 purchase of Indiana Cities, less accumulated amortization, times the rate of return proposed by Indiana American. The end result of that calculation is a fair value increment for the Indiana Cities acquisition in the amount of \$991,468. Petitioner's Exhibit GMV-R at 51.

Mr. VerDouw next responded to Mr. Gorman's assertion that the acquisition adjustment is no longer necessary in light of capital additions made since the acquisition. While Mr. VerDouw agreed that there have been capital additions made since 1993, he noted that the Reproduction Cost New Less Depreciation ("RCNLD") Study that was included as Petitioner's Exhibit SSH-1 Schedule 1 in this case provides many examples of assets in place that predate the Indiana Cities acquisition. Petitioner's Exhibit GMV-R at 52. Mr. VerDouw stated that those assets are fully functional and provide a needed service to the customers of Indiana American. According to Mr. VerDouw, Mr. Gorman is essentially asking the Commission to exclude recovery of an asset that has seen approximately 40% of its amortized life. Indiana American continues to incur capital costs associated with the debt and equity funds used to acquire ICWC. Petitioner's Exhibit GMV-R at 52. Therefore, Mr. VerDouw did not agree with Mr. Gorman's position.

Mr. VerDouw next responded to Mr. Gorman's point regarding "substantial" impairment charges that American Water Works Company, Inc. ("American Water") and Indiana American have recorded over the years. Mr. VerDouw first stated that it is unclear what Mr. Gorman

considers “substantial.” Petitioner’s Exhibit GMV-R at 53. Mr. VerDouw acknowledged that American Water did record impairment charges on its books relative to the initial public offering (“IPO”) of American Water by RWE in April of 2008. But, as Mr. James Kalinovich, Treasurer of American Water and American Water Capital Corp. (“AWCC”), stated during cross-examination, the impairment charges relative to the RWE IPO of American Water had nothing to do with Indiana American’s value. Petitioner’s Exhibit GMV-R at 53–54. Additionally, Indiana American agreed that it would not seek any ratemaking treatment relative to the RWE purchase, so those impairment charges do not have any bearing on this case.

Mr. VerDouw disagreed with Mr. Gorman’s use of “substantial” to describe the impairment charges recorded on Indiana American’s financial statements. Petitioner’s Exhibit GMV-R at 54. Indiana American recognized an impairment charge in 2005 relative to capitalized software costs that were denied rate base treatment by the Commission, but that charge has nothing to do with the Indiana Cities AA, as Mr. Gorman asserted. Further, Mr. VerDouw stated that the Notes to Indiana American’s Audited Financial Statements as of December 31, 2008 and 2007 regarding Long Lived Assets and Goodwill make it clear that Indiana American’s goodwill assets do not relate to the Indiana Cities AA and are not being written off in any event, as Mr. Gorman suggested. Petitioner’s Exhibit GMV-R at 54–55. Mr. VerDouw maintained that the acquisition adjustment relative to ICWC’s acquisition sixteen years ago remains appropriate and should continue to be recognized for regulatory purposes as it always has been.

Finally, Mr. VerDouw responded to Mr. Gorman’s claim that goodwill assets are the financial reporting equivalent to a ratemaking acquisition adjustment. Mr. VerDouw stated that this testimony reveals a fundamental misunderstanding of the difference between goodwill and an acquisition adjustment. Petitioner’s Exhibit GMV-R at 55. Mr. VerDouw explained that an acquisition adjustment is recorded to reflect the difference between the purchase price and the net original cost of the assets to the seller. Conversely, goodwill is the difference between the purchase price and the fair market value of the assets acquired. In other words, explained Mr. VerDouw, goodwill is recorded to reflect that there is some inherent value in a business that is acquired, which is higher than simply the value of the assets themselves. Petitioner’s Exhibit GMV-R at 55. In the Indiana Cities AA, there was no goodwill recorded because the purchase price did not exceed the fair market value of the assets. Mr. VerDouw stated that Mr. Gorman’s entire testimony about goodwill impairment as related to Indiana Cities AA is a product of his failure to grasp and understand this fundamental difference between an acquisition adjustment and goodwill. Petitioner’s Exhibit GMV-R at 55–56. Mr. VerDouw concluded by stating that goodwill is not the financial reporting equivalent to an acquisition adjustment.

(5) Commission Discussion and Findings. The Industrial Group in this Cause argued that the Indiana Cities AA is no longer appropriate. In the 1996 Rate Order, 1997 Rate Order, 2002 Rate Order, and 2004 Rate Order, the Commission addressed the Indiana Cities AA. In each case, the Commission allowed Petitioner a full return on the Indiana Cities AA net of amortization through informed fair value ratemaking and a resulting fair value increment.

The two issues before the Commission with respect to the Indiana Cities AA are 1. whether Petitioner should be allowed to earn a return on the amount of the investment made to acquire Indiana Cities by including the acquisition adjustment in Indiana American’s rate base

(upon which Petitioner is allowed to earn a return) and 2. whether Petitioner should be allowed to recover its investment gradually over time by including the annual amortization of the acquisition adjustment as an allowable expense for ratemaking purposes. Indiana American proposed to include the Indiana Cities AA in its original cost rate base and be reflected above-the-line.

On pages 4–15 of the 1996 Rate Order, the Commission summarized the evidence presented. The Commission also engaged in a lengthy discussion of that evidence and the factors and issues to be considered when determining whether the acquisition adjustment should receive favorable ratemaking treatment. The Commission found that the purchase of Indiana Cities was made at arm’s length. 1996 Rate Order at 13. The Commission also stated, “Based on the evidence presented, we find that the purchase price was reasonable and appropriate to include in [Indiana American’s] fair value rate base. . . .Here, we have given [Indiana American] authority to recognize 100% of its investment in rates through its fair value rate base.” 1996 Rate Order at 15. The Commission emphasized its finding when it stated, “Finally, the Commission has found that Petitioner can and should be compensated for its investment in the Indiana Cities properties through informed fair value ratemaking by fully recognizing their fair value in its fair value rate base determination.” 1996 Rate Order at 49. The Commission also found that the Indiana Cities AA should not be amortized above-the-line and not treated as a recoverable expense. 1996 Rate Order at 15.

In the 1997 Rate Order, the Commission confirmed its position taken in the 1996 Rate Order with respect to Indiana American’s compensation for the Indiana Cities AA. The Commission discussed the Commission’s findings made in the 1996 Rate Order, including the language quoted in the previous paragraph. The Commission noted that in Cause No. 40103, Indiana American presented significant evidence concerning the considerable cost savings realized as a result of the acquisition and the capital invested by Indiana American. The Commission then stated:

Under informed fair value ratemaking, Indiana American will be compensated for that investment by recognition of the full amount of the purchase price in the fair value rate base. Indiana American continues to incur the capital costs associated with the debt and equity funds used to acquire Indiana Cities. We must also continue to grant a fair value return increment which provides that compensation, an issue we shall discuss in more detail later.

1997 Rate Order at 30. The Commission permitted Indiana American to include the Indiana Cities AA in its fair value rate base. 1997 Rate Order at 40.

The inclusion of the Indiana Cities AA in Petitioner’s fair value rate base was not disputed in Cause No. 42029 and, therefore, the inclusion or alteration of the Indiana Cities AA was not addressed in the 2002 Rate Order. The Commission included in the 2002 Rate Order a fair value increment for the Indiana Cities AA based on the net of the accumulated amortization. 2002 Rate Order at 13. In the 2004 Rate Order, the Commission allowed a return on the net amortized balance of the Indiana Cities AA and included it in rate base, but the annual amortization was included as a below-the-line adjustment. 2004 Rate Order at 38.

Thus, the Commission has consistently found that Indiana American should be afforded a complete and full opportunity to earn a return commensurate with 100% of its costs to acquire and merge with Indiana Cities. The Commission has granted the fair value increment because the purchase price was fair, reasonable, and negotiated at arm's length and because the acquisition produces benefits to this day that exceed the costs. Nothing with respect to that determination has changed, and the OUCC and Industrial Group do not contend otherwise. The current value of the Indiana Cities assets is immaterial to the Commission's previous determinations that Indiana American may recover its 1993 investment in Indiana Cities over a forty-year period. Accordingly, the Commission finds that a fair value increment for the Indiana Cities AA should continue to be included in Petitioner's revenue requirement consistent with our findings in the 1996 Rate Order, 1997 Rate Order, 2002 Rate Order, and 2004 Rate Order.

**D. Reproduction Cost New Less Depreciation.**

(1) Petitioner's Position. Petitioner's Witness Stacy Hoffman sponsored a study and analysis of the Reproduction Cost New ("RCN") and RCNLD of the Company's utility plant and equipment used in providing service to the public. Petitioner's Exhibit SSH at 22, Petitioner's Exhibit SSH-1. Mr. Hoffman expressed the opinion that Indiana American's plant and systems are in a good state of operating condition, are well maintained, and are used to provide utility service to the public. Petitioner's Exhibit SSH at 24.

RCNLD refers to the estimated cost of reproducing existing facilities at current costs, adjusted for the loss in service value (depreciation) reflected in their current condition. Petitioner's Exhibit SSH at 24. The calculation of RCNLD is a two-step process. Mr. Hoffman first determined the cost of constructing, purchasing, or manufacturing new property that is substantially the same as the old property using costs at or about the time of the study. Petitioner's Exhibit SSH at 24. This is the RCN portion of the study. The second step is to determine the percent condition of the property. Percent condition measures the amount of the property's service value that has not been lost due to physical depreciation. The percent condition is then multiplied by the RCN, resulting in the RCNLD, which is a net cost recognizing both the current costs of reproducing the property and the loss of service value of the existing property due to depreciation in the form of wear and tear, obsolescence, and lack of utility. Petitioner's Exhibit SSH at 24.

Mr. Hoffman testified that the purpose of a RCNLD study is to assess the cost to reproduce the existing utility plant in service based on current material and equipment prices and current construction and wage levels. Petitioner's Exhibit SSH at 25. Mr. Hoffman stated that the original cost of a well-planned facility is representative of its value at the time of construction, but the original cost of plant constructed in the past is generally not representative of the RCN or RCNLD due to changes in unit costs caused by inflation and changes in construction practices. Petitioner's Exhibit SSH at 25.

Mr. Hoffman indicated that he used the Trended Original Cost method, as opposed to the Unit Price method, to determine the RCN of Petitioner's property. Petitioner's Exhibit SSH at 25–26. According to Mr. Hoffman, the Trended Original Cost method is significantly less costly to perform than the Unit Price method and produces a reasonable result. Petitioner's Exhibit SSH at 26. He believed that the Company's accounting records provide the necessary detail as

to original cost by account, sub-account, and vintage year for a Trended Original Cost study. In Mr. Hoffman's opinion, the Trended Original Cost method is reasonable and appropriate for determining the RCN of Indiana American's property. Petitioner's Exhibit SSH at 26. Mr. Hoffman further compared the results of the RCN against his knowledge of construction costs in the Indiana area and concluded that the index data is valid and reasonable. Petitioner's Exhibit SSH at 26.

The primary source of the trend factors used in Mr. Hoffman's study was the Handy-Whitman Index of Public Utility Construction Costs for Water Utilities located in the North Central United States ("Handy-Whitman Indexes"). Mr. Hoffman stated that he also used an index published by the U.S. Bureau of Labor Statistics for some accounts. Petitioner's Exhibit SSH at 26. Mr. Hoffman believed that the Handy-Whitman Indexes are reasonable to use for estimating RCN because they are designed for that purpose. Petitioner's Exhibit SSH at 27. The Handy-Whitman Indexes have been published continuously since 1924 and are well-recognized around the country as suitable for determining the RCN of utility property. Petitioner's Exhibit SSH at 28. Furthermore, Mr. Hoffman noted that for many years, Petitioner has calculated the RCN of its utility property using the Trended Original Cost method by means of the Handy-Whitman Indexes and has found the result to be a reasonable and conservative estimate of the cost to reproduce the property at current price levels. Petitioner's Exhibit SSH at 28. Mr. Hoffman's study included land at its original cost because of the expense of obtaining separate land appraisals. Mr. Hoffman stated that this is a conservative assumption. Petitioner's Exhibit SSH at 29.

Mr. Hoffman determined the RCNLD by deducting from the RCN depreciation necessary to reflect the current condition of the property. Petitioner's Exhibit SSH at 32–33. Mr. Hoffman calculated the percent condition of Indiana American's property to be 74.33. Petitioner's Exhibit SSH-1, Schedule 1, p. 4, Petitioner's Exhibit SSH at 33. This ratio reflects the inverse of the depreciation reserve divided by the plant investment as of June 30, 2009. Petitioner's Exhibit SSH at 33. Mr. Hoffman's study quantified the RCNLD of Petitioner's used and useful utility plant in service as of June 30, 2009 as not less than \$1,855,648,769. Petitioner's Exhibit SSH at 33, Petitioner's Exhibit SSH-1. Mr. Hoffman stated that his valuation does not include materials and supplies, capitalized tank painting, post in-service AFUDC, or deferred depreciation. Petitioner's Exhibit SSH at 33–34.

Mr. Hoffman's study also includes a calculation of the Trended Cost Adjusted for Technological Change. Petitioner's Exhibit SSH at 29. Mr. Hoffman computed the weighted average age of plant and equipment in the study based upon the RCNLD values, arriving at a weighted average age of fourteen years. Petitioner's Exhibit SSH at 29–30. Per Petitioner's Witness Paul R. Moul's request, the adjustment uses a productivity factor of 2.5% as the estimate of productivity gains. The results of this adjustment are identified on Petitioner's Exhibit SSH-1, Schedule 1 as "Trended Cost Adjusted for Technological Change." As shown in Mr. Hoffman's study, the total Trended Cost Adjusted for Technological Change amount is \$1,012,747,879.

(2) OUC's Position. OUC Witness Stull testified that historically Petitioner has presented a RCNLD study as evidence in support of its fair value rate base, including its last ten rate cases. Public's Exhibit No. 1 at 14. Ms. Stull noted that while Mr. Hoffman testified on page three of his testimony that he presents "the Company's [RCNLD

Study] for purposes of supporting the fair value of the Company's property," Mr. Hoffman does not state that the RCNLD study should be considered as the fair value of Petitioner's rate base figure. Public's Exhibit No. 1 at 14. Ms. Stull testified that Mr. Hoffman calculated a RCNLD figure of \$1,855,648,769, which Ms. Stull said included plant contributed to Indiana American that is treated as CIAC for accounting purposes and is not considered by the Commission when determining rate base. Public's Exhibit No. 1 at 14.

Ms. Stull emphasized that Petitioner did not use the RCNLD study to determine Petitioner's fair value rate base and that Petitioner's Witness Edward J. Grubb acknowledged that the Commission did not use the RCNLD studies in past cases to derive the fair value rate base. Public's Exhibit No. 1 at 14. Ms. Stull recommended that the Commission not give the RCNLD study any more weight in determining Petitioner's fair value rate base than it has in prior cases. Public's Exhibit No. 1 at 14–15.

(3) Petitioner's Rebuttal. In rebuttal, Petitioner's Witness VerDouw testified that, as Mr. Grubb testified in the case-in-chief, the fair value of Petitioner's properties is equal to the RCNLD adjusted for technological change. Petitioner's Exhibit GMV-R at 52. While Ms. Stull recommended that the Commission give no greater weight to the RCNLD study than it typically does in a rate case, Mr. VerDouw opined that the Commission must consider the RCNLD and has in the past considered Indiana American's RCNLD studies. Petitioner's Exhibit GMV-R at 53. Mr. VerDouw expected that the Commission would consider the RCNLD study just as it has in the past.

(4) Commission Discussion and Findings. The Commission has long taken RCNLD studies into consideration in setting rates. As we have previously noted, "This Commission has routinely accepted RCNLD studies into the record and considered [them] as evidence in support of Petitioners' fair value." S. Haven Sewer Works, Inc., Cause No. 41903, p. 2 (IURC 6/05/2002). The Indiana Supreme Court and the Indiana Court of Appeals have recognized that RCNLD is one of several reasonable valuation methods that can be used in determining fair value. As the Indiana Supreme Court has said:

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

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

In Indianapolis Water v. Pub. Serv. Comm'n, 484 N.E.2d 635, 638–40 (Ind. Ct. App. 1985), the Indiana Court of Appeals explained that a fair value determination by the Commission is not an either/or proposition between original cost and reproduction cost, but derives from consideration of all legitimate value factors. Indiana Courts, therefore, recognize a number of legitimate valuation methods that the Commission should consider in determining fair value, one of which is the RCNLD method. Indeed, as a matter of law, "reproduction cost new less depreciation cannot be disregarded in fixing a valuation for rate making purposes." Pub. Serv. Comm'n v. City of Indianapolis, 131 N.E.2d 308, 325 (Ind. 1956). The Commission therefore

will give appropriate weight to the RCNLD of Petitioner's utility plant for purposes of our fair value finding.

**E. Update of Prior Fair Value Finding.** Consistent with several past Orders involving Indiana American and other public utilities, Petitioner's Witness Edward Grubb updated the fair value finding from the 2004 Rate Order for inflation that has occurred since the valuation date and for net investor supplied plant additions that would not have been included in that fair value finding. Petitioner's Exhibit EJG at 6. To implement this methodology, Mr. Grubb updated the fair value finding from the 2004 Rate Order of \$663,400,000 for inflation of 2.5% through June 30, 2009 based upon the annual inflation taken from Ibbotson Associate publication Stocks, Bonds, Bills and Inflation 2008 Yearbook ("Ibbotson's Year Book"). Petitioner's Exhibit EJG at 7. Mr. Grubb then added the net investor funded plant additions since Cause No. 42520 to arrive at a total updated fair value estimate of \$945,839,030. Petitioner's Exhibit EJG at 7. Mr. Grubb noted that this procedure is consistent with the procedure used by the Commission in the 1996 Rate Order, the 1997 Rate Order, the 2002 Rate Order, and the 2004 Rate Order.

No party directly disputed Mr. Grubb's calculation. However, the OUCC disputed the inclusion of two items in Petitioner's original cost rate: the fifth pump at the SIOTC for a net reduction of \$274,186 and the Muncie Meters for a net reduction of \$42,252. As discussed previously in this Order, the Commission agrees with the OUCC that these items should be removed from the original cost rate base. Accordingly, these items should also be removed from any fair value rate base determination. Removing these items reduces Petitioner's fair value rate base by \$316,438 ( $\$274,186 + \$42,252 = \$316,438$ ). The Commission finds that Indiana American's total updated fair value estimate should be \$945,522,592.

**F. Ultimate Fair Value Finding.** IC 8-1-2-6 establishes that this Commission shall value a public utility's property at its "fair value." In Indianapolis Water, the Indiana Court of Appeals confirmed that a utility should be entitled to earn a fair rate of return on the fair value of its rate base. Indianapolis Water, 484 N.E.2d at 638-40. Furthermore, in its determination of "fair value" the Commission may not ignore the commonly known and recognized fact of inflation. Id. at 640. The Court of Appeals reaffirmed that holding in City of Indianapolis, stating that "reproduction cost new cannot be disregarded in fixing a valuation for rate making purposes." City of Indianapolis, 131 N.E.2d at 325. The Court of Appeals has more recently confirmed that the Commission must authorize rates that provide the utility with the opportunity to earn a fair return on the fair value of its property. Gary-Hobart Water Corp. v. Office of Util. Consumer Counselor, 591 N.E.2d 649, 653-54 (Ind. Ct. App. 1992), *reh'g denied*; Office of Util. Consumer Counselor v. Gary-Hobart Water Corp., 650 N.E.2d 1201, 1203 (Ind. Ct. App. 1995).

Based on the evidence presented, which includes quantification of the difference between the purchase prices and book values, the reproduction cost new less depreciation of Petitioner's utility properties, the replacement cost less depreciation of Petitioner's utility properties, and an update of the Commission's previous fair value finding for inflation and new additions, the Commission finds that the fair value of Indiana American's utility property used and useful in the provision of utility service is not less than \$945,522,592.

**8. Fair Rate Of Return.**

**A. Cost of Common Equity.**

(1) Petitioner's Position. Mr. Paul R. Moul, Managing Consultant of the firm P. Moul & Associates, presented Petitioner's cost of equity recommendation. Mr. Moul testified that a reasonable cost of equity for Petitioner would be 12.0%. Mr. Moul explained that in analyzing the Company's cost of equity, he relied upon four well-recognized measures: the Discounted Cash Flow ("DCF") model, the Risk Premium Model, the Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings approach. Petitioner's Exhibit PRM at 5–6.

Mr. Moul discussed the risks facing the water utility industry generally and Indiana American specifically. He noted that the business risk of the water utilities has been strongly influenced by water quality concerns and that regulations promulgated by the Environmental Protection Agency and other federal statutes will bear upon the risk of all water utilities. Petitioner's Exhibit PRM at 8. Mr. Moul stated that water companies have experienced increased water treatment and monitoring requirements and escalating costs in order to comply with the increasingly stringent regulatory requirements being added. Water utilities must now also address potential threats from terrorists. Petitioner's Exhibit PRM at 9–10.

Mr. Moul testified that water companies face higher degrees of capital intensity than other utilities, more costly water disposal requirements, and threats to their sources of supply. He indicated that the high fixed costs of water utilities makes earnings vulnerable to significant variations when usage fluctuates with weather, the economy, and customer conservation efforts. Petitioner's Exhibit PRM at 10. In addition, Mr. Moul stated that increased attention to conservation and wise water use can affect the business risk of the water utility industry.

Mr. Moul next discussed some of the specific water utility risk factors that impact the Company. He identified a number of regulations with which the Company must comply, as well as the fact that the Company's investment in net plant is 4.59 times its revenue, as compared to his proxy group's investment in net plant, which is 3.39 times its revenue. Petitioner's Exhibit PRM at 11. He stated that the Company is engaged in a continuing capital expenditure program necessary to meet the needs of its customers and to comply with various regulations. He also stated that the Company's total capital expenditures over the next five years will represent approximately 45% of the net utility plant in service. Petitioner's Exhibit PRM at 12.

Mr. Moul testified about DSICs as a source of revenue for Indiana American. While Mr. Moul acknowledged that the DSIC provides Indiana American with a means to collect from its customers the capital costs associated with non-revenue producing and non-expense reducing investment in distribution facilities, he pointed out that the DSIC does not provide a cash return to the utility on qualifying investments during construction, nor does it eliminate regulatory lag. Petitioner's Exhibit PRM at 12–13. Given the various benefits and limitations surrounding the DSIC, Mr. Moul did not believe that Indiana American's rate of return needed to be adjusted. He noted that the DSIC has become increasingly common in the water utility industry. He added

that it is designed simply to provide Petitioner with the opportunity to achieve the returns that investors expect and the rating agencies require in their credit rating analyses. Petitioner's Exhibit PRM at 13–14. He concluded that the Company is required to invest in new facilities and to maintain and upgrade existing facilities in its service territory, and thus supportive regulation is absolutely essential. Petitioner's Exhibit PRM at 14.

For purposes of his analysis, Mr. Moul used average market data from a proxy group of seven water companies (the “Water Group”). He stated that the use of average data, rather than individual company data, helps to minimize the effect of extraneous influences on the market data for an individual company. Petitioner's Exhibit PRM at 6. According to Mr. Moul, the Water Group companies have the following characteristics: (i) they are listed in the “Water Utility Industry” section (basic and expanded) of the Value Line Investment Survey, (ii) their stock is publicly traded, and (iii) they are not currently the target of a publicly-announced merger or acquisition. Petitioner's Exhibit PRM at 15. He stated that he specifically excluded Southwest Water Company from his Water Group as a result of financial reporting issues that are currently affecting that company.

Mr. Moul next compared Indiana American's financial data with that from the Water Group. Mr. Moul stated that the Company has a higher degree of capital intensity than the Water Group, its common equity is lower thereby displaying more financial risk, its equity returns display more variability, and its interest coverage and returns are lower. Petitioner's Exhibit PRM at 21–22. He further stated that Petitioner has very substantial construction requirements for the future. Based upon his analysis, Mr. Moul concluded that the fundamental risk factors indicated that the Water Group provides a conservative basis for measuring the Company's cost of equity. Petitioner's Exhibit PRM at 22.

Mr. Moul then discussed the results of his DCF analysis. He stated that the DCF methodology requires the use of an expected dividend yield to establish the investor-required cost of equity. Petitioner's Exhibit PRM at 24. For purposes of his analysis, Mr. Moul used the six-month average dividend yield of 3.31% for the Water Group, which he stated represents the six-month average yield and will reflect current capital costs while avoiding spot yields. Petitioner's Exhibit PRM at 24–25. Mr. Moul then adjusted this six-month average dividend yield to reflect growth in dividends during the initial investment period and quarterly dividend payments to arrive at an adjusted dividend yield of 3.43% for the Water Group. Petitioner's Exhibit PRM at 25.

As to the appropriate growth rate, Mr. Moul opined that all relevant growth rate indicators using a variety of techniques must be evaluated when formulating a judgment of investor expected growth. Petitioner's Exhibit PRM at 27. He stated that negative growth rates reflected in historical data provide no reliable guide to gauge investor expected growth for the future and thus should not be given any weight when formulating a composite growth rate expectation. Mr. Moul testified that although ideally historical and projected earnings per share and dividends per share growth indicators would be used to provide an assessment of investor growth expectations for a firm, the circumstances of the Water Group mandate that the greater emphasis be placed upon projected earnings per share growth. Petitioner's Exhibit PRM at 31. He opined that projections of future earnings growth provide the principal focus of investor expectations and represent a reasonable assessment of investor expectations.

Mr. Moul provided projected earnings per share growth rates taken from analysts' forecasts compiled by IBES/First Call, Zacks and from Value Line. He testified that a five-year investment horizon associated with the analysts' forecasts is consistent with the DCF model. Petitioner's Exhibit PRM at 29. The earnings per share growth provides the principal focus of investor expectations and is consistent with the recommendations of Professor Myron Gordon, the foremost proponent of the DCF model in rate cases. In fact, Mr. Moul believed that his focus on five-year growth rates avoids the unrealistic assumption inherent in the infinite form of the DCF model. He stated that if investors really required forecasts which extended beyond five years in order to properly value common stocks, then some investment advisory services would begin publishing that information for individual stocks. Mr. Moul believed that the absence of such a publication signals that investors do not require infinite forecasts in order to purchase and sell stocks in the marketplace. Petitioner's Exhibit PRM at 30. Mr. Moul indicated that the forecasts of earnings per share growth provide a range of growth rates from 8.45% to 9.42%. He concluded that his use of an investor-expected growth rate of 7.50% is a conservative representation of the analysts' growth rate forecasts. Petitioner's Exhibit PRM at 32.

Mr. Moul made two adjustments to his DCF results: a leverage adjustment and a flotation cost adjustment. Mr. Moul stated that a leverage adjustment is necessary if book values are used to compute the capital structure ratios. Petitioner's Exhibit PRM at 33. If regulators rely upon the results of the DCF (which are based on the market price of the stock of the companies analyzed) and use those results in computing the weighted average cost of capital with a book value capital structure, those results will not reflect the degree of financial risk associated with the capital structure shown by the market capitalization. Petitioner's Exhibit PRM at 33. His leverage adjustment is computed by comparing the cost of equity at book value for an unleveraged company to its cost of equity at market value.

Mr. Moul testified that the Pennsylvania Public Utility Commission recognized this shortcoming of the DCF model and approved specific adjustments to recognize this risk difference in a number of water utility cases. He explained that his leverage adjustment is developed through precise mathematical calculations, using well-recognized analytical procedures that are widely accepted in the financial literature. Petitioner's Exhibit PRM at 33–35. Mr. Moul testified that his adjustment was not in any way related to a transformation of the return designed to address the market-to-book ratio, but rather was a convenient way to identify the adjustment in terms of the simple DCF model when applied to the capital structure used in ratemaking. Based on his calculation, Mr. Moul concluded that the appropriate leverage adjustment for the Indiana American was 1.02%. Petitioner's Exhibit PRM at 36–37.

Mr. Moul's DCF model produced a cost of capital for the Company of 12.19%, based upon an adjusted dividend yield of 3.43%, a projected growth rate of 7.50%, a leverage adjustment of 1.02% and a flotation cost adjustment of 0.24%. Petitioner's Exhibit PRM at 39. His flotation cost adjustment is computed to avoid dilution when additional common equity is issued. This is to compensate for the underwriting discount and issuance expenses associated with issuance of new common stock. He reiterated that the DCF results represents the simplified (i.e., Gordon) form of the model that contains a constant growth assumption and further assumes unrealistically that there will be no prospective change in the price-earnings multiple. Petitioner's Exhibit PRM at 39–40.

Mr. Moul next discussed his Risk Premium analysis. He stated that with this method, the cost of equity capital is determined by corporate bond yields plus a premium to account for the fact that common equity is exposed to greater investment risk than debt capital. Petitioner's Exhibit PRM at 40. Mr. Moul used a long-term public utility debt cost rate of 6.25%, which he opined was a reasonable estimate of the prospective yield on long-term A-rated public utility bonds. Mr. Moul stated that his long-term cost rate of 6.25% is supported by the Moody's Index and the Blue Chip forecasts. He noted that the historical yields for long-term public utility debt during the twelve months ended February 2009 have ranged from 6.21% to 7.60%. Petitioner's Exhibit PRM at 40–41. As Mr. Moul explained, the yield that he used in his Risk Premium Model is consistent with the 6.31% effective cost on the Company's recent debt issue.

Mr. Moul determined the prospective yield on A-rated public utility debt by using the Blue Chip Financial Forecasts along with the spread in the historical yields noted above. He testified that the Blue Chip is a reliable authority and contains consensus forecasts of a variety of interest rates compiled from a panel of banking, brokerage, and investment advisory services. Petitioner's Exhibit PRM at 43. He stated that because Blue Chip stopped publishing forecasts of yields on A-rated public utility bonds in early 1999, he combined the forecast yields on long-term Treasury bonds published on February 1, 2009 with a yield spread of 2.50%, which he opined was a reasonable spread for the yield on A-rated public utility bonds over Treasury bonds. Mr. Moul also provided Blue Chip's long-term forecasts of interest rates, which he stated further supported the use of a 6.25% yield.

Mr. Moul stated that he calculated the equity risk premium by comparing the market returns on utility stocks and the market returns on utility bonds. He used the S&P Public Utility Index for the purpose of measuring the market returns for utility stocks, which he stated is reflective of the risk associated with regulated utilities and reduces the role of judgment in establishing the risk premium for public utilities. Petitioner's Exhibit PRM at 44. To develop an appropriate risk premium, Mr. Moul averaged the results for the S&P Public Utilities by averaging (i) the midpoint of the range shown by the geometric mean and median and (ii) the arithmetic mean. He explained that this procedure was employed to provide a comprehensive way of measuring the central tendency of the historical returns. Petitioner's Exhibit PRM at 45.

Based on this analysis Mr. Moul determined that 6.23% represents a reasonable risk premium for the S&P Public Utilities in this case. Petitioner's Exhibit PRM at 46. Mr. Moul stated that differences in risk characteristics must be taken into account when applying the results for the S&P Public Utilities to the Water Group including size, market ratios, common equity ratio, return on book equity, operating ratios, coverage, quality of earnings, internally generated funds, and betas. Petitioner's Exhibit PRM at 46. Mr. Moul said that these differences indicate that 5.50% represents a reasonable common equity risk premium in this case and is reflective of the lower risk of the Water Group compared to the S&P Public Utilities. Petitioner's Exhibit PRM at 46–47. Using this risk premium together with the prospective yield for long-term public utility debt and his flotation adjustment, Mr. Moul's Risk Premium approach provided a cost of equity for Petitioner of 11.99%. Petitioner's Exhibit PRM at 47.

Mr. Moul next discussed his CAPM results. He stated that three components are necessary to compute the cost of equity with the CAPM: a risk-free rate of return, the beta measure of systematic risk, and the market risk premium. For the beta, Mr. Moul initially

considered the Value Line betas. Petitioner's Exhibit PRM at 48. However, because the betas must be reflective of the financial risk associated with the ratesetting capital structure that is measured at book value, Mr. Moul testified that a leverage adjustment similar to that utilized on the DCF model would be necessary. He used the Hamada formula to unleverage and re leverage the Value Line betas for the common equity ratios using book values. Petitioner's Exhibit PRM at 49. Mr. Moul calculated a leveraged beta of 1.12 for the Water Group associated with book value capital structure.

For the risk-free rate, Mr. Moul employed the yields on twenty-year Treasury bonds using historical data. For forecasts, Mr. Moul used the yields on thirty-year Treasury bonds that are published by Blue Chip. Petitioner's Exhibit PRM at 50. Mr. Moul summarized the various yields and determined that a 4.00% risk-free rate of return would be appropriate for CAPM purposes. He explained that it is appropriate because it considers not only the Blue Chip forecasts but also the recent trend in the yields on long-term Treasury bonds. Petitioner's Exhibit PRM at 51.

Mr. Moul derived his market premium from the SBBI Classic Yearbook and the Value Line and S&P 500 returns. For the historically based market premium he used the arithmetic mean. Mr. Moul acknowledged that the Commission has expressed its preference for considering both the arithmetic mean and the geometric mean and stated that if that approach is used, much more weight should be placed on the arithmetic mean because it is the correct measure in the single-period model specification of the CAPM. Petitioner's Exhibit PRM at 51. Mr. Moul indicated that the market premium as taken from these sources is 8.95%.

Mr. Moul testified that an adjustment must be made to the CAPM result relating to the size of the company or portfolio for which the calculation is performed. Mr. Moul explained that as the size of a firm decreases, its risk and its required return increases. Petitioner's Exhibit PRM at 51–52. He stated that the Water Group has an average market equity capitalization of \$777 million, which would make it a low-cap portfolio. While Mr. Moul noted that this low-cap market capitalization would indicate a size premium of 1.74%, he used a more conservative size adjustment of 0.94%, which represents the mid-cap adjustment. Petitioner's Exhibit PRM at 52. Based upon a 4.00% risk-free rate of return, the leverage adjusted beta of 1.12 for the Water Group, the 8.95% market premium, the 0.94% size adjustment, and the flotation cost adjustment developed previously, the cost of equity resulting from Mr. Moul's CAPM analysis is 15.20%. Petitioner's Exhibit PRM at 52–53.

Finally, Mr. Moul discussed his Comparable Earnings approach. He performed this analysis because regulation is a substitute for competitively driven prices, and the returns realized by non-regulated firms with comparable risks provide useful insight into an appropriate rate of return. He selected non-regulated companies from the Value Line Investment Survey that have six categories of comparability designed to reflect the risk of the Water Group. Petitioner's Exhibit PRM at 54. Mr. Moul stated that Value Line provides a comprehensive basis for evaluating the risks of the comparable firms. He used both historical realized returns and forecasted returns covering a ten-year period (five historical years and five projected years) in order to cover conditions over an entire business cycle. Petitioner's Exhibit PRM at 55–56.

Unlike with the DCF or CAPM approaches, Mr. Moul indicated that a leverage adjustment was not necessary when using the Comparable Earnings method because it can be applied directly to the book value capitalization, avoiding the potential misspecification with the other models. Petitioner's Exhibit PRM at 56. Mr. Moul stated that the results from the Comparable Earnings approach suggest a reasonable cost of equity for Petitioner of 13.95%, representing the average of the historical and forecast median rates of return for the comparable earnings group. Petitioner's Exhibit PRM at 56.

Based upon his application of a variety of methods and models, Mr. Moul opined that the cost of common equity is 12.00% for the Company in this case. Petitioner's Exhibit PRM at 57. He further opined that it is essential that the Commission employ a variety of techniques to measure the Company's cost of equity because of the limitations/infirmities that are inherent in each method.

(2) OUCC's Position. Mr. Edward R. Kaufman, a Senior Analyst employed by the OUCC, presented testimony regarding Petitioner's cost of equity. Mr. Kaufman used both a DCF and CAPM analysis to estimate Petitioner's cost of equity at 9.25%. He did not conduct a Risk Premium or Comparable Earnings analysis. Mr. Kaufman said that his DCF Model produced a range of estimates from 8.83% to 9.68% and his CAPM analysis produced a range of estimates of 7.54% to 8.10%. Mr. Kaufman stated that a cost of equity of 9.25% results in a weighted cost of capital of 7.28%, as shown by OUCC Witness Stull. Public's Exhibit No. 8 at 4.

Mr. Kaufman indicated that his estimate of Petitioner's cost of equity is 275 basis points less than Mr. Moul's recommended cost of equity, which is the same difference the witnesses had in Indiana American's last rate case. He stated that the majority of the differences are explained by inputs to the various models, adjustments that Mr. Moul made to his models, and the weight given to each of the models. Public's Exhibit No. 8 at 5. Mr. Kaufman added that inflation influences interest rates and interest rates influence the cost of equity. He stated that inflation rates are at historically low levels and low inflation has caused long-term interest rates to remain at historically low levels that are still lower than they have been during most of the last forty years. Public's Exhibit No. 8 at 5. He asserted that lower interest rates translate directly into a lower cost of equity.

Mr. Kaufman stated that risk-free interest rates have declined since Petitioner's last rate case. He indicated that Mr. Moul used a forecasted long-term, risk-free rate of 5.25% in Petitioner's last rate case, as compared to a forecasted, risk-free rate of 4.00% in the present case. He stated that as of October 13, 2009, the current or spot yield on long-term U.S. Treasury bonds was 4.20%, as compared to a spot yield of 4.8% at the time he filed testimony in Petitioner's last rate case. Public's Exhibit No. 8 at 7.

Mr. Kaufman stated that the debt issued by Petitioner in 2009 is the most expensive debt in Petitioner's capital structure other than debt issued in March 1990. Public's Exhibit No. 8 at 7. He stated that due to these recent debt issuances, Petitioner's proposed average cost of long-term debt has increased since its last rate case from 6.79% to 7.15%. However, Mr. Kaufman maintained that bond markets have stabilized over the past few months and Petitioner should be able to issue debt at rates well below 8.25%. He stated that if Petitioner is able to issue its

anticipated \$27.5 million in long-term debt at 6.40%, then its average cost of long-term debt would decrease from 7.15% to approximately 6.98%. Thus, Mr. Kaufman opined that despite the financial disruptions in the debt markets earlier this year, Petitioner's average cost of long-term debt is not significantly higher than it was at the time of its last rate case, and its anticipated cost of debt on new issuances is at or below its average cost at the time of its last rate case. Public's Exhibit No. 8 at 8.

Mr. Kaufman acknowledged that Petitioner's risk has increased since its last rate case. He stated that his estimated cost of equity in this cause is fifty basis points higher than it was for Petitioner's last rate case. Public's Exhibit No. 8 at 8. However, Mr. Kaufman asserted that forecasted inflation remains low and the corporate bond market has stabilized. In addition, his estimated cost of equity reflects the fact that we are still in a low inflationary environment.

Mr. Kaufman explained that he generally accepted and used Mr. Moul's proxy group of seven water utilities, although he divided them into two categories for purposes of his DCF model: (1) the "Value Line proxy group" consisting of three out of the five water companies covered by Value Line's Standard Universe and (2) the "AUS proxy group" or "Moul proxy group" comprising the same seven companies used in Mr. Moul's analysis. Public's Exhibit No. 8 at 9–10. He indicated that his use of two proxy groups is not intended to be a criticism of Mr. Moul's selection of a proxy group but rather is a stylistic difference. Mr. Kaufman stated that he did not have the same level of data for his AUS proxy group as he did for his Value Line proxy group and therefore gave it less weight than his Value Line proxy group. He stated that it was not necessary to divide the companies into two proxy groups for purposes of his CAPM analysis because he had the same level of detail (beta) for all seven companies.

Mr. Kaufman used a traditional single-stage DCF model for his Value Line proxy group and used both historical and forecasted growth rates of earnings per share, dividends per share, and book value per share. He stated that he used Value Line as his primary source of growth rates and estimated a growth rate of 5.61% for his Value Line proxy group. Public's Exhibit No. 8 at 13. For his AUS proxy group, Mr. Kaufman used a two-stage DCF model. For the first stage he used forecasted growth rates of earnings per share from Zacks and Reuters, as well as forecasted growth rates in dividends per share from AUS to determine an estimated growth rate of 7.25%. For his second stage Mr. Kaufman used an estimated long-run growth rate of the U.S. economy equal to 5.5%. Public's Exhibit No. 8 at 14.

In both DCF analyses Mr. Kaufman eliminated zero and negative growth rates, consistent with the 1996 Rate Order, although he did not believe that investors completely ignore these growth rates. Public's Exhibit No. 8 at 14. He did not eliminate low positive growth rates because, in Mr. Kaufman's opinion, low growth rates are not ignored by investors. He stated that his growth rate of 5.6% is supported by a Value Line chart titled A Long Term Perspective, which provides average growth rates in earnings per share, dividends per share, and book value per share. He stated that the average growth rate for each of these measures for the Dow Jones Industrial Average was each less than 5.61% from 1920 – 2005, and thus helped support his use of a growth rate of 5.61% in his Value Line DCF analysis. Public's Exhibit No. 8 at 15.

Mr. Kaufman asserted that short-term to intermediate-term forecasts can lead to unreasonably high estimated growth rates in a DCF analysis and should not be mechanically

incorporated into a DCF analysis. In support of his claim, Mr. Kaufman referenced a 2003 article published in the National Regulatory Research Institute (“NRRI”) Journal of Applied Regulation which stated that no utility can sustain a growth rate over the long-run that exceeds the growth rate of the economy. Mr. Kaufman further cited a 2003 Wall Street Journal article as indicating that analysts’ forecasts are potentially biased upwards due to possible financial incentives. Public’s Exhibit No. 8 at 17. Mr. Kaufman concluded that both the potential for analyst bias and the intermediate-term nature of analyst forecasts of earnings per share may make these estimates potentially unreliable. Public’s Exhibit No. 8 at 18.

Mr. Kaufman stated that a two-stage DCF model would allow one to give appropriate weight to short-term or intermediate-term forecasts in earnings per share to estimate the cost of equity. He opined that it would be reasonable, if not conservatively high, to use a forecasted growth rate of the U.S. economy as a long-term sustainable growth. Public’s Exhibit No. 8 at 19. To determine this growth rate, Mr. Kaufman consulted a number of sources that provide forecasted real growth and forecasted inflation. Based on his review of this information Mr. Kaufman used a long-term growth rate of 5.5%. Public’s Exhibit No. 8 at 19–20.

Mr. Kaufman next explained the mechanics of his two-stage DCF analysis. He indicated that he estimated quarterly dividend payments over the next 200 years (representing infinity). For the first five years he increased dividends by 7.25% annually and then increased dividends by 5.5% annually for the remaining 195 years. Public’s Exhibit No. 8 at 20. To derive a stream of dividend payments, Mr. Kaufman applied the proxy groups’ dividend yields of 3.58% and 3.61% to a hypothetical stock price of \$25.00. Mr. Kaufman observed that the results of his two-stage DCF analysis produced two cost of equity results: 9.66% and 9.70%. Public’s Exhibit No. 8 at 20–21.

Mr. Kaufman then presented the results of his CAPM analysis. He indicated that the CAPM is typically more controversial and less reliable than the DCF model and that different applications of CAPM may cause vastly different cost of equity estimates. Public’s Exhibit No. 8 at 24. He testified that he believed the geometric mean is a better approach to determining risk premium than an arithmetic mean risk premium, but he stated that his CAPM analysis considers both geometric and arithmetic mean risk premiums. In support of his position, Mr. Kaufman relied upon a 1982 Ibbotson Year Book, although he admitted that more recent versions of Ibbotson advocate the use of only the arithmetic mean. Public’s Exhibit No. 8 at 25–26. He then cited to a number of articles recommending the use of the geometric mean rather than the arithmetic mean. Mr. Kaufman asserted that the Commission has consistently given weight to both the arithmetic mean risk premium and the geometric mean risk premium, including in prior cases involving Petitioner. Public’s Exhibit No. 8 at 29.

Mr. Kaufman stated that he developed a forecasted risk premium in addition to a risk premium based on historical data out of concern that the expected risk premium is below the historical averages. Public’s Exhibit No. 8 at 30–34. Based upon his review of a number of articles that provided a range of forecasted market risk premiums from a low of 1.5% to a high of 5.25%, Mr. Kaufman stated that his CAPM analysis used a forecasted risk premium of 4.25%. Public’s Exhibit No. 8 at 35. He noted, however, that the significant decline in the market in 2008 has caused the historical risk premium and the forecasted risk premium to have (for the time being) converged to the point where either could be reasonably used. Mr. Kaufman

testified that the cost of equity based on his CAPM analysis using a historical risk premium ranged from 7.94% to 8.10%, and the cost of equity based on his CAPM analysis using a forecasted risk premium ranged from 7.54% to 7.70%. Public's Exhibit No. 8 at 38.

Based on his DCF and CAPM analyses, Mr. Kaufman recommended a cost of equity of 9.25%. He opined that there was no need to adjust the results of his proxy group's cost of equity to make it applicable to Indiana American. He explained that he believed Indiana American has a similar business and financial risk to the companies in the proxy group. Public's Exhibit No. 8 at 39.

Mr. Kaufman next commented on Mr. Moul's DCF model. He contended that Mr. Moul's reliance on intermediate-term forecasts for earning per share results in a growth rate that is unrealistically high. Public's Exhibit No. 8 at 46. Mr. Kaufman opined that Mr. Moul improperly adjusted the results of his DCF by 102 basis points for financial leverage and added twenty-four basis points to his DCF analysis for flotation costs.

Mr. Kaufman disagreed with Mr. Moul's reliance on forecasted growth rates for his DCF analysis and stated that such estimates are not long-term (perpetual) estimates. Mr. Kaufman suggested that these estimates are made typically for only three to five years and are likely to be optimistic and overstate long term-growth. Public's Exhibit No. 8 at 47. He stated that if one uses a single-stage DCF model, it is necessary to use a growth rate that is sustainable over the long-run as the equation used in the DCF model assumes an infinite time frame. Public's Exhibit No. 8 at 48. Mr. Kaufman recommended that the Commission review and give weight to both historical and forecasted data of growth rates in earnings per share, dividends per share, and book value per share. He also stated that one could give weight to the long-term sustainable economic growth rate of the U.S. economy if using a two-stage DCF model. Public's Exhibit No. 8 at 51–52.

Mr. Kaufman next discussed his concerns with Mr. Moul's leverage adjustment. He did not agree that the difference between market and book value creates a need to adjust the results of a DCF analysis and therefore opined that Mr. Moul's leverage adjustment is unnecessary. Public's Exhibit No. 8 at 55. He indicated that Mr. Moul provided no numerical analysis to support his argument that a leverage adjustment is necessary when a utility's market-to-book ratio is different from 1.0, and he stated that most jurisdictions do not use Mr. Moul's adjustment. Public's Exhibit No. 8 at 55–56. Mr. Kaufman testified that the leverage adjustment proposed by Mr. Moul has the effect of rewarding utilities when market-to-book ratios are high and penalizing utilities when market-to-book ratios are low. Finally, Mr. Kaufman asserted that if Mr. Moul applied his leverage adjustment directly to American Water, it would likely lead to a negative leverage adjustment. Public's Exhibit No. 8 at 56–57.

Mr. Kaufman next addressed Mr. Moul's CAPM analysis, which Mr. Kaufman contended contained an improper leverage adjustment, overstated the risk premium, and included unnecessary adjustments for size and for flotation costs. Public's Exhibit No. 8 at 58–59. Mr. Kaufman disagreed with Mr. Moul's use of an arithmetic mean calculation over a geometric mean to determine the historical risk premium and stated that this resulted in an overstatement of expected returns. Public's Exhibit No. 8 at 59–60. He also took issue with Mr. Moul's second historical risk premium, which Mr. Kaufman stated improperly used bond income returns instead

of bond total returns. Mr. Kaufman further disagreed with Mr. Moul's calculation of the forecasted risk premium and contended that the sources relied upon by Mr. Moul were overly optimistic. Public's Exhibit No. 8 at 61–64.

Mr. Kaufman disagreed with Mr. Moul's size adjustment and stated that it was not appropriate to directly apply Ibbotson's equity size premium adjustment to regulated water utilities. Public's Exhibit No. 8 at 65. He stated that regulation decreases the risks faced by Petitioner and the companies in Mr. Moul's Water Group, and he added that those companies do not face the same bankruptcy risks that other small companies may face. He also stated that the Commission in Cause No. 40398 determined that Ibbotson's small cap adjustment cannot be directly applied to utilities. Public's Exhibit No. 8 at 65. Mr. Kaufman cited to two articles reaching similar conclusions. Public's Exhibit No. 8 at 66–67.

Mr. Kaufman also disagreed with the leverage adjustment that Mr. Moul made to his CAPM analysis for the same reasons he disagreed with the leverage adjustment proposed in Mr. Moul's DCF analysis. He noted that Mr. Moul did not cite any jurisdictions that accepted his leverage adjustment for a CAPM analysis. Public's Exhibit No. 8 at 67.

Mr. Kaufman testified that Mr. Moul's Risk Premium Model overstated the risk premium, used a forecasted interest rate that exceeded the current interest rate, and included an unnecessary adjustment for flotation costs. Public's Exhibit No. 8 at 67–68. He disagreed with Mr. Moul's use of median returns and stated that this approach inflated the expected return for the S&P Utility Index and deflated the expected return for Public Utility Bonds. Public's Exhibit No. 8 at 68–69. Mr. Kaufman testified that if Mr. Moul's Risk Premium model were updated to incorporate 2008 data, it would have resulted in an unadjusted risk premium of 4.99%. Public's Exhibit No. 8 at 70. Mr. Kaufman further testified that if Mr. Moul's Risk Premium model were adjusted to give equal weight to arithmetic and geometric means and no weight to median returns, it would have result in an unadjusted risk premium of 4.07%. Public's Exhibit No. 8 at 71.

Mr. Kaufman did not agree with Mr. Moul's use of forecasted interest rates in his CAPM and Risk Premium analyses. He opined that a purchaser of long-term debt is in essence making a forecast, and therefore the purchase price produces a yield that the investor is willing to accept over the life of the debt. Mr. Kaufman surmised that a current yield is already a forward-looking yield over the investment horizon. Public's Exhibit No. 8 at 72–73. Mr. Kaufman asserted that if a forecasted risk premium (midpoint) were given any weight in a Risk Premium model, it would result in both a smaller risk premium and a lower estimated cost of equity than the risk premium and subsequent cost of equity used by Mr. Moul. Public's Exhibit No. 8 at 74–75. Mr. Kaufman concluded that if one accepts the premise that the risk premium will be lower in the future than it has been in the past, then Mr. Moul's Risk Premium models overstate the cost of equity. Public's Exhibit No. 8 at 77.

Mr. Kaufman also expressed concern with Mr. Moul's Comparable Earnings approach. He noted that Mr. Moul gave little weight to the results of his Comparable Earnings analysis. Public's Exhibit No. 8 at 78. He testified that Mr. Moul's analysis did not exclude outliers, and Mr. Moul did not screen the Water Group for dividends or percentage of long-term debt. He contended that a company that has no or little long-term debt or does not pay significant

dividends is not comparable to either Indiana American or the Water Group. Mr. Kaufman also expressed concern that historical returns do not react to changes in market conditions, and so the Comparable Earnings methodology can produce increasing returns during periods of declining capital costs. Public's Exhibit No. 8 at 79.

With respect to Mr. Moul's flotation cost adjustment, Mr. Kaufman asserted that Petitioner did not justify the need to recover flotation costs in this case. Public's Exhibit No. 8 at 80. He noted that the Commission has typically allowed utilities to recover measurable and reasonable flotation costs when the utility has recently incurred or expects to incur flotation costs in the near future. Mr. Kaufman stated that because Mr. Moul proposed a generic flotation cost adjustment which is not based on actual costs incurred by Indiana American or by American Water on behalf of Indiana American, a flotation cost adjustment should not be included in Indiana American's authorized cost of equity. Public's Exhibit No. 8 at 81.

(3) Intervenors' Position. Industrial Group Witness Gorman sponsored testimony supporting a cost of equity of 9.90%. Mr. Gorman opined that Indiana American's cost of common equity is no higher today than it was in its last rate case, where a return on equity of 10.0% was authorized. Mr. Gorman stated that his estimated return of 9.90% is reasonable. Industrial Group's Exhibit No. 2 at 9–10. He stated that a comparison of current utility bond yields and utility bond yields right before the issuance of the Final Order in Indiana American's last rate case indicates that at a minimum, Indiana American's current market cost of capital is no higher today than it was in its last rate case.

Mr. Gorman used five models to estimate Indiana American's cost of common equity: (1) a constant growth DCF Model using analyst growth data, (2) a constant growth DCF Model using sustainable growth rates, (3) a multi-stage growth DCF Model, (4) a Risk Premium analysis, and (5) a CAPM analysis. Industrial Group's Exhibit No. 2 at 15–16. Mr. Gorman stated that he used two proxy groups: the first consisted of Mr. Moul's Water Group minus SJW Corp. (the "Water Utility Proxy") and the second consisted of a gas utility proxy group (the "Gas Utility Proxy"). Mr. Gorman asserted that both proxy groups had comparable risk profiles and common equity ratios to Indiana American. Industrial Group's Exhibit No. 2 at 16–17. He did not conduct a Comparable Earnings analysis.

For purposes of his constant growth DCF Model, Mr. Gorman relied upon the average of the weekly high and low stock prices of the proxy groups over a thirteen-week period ended October 2, 2009. Industrial Group's Exhibit No. 2 at 19. Mr. Gorman testified that a thirteen-week average stock price is still short enough to contain data that reasonably reflect current market expectations, but is not so short a period to be susceptible to market price variations that may not be reflective of the security's long-term value. Mr. Gorman stated that he relied on two sources of growth for his constant growth DCF model. Industrial Group's Exhibit No. 2 at 20. In his constant growth DCF analysis, Mr. Gorman relied on a consensus of security analysts' earnings growth estimates as a proxy for investor dividend growth rate expectations. More specifically, Mr. Gorman averaged analysts' growth rate estimates from four sources and calculated average growth rates of 7.29% and 5.30% for the Water Utility Proxy and Gas Utility Proxy, respectively. Industrial Group's Exhibit No. 2 at 20–21. Using these growth rates, Mr. Gorman's constant growth DCF Model estimated Petitioner's cost of equity at 11.06% for the Water Utility Proxy and 10.09% for the Gas Utility Proxy. Industrial Group's Exhibit No. 2 at

22. Mr. Gorman concluded that the constant growth DCF return for his Water Utility Proxy is not reasonable and represents an inflated return for Indiana American at this time. He stated that the growth rate of 7.29% is far too high to be a long-term sustainable growth rate as required by the constant growth model. He did, however, believe that the constant growth DCF return for his Gas Utility Proxy was a reasonable estimate. Industrial Group's Exhibit No. 2 at 22.

Mr. Gorman contended that the three-year to five-year earnings growth projections for his two proxy groups were not reasonable estimates of long-term sustainable growth because they exceed the projected growth rate of the GDP. Industrial Group's Exhibit No. 2 at 23. Mr. Gorman stated that the GDP growth projection serves as a ceiling growth rate for a utility. He explained that utilities cannot indefinitely sustain a growth rate greater than the overall economy. Industrial Group's Exhibit No. 2 at 24.

Mr. Gorman next discussed his constant growth DCF Model using a sustainable growth rate model. Mr. Gorman indicated that he used the internal growth rate methodology for this purpose, which is tied to the percentage of earnings retained in a company and not paid out as dividends. Industrial Group's Exhibit No. 2 at 26. He stated that the sustainable growth rates for the Water Utility Proxy using this internal growth rate model range from 6.89% (average) to 7.04% (median), while sustainable growth rates for the Gas Utility Proxy range from 5.05% (average) to 5.21% (median). Based on these inputs, Mr. Gorman's constant growth DCF sustainable growth analysis estimated a return of 10.15% for the Water Utility Proxy and 9.83% for the Gas Utility Proxy. Industrial Group's Exhibit No. 2 at 27–28.

Mr. Gorman testified that he also performed a multi-stage growth DCF analysis to reflect three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of the next five years (year six through ten); and (3) a long-term growth period, starting in year eleven through perpetuity. Industrial Group's Exhibit No. 2 at 29. For the short-term growth period, Mr. Gorman relied upon the same analysts' growth projections he used in his constant growth DCF model. For the transition period, Mr. Gorman reduced or increased the growth rates by an equal factor to reflect the difference between the analysts' growth rates and the GDP growth rate. Finally, for the long-term growth period Mr. Gorman assumed each company's growth would converge to the analysts' projected growth for the U.S. GDP of 4.7% starting in eleven years. Industrial Group's Exhibit No. 2 at 29. Mr. Gorman testified that the average multi-stage growth DCF return on equity was 9.04% for the Water Utility Proxy and 9.60% for the Gas Utility Proxy. Based on the results from all three of his DCF Models, Mr. Gorman concluded that a reasonable range for these DCF return estimates is 9.8% to 10.1%, with a midpoint estimate of 9.95%. Industrial Group's Exhibit No. 2 at 30–31.

Mr. Gorman then described his Risk Premium Model. He stated that his Model is based on two estimates of an equity risk premium. First, he estimated the difference between the required return on utility common equity investments and Treasury bonds, or the risk premium. Industrial Group's Exhibit No. 2 at 32. He stated that the common equity required returns were based on regulatory commission-authorized returns for gas utility companies. The second equity risk premium method used by Mr. Gorman is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields. Mr. Gorman used the time period of 1986 through 2008 for both of these estimates. Based on this analysis, Mr. Gorman stated that the average equity risk premium over U.S.

Treasury bond yields has been 5.00%, with most observed risk premiums falling in the range of 4.15% to 5.81%. Industrial Group's Exhibit No. 2 at 32. Mr. Gorman further stated that the average equity risk premium over contemporary Moody's utility bond yields was 3.57% over the period 1986 through 2008, with a primary range of 3.04% to 4.41%. Industrial Group's Exhibit No. 2 at 33.

Mr. Gorman stated that the equity risk premium should reflect the relative market perception of risk in the utility industry today. He reviewed utility bond yield spreads over Treasury bond yields for 2008 and the first half of 2009 and concluded that, while they reflect unusually large spreads, the market has started to improve and these spreads have started to decline to more normal levels. Industrial Group's Exhibit No. 2 at 34. Mr. Gorman therefore proposed to use his historical risk premium information to estimate the return on equity for Indiana American. Using a projected thirty-year bond yield of 5.1% and a Treasury bond risk premium of 4.15% to 5.81%, Mr. Gorman produced an estimated common equity return in the range of 9.25% to 10.91%, with a midpoint of 10.08%. Using his utility bond risk premium of 3.04% to 4.41% and the thirteen-week average yield on "Baa" rated utility bonds of 6.39%, Mr. Gorman calculated a cost of equity in the range of 9.43% to 10.80%, with a midpoint of 10.12%. Thus, Mr. Gorman testified that his risk premium analyses produce a return estimate in the range of 10.08% to 10.12%, with a midpoint estimate of 10.10%. Industrial Group's Exhibit No. 2 at 35–36.

Mr. Gorman's CAPM analysis produced an estimated return of 9.38% for the Water Utility Proxy and 8.94% for the Gas Utility Proxy. Industrial Group's Exhibit No. 2 at 41. To conduct his CAPM analysis, Mr. Gorman relied upon a historical market risk premium of 5.60%, a prospective market risk premium of 5.68%, a risk-free rate of 5.10%, and beta estimates of 0.76 and 0.86 for his Water Utility Proxy and Gas Utility Proxy, respectively. Mr. Gorman's risk-free rate of 5.10% was based on Blue Chip Financial Forecasts' projected thirty-year Treasury bond yield. Industrial Group's Exhibit No. 2 at 37–38. Mr. Gorman's betas were based on the average Value Line beta estimates for each company in his proxy group. Industrial Group's Exhibit No. 2 at 38. As for the historical market risk premium, Mr. Gorman used Morningstar data from 1926 through 2008, which estimated the arithmetic average of the achieved total return on the S&P 500 as 11.70%, and the total return on long-term Treasury bonds as 6.10%. Industrial Group's Exhibit No. 2 at 39. Finally, Mr. Gorman's forward-looking risk premium estimate was derived by estimating the expected return on the market as represented by the S&P 500 and subtracting the risk-free rate from this estimate. Industrial Group's Exhibit No. 2 at 39. Mr. Gorman indicated that his 5.68% market risk premium is consistent with Morningstar's estimates, which range from 5.7% to 6.5%. Industrial Group's Exhibit No. 2 at 41.

Based on all of his cost of equity models, Mr. Gorman recommended an overall return on equity for Indiana American of 9.90%. Mr. Gorman asserted that this overall rate of return would support an investment grade bond rating for Indiana American based on S&P benchmark financial ratios and S&P's new credit metric ranges. Industrial Group's Exhibit No. 2 at 42–43. Mr. Gorman also conducted a credit metric calculation using S&P's old credit metric guidelines and opined that with Indiana American's proposed capital structure and his return on equity, Indiana American's financial credit metrics are supportive of a strong "A" utility bond rating. Industrial Group's Exhibit No. 2 at 46.

Mr. Gorman next responded to Mr. Moul's recommended return on common equity. He opined that Mr. Moul's recommended return on equity of 12.0% is excessive and would, with reasonable and appropriate adjustments, support a return on equity of 9.91%, which is very similar to Mr. Gorman's recommended return on equity of 9.90%. Industrial Group's Exhibit No. 2 at 46-47.

Mr. Gorman stated that, at a minimum, Mr. Moul's proposed flotation cost and leverage adjustments should be rejected. He believed that even with these adjustments removed, Mr. Moul's adjusted DCF would be excessive because it relies on an unsustainable growth rate of 7.50%. Mr. Gorman stated that Mr. Moul's proposed leverage adjustment is not based on accurate financial principles because investors do not evaluate two different types of financial risk (market and book) in valuing utility plant investments. Industrial Group's Exhibit No. 2 at 48. Rather, Mr. Gorman maintained that a clear review of the evidence in this case indicates that the financial risk of a utility is based on book value leverage, not market value leverage. Consequently, Mr. Gorman stated that Mr. Moul's contention that his estimated DCF return on equity reflects the market value leverage rather than the book value leverage is completely misplaced. Industrial Group's Exhibit No. 2 at 50.

Mr. Gorman also disagreed with Mr. Moul's flotation cost adjustment. He stated that Mr. Moul's flotation expense adjustment should be rejected because it is not based on Indiana American's actual and verifiable flotation expenses. Rather, it is based on other publicly traded companies' flotation expenses. Mr. Gorman concluded that there is no way to verify the reasonableness and appropriateness of Mr. Moul's proposed flotation cost recognition in utility rates. Industrial Group's Exhibit No. 2 at 52.

Mr. Gorman expressed his concerns with Mr. Moul's growth rate estimate. He noted that Mr. Moul correctly placed emphasis on the projected three-year to five-year growth rates from I/B/E/S, Zacks, and Value Line, but Mr. Gorman argued that Mr. Moul failed to recognize the current utility environment. Industrial Group's Exhibit No. 2 at 52. He agreed that the utility industry is currently in a construction cycle, but he stated that this construction cycle will not continue indefinitely. Thus, Mr. Gorman stated that Mr. Moul's DCF analysis needs to be corrected to reflect reasonable and rational long-term sustainable growth outlooks. Industrial Group's Exhibit No. 2 at 53. Mr. Gorman repeated his belief that rational estimates of long-term sustainable growth cannot exceed the GDP growth rate over sustained periods of time, even if short-term growth rates can. Industrial Group's Exhibit No. 2 at 54. He believed that a multi-stage growth DCF model would produce more reasonable and accurate DCF return estimates than a three- to five-year growth rate, irrespective of whether it is a reasonable estimate of long-term sustainable growth. Industrial Group's Exhibit No. 2 at 54.

Mr. Gorman stated that Mr. Moul's Risk Premium analysis uses an equity risk premium estimate of 5.50%, which Mr. Gorman opined is arbitrary and has not been shown to be appropriate for Indiana American. Industrial Group's Exhibit No. 2 at 55. Mr. Gorman stated that Mr. Moul's risk premium estimate is not based on observable and verifiable market evidence, which eliminates its usefulness. He noted that the Water Proxy Group has similar systematic risk to the S&P Public Utility Index, yet Mr. Moul used an equity risk premium of 5.50%, rather than the historical equity risk premium of 3.57%. Industrial Group's Exhibit No. 2 at 56.

Mr. Gorman expressed similar concerns with Mr. Moul's CAPM analysis as he did with Mr. Moul's DCF model. Mr. Gorman did not agree with Mr. Moul's leverage, flotation cost, and small cap adjustments, and he testified that Mr. Moul's market risk premium was excessive. Industrial Group's Exhibit No. 2 at 58. Mr. Gorman stated that if Mr. Moul's adjustments were not used and his prospective market risk premium was rejected, Mr. Moul's CAPM analysis would produce a return estimate of 8.78%. Industrial Group's Exhibit No. 2 at 61.

Finally, Mr. Gorman responded to Mr. Moul's Comparable Earnings approach. He stated that a Comparable Earnings analysis does not measure the market-required return appropriate for assuming the investment risk of Indiana American. Mr. Gorman also stated that Mr. Moul's analysis does not measure the appropriate return to use to ensure that Indiana American is fairly compensated and ratepayers are not charged an excessive rate of return. Mr. Gorman further stated that Mr. Moul's analysis is not based on companies that have been shown to have risk comparable to Indiana American. He stated that the return on book equity cannot be considered a comparable "accounting" return appropriate to set Indiana American's rates. Industrial Group's Exhibit No. 2 at 62. He opined that it is not reasonable to estimate an appropriate book return on book equity for Indiana American from book return on equities for non-regulated companies. In light of these issues Mr. Gorman recommended that Mr. Moul's Comparable Earnings model be disregarded. Industrial Group's Exhibit No. 2 at 63.

Intervenor Schererville's witness Theodore J. Sommer, a Partner with London Witte Group, LLC, testified that Indiana American's return on equity should be less than 10.0%. Schererville's Exhibit TJS at 17. Mr. Sommer testified that Indiana American has proposed returns on equity that are fifty and 100 basis points above its proposal in Cause No. 42520. He explained that his proposal reflects the same change in basis points. Schererville's Exhibit TJS at 17. Mr. Sommer noted that Indiana American has grown both in the number of customers and the size of its rate base since its last case. Mr. Sommer also stated that economic conditions have worsened since the issuance of the 2007 Rate Order, and a fair rate of return now could be less than what would have been reasonable previously. As a result, Mr. Sommer encouraged the Commission to balance the interests Petitioner's customers and investors. He concluded by stating that a fair rate of return should be less than the 10.0% determined to be appropriate by the Commission in its 2007 Rate Order. Schererville's Exhibit TJS at 18.

(4) Petitioner's Rebuttal. In rebuttal, Mr. Moul testified that there is nothing in the testimony of Mr. Kaufman or Mr. Gorman that causes him to change his recommendation that the Commission find the Company's cost of common equity to be 12.0%. Mr. Moul noted that both Mr. Kaufman and Mr. Gorman recommended a higher cost of equity in this case than in Petitioner's prior rate case, and thus there is general agreement among the witnesses that the Indiana American's cost of equity is higher today than at the time of the its last rate case. Petitioner's Exhibit PRM-R at 2. Mr. Moul stated that the returns recommended by both Mr. Kaufman and Mr. Gorman are too low by reference to the returns expected by investors and those granted by regulators, both here in Indiana and elsewhere in the country. Mr. Moul opined that such a return would be punitive for the Company and would be alarming to investors. He therefore recommended that the Commission find Indiana American's cost of equity to be 12.0%. Petitioner's Exhibit PRM-R at 36.

Mr. Moul testified that there is some consensus among the experts concerning the group of water companies that could be used to measure the cost of equity. He noted that both Mr. Kaufman and he used the same seven-company Water Group in their analyses. He further noted that Mr. Gorman accepted most of these same companies, but he erroneously excluded SJW Corporation from his group. Petitioner's Exhibit PRM-R at 3.

Mr. Moul stated that Mr. Gorman also submitted a secondary group of natural gas utilities, but that there is no need to consider gas companies because there are an adequate number of water companies present. He further noted that Mr. Gorman's use of natural gas companies in a water company rate case has not received wide acceptance. The only jurisdiction to routinely use natural gas utilities to set the cost of equity for water and wastewater utilities is the Florida Public Service Commission ("PSC"). Petitioner's Exhibit PRM-R at 3. Mr. Moul stated that the PSC establishes the cost of equity through the use of a leverage formula, which expresses the equity return as a function of the common equity ratio. Applying the PSC's formula to Petitioner's capital structure in this case provides a cost of equity of 11.72%, well above the 9.9% return proposed by Mr. Gorman and significantly different from the return proposed by Mr. Kaufman. Petitioner's Exhibit PRM-R at 4. Mr. Moul further noted that the 11.72% return on equity produced by the PSC formula is quite close to the 12.0% proposed by the Indiana American in this case.

Mr. Moul then described some of the limitations of the DCF Model as employed by Mr. Kaufman and Mr. Gorman. Mr. Moul stated that the "Gordon" form of the DCF model is not without its limitations because many of the assumptions that must be made to utilize this model are simply not realistic. These include constant and infinite growth and the assumption that earnings per share, dividends per share, book value per share, and price per share will all appreciate at the same constant rate absent any change in dividend payout and price-earnings multiple. Petitioner's Exhibit PRM-R at 5. He testified that the Gordon model does not account for, or reflect changes in, the variables that are common characteristics of the equity market. According to Mr. Moul, the evidence shows that these steady-state (i.e., constant growth) conditions represent unrealistic assumptions of investor expectations. Mr. Moul stated that this is shown by the dividend payout ratios calculated from the forecasts by Value Line for the water companies, which are forecasted to decline in the future. Petitioner's Exhibit PRM-R at 5. Mr. Moul said that with the forecasted trend of lower payout ratios, the use of dividend growth by Mr. Kaufman is particularly inappropriate for DCF purposes. As to the issue of book value per share growth, which Mr. Kaufman also presents, stocks do not trade at a constant market-to-book-ratio, thereby limiting the usefulness of this measure of growth. Petitioner's Exhibit PRM-R at 5.

Mr. Moul next discussed the financial variables that should be given the greatest weight when assessing investor expectations. Mr. Moul stated that he agreed generally with the Commission's preference for considering a variety of sources in the development of the DCF growth rate and that he has presented all of the variables that the Commission enumerated in its 2002 Rate Order. However, Mr. Moul believed that there is no justification for giving each of these variables equal weight. Petitioner's Exhibit PRM-R at 6. Mr. Moul testified that if a specific variable must be emphasized, then it is necessary to substantiate the reason for giving additional emphasis to that variable. He noted that the theory of DCF indicates that the value of a firm's equity (i.e., its share price) will grow at the same rate as earnings per share. Hence, the

theory of DCF indicates earnings growth should be emphasized. Mr. Moul stated that dividends per share growth should not be emphasized because the payout ratios for the water companies are forecasted to decline. He also stated that book value cannot be emphasized because market-to-book ratios do not remain constant. Retention growth would likewise be inappropriate because it merely provides the individual components that cause book value per share to change. Therefore, Mr. Moul testified that in order to reflect investor expectations within the limitations of the DCF Model, earnings per share growth, which is the basis of capital gains yield and the source of dividend payments, must be given primary emphasis. Petitioner's Exhibit PRM-R at 6.

Mr. Moul then addressed Mr. Kaufman's testimony. He recognized that Mr. Kaufman removed negative rates from his growth analysis, but he stated that Mr. Kaufman's mechanical averaging of the remaining growth rates does not conform to the specification of the DCF Model he discussed previously. Mr. Moul testified that Mr. Kaufman has been inconsistent in his selection of variables in his DCF growth analysis. For example, Mr. Kaufman's constant growth form of the DCF Model used earnings per share, dividends per share, and book value per share and gave each variable one-third weight. Yet when selecting his first-stage growth rate in his two-stage DCF, Mr. Kaufman used only earnings per share growth, thereby giving it 100% weight. Petitioner's Exhibit PRM-R at 7. Likewise, Mr. Kaufman gave two-thirds weight to historical growth in his constant growth DCF model, but he gave 0.0% weight to history in his first-stage growth rate in his two-stage DCF model. Mr. Moul also pointed out that Mr. Kaufman completely ignored the Zacks, Reuters, and AUS forecasts in his constant growth DCF Model, but he used these forecasts exclusively in his two-stage DCF Model. Mr. Moul stated that it must be recognized that in developing a forecast of future-earnings growth, an analyst would first apprise himself/herself of the historical performance of a company. Therefore, there is no need to count historical growth rates a second time because historical performance is already reflected in analysts' forecasts, which reflect an assessment of how the future will diverge from historical performance. When Mr. Kaufman presented earnings growth rates, he ignored growth rates from Value Line and First Call. Petitioner's Exhibit PRM-R at 7.

Mr. Moul testified that Mr. Kaufman's 5.61% growth rate for the Value Line group is much too low. Mr. Moul stated that Mr. Kaufman failed to acknowledge that the magnitude of the growth rates cannot be assessed in isolation, but rather must be viewed in the context of the dividend yields because investors' expectation of growth must be synchronized with the price that is used for the dividend yield calculation. Petitioner's Exhibit PRM-R at 8. He noted that the fundamentals for water companies are different today than they were in 2003 when the NRRI article relied upon by Mr. Kaufman was published. Also, the quote from that article in Mr. Kaufman's testimony contends utilities would have a long-term sustainable growth rate lower than the growth rate for the economy as a whole. Mr. Moul asserted that this assumption is unrealistic because if Mr. Kaufman were correct, then the contribution of public utilities to growth in the overall GDP would continually decline. Yet, Mr. Moul testified that he was aware of evidence supporting that notion. In fact, Mr. Moul stated that the evidence is to the contrary, indicating that utilities have contributed a relatively stable percentage of the GDP when compared to all industries. Petitioner's Exhibit PRM-R at 8. This means that long-term growth for utilities cannot be significantly smaller than the growth of other corporations. Mr. Moul therefore concluded that it is unrealistic to believe that second-stage growth for utilities is substantially below GDP. Petitioner's Exhibit PRM-R at 9. If forecast earnings per share growth were incorporated into Mr. Kaufman's DCF cost rate, the DCF cost rate would become:

	$D_1/P_0$	+	$G$	=	$K$
Value Line Group (3 cos.)					
Three-Months	3.23%	+	8.18%	=	11.41%
Six-Months	3.13%	+	8.18%	=	11.31%
AUS Group (7 cos.)					
Three-Months	3.58%	+	8.27%	=	11.85%
Six-Months	3.61%	+	8.27%	=	11.88%

Mr. Moul next discussed Mr. Kaufman's two-stage DCF model. Mr. Moul stated that Mr. Kaufman's claim that the forecasted growth rates in DCF models are unreasonably high disregards the information that is actually being used by investors in making their investment decisions. Petitioner's Exhibit PRM-R at 10. He also noted that Mr. Kaufman's criticism of analysts' forecasts is inconsistent with his presentation of analysts' forecasts in his DCF analysis. Mr. Moul said that what is important is what investors actually use in their decisions regarding the purchase, sale, or holding of stocks. The bottom line, according to Mr. Moul, is that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF Model to have any meaning as a representation of investors' required returns. Otherwise, the DCF result will be mis-specified, which is the case with Mr. Kaufman's result. Petitioner's Exhibit PRM-R at 10.

With respect to Mr. Kaufman's formulation of multi-stage growth, Mr. Moul testified that it is obvious that investors do not have a 200-year investment horizon that he has assumed. Further, Mr. Kaufman understated the first-stage growth rate and inappropriately used a second-stage growth based on GDP. Finally, Mr. Moul explained that Mr. Kaufman's two-stage model adds complexity to the DCF and opens its application to further manipulation. Petitioner's Exhibit PRM-R at 10-11.

Mr. Moul took issue with Mr. Kaufman's failure to consider a flotation cost adjustment as part of his cost of equity analysis. Mr. Moul stated that Mr. Kaufman did not elaborate on the circumstances where a flotation cost adjustment would be warranted, but that Mr. Kaufman quotes from a Commission Order stating that the Commission has authorized a flotation cost adjustment only when there is a projected near-term need to issue new stock. Mr. Moul stated that this criterion is satisfied in this case based on stock sales by American Water. Petitioner's Exhibit PRM-R at 11. Mr. Moul described the various sales of stock of American Water that have taken place during the process of divestiture by RWE AG, as well as sales of common shares by American Water to raise new common equity for its own operations. Petitioner's Exhibit PRM-R at 11.

Mr. Moul testified that the sale of American Water common stock warrants a flotation cost allowance as part of the cost of equity because it meets the Commission-established requirement that such costs be measurable and reasonable. Mr. Moul stated that American Water has recently incurred flotation costs that represented 3.60% of the offering price to the public. He added that in this offering, the underwriting discount was 3.00% of the offering price to the public and the expenses incurred directly by American Water was 0.60% of the offering price to the public. Furthermore, Indiana American periodically receives equity infusions from American Water. Mr. Moul stated that this provides ample justification for considering flotation costs in the determination of Indiana American's cost of common equity. Petitioner's Exhibit PRM-R at 11–12. Mr. Moul did not believe that the stock price in relation to book value has any bearing on the allowance for flotation costs because there are costs associated with the issuance of new common shares regardless of whether a stock trades at 50% of book value or 200% of book value. Petitioner's Exhibit PRM-R at 12.

Mr. Moul then responded to Mr. Kaufman's criticism of his leverage adjustment. Mr. Moul pointed out that his leverage adjustment was not the same as a market-to-book ratio adjustment. Mr. Moul stated that the importance of the leverage modification to the DCF results was fully supported in his direct testimony, wherein it was shown that the market value of the equity in the Water Group's capitalization was much higher than its book value. Petitioner's Exhibit PRM-R at 12–13. Mr. Moul stated that it is necessary to account for the higher financial risk that arises from the lower common equity ratio measured by book value as compared to the higher common equity ratio measured by market value. Mr. Moul stated that the Commission, along with the commissions in many other states, has recognized that the DCF results understate the cost of equity when market prices exceed book value. Petitioner's Exhibit PRM-R at 13.

Mr. Moul stated that leverage adjustments have been accepted in other jurisdictions, including the PSC and the Pennsylvania Public Utility Commission. He noted that Mr. Kaufman has not disputed the fact that there is more financial risk associated with a lower common equity ratio. As financial risk increases with a declining common equity ratio, Mr. Moul argued that the cost of equity must likewise increase. Mr. Moul disputed Mr. Kaufman's claim that the leverage adjustment encouraged a particular market-to-book ratio, and he stated that essentially the leverage adjustment adds stability to the simple DCF returns. Petitioner's Exhibit PRM-R at 14.

Mr. Moul discussed Mr. Kaufman's CAPM analysis. He stated that Mr. Kaufman presents a variety of CAPM calculations that are simply not credible because they provide returns that are either lower than or nearly equal to the cost of the Company's debt. Petitioner's Exhibit PRM-R at 15. Mr. Moul testified that any cost of equity calculation which provides a result that nearly equals the yield on a public utility bond is unreliable. Mr. Moul agreed that the Value Line betas used by Mr. Kaufman can be used as a starting point in the analysis, but he maintained that they must be unlevered and relevered for the same reasons indicated with regard to the DCF (i.e., for the leverage difference between the market and book value capitalization). Mr. Moul stated that the Hamada formula he used to leverage-adjust the betas is merely an extension of the Modigliani and Miller formula he used in the DCF calculation. Petitioner's Exhibit PRM-R at 15.

Mr. Moul stated that the arithmetic mean should be used to the exclusion of the geometric mean in the CAPM and that the theory of the CAPM requires this choice. He testified that the

arithmetic mean provides the correct representation of all probable outcomes. It also has a measurable variance, unlike the geometric mean used by Mr. Kaufman, which consists merely of a rate of return taken from two data points. Petitioner's Exhibit PRM-R at 16. Mr. Moul stated that, contrary to Mr. Kaufman's testimony, Ibbotson carefully explains the rationale for using the arithmetic means in a single period model, such as the CAPM. Mr. Moul stated that there is no relevance to Mr. Kaufman's reference to a twenty-five year old article that does not discuss the CAPM because today Ibbotson is very clear on this point. Petitioner's Exhibit PRM-R at 16. Mr. Moul stated that because the geometric mean does not fulfill any role in determining the market premium component of the CAPM, it certainly should be not be given 50% weight but, rather should be discounted to the greatest extent possible. Petitioner's Exhibit PRM-R at 17.

Mr. Moul criticized Mr. Kaufman's use of the yield on short-term Treasury obligations as inappropriate because it produces returns that are simply not credible. Mr. Moul further criticized Mr. Kaufman's use of a constant 4.25% market premium as being well off the mark. He testified that the Value Line semi-annual forecast dated November 6, 2009 forecasted the total return for the industrial composite at 12.0%, which represents the midpoint of the range of returns of 7.0% as the low and 17.0% as the high. According to Mr. Moul, these returns call into serious question the reasonableness of Mr. Kaufman's market premium. Petitioner's Exhibit PRM-R at 18.

Mr. Moul then defended his adjustment to the CAPM to compensate for the risk associated with small size. He stated that Mr. Kaufman's arguments revolve around a statement by the Commission in a 1997 sewer rate case and articles published in 1999 and 1993. Petitioner's Exhibit PRM-R at 18. With respect to the Commission Order, Mr. Moul indicated that the Commission seemed troubled by the large 400 basis point adjustment. In this case, Mr. Moul used a 0.94% midcap size adjustment, even though a larger 1.74% low cap adjustment is justified. He believed that his conservative approach to the size adjustment satisfies the Commission's concerns in the sewer case Mr. Kaufman cites, as well as the 1999 article. As to Mr. Kaufman's reliance on the 1993 Wong article, Mr. Moul noted that the article employed data going back into the 1960s. Mr. Moul stated that enormous changes have occurred in the utility industry since the 1960s which have fundamentally changed the utility business. Petitioner's Exhibit PRM-R at 19. According to Mr. Moul, the conclusions in the Wong article do not invalidate the additional risk associated with small size. Moreover, Mr. Moul pointed out that the Wong article erroneously used betas to reach its conclusion; beta is not designed to measure the influence of size on a company's risk. Petitioner's Exhibit PRM-R at 19.

Mr. Moul then responded to Mr. Kaufman's criticism of the Risk Premium approach and in particular Mr. Moul's use of median values and the arithmetic mean. He testified that medians are a well accepted measure of central tendency that can be found in any basic statistic textbook. He noted that Mr. Gorman correctly used the arithmetic mean in his application of the CAPM. Petitioner's Exhibit PRM-R at 19-20.

Mr. Moul next defended his Comparable Earnings approach. He stated that the Comparable Earnings approach satisfies the comparability standard established in the Bluefield decision. Mr. Moul added that the approach reflects the view of the financial community that the regulatory process must consider the returns that are being achieved in the non-regulated sector

to ensure that regulated companies can effectively compete in the capital markets. Petitioner's Exhibit PRM-R at 20.

Mr. Moul also responded to Mr. Gorman's testimony. Mr. Moul stated that he had some of the same issues that he discussed concerning the testimony of Mr. Kaufman, such as ignoring the element of flotation costs, the adjustment that is necessary to make the DCF cost rate applicable in the ratesetting context, and the size adjustment to the CAPM. Petitioner's Exhibit PRM-R at 20. He stated that Mr. Gorman's DCF results in several instances are simply not credible. For example, he indicated that the numerous DCF returns below 9% shown on MPG-12 are outside the range of reasonable returns. Petitioner's Exhibit PRM-R at 21.

Mr. Moul testified that Mr. Gorman's use of a two-stage DCF approach essentially contradicts Mr. Gorman's own testimony and depresses his DCF results by approximately two percentage points (from 11.06% to 9.04%) for the Water Group. Petitioner's Exhibit PRM-R at 21–22. Mr. Moul disagreed with Mr. Gorman's purported rationale for employing a two-stage DCF model. He stated that Mr. Gorman's comparisons between the analysts' forecasts and the historical growth of dividends per share simply do not justify the repudiation of the analysts' growth rates by employing a two-stage DCF model that is intended to produce lower results. Mr. Moul repeated that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF model to have any meaning as a representation of investors' required returns. Petitioner's Exhibit PRM-R at 22–23.

Mr. Moul testified that Mr. Gorman's sustainable (i.e., retention) growth form of the DCF does not provide a reasonable cost of equity in this case. He stated that there are serious limitations in this approach and that it fails to account for a number of factors, which actually contribute to investors' expectations of earnings growth, including (i) the earnings rate on existing equity, (ii) the portion of earnings not paid out in dividends, (iii) sales of additional common equity, (iv) reacquisition of common stock previously issued, (v) changes in financial leverage, (vi) acquisitions of new business opportunities, (vii) profitable liquidation of assets, and (viii) repositioning of existing assets. Petitioner's Exhibit PRM-R at 23. Mr. Moul opined that book value per share growth, or its surrogate retention growth, does not represent the proper financial variable to be considered when selecting the DCF growth component because utility stocks do not typically trade at book value.

Mr. Moul further stated that there are mechanical problems with the sustainable growth method proposed by Mr. Gorman. He observed that Mr. Gorman's input values were taken from Value Line reports and represent forecasts covering the period 2012–2014. Thus, Mr. Gorman's projections are for a very specific period and have not been shown to be sustainable beyond that point. Furthermore, Mr. Gorman's approach to sustainable growth ignores investors' expectations for 2009–2011 and the growth that will occur during that period. Petitioner's Exhibit PRM-R at 24. Mr. Moul stated that Mr. Gorman neglected to adjust his assumed return on book value for average rather than year-end book values. Without an adjustment to convert the Value Line forecast returns from year-end to average book values, Mr. Moul stated that there is a downward bias in the results. Mr. Moul indicated that the Federal Energy Regulatory Commission ("FERC") adjusts the year-end returns to derive the average yearly return for that reason. Using a variant of FERC's adjustment procedure, Mr. Moul recalculated Mr. Gorman's return on equity shown on Exhibit MPG-10 to reflect average book values. The return on equity

calculated with average book values increases from 11.85% to 12.21% for the Water Utility Proxy and from 10.93% to 11.21% for the Gas Utility Proxy. Petitioner's Exhibit PRM-R at 24–25.

Mr. Moul also took issue with Mr. Gorman's calculation of the external financing growth rate in his sustainable growth analyses. Mr. Moul stated that Mr. Gorman made an incorrect selection of the book value per share from Value Line by using the projected three-year to five-year book value per share, which is incompatible with the thirteen-week average stock prices that he used covering the period of July 10, 2009 through October 2, 2009. Mr. Moul indicated that the actual year end 2008 book value per share reported by Value Line is the correct input value. Correcting for this error, Mr. Moul stated that the external growth rate becomes 1.60% (a 0.56% increase) for the Water Utility Proxy and 0.76% (a 0.47% increase) for the Gas Utility Proxy. Petitioner's Exhibit PRM-R at 25. With these two corrections, Mr. Moul stated that Mr. Gorman's sustainable growth DCF result increases from 10.15% to 10.91% for the Water Utility Proxy and from 9.83% to 10.44% for the Gas Utility Proxy. Petitioner's Exhibit PRM-R at 26.

Mr. Moul commented on Mr. Gorman's assertion that analysts' growth rates for water companies are abnormally high. He stated that there are several reasons that explain the current analysts' growth forecasts for water utilities. Mr. Moul added that that growth rates cannot be viewed in a vacuum. He explained that historical results cannot be used to "test" forecasts because analysts have concluded that future performance will diverge from the past five-years and ten-years. Petitioner's Exhibit PRM-R at 26.

Mr. Moul testified that Mr. Gorman failed to justify his reasons for focusing on GDP as a growth rate measure and did not establish a cause and effect relationship or linkage among these variables other than to observe that they are different. He opined that we could just as easily conclude that dividend growth and growth in the GDP understate investors' expectations of growth for the Water Proxy Group and Gas Proxy Group when compared to analysts' forecasts. Petitioner's Exhibit PRM-R at 26. Mr. Moul stated that Mr. Gorman's projected growth in earnings per share for the water and gas utilities is significantly impacted by growth in rate base that is not revealed by either a broad measure of inflation or of GDP growth that is not specific to any of the companies in Mr. Gorman's proxy group. Yet, according to Mr. Moul, analysts' growth rates are company-specific and take into account specific factors, such as rate base growth, that impacts future earnings growth. Mr. Moul believed that there is no justification for injecting generic growth measures derived from the GDP when company-specific growth rates are available that relate to the stock prices employed in the DCF. Petitioner's Exhibit PRM-R at 27.

Mr. Moul stated that although Mr. Gorman argues that one limitation of the constant growth DCF is that it cannot accommodate a change in high or low short-term growth that will be followed by sustainable long-term growth thereafter, Mr. Gorman's argument is not supported by the Brigham and Houston text he references. Petitioner's Exhibit PRM-R at 27. Mr. Moul noted that Mr. Gorman quoted from the 2007 edition of Fundamentals of Financial Management, but he deleted the next sentence which states that the dividends of an average, or "normal," company would be expected to grow at a rate of 5% to 8%. Mr. Moul further noted that the authors' view has not changed in light of the 2008 financial crisis because the 2009 edition of the same text expresses the same view that the growth rate for a "normal" company would be in the

range of 5% to 8% per year. Since the growth rate supported by Bingham and Houston is significantly higher than the 4.7% GDP growth rate cited by Mr. Gorman, Mr. Moul concluded that there is no reason to abandon the traditional constant growth form of the DCF because the average growth rate is within that range. Petitioner's Exhibit PRM-R at 27–28.

Mr. Moul stated that there are objective measures that could be used to determine whether or not to employ a two-stage DCF. He explained that FERC set forth specific criteria to be applied when deciding whether to employ the two-stage DCF model: (i) a dividend payout ratios analysis, (ii) an assessment of electric utilities relative to other industries, and (iii) whether analysts' forecasts were two to three times greater than GDP growth. Petitioner's Exhibit PRM-R at 28. Mr. Moul found that the dividend payout ratios of the water utilities do not approach, nor are they projected to approach, the 20%–30% levels for other, mostly non-regulated industrial companies where the two-step DCF model has been used. Thus, based on criteria employed by FERC, Mr. Moul stated that application of a two-stage growth rate in the DCF analysis is unsupported. Petitioner's Exhibit PRM-R at 28.

With respect to the technical aspects of Mr. Gorman's proposed two-stage DCF, Mr. Moul again criticized his assumption of a 200-year investment horizon. Mr. Moul testified that when the FERC uses a two-stage DCF model for natural gas pipelines, it weights the analysts' growth rate (i.e., first-stage growth) two-thirds (66.7%) and second-stage growth by one-third (33.3%) in the case of corporations. Additionally, FERC's application of the two-stage model removes the additional complexity that exists by inserting, as Mr. Gorman did, transitional growth for years six through ten. Mr. Moul stated that if Mr. Gorman had employed FERC's methodology, his two-stage DCF result would be 10.17%. Petitioner's Exhibit PRM-R at 29.

Mr. Moul expressed his concern regarding the CAPM application by Mr. Gorman. He stated that Mr. Gorman properly used the arithmetic mean market premium of 5.60% from the Morningstar study, but he then neglected to incorporate forecasts of market returns in the development of his market premium. Petitioner's Exhibit PRM-R at 29. Mr. Moul testified that forecasts of market returns are necessary to comply with the "ex ante" specification of the CAPM because market models of the cost of equity are a reflection of the forward-looking nature of investor return expectations. Mr. Moul noted that those returns average 12.41%, thus producing a market premium of 7.31%, which is considerably higher than the alternative 5.68% market premium used by Mr. Gorman. Petitioner's Exhibit PRM-R at 29.

Mr. Moul responded to Mr. Gorman's criticism of his leverage adjustment. He explained that although modern financial theory rests on the principal that the weighted average cost of capital for a firm is based upon the market value of each component, only in the public utility ratesetting model is book value employed. Thus, according to Mr. Moul, in order to make the DCF results relevant in the ratesetting context, the market-derived cost rate cannot be used without modification. Petitioner's Exhibit PRM-R at 30. Mr. Moul repeated that to make the market-derived results using either DCF or CAPM applicable in the ratesetting context, an adjustment is needed to account for the higher financial risk that arises from the lower common equity ratio measured by book value capitalization as compared to the higher common equity ratio measured by market capitalization. Petitioner's Exhibit PRM-R at 30–31.

Mr. Moul denied that there was some inconsistency in his leverage adjustment and stated that it is entirely consistent with the analysts' forecasts that are used to represent the growth component of the DCF. Petitioner's Exhibit PRM-R at 31. He explained that the analysts' forecasts can be used as a proxy for the appreciation in the market value of a utility stock because the constant P-E multiple assumption of the DCF requires the market price and earnings to grow at the same rate. He also explained that the book value measures of financial performance shown on his schedules have different risk properties than market-based returns, such as those shown by the DCF model. Petitioner's Exhibit PRM-R at 31.

Mr. Moul next commented on Mr. Gorman's Risk Premium approach. He opined that, for a variety of reasons, this type of risk premium study provides only limited evidence of the cost of equity. He observed that the historical periods selected by Mr. Gorman are arbitrary and that by shortening his time period, progressively higher risk premiums would result when using the yields on Treasury bonds and utility bonds. Petitioner's Exhibit PRM-R at 31–32. For example, Mr. Moul stated that the five-year average period (2004–2008) and the ten-year average period (1999–2008) indicate that the risk premium would be higher than the averages Mr. Gorman used. He pointed out that this type of risk premium study also mixes authorized gas returns on book value with market-determined yields based on Treasury bonds and utility bonds, and thus employs non-comparable variables and does not provide a reliable measure of the risk premium. Petitioner's Exhibit PRM-R at 32.

Mr. Moul testified that there is a potential for a mismatch of time frames between Mr. Gorman's tabulation of the authorized gas returns and the yield on Treasury bonds and utility bonds. He explained that this failure arises because there is a time lag between the development of the evidentiary record in a rate case proceeding and the issuance of an order by a regulatory agency. He explained that this is unlike the yield on Treasury bonds and utility bonds, which are measured after-the-fact. Petitioner's Exhibit PRM-R at 32.

Mr. Moul also testified that it is unknown how the authorized gas returns may have been influenced by regulatory policy or political factors. He explained that a regulatory agency may employ the authorized gas returns as a tool to reflect policy decisions in other ratesetting areas such as interim rates, rates collected subject to refund, use of historic or future test periods, use of average or year-end rate bases, various procedures to calculate depreciation, allowances or disallowances of certain operating costs, and a host of other regulatory practices. Petitioner's Exhibit PRM-R at 32. Moreover, Mr. Moul asserted that it is well known that regulatory agencies have used the authorized gas returns as a means of accomplishing certain goals, such as rewarding or penalizing management performance, and thus it is impossible to determine whether these authorized gas returns in fact represent investor-required returns for the time periods in which those decisions were rendered. Petitioner's Exhibit PRM-R at 32–33. Given all of the unknown factors that influence authorized gas returns, he stated that Mr. Gorman's approach employs an unsuitable benchmark to measure the equity risk premium. Finally, he stated that there is no assurance that the historically derived authorized gas returns are reflective of the new risks facing the gas utility today. Using the yields on utility bonds and Treasury bonds proposed by Mr. Gorman, Mr. Moul testified that the cost of equity would be 10.98%. Petitioner's Exhibit PRM-R at 33.

Mr. Moul then addressed Mr. Gorman's CAPM analysis. He noted that Mr. Gorman properly used the arithmetic mean market premium from the Ibbotson study, but he failed to include the flotation cost adjustment and neglected to adjust the beta for the financial risk adjustment associated with the differences in market capitalization and book value capitalization. Petitioner's Exhibit PRM-R at 33. He stated that the beta used by Mr. Gorman was taken directly from Value Line without the necessary modification to synchronize it with the book value capitalization. He further stated that Mr. Gorman failed to include the size adjustment, which is indicated to be 0.94% and would bring his CAPM result to 10.56% with flotation costs. Petitioner's Exhibit PRM-R at 33–34. He said that Mr. Gorman's CAPM suffers from the same infirmity (i.e., the absence of the size adjustment) as with Mr. Kaufman's CAPM calculation. He stated that the famous Fama/French study specifically identified the size of a firm as an additional factor that requires separate recognition from beta in a multi-factor model. Because the CAPM is a single-factor model, Mr. Moul stated that the risk associated with the size of a firm, or portfolio, must be separately recognized in the CAPM return. Petitioner's Exhibit PRM-R at 34.

(5) Commission Discussion and Findings. The record contains a number of different methods of estimating Petitioner's cost of common equity. The Commission recognizes that the cost of common equity cannot be precisely calculated and estimating it requires the use of judgment. Due to this lack of precision, the use of multiple methods is desirable because no single method will produce the most reasonable result under all conditions and circumstances. The four primary models used to determine a cost of equity—DCF, CAPM, Risk Premium, and Comparable Earnings—were discussed in varying degrees of detail by the parties in this Cause.

There was disagreement among the parties concerning the certain mechanics of the DCF Model. First, regarding the estimation of the sustainable growth rate, Mr. Moul chose the three-year to five-year analysts' forecasted growth rates. While Mr. Gorman agreed with Mr. Moul's selection of growth rates, he argued that Mr. Moul failed to recognize and make adjustments for the current utility environment. Mr. Gorman proposed correcting Mr. Moul's analysis to produce reasonable and rational long-term sustainable growth outlooks. Mr. Kaufman used both historical and projected growth rates of earnings, dividends, and book value per share. We note that while Mr. Kaufman and Mr. Gorman relied on different estimators of growth for their respective DCF analyses, both estimates of growth had very similar results.

The Commission has repeatedly affirmed our view regarding the growth rate. For example, in the 1996 Rate Order we stated:

The Commission has considerable experience with the DCF model for estimating the cost of equity. We are well aware of the advantages and limitations of the various approaches used by each of the witnesses. . . .In all cases, however, the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analyses.

1996 Rate Order at 40–41.

This Commission expects the parties to exercise sound judgment when deciding which

inputs to include as part of their analysis. We have concerns regarding Mr. Moul's sole reliance on analysts' intermediate-term forecasts in his DCF model. The Commission believes that both historical and forecasted earnings and dividends and book value per share data are useful when employing the DCF Model. Although Mr. Gorman agreed with Mr. Moul's forecasted growth rates, Mr. Gorman recommended adjustments that would modify Mr. Moul's outcomes to be much more in line with Mr. Kaufman's and Mr. Gorman's results. We agree with Mr. Kaufman that Mr. Moul's reliance on intermediate-term forecasts results in a growth rate that is unrealistically high.

We also agree with Mr. Gorman that the constant growth DCF return used by Mr. Moul for the Water Proxy Group is not reasonable and represents an inflated return for Indiana-American at this time. The constant growth DCF results for the Water Proxy Group are based on growth rates of 7.29% (Mr. Gorman) and 7.5% (Mr. Moul). The Commission finds these growth rates to be unsustainable for the long-term, which is required by the constant growth model.

Second, the Commission notes that Indiana American made at least one of the following adjustments to its DCF, CAPM, and Risk Premium models that increased the range of its recommended cost of equity: an equity size premium adjustment, a leverage adjustment, or a flotation adjustment. The OUCC and Industrial Group objected to the use of these adjustments. The Commission agrees that these adjustments are inappropriate in this Cause.

The Commission rejects Petitioner's equity size premium adjustment because it can not be directly applied to regulated water utilities. Regulated water utilities do not experience the same risks as other small companies. Therefore, a size adjustment is simply inapplicable and inappropriate for Indiana American.

With respect to the leverage adjustment, the Commission agrees with Mr. Gorman's observation that investors do not evaluate two different types of financial risk in valuing utility investments and that market risk for a utility is based on book value leverage rather than market value leverage. Mr. Kaufman's observation that Mr. Moul's adjustment would reward some utilities when market-to-book ratios are high and penalize those whose market-to-book ratio is low is persuasive. Thus, the Commission finds Petitioner's leverage adjustment to be inappropriate and rejects its use here.

The Commission also rejects Indiana American's flotation adjustment even though Indiana American showed that it incurred costs when it issued stock. For example, Mr. Moul added 0.24% to his DCF Model for his flotation adjustment. Mr. Moul testified that costs have been incurred as the result of stock sales, and specifically, American Water's costs were 3.6% of its total offering. 3.0% of the costs were for the underwriting discount and 0.60% of the costs were for expenses incurred by American Water. However, Mr. Moul failed to show which portion of the costs incurred as a result of the issuance of stock are attributed to Indiana American and how his 0.24% flotation adjustment identifiably accounts for costs specifically incurred by Indiana American. Further, Mr. Moul's flotation adjustment is not based on any actual or verifiable flotation expense but instead was derived by examining publicly traded companies' flotation expenses. The Commission will only allow such an adjustment when it is based on verifiable actual costs so that the reasonableness and appropriateness of the costs may

be examined.

In addition, the Commission notes that with respect to the CAPM analysis, Petitioner relied exclusively on the arithmetic mean premium to estimate his market risk premium, while Mr. Kaufman relied on both the arithmetic and geometric mean. In the 2004 Rate Order we stated, “In past rate cases this Commission has given weight to both the arithmetic and the geometric mean risk premiums. This position was reaffirmed in our 1996 Rate Order, when we stated [‘][t]he debate over the proper use of the arithmetic and geometric means is one we consider resolved. As we stated in Indianapolis Water Company, Cause No. 39713-39843, each method has its strengths and weaknesses, and neither is so clearly appropriate as to exclude consideration of the other.[’]” 2004 Rate Order at 59 (citation omitted). Also, in the 2002 Rate Order, the Commission stated “that, while the debate over the proposed use of the arithmetic and geometric means continues, however, each method has its strengths and weaknesses, neither is so clearly appropriate as to exclude consideration of the other.” 2002 Rate Order at 32. The Commission also noted that the use of the arithmetic mean only increases the estimated risk premium. 2002 Rate Order at 32.

As we stated on page fifty-nine of the 2004 Rate Order, page fifty-nine of Dr. Ibbotson’s 1982 edition of Stocks, Bonds, Bills, and Inflation: the Past and the Future supports our finding that the arithmetic and geometric methodologies should be considered when determining risk premiums.

Neither the arithmetic risk premium nor the geometric mean risk premium should be excluded in favor of the other, and nothing has caused us to change our opinion regarding the appropriate application of both arithmetic and geometric mean risk premiums. Therefore, the Commission will continue to give both the geometric and arithmetic mean risk premiums substantial weight.

The Risk Premium Model calculates the cost of equity by analyzing the relationship between the cost of debt and the cost of equity. As Mr. Moul explained, the cost of equity capital is determined by corporate bond yields plus a risk premium to account for the fact that common equity is exposed to greater investment risk than debt capital. Mr. Moul’s bond yield was 6.25% and comparable to Mr. Gorman’s, which was 6.39%. But, Mr. Moul’s adjusted risk premium is inappropriately high.

To calculate the historical risk premium, a range is typically determined using the most current yearly data, which in this case is 2008. However, Mr. Moul failed to include data from 2008 in his calculations for the unadjusted risk premium and the risk premium adjusted downward to account for differences in risk characteristics of the S&P Public Utilities and the Water Proxy Group. When data from 2008 is appropriately included, Mr. Moul’s unadjusted risk premium of 6.23% is reduced to 4.99%, while his adjusted risk premium of 5.50% is reduced to 4.39%.

With respect to Mr. Moul’s Comparable Earnings approach, Mr. Gorman and Mr. Kaufman both raised several concerns. The Commission has carefully reviewed these and concludes that the approach as implemented by Mr. Moul does not measure the appropriate return for Indiana American. As Mr. Kaufman observed, Mr. Moul appears to give little weight to his own Comparable Earnings results. The Commission finds that the results should be

disregarded.

The Commission also notes the possibility that American Water is now a riskier entity, and therefore Indiana American may also be riskier. Since the 2004 Rate Order, Standard & Poor's lowered the credit rating of AWCC from A- to BBB+. Petitioner's Exhibit JMK at 8.<sup>2</sup> Also, we noted on page sixty of the 2004 Rate Order that American Water's acquisition by RWE AG, a multinational conglomerate, made it less risky because of increased access to financial markets. American Water has now completely severed its relationship with RWE AG.

We are also mindful of the decline in interest rates as a result of the recent economic crisis. When Indiana American filed its case-in-chief, it used 8.25% as its likely coupon rate when calculating its most recent debt offering. Petitioner's Exhibit SWR at 7. The actual coupon rate for the debt offering was 6.0%. Petitioner's Exhibit SWR-R at 9. Therefore, Indiana American's cost of debt has declined.

Petitioner recommended a return of 12.0% on equity capital. However, the foregoing discussion of the evidence demonstrates that Petitioner's recommendation is too high given current levels of capital costs, prevailing economic conditions and because of adjustments made to Mr. Moul's raw results. Petitioner's adjusted DCF and CAPM results were 12.19% and 15.20%, respectively. OUCC witness Mr. Kaufman recommended a return on equity capital of 9.25% based on DCF results ranging from 8.83% to 9.68% and CAPM results ranging from 7.54% to 8.10%. Mr. Gorman recommended a return of 9.90% based on the results of his DCF, Risk Premium, and CAPM analysis.

Based on our discussion above, the Commission finds a 10.0% cost of equity is fair and reasonable. We find that this cost of equity will provide Petitioner an opportunity to earn a pre-tax interest coverage ratio that will preserve a "BBB+" bond rating and is high enough to compensate Petitioner for any marginal risks it faces.

## **B. Capital Structure and Weighted Cost of Capital.**

(1) Petitioner's Position. Scott W. Rungren testified concerning Petitioner's capital structure. He presented the capital structure as of June 30, 2009 adjusted for certain changes anticipated to occur thereafter and before the final hearing. For purposes of long-term debt, he started with the Company's long-term debt schedule as of November 30, 2008. Petitioner's Exhibit SWR at 4. Mr. Rungren then made the following adjustments: (1) a \$22 million long-term debt issuance that occurred on February 4, 2009, (2) an anticipated \$43 million debt issuance expected to occur during the fall of 2009, and (3) the maturity of a \$20 million 6.90% series occurring on July 1, 2009. The interest rate assumed for the \$43 million issuance was 8.25%, which was the same rate for the February issuance. Petitioner's Exhibit SWR at 6-7.

Mr. Rungren also adjusted Petitioner's common equity balance. He started with the balance as of November 30, 2008 and adjusted for a common equity infusion of \$32 million in April 2009, the projected change in retained earnings from November 30, 2008 to June 30, 2009,

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<sup>2</sup> See also American Water Capital Corp.'s New \$60M Notes Rated 'BBB+', Global Credit Portal: Ratings Direct (Standard & Poor's, New York, N.Y.), Dec. 1, 2009, at 1.

and other minor changes to paid-in capital projected to occur during this same period. Petitioner's Exhibit SWR at 9. With these adjustments, Mr. Rungren presented a projected *pro forma* capitalization of \$624,713,337 with an overall weighted cost of capital of 8.57%. That cost reflects the cost of common equity of 12.0% recommended by Mr. Moul. Petitioner's Exhibit SWR at 4.

Mr. Kalinovich testified concerning current conditions in the capital markets and the impact those conditions are having on AWCC and Indiana American. He testified that for several years, Indiana American has obtained most of its long-term debt financing through AWCC. Petitioner's Exhibit JMK at 1. AWCC is a wholly-owned subsidiary of American Water dedicated to providing financial services to American Water's water and wastewater service subsidiaries by pooling the financing requirements of such subsidiaries and creating larger and more cost efficient debt issues at more attractive interest rates and lower transaction costs than would otherwise be available for the subsidiaries. Petitioner's Exhibit JMK at 2. Under their respective agreements with AWCC, each participant, including Indiana American, provides AWCC with an estimate of its borrowing requirements for the coming year and, on a rolling basis, for one to three years in advance. On the basis of this information, AWCC arranges to obtain funds necessary to meet the participants' short- and long-term debt requirements. AWCC loans the proceeds of its borrowings and debt issuances to the participants, including Indiana American, on the same terms as those obtained by AWCC. While Mr. Kalinovich did not expect that Indiana American could secure a credit rating as favorable as AWCC's, the agreement between Indiana American and AWCC provided Indiana American the option to borrow from any source. Petitioner's Exhibit JMK at 3-4.

Mr. Kalinovich testified that the current economic situation has resulted in a significant setback to the banking industry and capital markets. This, in turn, has caused a serious economic slowdown, which is most visible in the rapid decline in and the value of publicly-traded equity and debt securities and rapidly rising unemployment. While government intervention has made a positive impact, Mr. Kalinovich testified that structural problems still exist and long-term economic prospects are uncertain. He said that the structural problems are past mistakes by the banking industry which have caused several large financial institutions to falter. Petitioner's Exhibit JMK at 5. He testified that the combined effects of the economic events has been a rapid flight to quality by investors and a rapid price decline in all investment asset categories except U.S. Treasury Securities and precious metals. Petitioner's Exhibit JMK at 6. Mr. Kalinovich explained that while utilities are typically a high-quality, low-risk investment, investors are much more sensitive to credit quality than in past economic down times. He stated that while the current recession started in 2007, the most notable market disruption was the bankruptcy of Lehman Brothers in September 2008. Petitioner's Exhibit JMK at 6-7.

He explained the impact this financial crisis has had on utilities' access to capital. While utilities that are financially stable are still able to access the debt markets, they are paying higher interest rates. Petitioner was able to manage this credit crisis primarily through its relationship with AWCC. Petitioner's Exhibit JMK at 7-8. There was a brief period during September 2008 and early October 2008 where neither AWCC nor Indiana American had access to long-term debt markets at reasonable rates. Since then, AWCC and Indiana American have been able to issue debt, but at a higher spread over fifteen year Treasury securities. In December 2008, AWCC issued debt at an interest rate of 10.0%. None of this money was loaned to Indiana

American because there were other affiliates at that time in more immediate need of long-term debt as a result of liquidity issues. Indiana American accessed the long-term debt markets through AWCC in February 2009 at a rate of 8.25%. He explained that Indiana American, through AWCC will balance the benefit of accessing the credit markets in small increments to dollar average rapid changes in interest rates with the high transaction costs associated with small issuances. Petitioner's Exhibit JMK at 8–9. Mr. Kalinovich testified that as long as Indiana American is provided the opportunity to earn reasonable returns on equity, Indiana American would be able to access the debt capital market at reasonable rates. Petitioner's Exhibit JMK at 9.

(2) OUCC's Position. The OUCC proposed a weighted cost of capital of 7.28%. The OUCC made four changes to the capital structure proposed by Mr. Rungren. First and as noted previously, Mr. Kaufman recommended a 9.25% cost of common equity. Second, the OUCC adjusted the anticipated interest rate on the \$43 million issuance to reflect more current information. Ms. Stull noted that in May 2009, Petitioner issued \$15.5 million of this new debt at a rate of 8.27%, but pursuant to a discovery request, she lowered its projection on the remainder of the debt issuance to 6.64%. Public's Exhibit No. 1 at 12. Third, Ms. Stull adjusted debt issuance costs. She testified that Petitioner neglected to include any debt issuance costs on the \$43 million issuance. Public's Exhibit No. 1 at 13. Fourth, Ms. Stull made an additional adjustment to reflect a tax-free interest rate on a loan from the Drinking Water State Revolving Fund (“DWSRF”) and the inclusion as zero cost capital certain funds that are classified as “forgivable loans.” Public's Exhibit No. 1 at 12; Schedule 11, Support Schedule 1, page 1 of 1.

(3) Industrial Group Position. Mr. Gorman testified on behalf of the Industrial Group concerning Petitioner's capital structure. He recommended using a June 30, 2009 capital structure without any *pro forma* adjustments and claimed that any such adjustments would result in a hypothetical capital structure. In addition, he proposed to include a portion of Petitioner's short-term debt in the ratemaking capital structure. He presented Petitioner's short-term debt and construction work in progress (“CWIP”) balances as of June 30, 2009, which showed that short-term debt exceeded CWIP by \$14,405,000. He included this portion of Petitioner's short-term debt in Petitioner's capital structure, concluding that short-term debt to was being used to support rate base investments. Industrial Group's Exhibit No. 2 at 13; Exhibit MPG-1. Mr. Gorman also utilized his recommended cost of common equity of 9.90% and arrived at a proposed weighted cost of capital of 7.44%.

(4) Petitioner's Rebuttal. Mr. Rungren testified in response to Ms. Stull and Mr. Gorman. He first testified that the planned debt issuance for the fall of 2009 had closed as of the time of the final hearing. He agreed with Ms. Stull that in May, the Company issued \$15.5 million of this debt at an interest rate of 8.27%. Petitioner's Exhibit SWR-R at 2. An additional taxable issuance in the amount of \$24.7 million was issued in December 2009 with a coupon interest of 6.0%. He explained that the balance was in the form of a tax-exempt offering totaling \$2.771 million through the DWSRF, which had also closed as of the final hearing. He testified that this tax exempt debt is a draw loan, which means that while Petitioner has closed, Petitioner will not receive any proceeds until construction begins and draws are made. He noted that this loan is tied to financing-specific construction projects, that construction had yet to begin, and that projects to be financed with the debt are not included in rate base. Petitioner's Exhibit SWR-R at 3–4. He agreed with Ms. Stull that the previously estimated carrying value of this

debt issuance did not reflect estimated debt issuance costs. He updated both the May and December 2009 issuances for the actual issuance costs and proposed an updated weighted cost of capital of 8.41%. This reflects the actual common equity balance as of June 30, 2009, the actual cost of long-term debt as of the final hearing (excluding the DWSRF loan), and Mr. Moul's recommended cost of common equity of 12.0%. Petitioner's Exhibit SWR-R at 5.

He objected to Ms. Stull's inclusion of the DWSRF financing in her long-term debt schedule because no funds had been received, and the assets to be financed with the anticipated funds were not included in rate base. Petitioner's Exhibit SWR-R at 6-7. He further noted that Ms. Stull's recommendation to include the forgivable loan as zero cost capital was inconsistent with the terms and conditions of the Commission's Order in Cause No. 43767, which requires that to the extent the approved projects are financed with forgiven debt, Indiana American is to record the debt as CIAC. Since the assets are not yet in rate base, the debt recorded as CIAC should not be in rate base. Petitioner's Exhibit SWR-R at 7.

Mr. Rungren also objected to Mr. Gorman's recommendation to use the capital structure as of June 30, 2009. He noted that the terms of the Prehearing Conference Order provide that the capital structure may be updated. Mr. Rungren added that June 30, 2009 is not the cutoff date for Indiana American's capital structure. Petitioner's Exhibit SWR-R at 11.

Next, Mr. Rungren responded to Mr. Gorman's presentation of the cost of long-term debt. He noted that Mr. Gorman did not deduct unamortized debt issuance costs from the principal amount outstanding to compute the carrying value of long-term debt to include in the capital structure, but Mr. Gorman did correctly use the carrying value of long-term debt to compute the cost of long-term debt. Mr. Rungren concluded that Mr. Gorman's capital structure and cost of long-term debt calculation utilizes differing long-term debt balances. Petitioner's Exhibit SWR-R at 12-13.

With respect to short-term debt, Mr. Rungren testified that after adjusting for the repayment of short-term debt by the amount of the long-term debt issuance that closed immediately before the hearing in the amount of \$24.7 million, Mr. Gorman's calculation of the amount by which short-term debt exceeds CWIP would no longer show a positive balance. Petitioner's Exhibit SWR-R at 13. Second, Mr. Rungren noted that Petitioner has been authorized to borrow considerably more over its two-year financing program than the amount that closed in December. As such, any short-term debt would truly be temporary financing, which is not used as a source of financing for rate base. Finally, Mr. Rungren noted that short-term debt is used to finance other components besides CWIP that are not in rate base, including working capital. He testified that the short-term debt balance is periodically retired or reduced to de minimus levels and is not a source of permanent capital. He noted that a very similar adjustment had been rejected by the Commission in two Orders involving PSI Energy, Inc. in Cause No. 40003, p. 19 (IURC 9/27/96) and in Cause No. 42359, p. 11 (IURC 5/18/04). Petitioner's Exhibit SWR-R at 13-14.

Mr. Kalinovich also responded to Mr. Gorman's testimony concerning short-term debt. He testified that if short-term debt were used as a permanent source of financing, the need for short-term debt would be continually escalating. A portion would serve as permanent financing and the remainder would finance construction needs. As the short-term debt balance grows in

this fashion, the cost of long-term debt will grow because the Company will become riskier. Moreover, the maturity date for short-term debt is in the short-term. When that debt comes due, the Company must secure replacement financing. The risk of not being able to pay its debt when it comes due is called liquidity risk. Petitioner's Exhibit JMK-R at 6.

Mr. Kalinovich testified that Mr. Gorman assumed that when short-term debt (which he believes is supporting rate base) comes due, the Company (1) will be able to secure replacement financing and (2) will be able to do so at lower rates than it can secure for long-term financing today. During the most recent economic crisis, this strategy forced many companies to face rapidly rising costs of financing, and these companies must now address the negative consequences associated with these higher costs. In Mr. Kalinovich's judgment, it is bad advice to finance long-term investments with short-term financing. Petitioner's Exhibit JMK-R at 8-7.

(5) Commission Discussion and Findings. There appears to be no more debate concerning the actual long-term debt component of Petitioner's capital structure except for the inclusion of funds secured through the DWSRF. Petitioner has issued the debt and the actual interest rate and issuance costs of that debt are reflected in Mr. Rungren's rebuttal testimony and exhibits. The Commission agrees with Mr. Rungren that the balance of long-term debt to be included in the capital structure should be computed net of unamortized issuance costs. The Commission also rejects Mr. Gorman's request that we use the June 30, 2009 capital structure because this is inconsistent with the terms of the Prehearing Conference Order.

The Commission also rejects Ms. Stull's request to reflect the DWSRF financing in Indiana American's capital structure. While Petitioner closed on this loan prior to the final hearing, Petitioner has received no funds and thus, has not yet financed any assets through this transaction at this time. These funds are to finance construction projects, which are not yet reflected in Petitioner's rate base.

The final issue the Commission must consider is the inclusion of short-term debt in the capital structure. As noted by Mr. Rungren, we have twice previously rejected precisely the request that Mr. Gorman makes in this case. Moreover, with the recent debt issuance, Mr. Gorman's calculation of the amount that he would propose to include would now reveal a balance of zero. The Commission is further persuaded by Mr. Kalinovich's testimony that it would be a financially risky strategy for utilities to finance long-term capital assets with short-term debt on a recurring basis. This creates liquidity risks and could very well lead to much higher costs of capital. There is no evidence that Petitioner uses short-term debt for anything other than bridge financing, and it is not used to support Indiana American's rate base. Accordingly, the Commission rejects Mr. Gorman's proposal to include short-term debt in the capital structure.

Based on these findings and after giving effect to the cost of common equity of 10.0%, the Commission finds that Petitioner's capital structure and weighted cost of capital is as follows:

<b>Class of Capital</b>	<b>Pro Forma Amount</b>	<b>% of Total</b>	<b>% Cost</b>	<b>Weighted Cost</b>
Long-Term Debt	\$284,014,760	45.42%	6.96%	3.16%
Deferred Income Taxes	64,790,031	10.36 %	0.00%	0.00%
Acc. Dep. on Contributed Utility Plant for Muncie Sewer	57,224	0.01%	0.00%	0.00%
Post Retirement Benefits, net	2,451,813	0.39%	0.00%	0.00%
Accumulated Deferred Investment Tax Credits – Pre 1971	51,033	0.01%	0.00%	0.00%
Job Development Investment Tax Credits	1,670,480	0.27%	8.44%	0.02%
Preferred Stock	270,000	0.04%	6.00%	0.00%
Common Equity	<u>272,015,435</u>	<u>43.50%</u>	10.00%	<u>4.35%</u>
Total Capitalization	<u>\$625,320,776</u>	100.00%		7.53%

**C. Fair Rate of Return and Net Operating Income.**

(1) Petitioner's Position. Mr. Moul provided an analysis by which the Commission can derive a fair return on fair value using a weighted average of the fair value of Petitioner's plant. Mr. Moul began with the replacement cost of Petitioner's plant as determined by Mr. Hoffman. This was derived from the RCNLD valuation and adjusted generally downward by 2.5% per year for technological change. Petitioner's Exhibit PRM-1 at 58. Mr. Moul then derived a weighted average of the fair value rate base, assigning the percentage to replacement cost equal to Petitioner's common equity ratio and the balance to original cost. He did this in an effort to be certain that, at a minimum, the Company receives the benefit of the appreciation and value of its assets to the extent they were financed by the common equity investor. Petitioner's Exhibit PRM at 58.

He derived the 2.5% for technological change based upon the Bureau of Labor Statistics and the average age of the Indiana American's utility plant. For purposes of then determining a fair return, Mr. Moul deducted historic inflation from the common equity cost rate used in the determination of the Company's cost of capital. He did this even though he expressed reservations about the theory behind deducting historic inflation from a cost of capital intended to compensate for future inflation. Petitioner's Exhibit PRM at 59–61. Using this calculation, Mr. Moul determined a fair return on fair value of \$61,120,065. Since the Company's request was less than this, Mr. Moul opined that the Company's requested return was reasonable. Petitioner's Exhibit PRM at 63.

Mr. Grubb also provided an analysis of an appropriate fair return on fair value, which took the form of five reasonableness tests as applied to the Company's request. Mr. Grubb conducted his analysis independently of Mr. Moul's. Petitioner's Exhibit EJJ at 6. He started

with the most recent fair value finding from Petitioner's last litigated rate case and updated it by 2.5% for inflation and for investor-funded plant additions. He then computed five different fair rates of return on that fair value. Petitioner's Exhibit EJG at 7.

Mr. Grubb computed in the first reasonableness test the fair rate of return in the same manner by which the Company computed fair return in its last two rate cases, which is to recompute the Indiana American's weighted cost of capital by deducting from the weighted cost of debt the historic inflation during the time of each individual debt issue. This produced a fair rate of return of 7.84% and a net operating income of \$74,153,780. His second test was derived from the Commission's fair rate of return finding in Cause No. 42520, which was 5.38%. Mr. Grubb noted that while the Commission did not explain specifically how it arrived at this figure, 5.38% is the rate that would be produced by deducting historic inflation from the weighted cost of debt at an approximate rate of 3.5%. Mr. Grubb then deducted 3.5% from the weighted cost of debt in this case to arrive at a fair rate of return of 6.97% and a net operating income of \$65,924,980. Petitioner's Exhibit EJG at 8.

In his third test, Mr. Grubb deducted from the weighted cost of debt historic inflation over the weighted average life of utility plant in service at the inflation rate over that period. Mr. Grubb used an historical inflation rate of 2.5% from the Ibbotson Yearbook for the years 1994–2008. Mr. Grubb explained that this fourteen-year time period corresponds to the average age of Petitioner's plant as provided by Mr. Hoffman. This produced a fair rate of return of 7.42% and a net operating income of \$70,181,256.

Mr. Grubb, in the fourth test, did not make a specific deduction for purposes of inflation, but rather he computed the differential between the weighted cost of capital found by the Commission in Cause No. 42520 and the fair rate of return found in that case. This produced a differential of 1.79%, which Mr. Grubb subtracted from the weighted cost of capital proposed by Petitioner in this case, resulting in a fair rate of return of 6.78% and a net operating income of \$64,127,886. For purposes of the fifth test, Mr. Grubb adjusted the 5.38% fair rate of return finding from Cause No. 42520 for Indiana American's current capital structure and the cost of common equity used in Petitioner's DSIC cases. After deducting the 3.5% rate for historic inflation used by the Commission in Cause No. 42520, this produced a fair rate of return of 6.10% and a net operating income of \$57,696,181. Petitioner's Exhibit EJG at 9–10. Since this amount was only slightly higher than Petitioner's requested net operating income in this case, Mr. Grubb testified that Petitioner's request was reasonable.

(2) Industrial Group's Position. Mr. Gorman testified that Mr. Moul's fair value rate of return and net operating income recommendations were unreasonable because the fair value rate base substantially overstates a fair earnings entitlement. Gorman stated that the net operating income should be the same whether using an original cost rate base or fair value rate base. Industrial Group Exhibit No. 2 at 64. In an original cost methodology, the investors are compensated by the allowed return on rate base. The increase in value of assets included in rate base is not included in the original cost methodology. Thus, investors are compensated for an expectation that asset values will increase by applying a market-based rate of return to the original cost of assets. Under a fair value methodology, the expected increase in the value of assets is reflected in rate setting. The total return to investors includes the growth in the value of assets plus the rate of return applied to the rate base. Industrial Group Exhibit No. 2 at 64. Mr.

Gorman explained that regardless of the method, the net operating income should remain the same. Industrial Group Exhibit No. 2 at 65.

Mr. Gorman testified that the fair rate of return to apply to a fair value rate base is based on the return an investor would expect to receive by making an alternative comparable risk investment, which is comprised of the expectation that the investment value will grow and that the investment may receive some current return on the asset. For example, Mr. Gorman explained that if a utility investor expects a 10.0% return, and the value of the assets are expected to grow by 4.0%, then the fair rate of return should be 6.0%. Industrial Group Exhibit No. 2 at 65. Mr. Gorman then testified that the most direct way to determine the fair rate of return to a fair value rate base is to start with the rate of return developed for the original cost rate base with the return on equity adjusted to remove the expected future growth in the utility's asset values. Industrial Group Exhibit No. 2 at 66.

Mr. Gorman explained that his approach and the original cost rate of return produced fair compensation to investors by using simple numbers. For purposes of illustration under an original cost methodology, he assumed a rate base of \$100 at the beginning of the year, a return of 10%, an escalation of the value of the assets at 3%, annual depreciation of \$3, and capital expenditures of \$3.10. Industrial Group Exhibit No. 2 at 66. In this scenario, the current rate of return was \$10, or 10% of the original cost. Industrial Group Exhibit No. 2 at 66–67. In contrast, Mr. Gorman presented a scenario with the same \$100 beginning rate base and capital expenditures, but a fair value return of 7% and an asset escalation of 3%. Industrial Group Exhibit No. 2 at 67. In this case, the year end rate base increased to \$103, reflecting the 3% escalation in value. Here, the investor has a current return of 7%, appreciation in asset value of 3%, and a total return of 10%. Industrial Group Exhibit No. 2 at 67.

(3) Petitioner's Rebuttal. Mr. Moul testified that to accept Mr. Gorman's argument that the authorized return should be the same using an original cost rate base and a fair value rate base would be a repudiation of the role that fair value plays in setting rates by the Commission. He stated that this argument is without merit because if it were true, then fair value would equal original cost. Mr. Moul explained that Petitioner's valuation shows that the current cost of the assets, which comprises its rate base, is much higher than the original cost. Therefore, Mr. Gorman's assertion must be incorrect. Petitioner's Exhibit PRM-R at 34–35.

Mr. Moul also disagreed with Mr. Gorman's argument that part of a utility's return reflects the appreciation expectations of investors represented by unrealized returns. He opined that this argument is incorrect because in Mr. Gorman's sustainable growth rate form of the DCF Model, future appreciation is generated by reinvestment of expected future earnings, but this has nothing to do with the appreciated value of assets already invested in the business (i.e., the rate base). Mr. Moul stated that Mr. Gorman's argument is also incorrect because the appreciation in Indiana American's rate base is attributed principally to the changing value of the dollar since existing assets were installed. Petitioner's Exhibit PRM-R at 35.

Mr. Moul indicated that Mr. Gorman was wrong when he stated on page sixty-five that "in a fair value methodology, expected growth in the value of the assets is picked up in the growth to the rate base itself." Mr. Moul stated that the fair value rate base reflects appreciation in asset values through the present time, not expected future growth in value. Mr. Moul

explained that, just like a homeowner benefits from the appreciation in the value of his/her home over time without investing additional amounts in his/her property, investors in Indiana American also realize the appreciation (or depreciation) in the value of the rate base without expending additional dollars (i.e., reinvestment earnings realized from future returns that are not paid out as dividends). Hence, Mr. Moul concluded that original cost is not the same as fair value, and changes in value realized since the original installation of the assets must be recognized in the fair value determination. Petitioner's Exhibit PRM-R at 35–36.

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

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

Duquesne Light Co., 488 U.S. at 308–09. As previously discussed, the Indiana fair value rule is a significant factor in treating the Indiana Cities AA at issue in this case. In light of the findings made above, including how the purchase price served to bring the property to its present state of efficiency and the cost savings that investment made possible, Petitioner should be allowed a return on the net amount of the Indiana Cities AA through fair value ratemaking.

As the Commission did in the 2002 Rate Order and the 2004 Rate Order, we will use the following standards and criteria to determine a fair rate of return on Petitioner’s investment in its utility plant:

- 1) Return comparable to return on investments in other enterprises having corresponding risks;
- 2) Return sufficient to ensure confidence in the financial integrity of the Petitioner;

- 3) Return sufficient to maintain and support the Petitioner's credit [rating];
- 4) Return sufficient to attract capital as reasonably required by the Petitioner in its utility business.

2002 Rate Order at 38; 2004 Rate Order at 68. One recognized method for evaluating the reasonableness of a utility's allowed return involves investigation of the utility's capital structure. From such investigation, we can develop the overall weighted cost of capital. This cost of capital may then be considered in determining a fair return. Having previously determined that the fair value of Petitioner's rate base is \$945,522,592, it is now the Commission's duty to determine a fair rate of return that can be used to calculate a fair dollar return for Petitioner's net operating income.

As the Supreme Court of Indiana previously determined in Public Serv. Comm'n:

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

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

The Commission has asserted in previous rate cases, insofar as the fair value rate base contains historical inflation, that it is historical inflation and not the prospective inflation that should be removed from the cost of capital to estimate a fair rate of return. The Commission previously explained that "[i]n order to avoid over-compensating Petitioner for the effects of historical inflation, it is necessary to remove the historical inflation component from the costs of capital to derive a fair return." 2004 Rate Order at 69. See also 2002 Rate Order at 39.

In test two and five of his five fair value reasonableness tests, Mr. Grubb used an historical inflation rate of 3.5%, which was the rate, according to Mr. Grubb, used by the Commission in Cause No. 42520. However, in test three, Mr. Grubb used an historical inflation rate of 2.5%, which is the average inflation rate from 1994–2008. This time period provides fourteen years of data and corresponds to the average age of Indiana American's plant as provided by Mr. Hoffman. In addition, the Commission notes that in footnote two on page five of his testimony, Mr. Kaufman explained that from 1991–2008 the inflation has averaged 2.5%. The Commission finds that 2.5% is the appropriate historical inflation rate.

The Commission first notes that the OUCC did not provide testimony or a

recommendation concerning Petitioner's fair rate of return. Although the Industrial Group provided testimony on the fair rate of return, it did not provide a recommended fair rate of return. Indiana American's recommended range for its fair rate of return provided by the five reasonableness tests is 6.10%–7.84%. As noted previously, only reasonableness test number two, which produced a fair value rate of return of 6.97%, used 2.5% for its historical inflation rate and removed historical inflation values from Petitioner's cost of debt only.

Using the 2.5% historical inflation rate to remove inflation values from Indiana American's overall cost of capital yields a fair value rate of return of 5.03%. Using that same rate to remove inflation values from Indiana American's cost of debt yields a fair value rate of return of 6.40%. Accordingly, the range for Petitioner's fair value rate of return is 5.03%–6.40%. Based on the evidence presented, the Commission finds 5.32% to be Indiana American's fair value rate of return. When this is applied to Indiana American's fair value rate base of \$945,522,592, the result is a net operating income of \$50,262,867.

## **9. Operating Results Under Present Rates.**

**A. Revenues.** Petitioner's proposed *pro forma* annual revenues at present rates originally totaled \$162,481,343. Petitioner's Exhibit GMV at 18. The OUCC's proposed *pro forma* revenues at present rates equaled \$161,306,564. OUCC Revised Schedule 5 at 1. The OUCC accepted Petitioner's proposed adjustments for Bill Analysis Reconciliation, Unbilled Revenue, Large Customer Usage, and Other Revenue. Petitioner accepted on rebuttal the OUCC's proposed adjustments for the Portage Billing Error, Insufficient Funds Charges, and Non-Utility Rent. On rebuttal, Petitioner presented evidence of a small adjustment to increase revenues as a result of billing errors from some new meters that had a defect and had been installed in the Southern Indiana Operation. This problem was not discovered until several weeks after the hearing on Petitioner's case-in-chief, but no party opposed the adjustment. The remaining differences as well as issues raised by other parties are described and reconciled hereinafter.

### **(1) Residential and Commercial Revenue Growth Normalization.**

**(a) Petitioner's Position.** Petitioner proposed to normalize residential and commercial revenues to reflect changing customer counts during the test year. This adjustment used actual residential and commercial customers from December 2007 through November 2008 (end of test year). Book 2 of 12, MSFR # 10 Workpapers – Revenue, pp. 18–20 of 211. For the service charge portion, Mr. VerDouw asserted that his adjustment is consistent with the Company's treatment accepted by the Commission in Cause No. 39595, and the 1996, 1997, 2002, and 2004 Rate Orders. He also asserted that for the usage portion, his adjustment was consistent with the Commission's decision in the 2004 Rate Order.

Mr. VerDouw calculated the change in the number of residential and commercial customers for each month of the test year and used actual changes in customer counts from December 2007 through November 2008. Petitioner's Exhibit GMV at 14. Mr. VerDouw added six months of service charges to the test year for residential and commercial sprinkler meters. Mr. VerDouw explained that the change in customers was calculated for each month and then annualized for the number of months that the service charge was not accounted for in the test

year bill analysis. For the volumetric growth portion of the adjustment, Mr. VerDouw assumed volumetric usage of five centum cubic feet (“ccf”) per month, which is a typical month’s consumption for a residential or small commercial customer. Petitioner’s Exhibit GMV at 15. Mr. VerDouw further stated that the volumetric usage portion of the adjustment is consistent with the methodology proposed by the OUCC and accepted by the Commission in the 2004 Rate Order. He added that Petitioner accepted the volumetric usage adjustment for purposes of the approved settlement in Cause No. 43187. Petitioner’s Exhibit GMV at 14. The calculation for service charge and volumetric adjustment was made up or down, depending on whether the number of residential and commercial customers went up or down over the period. Petitioner’s Exhibit GMV at 15.

(b) OUCC’s Position. Mr. Patrick used Mr. VerDouw’s methodology to normalize revenues during the test year with three changes. Public’s Exhibit No. 3 at 4. First, he calculated a district average ccf per customer rather than using a five ccf. Second, Mr. Patrick used actual customer counts rather than the budgeted information used by Petitioner. Third, Mr. Patrick corrected several of the volumetric rates and monthly charges used by Petitioner for certain districts he believed were incorrect. Public’s Exhibit No. 3 at 4. Based on these revisions, Mr. Patrick recommended a normalization of residential revenues of negative \$349,314 and a normalization of commercial revenues of negative \$368,961. Public’s Exhibit No. 3 at 4 and 6.

Mr. Patrick testified that Petitioner did not propose an adjustment for residential and commercial customer growth which occurred in the seven month period following the test year. However, the OUCC proposed such an adjustment. Public’s Exhibit No. 3 at 7–8; CEP Attachment 5. To calculate his customer growth adjustment, Mr. Patrick analyzed each district’s customer counts for each customer class. He subtracted the November 2008 customer count (end of test year) from the June 2009 customer count for each customer class in each district. Mr. Patrick then multiplied the increase or decrease in customers for each customer class times the average test year monthly bill for that district. The average test year monthly bill included both the monthly service charges and the volumetric usage. For his growth adjustment, Mr. Patrick recommended an increase to operating revenues of \$943,194 for residential customers and an increase of \$486,772 for commercial customers. Public’s Exhibit No. 3 at 7–8.

(c) Petitioner’s Rebuttal. In rebuttal, Petitioner’s Witness Gary VerDouw stated that although the OUCC took a different approach than the one taken by Petitioner to normalize test year residential and commercial revenue, he did follow Mr. Patrick’s logic and could agree with his approach. Mr. VerDouw therefore agreed with Mr. Patrick’s *pro forma* adjustment to normalize test year residential and commercial revenue. Petitioner’s Exhibit GMV-R at 31.

(d) Commission Discussion and Findings. The OUCC and Petitioner agree on the methodology for calculating revenue normalization resulting from changes in the number of residential and commercial customers during the test year. While Mr. VerDouw proposed to use five ccf for usage as accepted in prior methods, Mr. Patrick calculated average usage by division during the test year. Mr. VerDouw agreed to this methodology. The Commission accepts this methodology and finds that residential test year revenues should be adjusted by a negative \$349,314 and commercial revenues by a negative \$368,961.

(2) DSIC Normalization.

(a) Petitioner's Position. Petitioner's Witness VerDouw sponsored an adjustment to increase test year revenue by \$5,514,129 to reflect the amount of *pro forma* DSIC revenue not included in the test year. Mr. VerDouw explained that two DSIC filings have been approved since the conclusion of Cause No. 43187 in October 2007. Petitioner's Exhibit GMV at 13. The first DSIC was authorized in Cause No. 42351-DSIC-4 pursuant to an Order issued April 2, 2008. The second DSIC was approved by the Commission pursuant to its April 15, 2009 Order in Cause No. 42351-DSIC-5. Mr. VerDouw stated that the test year includes surcharge revenue generated through the DSIC in all water tariffs. He indicated that the effects of DSIC-4 and DSIC-5 were annualized and an adjustment was made for the amount of DSIC surcharge revenue over and above what was included in actual test year DSIC revenue from April through November 2008 as actual test year DSIC-4 surcharge revenue. Petitioner's Exhibit GMV at 13–14. Mr. VerDouw stated that additional detail for this adjustment is shown in Petitioner's Exhibit GMV-3, Schedule 3.

(b) OUCC's Position. OUCC Witness Charles Patrick stated that the OUCC accepted Petitioner's methodology for calculating the DSIC normalization, but proposed a DSIC normalization of \$5,469,492. Public's Exhibit No. 3 at 6. Mr. Patrick's calculation differed from Petitioner's in two respects. First, he incorporated the OUCC's revenue adjustments. Second, he multiplied OUCC *pro forma* revenues by 5%, per IC 8-1-31-13 to arrive at a *pro forma* DSIC normalization of \$7,665,577. Subtracting test year DSIC revenues of \$2,196,085 resulted in an increase of \$5,469,492. Public's Exhibit No. 3, p. 6–7; CEP Attachment 9.

(c) Petitioner's Rebuttal. Petitioner's Witness VerDouw testified that Indiana American's allowed DSIC percentage when compared to authorized revenue is 4.93%. Petitioner's Exhibit GMV-R at 32. While Mr. Patrick is correct that IC 8-1-31-13 limits DSIC revenues to 5% of the public utility's base revenue level as approved in the most recent rate proceeding, Mr. VerDouw testified that the authorized revenues approved in Cause No. 42351-DSIC-5 should be utilized. Petitioner's Exhibit GMV-R at 32. Mr. VerDouw added that the calculation used by the Petitioner in its DSIC normalization took test year revenue by district times the appropriate DSIC percentage, less test year DSIC revenue. This calculation, according to Mr. VerDouw, comes very close to achieving the revenue requirement approved in Cause No. 42351-DSIC-5. Mr. VerDouw therefore opined that Petitioner's calculation of the DSIC normalization is correct, and thus the Petitioner's DSIC normalization adjustment of \$5,514,129 should be used. Petitioner's Exhibit GMV-R at 33.

(d) Commission Discussion and Findings. Both parties agree there should be a DSIC normalization adjustment. Thus, the only issue to be resolved by the Commission is how to compute it and whether to use the approved DSIC percentage from Cause No. 42351-DSIC-5 or the 5% statutory DSIC limit found in IC 8-1-31-13. The statutory 5% limit is just that—a limit on the DSIC percentage that can be approved. Consequently, the Commission finds that the use of Petitioner's actual approved DSIC percentage of 4.93%, as determined in our April 14, 2009 Order in Cause No. 42351-DSIC-5, should be used to calculate normalized DSIC revenue. When the appropriate percentage is applied to each existing rate group and to the Commission's *pro forma* revenues, the result is a DSIC normalization

adjustment of \$5,514,129.

(3) Weather Normalization.

(a) Industrial Group's Position. Industrial Group Witness Brian C. Collins proposed that Petitioner's residential and commercial test year sales volumes be normalized for weather Industrial Group's Exhibit No. 1 at 3. According to Mr. Collins, it is important that rates be set based on normalized usage to eliminate the effects of unusual events and weather variations. Industrial Group's Exhibit No. 1 at 4. Mr. Collins stated that, on a total Company basis, the actual annual water usage per residential customer was 88.06 ccf in the year 2007. This usage is higher than the water usage per customer utilized in the Company's filing to calculate test year water sales volumes and corresponding test year sales revenues. Industrial Group's Exhibit No. 1 at 5. Mr. Collins stated that according to the Palmer Drought Severity Index ("PDSI") data for Indiana, 2007 was a normal year with respect to precipitation, and therefore one would also expect the Indiana American's average residential water usage per customer to be normal or average for the year 2007. In comparison, Mr. Collins stated 2008 and the first eight months of 2009 were much wetter than normal. Industrial Group's Exhibit No. 1 at 5. Mr. Collins testified that above average rainfall is significant because in wetter years customers tend to use less water, particularly to irrigate their lawns, thus reducing the average water use per residential customer. Industrial Group's Exhibit No. 1 at 6. Mr. Collins therefore recommended use of the 2007 actual annual residential water usage per customer of 88.06 ccf on a total Company basis to normalize test year sales volumes for weather. Industrial Group's Exhibit No. 1 at 6. The effect is to increase the annual residential water sales volume by 1,430,096 ccf. Industrial Group's Exhibit No. 1 at 7.

Mr. Collins recommended an equivalent adjustment to normalize commercial water sales volumes. Mr. Collins stated that, on a total Company basis, the annual commercial water usage per customer in 2007 was 474.32 ccf. Industrial Group's Exhibit No. 1 at 8. Mr. Collins recommended using the 2007 actual annual commercial water usage per customer to normalize test year commercial sales volumes for weather. The impact of this adjustment is to increase annual commercial water sales volumes by 115,708 ccf. Industrial Group's Exhibit No. 1 at 9.

(b) Petitioner's Rebuttal. Petitioner's Witness Kerry A. Heid responded to Mr. Collins' proposed weather normalization adjustments. Mr. Heid explained that the PDSI is an indicator of drought severity using zero as normal, where a negative number represents drought severity and a positive number represents higher than normal precipitation. Petitioner's Exhibit KAH-R at 10–11. Mr. Heid expressed a number of concerns with Mr. Collins' reliance on the PDSI to weather normalize Indiana American's revenues. Mr. Heid testified that Mr. Collins failed to demonstrate a direct correlation between the PDSI and water usage. Mr. Heid stated that as the Commission found in its May 16, 1990 Order in Indianapolis Water Company, Cause No. 38868, it is not sufficient to establish a correlation; rather, it is necessary to establish a direct correlation. Mr. Heid noted Mr. Collins admitted in response to discovery requests that he had not conducted any analysis to demonstrate a direct correlation between the PDSI and water usage. Petitioner's Exhibit KAH-R at 11–12.

Mr. Heid stated that Mr. Collins' own data disproves the existence of a direct correlation between the PDSI and water usage. The PDSI for 2006 was 1.81, indicating it was significantly wetter than normal. If a direct relationship between PDSI and usage existed, Mr. Heid explained that the average usage per customer in 2006 should have been significantly less than in 2007, which was a drier year. He also stated that Mr. Collins' workpapers demonstrated that virtually all of Indiana American's districts showed higher usage in 2006 than in 2007. Petitioner's Exhibit KAH-R at 14; Petitioner's Exhibit KAH-3R. Mr. Heid opined that this result demonstrated that the PDSI cannot be used in isolation to determine normal usage and that Mr. Collins' adjustment was too simplistic.

Mr. Heid testified that the Commission recently rejected similar usage normalization in Cause No. 43645 involving the Indianapolis Department of Waterworks. Petitioner's Exhibit KAH-R at 12. According to Mr. Heid, in a case involving the Indianapolis Department of Waterworks, the Commission rejected the Industrial Group's proposal to use 2007 sales volumes instead of 2008 test year volumes because 2007 represented a more normal year and stated:

While the parties appear to agree that 2008 was a wetter than normal year and that 2007 was a dryer than normal year, we lack any evidence demonstrating that an average of the two years is representative of "normal weather conditions" on a going forward basis. The testimony presented fails to provide a sufficient basis upon which to make a reliable adjustment to the test year revenues, and we therefore find that the 2008 revenues should be used for the setting of emergency rates.

Petition of the Dep't of Waterworks, Cause No. 43645, p. 22 (IURC 6/30/09).

Mr. Heid also stated that the PDSI has been subject to criticism and was never developed for the purpose of normalizing water usage. In addition, Mr. Heid testified that the PDSI covers the entire state, even though Indiana American serves in only sections of the state. Petitioner's Exhibit KAH-R at 13. Mr. Heid further stated that Mr. Collins failed to evaluate when the precipitation occurred. Wet weather impacts water usage when it occurs in the summer because it replaces lawn watering. Although Mr. Collins states that a PDSI of zero represents average conditions by definition, Mr. Heid noted that a review of the annual average PDSIs provided in Mr. Collins' workpapers showed the thirty-year average PDSI to be 0.83 and a sixty-year average PDSI to be 0.52. Petitioner's Exhibit KAH-R at 13; Petitioner's Exhibit KAH-2R. Therefore, argued Mr. Heid, even if one accepted the appropriateness of using the PDSI to adjust usage back to normal, there is an obvious discrepancy over what constitutes normal. The PDSI for 2007 shows that it is significantly drier than either a thirty-year or sixty-year average, thus making the year 2007 inappropriate as a basis for usage normalization. Petitioner's Exhibit KAH-R at 13-14.

Mr. Heid detailed the existence of non-meteorological predictors that affect water usage such as gradual implementation of water-conserving plumbing fixtures and appliances. Petitioner's Exhibit KAH-R at 15. Mr. Heid stated that while it is very difficult to quantify the impact of conservation, it is a very real phenomenon. In addition, the price elasticity of demand causes declining average use per customer over time. He acknowledged that basic water uses are

not as sensitive to price, but he emphasized that discretionary uses such as lawn irrigation are more sensitive to price. In fact, Mr. Heid indicated that Indiana American's average use per customer during 2006, 2007, and 2008 showed a consistently declining trend in average use per customer. Also, the impact of the economy has a pronounced effect on water usage, particularly discretionary water use. Petitioner's Exhibit KAH-R at 15. Mr. Heid explained that while he had not attempted to evaluate the meteorological and non-meteorological factors that explain this trend, it is clear that the Industrial Group's overly-simplistic assumptions on usage normalization are grossly inadequate. Petitioner's Exhibit KAH-R at 15. Finally, Mr. Heid pointed out that Mr. Collins did not rely upon any precedent in Indiana to support the use of the PDSI, nor was Mr. Collins aware of any other regulatory jurisdictions in which a regulatory commission has accepted or approved a water usage normalization adjustment based on the PDSI. Petitioner's Exhibit KAH-R at 16.

(c) Commission Discussion and Findings. The Commission first notes that Indiana American did not propose a weather normalization adjustment. While the Commission is not necessarily adverse to weather normalizing water usage, Mr. Collins has proposed a weather normalization adjustment similar to one we recently rejected in Cause No. 43645. In that case, Industrial Group Witness Gorman proposed to average 2007 and 2008 revenues to arrive at a weather normalized adjustment. The Commission rejected that methodology on the basis that there was no evidence demonstrating that an average of the two years is representative of "normal weather conditions." *Id.* at 22. Mr. Collins has attempted to justify using 2007 consumption through the PDSI index results. However, the Commission concludes that there is also no direct relationship between the PDSI and water consumption. Mr. Heid noted a number of problems with this relationship. Particularly troubling was the demonstration that the PDSI failed to correlate to usage in 2006. We are not convinced that the PDSI index, standing alone, is sufficient to support the weather normalization of water usage. As Mr. Heid noted, precipitation must occur during seasons when customers would be irrigating their lawn to impact water usage. Mr. Collins acknowledged he could not establish a direct correlation. The PDSI, standing alone, does not consider the timing or location of precipitation. For these reasons, the Commission rejects Mr. Collins' proposed weather normalization adjustment.

(4) Customer Growth.

(a) OUCC's Position. Mr. Patrick stated that Petitioner did not propose an adjustment for residential or commercial growth occurring in the seven month period following the test year but that the OUCC was proposing such an adjustment. Public's Exhibit No. 3 at 7-8; CEP Attachment 5. Mr. Patrick subtracted the June 2009 residential and commercial customer count from the November 2008 residential and commercial customer count by district and then multiplied the result by the average test year monthly bill, including the service charge and volumetric charge, by district to generate a customer growth adjustment of \$943,194 for residential customers and \$486,772 for commercial customers. Public's Exhibit No. 3 at 7-8. According to the OUCC, this calculation yielded the annual revenues the Petitioner will collect from these additional residential customers. Public's Exhibit No. 3 at 7.

(b) Petitioner's Rebuttal. Petitioner's Witness VerDouw did not agree that Mr. Patrick's proposed growth adjustment reflected revenues the Petitioner was likely to

receive. While he agreed with Mr. Patrick that the change in residential and commercial customers in the seven months following the test year could be determined with certainty, Mr. VerDouw believed it was inappropriate to use average test year revenue to normalize revenues for the seven months following the test year. Petitioner's Exhibit GMV-R at 33. According to Mr. VerDouw, this mismatch credits customers with higher revenues when usage is higher (as it was during the test year) and lowers expenses when usage was down (as in 2009).

Mr. VerDouw opined that if actual customer count is to be used in making this calculation, then 1) actual sales through that period should be used as well; 2) a growth adjustment should be made for all account categories, including industrial and other public authority; and 3) an adjustment for actual revenue through June 30, 2009 should be made to reflect the decrease in sales that the Company has experienced from the end of November 2008 through June 30, 2009. Petitioner's Exhibit GMV-R at 33–34. Mr. VerDouw emphasized that if one actual set of data through June 30, 2009 is to be used, then it should be used for all adjustments. Because this was not done, Mr. VerDouw recommended that the adjustments proposed by the OUCC for Residential and Commercial Growth not be considered. Petitioner's Exhibit GMV-R at 34.

(c) Commission Discussion and Findings. The Commission notes that the OUCC stated that Petitioner did not propose an adjustment for residential and customer growth occurring subsequent to the test year. However, Petitioner did propose a growth adjustment as detailed in Petitioner's Exhibit GMV at 11–12. While the OUCC and Petitioner agree that additional customers have been added during the seven months following the test year, they disagree over the ability to calculate with certainty the additional revenue that will be generated by these customers. Mr. Patrick used the test year average billings by district as a proxy for the billings that these new customers could be expected to generate. Mr. VerDouw contended that using average test year revenue to adjust the seven months after the test year mismatches revenues and expenses and is not fixed, known, and measurable. He explained that actual usage was significantly down in 2009 but that the OUCC's use of test year revenues for this period did not account for this reduction. While the Commission does not know the cause for this decrease, it is possible that it is attributable to the economy or conservation. Mr. Heid testified that Indiana American's conservation efforts support the trend of declining use per customer. Petitioner's Exhibit KAH-R at 15. New customers' usage may, in particular, be impacted by conservation because often new structures with efficient appliances are being connected.

Whatever the cause, this significant drop in consumption during 2009 causes the Commission to revisit the different positions we have adopted with respect to growth in the number of customers subsequent to the test year. There was previously a long history of this Commission only accepting a customer growth adjustment for the service charge portion of the bill because that was the only portion that we found to be fixed, known, and measurable. In Indianapolis Water Co., Cause Nos. 39713 and 39843 (IURC 8/10/94), we explained:

Mr. Broyles stated while the number of customers rose by 2.2% in the 12 months ended September 30, 1993, water sold has decreased by 1.1%. Mr. Broyles explained that revenues reflect various factors other than the number of customers. Revenues are affected

by weather conditions and patterns, conservation efforts and economic conditions which factors often offset growth in the number of customers. Mr. Broyles also pointed out that Mr. Blakley's operating expense adjustment erroneously overlooked transmission and distribution costs, which are items related to an increased customer base and pumpage. Also, Mr. Broyles stated that Mr. Blakley ignored the costs associated with additional meter readings, which clearly vary directly with customer base.

Based upon the evidence presented, we reject the OUCC's proposed adjustments. The undisputed evidence in this case clearly demonstrates that revenues associated with mere growth in the number of customers is not fixed, known and measurable. Indeed, the presumed growth in revenues is undetermined by the facts showing a reduction in revenues.

Id. at 24. See also Indiana-American Water Co., Cause No. 39215, pp. 3–4 (IURC 5/27/92); Indianapolis Water Co., Cause No. 39128, pp. 19–20, (IURC 11/6/91).

We departed from this practice in the 2004 Rate Order. However, the Commission is faced with precisely the situation presented in the Orders cited above where we previously rejected a usage adjustment based on customer growth where there was an increase in the number of customers but a significant decline in total consumption. Mr. Patrick asks us to assume that these customers added after the close of the test year will consume water at an average rate (test year levels) to which they did not contribute. The average during the period in which they were added is significantly lower, and it is likely that there is more that impacts usage than a change in customers.

Accordingly, the Commission finds that revenues should be adjusted for customers added after the test year based upon the service charge component of the bill but that there should be no adjustment for the volumetric component of the bill for such customers. The adjustment for the service charge component should be based on actual customers as of June 30, 2009. The total amount of the adjustment to test year revenues is \$441,727, which can be determined from Public's Exhibits CEP 5 and 6 and by substituting the customer charges for the test year average bill by district.

**B. Operating Expenses.** The Company proposed in its case-in-chief total *pro forma* Operating Expenses of \$151,912,812. The OUCC proposed total Operating Expenses of \$137,144,019. The OUCC accepted Petitioner's adjustments for purchased water, postage and mailing, relocation, net negative salvage, security, vehicle insurance, leased vehicles, property tax, and rate case expense. On Rebuttal, Petitioner accepted the OUCC's *pro forma* level of temporary workers, incentive pay, pension and OPEB expense, rents, and lobbying expense. The Commission will now proceed to address the remaining contested issues, as well as issues raised by other parties.

(1) Labor Expense. Petitioner proposed a *pro forma* adjustment to labor expense in excess of test year labor expenses. The increase in labor expense falls into five basic

categories: 1) Operations and Maintenance (“O&M”) Labor Positions; 2) Temporary Workers; 3) Incentive Pay; 4) Overtime Pay; and 5) Wage Increases. We will discuss each area of labor expense below.

(a) O&M Labor Positions.

(i) Petitioner’s Position. Petitioner’s Witness VerDouw calculated a level of *pro forma* labor expense based upon 382.5 full-time associates. Mr. VerDouw testified that each associate’s *pro forma* salary and wage was calculated and applied to his or her test year hours as adjusted. Petitioner’s Exhibit GMV at 18; Petitioner’s Exhibit GMV-4, Schedule 1.

Mr. VerDouw stated that if an associate was hired during the test year, his or her hours were adjusted to reflect a full year of employment. Likewise, if an associate left during the test year, Mr. VerDouw stated that those hours were eliminated. Petitioner’s Exhibit GMV at 18–19. Finally, Mr. VerDouw testified that any current vacancies were adjusted to reflect the normal level of regular and overtime hours for each specific classification.

(ii) OUCC’s Position. OUCC Witness Riceman disagreed with Petitioner’s proposed *pro forma* labor expense. Mr. Riceman testified that he calculated *pro forma* labor expense using actual employee levels as of June 30, 2009. Public’s Exhibit No. 2 at 3; Attachment HHR 1. Mr. Riceman asserted that, based upon information provided by Petitioner in three separate data requests and in worksheets provided by Petitioner via email, the appropriate staffing level assumes 353 full-time employees. Public’s Exhibit No. 2 at 5. Mr. Riceman explained that he began with Petitioner’s 383 *pro forma* full-time employees. As of June 30, 2009, he calculated that nine of these employees left the company, and five of those positions were filled internally. Mr. Riceman therefore removed those O&M labor dollars from *pro forma* expense. Public’s Exhibit No. 2 at 4; Attachments HHR 2 and 5. Mr. Riceman then added O&M labor dollars associated with seven new employees, which were hired as of June 30, 2009. Because thirty-two of the thirty-nine new employee positions were either not filled or were filled internally as of June 30, 2009, Mr. Riceman proposed that the O&M labor dollars associated with those positions be removed. Public’s Exhibit No. 2 at 5.

(iii) Petitioner’s Rebuttal. On rebuttal, Mr. VerDouw proposed that labor and labor-related expense adjustments be based on a staffing level of 366 full-time employees. Mr. VerDouw first explained that Mr. Riceman did not use the correct number of employees as of June 30, 2009. Mr. VerDouw clarified that although Mr. Riceman stated in his testimony that his staffing levels were based upon the number of full-time and temporary associates as of June 30, 2009 as a result of the worksheets provided via email, the attachment actually included a listing of 358 full-time employees, rather than the 353 full-time employees asserted by Mr. Riceman. Petitioner’s Exhibit GMV-R at 22. Indiana American’s full-time staffing level as of November 12, 2009 is 360 positions.

Mr. VerDouw also disagreed with Mr. Riceman’s assumptions that positions not filled on June 30, 2009 would not be filled any time in the future. Petitioner’s Exhibit GMV-R at 21–22. Mr. VerDouw acknowledged this may be true for some of the positions but stated that other

positions are necessary positions that are required to be filled in order to provide the services necessary for Petitioner's customers. With respect to the 22.5 positions that are currently unfilled, Mr. VerDouw stated that 16.5 positions are currently on hold and would not be filled before the end of the adjustment period. Of those, 8.5 will not be filled at all, as explained by Mr. Baker. The status of the remaining six unfilled positions was provided in Petitioner's Schedule GMV-2R, which listed all vacant positions and the corresponding *pro forma* labor expense adjustment for each. Petitioner's Exhibit GMV-R at 23. Mr. VerDouw stated that it is the intent of the Company to fill the six vacant full-time positions not currently on hold as quickly as possible because those positions continue to be needed on a *pro forma* basis. Mr. VerDouw noted that recruitment to fill the current vacant positions not on hold is ongoing and is very active. The labor expense for the 16.5 full-time positions on hold total \$516,673.

(iv) Commission Discussion and Findings. The Commission finds that labor expense should be based on 366 full-time employees. Even though Indiana American delayed the hiring of 16.5 full-time positions, Indiana American also continued to hire employees and has 360 full-time staffing positions as of November 12, 2009. In addition, Indiana American is working to fill six remaining positions. Because Petitioner is actively attempting to fill six of the vacant positions as soon as possible, the Commission believes the expenses for these positions should be included in rates. There has been no dispute as to the need for these temporarily-vacant positions or that these positions are normal to the Company's operations. See Indiana Gas Co., Cause No. 38080, p. 14 (IURC 9/18/87) (allowing labor expenses for vacant positions normal to the utility's operation). Therefore, the Commission accepts Petitioner's adjustment for O&M Labor Positions.

(b) Temporary Workers.

(i) Petitioner's Position. Petitioner's Witness VerDouw proposed that O&M labor expense be increased by \$100,320 to reflect eighteen temporary positions. Mr. VerDouw indicated that all of the temporary positions were assumed to be in place for 480 hours, or three months, and that entry level wages were also assumed for these positions. Petitioner's Exhibit GMV at 19. Mr. VerDouw further indicated that no benefits other than the mandatory social security, state unemployment, and federal unemployment were included. Mr. VerDouw stated that although temporary employees are hired at Indiana American every year, Petitioner did not propose to include temporary positions in its last rate case. Petitioner's Exhibit GMV at 19. Mr. VerDouw explained that the hiring of temporary positions allows the Company to better manage and complete its planned construction and maintenance work while at the same time decreasing employee overtime and contractor usage, which would occur should these temporary positions not be filled. Mr. VerDouw testified that this is a prudent business expense that Indiana American should be allowed to recover in rates. Petitioner's Exhibit GMV at 19.

(ii) OUC's Position. OUC Witness Riceman testified that six of the eighteen temporary workers should be removed from the *pro forma* O&M labor expense because they were not filled as of June 30, 2009. Public's Exhibit No. 2 at 5; Attachment HHR 1.

(iii) Schererville's Position. Schererville Witness Bonnie J.

Mann, a Certified Public Accountant with London Witte Group, LLC, recommended that the wages associated with temporary workers be excluded in this rate proceeding. Schererville's Exhibit BJM at 5. Ms. Mann stated that, according to Petitioner's Witness VerDouw, wages of temporary workers were not requested in the last rate case, but temporary workers are hired by the Petitioner each year. Ms. Mann suggested that since the lack of inclusion of these workers in revenue requirement in the past has not kept the Petitioner from hiring these workers and based on economic conditions today, she believed that these workers' wages should be excluded, resulting in a reduction to labor expense of \$100,320. Schererville's Exhibit BJM at 5.

(iv) Petitioner's Rebuttal. Petitioner's Witness VerDouw responded to Ms. Mann's recommendation by stating that just because Petitioner did not propose to recover an expense, or anything else for that matter, in a previous rate case does not mean that it should not be considered for inclusion in the current or any future rate case. Petitioner's Exhibit GMV-R at 41. Mr. VerDouw testified that temporary workers are hired every year at Indiana American and that they perform valuable services that would otherwise be completed by full-time employees or through contracted services. If the duties being performed by temporary workers were to be completed by full-time employees or through contracted services, Mr. VerDouw stated that it would cost ratepayers even more. Petitioner's Exhibit GMV-R at 41. Mr. VerDouw added that the temporary workers perform tasks such as hydrant painting and filing, which would still need to be performed if they were not completed by the temporary associates. Because these workers perform a valuable service not only to the Petitioner but to the ratepayers as well, Mr. VerDouw did not agree with Ms. Mann's position and stated that the temporary associates should be included as part of the *pro forma* labor expense in this rate case. Petitioner's Exhibit GMV-R at 41-42.

With respect to the OUCC's recommendation to reduce the number of temporary employees included in *pro forma* payroll expense, Mr. VerDouw agreed that because only twelve temporary employees were hired in 2009, twelve would be the appropriate number to use. Petitioner's Exhibit GMV-R at 22. Mr. VerDouw testified that this adjustment decreases the *pro forma* labor expense by \$40,565. Petitioner's Exhibit GMV-R at 22; Petitioner's Exhibit GMV-2R.

(v) Commission Discussion and Findings. The Commission finds that Ms. Mann's proposed disallowance should be rejected. While it may be true that Petitioner did not request recovery of the expense associated with temporary positions in its last rate case, it is undisputed by the parties that the temporary workers provide a material and tangible benefit to Petitioner and its ratepayers by performing tasks that would otherwise have to be performed by more costly full-time employees or through contracted services. Furthermore, the Commission does not believe it is sound policy to reject a proposed expense simply because recovery of that expense was not sought in a preceding rate case. Petitioner has accepted the OUCC's adjustment to reduce temporary staffing levels from eighteen to twelve temporary associates. Indiana American's actual staffing level for temporary employees during the test year and subsequent adjustment period was twelve and is therefore fixed, known, and measurable. Therefore, the Commission finds that *pro forma* O&M labor expense should be based on twelve temporary associates.

(c) Overtime Pay.

(i) Petitioner's Position. Mr. VerDouw testified that a three-year average of overtime hours was used to determine overtime hours for purposes of his adjustment. Mr. VerDouw noted that the three-year overtime average was less than was assumed in the 2009 labor budget for Indiana and that the more conservative number was used. Petitioner's Exhibit GMV at 19.

(ii) OUCC's Position. OUCC Witness Riceman disagreed with Petitioner's proposed overtime expense adjustment of \$878,936. Mr. Riceman stated that Petitioner's *pro forma* overtime expense was 5.41% of total O&M labor expense of \$16,250,034. Public's Exhibit No. 2 at 6. Applying this same percentage to Mr. Riceman's total O&M labor expense of \$15,077,840, Mr. Riceman calculated overtime pay to be \$815,534. Mr. Riceman therefore reduced Petitioner's adjustment by \$63,402. Public's Exhibit No. 2 at 6; Attachment HHR 3.

(iii) Schererville's Position. Schererville Witness Mann requested that the Commission reduce overtime costs by 50% to reflect Petitioner's commitment, as expressed by Petitioner's Witness Baker on cross-examination, to reduce overtime labor by 50% for the remainder of 2009 in an effort to reduce costs. Schererville's Exhibit BJM at 4-5. Ms. Mann stated that this commitment is not reflected in Petitioner's filings in this Cause and thus should be accounted for by reducing overtime labor by \$214,240. Schererville's Exhibit BJM at 5.

(iv) Petitioner's Rebuttal. In rebuttal, Petitioner's Witness VerDouw addressed the recommendations made by Mr. Riceman and Ms. Mann. With respect to the approach used by Mr. Riceman to calculate the *pro forma* adjustment for overtime pay, Mr. VerDouw stated Petitioner's approach is more accurate. Petitioner's Exhibit GMV-R at 25. Mr. VerDouw explained that overtime was calculated based on a three-year average of overtime for each position that is eligible for overtime. Mr. VerDouw stated that, for example, a salaried position would not have overtime, while a meter reader who is paid hourly would have overtime. Mr. VerDouw testified that Petitioner's Exhibit GMV-2R shows the calculation for overtime included in the Company's case-in-chief and the reduction in overtime for each position not included in the rebuttal totals. Petitioner's Exhibit GMV-R at 25. Mr. VerDouw stated that this methodology would be a more accurate calculation than Mr. Riceman's, which simply calculates the percentage of overtime based on the ratio of overtime to total O&M labor. Mr. VerDouw further stated that Mr. Riceman's methodology fails to account for the type of positions (i.e. salary or hourly) that are being removed. Petitioner's Exhibit GMV-R at 25.

With respect to Ms. Mann's argument that overtime expense should be reduced by 50%, Mr. VerDouw stated that his *pro forma* overtime expense reflects the overtime savings described by Mr. Baker. Petitioner's Exhibit GMV-R at 42. Mr. VerDouw explained that the commitment to cut in half the overtime budget for the remainder of 2009 was made after June 2009, which would be six months into calendar year 2009 and seven months after the end of the test year used in the case. Petitioner's Exhibit GMV-R at 25. In other words, it would not be a 50% reduction from the annual amounts but a 50% reduction from a six-month amount. Mr. VerDouw also explained that while the Company did make every effort to curtail overtime in an attempt to reduce expenses, overtime was not cut by 50% for an entire twelve-month period. Petitioner's

Exhibit GMV-R at 42. Mr. VerDouw noted that Mr. Baker stated in his rebuttal testimony that Petitioner deferred the filling of vacancies over the course of the year in those cases where an open position in the short-term saved more money than it cost in overtime for existing employees to perform those tasks. Petitioner's Exhibit GMV-R at 25–26. In addition, Mr. VerDouw noted that the three-year average used to determine *pro forma* overtime was less than what was assumed in the 2009 labor budget for the Petitioner; as such, the more conservative number was used. Petitioner's Exhibit GMV-R at 26.

Furthermore, Mr. VerDouw explained that this savings from reduced overtime is only temporary and will not continue indefinitely. Mr. VerDouw opined that, as Mr. Baker stated in his rebuttal testimony, these cost control measures do provide short-term relief but are not sustainable, and thus the three-year average is appropriate. Petitioner's Exhibit GMV-R at 42. Therefore, Mr. VerDouw did not believe that overtime expense should be adjusted downward any further than his recommended adjusted *pro forma* overtime expense of \$868,428. Petitioner's Exhibit GMV-R at 26, 42–43.

(v) Commission Discussion and Findings. Petitioner has sufficiently demonstrated the advantages of its methodology, which uses a three-year overtime average, over that recommended by the OUCC. None of the parties contested that the three-year overtime average is reasonably indicative of the ongoing level of overtime expense that Petitioner expects to incur. Regarding Ms. Mann's suggestion that the Commission further reduce Petitioner's overtime expense by 50% to reflect statements made by Mr. Baker during cross-examination, we find that Ms. Mann's proposal should be rejected. Mr. Baker did not testify that the annual overtime budget would be cut by 50%. Rather, he stated after June 2009 that the budget would be cut by 50%, which reduces the budget for approximately six months. Mr. VerDouw's proposed averaging method already produces a reduction from the 2009 budgeted levels. The Commission is further concerned that an additional reduction in overtime expense would not be reflective of the expected ongoing level of overtime expense that Petitioner reasonably expects to incur in the future. The Commission therefore finds that Petitioner's *pro forma* overtime expense of \$868,428 is reasonable and should be approved.

(d) Incentive Pay Program.

(i) Petitioner's Position. Petitioner included labor expenses associated with its annual incentive plan ("AIP") at the percentage of each eligible employee's expensed labor. Mr. Grubb explained that this is essentially the same methodology used to calculate AIP that was accepted in Cause No. 42520. He explained that some provisions have changed, but it continues to be necessary for Indiana American to offer competitive wages and to attract and retain its workforce. Petitioner's Exhibit EJJ at 34–35.

(ii) OUCC's Position. OUCC Witness Riceman proposed two adjustments to Petitioner's AIP expense. First, Mr. Riceman used his proposed staffing levels of 353 full-time employees to calculate a *pro forma* incentive pay expense of \$666,836, which is a \$141,564 decrease to Petitioner's proposed adjustment. Public's Exhibit No. 2 at 5; Attachment HHR 4. Second, Mr. Riceman stated that Petitioner's assumption that it will pay out 100% of the available incentive is not well founded based on Petitioner's past practices. Mr. Riceman testified that Petitioner's historical payout data for years 2007, 2008, and 2009 indicated actual

annual incentive payout percentages averaged 73.83%. Public's Exhibit No. 2 at 5. Mr. Riceman multiplied his *pro forma* incentive pay adjustment of \$666,836 times the three-year average payout of 73.83% to reach a *pro forma* adjustment of \$492,325. Public's Exhibit No. 2 at 5-6; Attachment HHR 3.

(iii) Schererville's Position. Schererville Witness Sommer testified that given the current economic conditions, Indiana American should suspend hiring, wage increases, and incentive pay packages. He argued that Indiana American's employees should be happy to remain employed during these difficult times. Schererville's Exhibit TJS at 5. Schererville Witness Mann also recommended that the Commission disallow labor expense associated with Petitioner's annual incentive plan. Ms. Mann noted that Mr. Baker during cross-examination testified that most employees in today's labor market would not be likely to leave if there was no wage increase in the current year. Schererville's Exhibit BJM at 5. Ms. Mann therefore proposed a reduction in labor expense of \$808,400 related to incentive pay.

(iv) Petitioner's Rebuttal. In rebuttal, Petitioner's Witness VerDouw noted that both Petitioner and the OUCG recommended recovery through rates of Petitioner's AIP. According to Mr. VerDouw, the difference of opinion relates to the amount of benefits that Petitioner assumes will be paid out on a *pro forma* basis. Petitioner's Exhibit GMV-R at 24. Mr. VerDouw stated that in its case-in-chief, Petitioner assumed that 100% of the available benefit would be paid out, whereas Mr. Riceman used a three-year average payout percentage of 73.83%. Mr. VerDouw noted that the actual 2009 AIP payout percentage was 73.67%, which closely tracks to the three-year average as presented by Mr. Riceman. Therefore, he believed that in this case a three-year average fairly presents the AIP payout for a typical test year. Petitioner's Exhibit GMV-R at 24. Mr. VerDouw stated that this percentage should be applied to the 366 full-time positions identified in his rebuttal testimony, resulting in an adjusted *pro forma* expense for incentive pay of \$552,000. Petitioner's Exhibit GMV-R at 24-25; Petitioner's Exhibit GMV-2R.

Mr. VerDouw also responded to the recommendation by Mr. Sommer and Ms. Mann to remove labor expense amounts for incentive pay. Mr. VerDouw stated that what Schererville's witnesses actually request is that Indiana American cut the pay of its employees. Petitioner's Exhibit GMV-R at 43. Mr. VerDouw explained that the AIP is a part of the total compensation package and is the portion of compensation that is "at risk." Petitioner's Exhibit GMV-R at 43-44. Mr. VerDouw stated that most professional employees today, including Ms. Mann, operate in an environment where some portion of their compensation is at risk. Mr. VerDouw averred that an AIP payout is not a gift to the employee; rather, it is compensation that is not paid unless the employee has actually earned it. Petitioner's Exhibit GMV-R at 44. According to Mr. VerDouw, the compensation system is carefully designed so that Indiana American targets base pay at the 50th percentile of compensation in the market for a given position, with an opportunity for employees to receive total compensation at the 65th percentile based on the additional performance elements included in the AIP performance evaluation. Mr. VerDouw explained that those who excel in this way receive more total compensation than the 50th percentile, which gives the Company a higher likelihood of attracting and retaining those talented individuals who excel. Petitioner's Exhibit GMV-R at 44.

Mr. VerDouw then explained why Schererville's proposal amounts to a pay cut. Mr. VerDouw provided an example of an employee who had total compensation of \$85,000 last year, including AIP, and received no increase in compensation this year. Mr. VerDouw agreed that under this scenario, the employee would still be receiving \$85,000 in total compensation and, as Mr. Baker suggested, the employee would not likely leave the Company over this. But, explained Mr. VerDouw, under Ms. Mann's recommendation Indiana American would not only cancel raises but would also suspend the employee's incentive pay. Petitioner's Exhibit GMV-R at 44. Mr. VerDouw noted that if the employee's incentive compensation is 15% of his or her total compensation, and the total compensation of \$85,000 included an incentive plan payment, then what Ms. Mann is really recommending is that the individual now receive total compensation of \$73,913, a 13% decrease. Mr. VerDouw opined that this result is unreasonable, particularly since the AIP is awarded only where the individual performed in such a way that he or she earned the incentive plan payment. Petitioner's Exhibit GMV-R at 44-45.

What makes Ms. Mann's recommendation even worse, according to Mr. VerDouw, is whose pay Schererville wants to cut. The employee whose performance has not earned an incentive payment in the past would not be impacted by this decision and would receive the same amount of compensation. Instead, explained Mr. VerDouw, it is the employees who are the top performers who would see the salary cut. The employees who Indiana American most wants to retain would therefore be the ones who would receive the pay cut under Schererville's approach. Mr. VerDouw pointed out that these are also the employees that have resumes most likely to attract offers of employment in the job market. In his judgment, this is no way to retain a qualified workforce. Petitioner's Exhibit GMV-R at 45.

Mr. VerDouw then explained how incentive pay is earned and how it benefits ratepayers. Mr. VerDouw testified that the AIP benefits ratepayers by helping the Company to attract and retain competent personnel, reduce expenses, maintain the financial health of Indiana American, improve service to customers, and increase operational efficiencies. Mr. VerDouw described the three components to the Company's incentive plan: financial, operational, and individual, each of which provides net benefits to ratepayers. Mr. VerDouw explained that the financial element of the incentive plan provides incentives to Company personnel related to meeting the overall financial goals of the Company, which benefits both shareholders and ratepayers. For example, Mr. VerDouw stated that an employee might improve financial results by finding ways to work that are more efficient, or identifying other ways to reduce expenses. While these improve financial performance for the shareholder in the short-term, Mr. VerDouw opined that such benefits inevitably accrue to ratepayers in the long-term. Petitioner's Exhibit GMV-R at 46.

Mr. VerDouw then described the operational and individual components of the AIP. He noted that approximately 60% of Petitioner's incentive plan expense is directly related to operational and individual goals, which provide employees with incentives to increase capabilities and improve service. In addition, explained Mr. VerDouw, it is customary in the utility industry and in the business community in general to provide employees with incentive compensation plans. Thus, concluded Mr. VerDouw, the inclusion of such a plan in the Company's employment compensation package allows the Company to attract and retain competent personnel. Petitioner's Exhibit GMV-R at 46.

Mr. VerDouw next identified some of the concrete and tangible benefits to ratepayers

provided by the operational and individual goals of the AIP. Mr. VerDouw testified that a participant in the AIP may receive incentive compensation if certain targets are met for various operational metrics, which motivates such participants to work to ensure that service is reliable and efficient and customer satisfaction is high. Petitioner's Exhibit GMV-R at 46–47. Mr. VerDouw summarized some of the operational metrics used by Indiana American to determine incentive pay, including the Customer Satisfaction Study, Customer Service Quality Study, Service Level, Notices of Violation, Lost Work Day Case Rate, Quality Measures, and Compliance. Petitioner's Exhibit GMV-R at 47–48. As for the individual components of the AIP, Mr. VerDouw explained that these include targets applicable to the specific job that each individual performs. Mr. VerDouw identified a number of possible goals and stated that these goals create incentives for Company and Service Company employees to improve efficiencies and customer service, and so directly benefit ratepayers. Mr. VerDouw concluded that Schererville's position concerning the suspension of incentive pay should be rejected and that the Commission should include the Company's recommended adjustment of \$552,000 relating to incentive pay. Petitioner's Exhibit GMV-R at 48–49.

(v) Commission Discussion and Findings. The Commission has previously addressed the recovery of Petitioner's incentive program and has analyzed whether the AIP is a profit-sharing plan and whether the level of compensation is unreasonable. With respect to incentive pay, we have determined that (1) a pure profit-sharing plan, which does not utilize metrics tied to individual performance, is not recoverable from ratepayers; and (2) a plan that causes compensation to exceed levels which are reasonably necessary to attract and retain a qualified workforce is not recoverable from ratepayers. 2004 Rate Order at 87. In the last two litigated rate cases, the Commission has found Petitioner's AIP to be recoverable.

The Commission's review of Petitioner's incentive plan leads us to the determination that the criteria discussed in the previous paragraph are still satisfied. Indiana American's plan is not a pure profit-sharing program. Rather, it utilizes metrics that are linked to individual performance. Mr. VerDouw explained that significant components of Indiana American's AIP are dependent upon Indiana American reaching its financial goals. The AIP is also dependent upon operational and individual goals, which incent employees to aid Indiana American in improving its capabilities and service through increased efficiency and reliability.

Further, Mr. VerDouw demonstrated that Indiana American's AIP does not cause compensation to exceed levels that are reasonably necessary to attract and retain a qualified and experienced workforce. The at-risk portion of the AIP is necessary to allow Petitioner to acknowledge and retain top performers at Indiana American who distinguish themselves by meeting individual goals and helping Indiana American to reach its financial and operational goals, thus improving service for ratepayers. Mr. VerDouw further demonstrated that the AIP is well within the mainstream for the market. Accordingly, the Commission finds that Ms. Mann's proposed adjustment should be rejected and Petitioner's adjustment of \$552,000 for its AIP should be approved and recoverable through rates.

(e) Wage Increases.

(i) Petitioner's Position. For corporate and non-union associates, Mr. VerDouw stated that the *pro forma* salaries and wages reflect an annualized April

1, 2009 merit increase that was calculated based on an overall corporate and non-union three-year average of merit increases. For those union employees operating under a collective bargaining agreement extending through the adjustment period, employee wages were based upon the applicable contract rates in effect as of November 30, 2009. For those union employees operating under a collective bargaining agreement that will expire and need to be renegotiated during the adjustment period, a 3% wage increase was assumed. Petitioner's Exhibit GMV at 18.

(ii) Schererville's Position. Ms. Mann recommended a reduction to *pro forma* labor expense of \$395,072 related to wage increases. She testified that due to the economy, Petitioner should suspend pay raises. She again pointed to Mr. Baker's testimony on cross-examination that employees are not likely in these economic times to change jobs due to the failure to receive a raise.

(iii) Petitioner's Rebuttal. Mr. Baker testified that American Water froze its executive compensation increases in 2009, meaning that Company executives at all levels, including subsidiary presidents, did not receive wage increases this year. However, Mr. Baker did not agree with Ms. Mann's proposal to suspend all pay raises. Petitioner's Exhibit DKB-R at 10–11. While he did not believe any employees would leave their positions during this recession if they did not receive a pay raise this year, Mr. Baker believed that eliminating pay raises could lead to significant problems in the long-term. He stated that Indiana American must be careful about the signals that it sends to its valued workers and avoid making a decision that would save a few dollars today but would produce dramatic unanticipated effects tomorrow. Mr. Baker stated that certainly today is not a good time to be entering the job market, and if Petitioner suspended pay raises he would not expect a significant number of employees to resign tomorrow as a result of that decision. Petitioner's Exhibit DKB-R at 11. But by suspending pay raises due to an economic downturn, he believed that Petitioner would be sending a bad signal to its employees that it does not value their services enough to recognize that they now have another year of experience and perhaps have seen cost of living increases themselves. Mr. Baker feared that this action would plant the seeds that perhaps they need to begin their search for new employment where their services are more valued. He concluded that while they may not resign tomorrow, when the economy turns around he would expect the decision to suspend pay raises would cause Petitioner to lose valued employees. Petitioner's Exhibit DKB-R at 11.

(iv) Commission Discussion and Findings. We find that Ms. Mann's position should be rejected. As Mr. Baker explained, executive compensation pay raises have been suspended, and so it is therefore appropriate to exclude these raises from the adjustment. Raises for the remainder of employees, both union and non-union, are still appropriate despite the economic times.

(f) Miscellaneous Labor Expenses. Petitioner's 401(k) expense and Defined Contribution Plan Expense are dependent on the number of full-time employees. Based on disputes about the appropriate number of full-time employees, the OUC and Petitioner proposed alternative expenses. Based on the Commission's finding of 366 full-time employees, we conclude *pro forma* 401(k) and Defined Contribution Plan Expense should be \$274,731 and \$201,167, respectively.

(g) Total Labor Expense. Based upon our findings above, the Commission finds Petitioner's total *pro forma* labor expense is \$16,396,540 annually.

(2) Pension Expense.

(a) Petitioner's Position. Mr. Grubb testified that Petitioner has seen a dramatic increase in pension expense as a result of the financial crisis in October 2008. He proposed an adjustment to test year pension expense of \$1,841,989 based upon the 2009 actuarial report prepared by Towers Perrin, a nationally recognized actuarial firm, which calculated the 2009 expense pursuant to SFAS 87. Petitioner originally proposed to recover an amortization over a three-year period of the amounts that would be deferred in Petitioner's proposed Pension/OPEB balancing account from January 2009 through June 2009. Petitioner's Exhibit EJG at 26, 29–30. On rebuttal, Petitioner withdrew the request to recover any annual amortization of amounts to be deferred in this case. Petitioner's Exhibit EJG-R at 9. This reduces the proposed adjustment to the test year to \$1,486,804. As such, the Commission will address the proposed Pension/OPEB balancing account later in this Order, but that proposal has no impact on the *pro forma* level of pension expense proposed in this case.

(b) Industrial Group's Position. The only witness opposing Petitioner's *pro forma* level of pension expense based upon the 2009 actuarial report is Mr. Gorman. Both the OUCC and Schererville accepted Mr. Grubb's proposed adjustment to test year pension expense based upon the 2009 actuarial report. Mr. Gorman testified that the 2009 level of expense was abnormal and unlikely to be repeated. He testified that the test year level is more representative than the 2009 level. He recommended what he described as a more modest adjustment to the test year of 30%. Industrial Group's Exhibit No. 2 at 70–71.

(c) Petitioner's Rebuttal. Mr. Grubb disagreed with Mr. Gorman's 30% adjustment. He testified that there is no evidence that Indiana American has returned to what would be considered "normal" prior to the collapse of the capital markets in the fall of 2008. Pension expense is a complex calculation based upon an actuarial report that considers a number of variables, only one of which is the value of the pension fund. He noted that there is no speculation that the 2009 pension is markedly higher than the test year and that there is nothing to indicate that 2010 and beyond will be more like 2008 than 2009. Petitioner's Exhibit EJG-R at 3. He noted that Mr. Gorman's recommendation to adjust pension expense by 30% is not supported by a current actuarial report or otherwise. Rather, it is based on Mr. Gorman's speculation as to the impact recent market movements will have on future actuarial reports. The current level of pension expense is supported by the most current information available and assumptions related to market conditions, interest rates, return on plan assets, salary increases, and demographic assumptions, which are used in the current actuarial report. Petitioner's Exhibit EJG-R at 4–5.

(d) Commission Findings and Discussions. The Commission could speculate as to what impact current market conditions will have on future pension expense. We could also speculate as to whether market conditions will reverse themselves in the future. What is beyond speculation is that Petitioner's current actuarial report fully supports Mr. Grubb's proposed adjustment. Mr. Gorman's 30% adjustment is not supported by any such study. The Commission therefore finds that Petitioner's proposed adjustment to pension expense detailed in Mr. Grubb's rebuttal testimony should be accepted. Therefore, Indiana American's adjustment for pension expense should be \$1,486,804.

(3) Support Services Expense.

(a) Petitioner's Position. Mr. VerDouw sponsored Petitioner's proposed adjustment to support services. He testified that support services relates to services provided to Indiana American by American Water Works Service Company, Inc. ("Service Company") and includes such services as billing, customer service, engineering, finance, legal, rates and regulations, human resources, and environmental. He proposed nine adjustments to test year support services. The first adjustment for one time costs related to the RWE divestiture of American Water as well as one time costs related to implementation of Sarbanes-Oxley compliance. The second adjustment eliminates non-recurring expenses. The third eliminates items that might be considered disputable with respect to rate case recovery such as employee meals and entertainment expenses. The fourth adjustment eliminates lobbying and non-deductible penalties. The fifth adjusts non-payroll related costs for an inflation factor of 2.5%. Petitioner's Exhibit GMV at 21–22. The sixth and seventh adjustments reclassify nine employees that were Service Company employees during the test year to Indiana American employees. The eighth reflects annualization of a salary increase at the Service Company level. The ninth concerns known increases to pension and OPEB benefits. Total *pro forma* support services expense is \$19,059,755. Petitioner's Exhibit GMV at 22–23.

Mr. Grubb explained how support services are billed to Indiana American. He provided detailed explanations of the types of services provided by the Service Company pursuant to a contract dated January 1, 1989. Mr. Grubb stated that those services are: accounting, administration, communication, legal, engineering, financial, human resources, information systems, operations (maintenance and leak detection), rate regulation, risk management, and water quality. Mr. Grubb explained in detail how the Service Company bills Indiana American for each of these services. He also sponsored a document that explains those services and how costs are charged or allocated. According to Mr. Grubb, Indiana American is requesting \$19,059,755 for support services. Petitioner's Exhibit EJJ at 11–29; Petitioner's Exhibit EJJ-4.

(b) OUCC's Position. OUCC Witness Margaret Stull testified regarding Petitioner's support services expense. Ms. Stull stated that American Water uses several allocation formulas, including a "Tier-One" formula, to allocate costs between regulated and non-regulated subsidiaries and "Regulated" formulas to allocate Service Company employees who provide no services to non-regulated subsidiaries. Public's Exhibit No. 1 at 33. Ms. Stull stated that Indiana American is one of American Water's larger regulated subsidiaries and, as such, is allocated a considerable amount of charges from the Service Company. Public's Exhibit No. 1 at 33. Ms. Stull contended that while Indiana American has certain built-in economies of scale, those economies of scale are diluted through American Water's allocation process since the allocation process charges the same amount per customer for the small inefficient systems as it does for the larger, more efficient ones. Public's Exhibit No. 1 at 33–34.

Ms. Stull testified that it was not possible to conduct a thorough review of management fees in the context of a rate case, especially an expedited case filed under the Commission's MSFR rules. Public's Exhibit No. 1 at 34. Because Petitioner's support services fees include hundreds of thousands of transactions, most of which are less than \$50, Ms. Stull stated that even if some inappropriate charges are found this would yield an immaterial adjustment. However, she added that the cost of these adjustments over time and the cost for OUCC resources used to

conduct such a review would be considerable. Public's Exhibit No. 1 at 34. Ms. Stull further stated that American Water's multi-level organizational structure makes reviewing and understanding the nature of the charges extremely difficult. Public's Exhibit No. 1 at 34. In light of these and other difficulties, Ms. Stull stated that in the last couple of rate cases the OUCC has attempted to review a sampling of transactions (usually choosing one or two months) as thoroughly as time allowed. Public's Exhibit No. 1 at 35. Ms. Stull indicated that this approach to reviewing management fees used large amounts of resources and yielded very little in results. It also focused too much on the costs being allocated while ignoring the process that determined the allocated amount. Public's Exhibit No. 1 at 35.

Ms. Stull suggested that a better approach would be to audit the source of these transactions, gaining an understanding of the reasonableness of the allocation methodologies employed as well as reviewing the actual transactions. Public's Exhibit No. 1 at 35. This would require access to American Water's books and records as well as access to all of its subsidiaries' books and records. Public's Exhibit No. 1 at 35–36. Ms. Stull opined that this expansive approach is essential to determining the appropriateness of American Water's allocation methodologies, which are at the heart of the bulk of charges included in management fees expenses. Public's Exhibit No. 1 at 36. Ms. Stull noted that other states have taken this approach, including California, Tennessee, Pennsylvania, and Illinois. Public's Exhibit No. 1 at 36–38. Ms. Stull recommended that the Commission order a review/audit of Indiana American's books and records, to be paid for by Indiana American, not its ratepayers. Public's Exhibit No. 1 at 38.

Ms. Stull testified that Petitioner's *pro forma* management fee expense represents a 23% increase over the management fees authorized in Cause No. 43187. Ms. Stull noted that since Cause No. 43187, Petitioner has not added any water or sewer systems to its operations in Indiana and the number of customers served has not increased materially (less than two percent). Public's Exhibit No. 1 at 39. Ms. Stull concluded that it is unreasonable for management fees to have increased by this magnitude without specific and quantifiable reasons for the increase. Public's Exhibit No. 1 at 39–40. Ms. Stull therefore proposed a *pro forma* management fee expense of \$17,675,629, as shown in Public's Exhibit No. 1 at 40; OUCC Schedule 6, page 4 of 10.

Ms. Stull stated that, given the complicated nature of Petitioner's allocation process, the need to review this process in more detail at the Service Company level, and the OUCC's limited resources and time, the OUCC estimated *pro forma* management fees based upon the costs authorized in Cause No. 43187. Public's Exhibit No. 1 at 40. More specifically, Ms. Stull calculated a 2006 cost per customer by taking the authorized management fees from Cause No. 43187 and dividing by the customers as of December 31, 2006. Ms. Stull then escalated this cost for inflation during 2007 and 2008, but she did not adjust for 2009 inflation since that number was negative. Public's Exhibit No. 1 at 40–41. Ms. Stull then multiplied the adjusted 2009 cost per customer times the number of customers as of September 20, 2009 to arrive at estimated management fees, to which she added the increased Pension/OPEB costs and the increased salary expenses proposed by Petitioner:

Management Fees authorized in Cause No. 43187	\$ 15,495,555
Divided by: Number of Customers at 12/31/06	<u>281,125</u>
2006 Cost per Customer	\$ 55.12
Times: 2007 Annual Inflation Factor	<u>4.1%</u>
2007 Cost per Customer	\$ 57.38
Times: 2008 Annual Inflation Factor	<u>0.1%</u>
2008/2009 Cost per Customer	\$ 57.44
Times: Number of Customers at 09/30/09	<u>286,426</u>
Estimated Management Fees	\$16,452,309
Add: Increased Pension/OPEB Costs	942,435
Increased Salary Expense	<u>280,885</u>
<i>Pro forma</i> Management Fee Expense	<u>\$17,675,629</u>

Public's Exhibit No. 1 at 41.

Ms. Stull concluded that this is a conservative estimate and possibly overstates Indiana American's total operating expense because Petitioner eliminated nine Service Company employees from management fee expense and included them in labor expense. Public's Exhibit No. 1 at 42.

(c) Schererville's Position. Schererville Witness Theodore J. Sommer testified that the American Water has developed an extensive and complex system of national and regional services provided to its various regulated and non-regulated subsidiaries. Schererville's Exhibit TJS at 5. Mr. Sommer stated that changes in allocation factors from the end of 2004 to 2007 have dramatically increased the proportion of costs being allocated to regulated operations, while the total amount of shared services costs continue to increase. Schererville's Exhibit TJS at 6.

Mr. Sommer testified that in 2003 American Water reorganized its operations, eliminating fifty-seven payroll positions locally while expanding the role of the regional service centers. Schererville's Exhibit TJS at 6. Indiana American also transitioned to the American

Customer Call Centers at that time. According to Mr. Sommer, American Water appears to be reorganizing its operations again, shifting the governance role back to Indiana and shuffling the Regional Service Centers. Schererville's Exhibit TJS at 7.

Mr. Sommer expressed concerns regarding the methodology used to allocate costs, and he opined that the method of allocating costs to the unregulated sector of American Water appears likely in situations of uncertainty to result in the assignment of costs to the regulated sector. Schererville's Exhibit TJS at 11. Mr. Sommer stated that when an employee is not performing work for a specific regulated company, that time defaults to being charged to the regulated companies. Schererville's Exhibit TJS at 11–12. Mr. Sommer asserted that the same is not true for non-regulated costs, which must be specifically identified and charged to non-regulated operations. Mr. Sommer questioned the continued relevancy of the methodology used to allocate costs to the non-regulated sector, arguing that any given dollar allocated to regulated operations is a dollar recovered, while a dollar allocated to non-regulated operations is a dollar at risk. Schererville's Exhibit TJS at 12. While Mr. Sommer did not recommend any specific changes to the allocation of shared services to Indiana American, he did recommend that the Commission initiate an analysis of shared services at the American Water level. Mr. Sommer indicated that other regulatory bodies are initiating similar studies of American Water at this time. Schererville's Exhibit TJS at 13.

Mr. Sommer recommended that the Commission reduce the test year amount of management fees from \$19,925,955 to \$17,524,773. Schererville's Exhibit TJS at 9. Mr. Sommer maintained that while support services and Customer Calling Center costs allocated to Indiana operations have increased over the last several years, customer growth and call volumes have not seen similar increases. Schererville's Exhibit TJS at 9–10. Mr. Sommer calculated his recommended level of management fees by using the year 2006 as a base year and increased the management fee by 3% per year for the years 2007 and 2008. Mr. Sommer stated that due to the lack of positive inflation during the last twelve months he did not increase the management fees for 2009. Schererville's Exhibit TJS at 11; Schererville's Exhibit TJS-2.

Mr. Sommer further recommended that the Commission exclude \$312,203 of business development expenses allocated to Indiana American during the test period and stated that little if any benefit accrues to the ratepayers of Indiana American as a result of these activities. Schererville's Exhibit TJS at 14. Mr. Sommer acknowledged that Indiana American, in discovery, pointed to the sale-for-resale agreement with the Town of Schererville as a direct benefit of business development activities. However, Mr. Sommer maintained that Schererville initiated those discussions and did so due to potential growth in its customer base and its desire to get out in front of the Great Lakes Initiative, which will regulate the amount of water taken out of the Great Lakes. Schererville's Exhibit TJS at 14–15. Finally, Mr. Sommer recommended excluding costs associated with governmental affairs within the test year, arguing that these expenses provide insufficient direct benefit to the customers of Indiana American. He added that Exhibit TJS-6, Data Requests Schererville 050-50 through 05-054 support his assertion that the government affairs group manages a Political Action Committee and lobbies on behalf of American Water. Schererville's Exhibit TJS at 15.

(d) Petitioner's Rebuttal. Mr. Grubb responded to the proposed adjustment by the OUCC and Schererville. He testified that their approach to support services is

flawed and that rather than starting with the test year, they started with a year that was three-years old. He stated that the Prehearing Conference Order established that the test year ending November 30, 2008 is to be used and then adjustments are to be proposed. Petitioner's Exhibit EJG-R at 14–15. He further explained why it was inappropriate to use a base year of 2006 for support services. Mr. Grubb testified that there were many increased costs that have occurred since 2006. First is the impact of wage and merit increases. Second is the issue of vacancies. The Shared Services Center had eighteen vacancies at the time of the last rate case that were not included and that have since been filled. Third is the issue of new employees, which are new positions that did not exist in 2006. Finally, the Customer Service Center needed to add fifty-one customer call handlers because customers have not utilized the interactive voice response system at a level previously estimated. In addition to the call handlers, he identified ninety-seven positions that were added in the areas of finance, customer service billing and collecting, and information technology services. Petitioner's Exhibit EJG-R at 15–17. He then explained in detail the job duties of the new positions. Petitioner's Exhibit EJG-R at 17–21.

Mr. Grubb also explained that Mr. Sommer's and Ms. Stull's approaches failed to account for an increase in depreciation expense at the Service Company level. Since 2006, the Service Company has purchased approximately \$54 million in depreciable assets, which has increased depreciation expense by \$807,000. Most of this is related to information technology system upgrades. Petitioner's Exhibit EJG-R at 21–22.

Mr. Grubb then proceeded to respond to the specific calculations made by Mr. Sommer and Ms. Stull. He noted that Mr. Sommer started with actual support services for the year 2006, which would have included one time costs that were eliminated in the last rate case. Mr. Grubb accounted for this adjustment and then added the Service Company's increase in pension and OPEB costs, which Schererville accepted at the Company level but were not included in its support services adjustment. Also, Mr. Sommer did not reflect the wage increase for Service Company employees that became effective in April 2009. While Schererville opposed wage increases, Mr. Grubb explained that the inclusion of this adjustment was necessary to put Mr. Sommer's proposal on an equivalent basis with Ms. Stull's. He then adjusted Ms. Stull's and Mr. Sommer's calculations to reflect the change in depreciation expense and the change in pension and OPEB costs between 2006 and 2008. Petitioner's Exhibit EJG-R at 22–25. With these two changes, both of their numbers are approximately the *pro forma* level recommend by Petitioner. Schererville's recommendation is \$306,202 greater than the *pro forma* level, while the OUCC's recommendation is \$63,468 less than the *pro forma* level. Petitioner's Exhibit EJG-R1. Mr. Grubb explained that this analysis demonstrated that Indiana American's *pro forma* level is reasonable and fully explains why the costs have increased since 2006.

Mr. Grubb responded to the request for an audit. He testified that a properly focused regulatory audit should be capable of identifying adjustments that should be made to the Support Services expense. Petitioner's Exhibit EJG-R at 26–28. He then noted that an audit has already been conducted by the Pennsylvania Public Service Commission. He stated that there were 114 recommendations Company-wide, but only six of those concerned relations with affiliates including cost allocations. That audit found none of the problems associated with the chief concern raised by Ms. Stull and Mr. Sommer, which is the allocation between regulated and unregulated affiliates. Petitioner's Exhibit EJG-R at 30–31; Petitioner's Exhibit EJG-R3. Mr. Grubb testified that an approach more efficient than ordering an audit would be to order the

Company to keep the Commission abreast of developments in light of the Pennsylvania audit. Petitioner's Exhibit EJG-R at 32. In the alternative, Mr. Grubb testified that any audit should be conducted pursuant to generally accepted auditing standards, and he recommended, among others, standards adopted by the National Association of Regulated Utility Commissioners ("NARUC"). Petitioner's Exhibit EJG-R at 32; Petitioner's Exhibit EJG-R4. Finally, he testified that the Commission should not predetermine who would pay for an audit but should await the results of such an audit before making that determination.

Mr. Grubb responded to Mr. Sommer's proposed disallowance of business development and government affairs expenses. He explained that Mr. Sommer is proposed to disallow \$312,203 of test year support services associated with business development on the grounds that the cost of the service exceeded the benefit. Mr. Grubb explained that Mr. Sommer has not fully captured the benefits of the contracts negotiated by the business development group. Petitioner's Exhibit EJG-R at 37-38. The annualized revenues from the business development deals consummated since 2005 exceed the current annual cost of the business development team by approximately \$417,000. Petitioner's Exhibit EJG-R5.

As to government affairs, Mr. Grubb explained that Mr. Sommer is proposed to eliminate \$181,721 of test year expenses. Mr. Grubb testified that Indiana American does not currently have a Political Action Committee, and he disagreed with Mr. Sommer's characterization that the government affairs group lobbies on behalf of American Water. Petitioner's Exhibit EJG-R at 38. The government affairs team addresses water and wastewater issues that are important to not only Indiana American and American Water but also to the rate payers of Indiana American. He explained that the primary role of government affairs is to provide senior-level strategic government affairs counsel to the State President and State Senior Management Team. Petitioner's Exhibit EJG-R at 39.

(e) Commission Discussion and Findings. The Commission first addresses the issue of the amount of support services expense to include in this case. We recognize that support services has obviously grown in cost since Petitioner's last case at a rate which exceeds general inflation. Ms. Stull testified that, absent some explanation for why the costs were higher, we should utilize an alternative approach similar to the OUCC's or Mr. Sommer's. Mr. Grubb provided that explanation. There are ninety-seven new positions and considerably higher depreciation expense associated with new capital investment.

In addition, we find persuasive Mr. Grubb's adjustments to the methodologies employed by Mr. Sommer and Ms. Stull. He started with their 2006 levels and made adjustments not captured by their analysis, which for the most part, have not been disputed. These are adjustments such as additional depreciation expense, higher pension and OPEB expenses during the last three years, and payroll increases. Mr. Grubb's analysis made no adjustment for the new positions that were not reflected in the 2006 totals. When Mr. Sommer's and Ms. Stull's methodologies are adjusted to reflect these additional known costs, the Commission finds that their *pro forma* level of support services would be very similar to that proposed by the Company.

The Commission next turns its attention to Schererville's proposed disallowances for business development and government affairs. With respect to business development, the Commission agrees that Schererville has undercounted the annual revenues. The revenues

generated by business development can be compared with our own main extension rules. When a developer installs a new main, he is given credit for three years' worth of revenues towards the cost of that main. This is in recognition of the fact that the benefits from connecting new customers are cumulative. In much the same way, the Commission cannot look at simply one year of deals that may be closed through the efforts of business development for purposes of determining whether the benefits exceed the costs. Mr. Grubb's analysis uses a three-year window, much like our main extension rules. Therefore, the Commission agrees with Mr. Grubb and rejects Schererville's proposed disallowance of business development expense.

With respect to government affairs, Mr. Grubb has not satisfied us that the government affairs group is more than a lobbying group. According to responses provided to Schererville's data requests, Indiana American's government affairs issues are handled by the Service Company, and specifically by Corporate Government Affairs and Central Region External Affairs. Exhibit TJS-6, Data Requests Schererville 05-054. Indiana American asserts that the primary role of government affairs is to provide counsel to Indiana American, but the job descriptions provided in Exhibit TJS-6, Data Requests Schererville 050-50 through 05-054 provide insight into the responsibilities of government affairs.

Corporate Government Affairs is to establish and foster relationships with lawmakers so that American Water is included in and consulted for water and wastewater discussions first. In addition, the group is to create a program at the federal, state, and local level to send "white papers on pertinent water issues to . . . lawmakers" that would establish American Water's expertise. Exhibit TJS-6, page 3 of 18. Notably, the Corporate Government Affairs job description provides that group is to "[l]obby in [Washington, D.C.] to help change or support key legislation on water or utility and business issues that may have an adverse or positive affect on [American Water and] [c]reate and manage a federal [Political Action Committee]. . . . Id.

The Central Region External Affairs job description provides that this position is to monitor all legislation for its potential impact and provides recommendations on how to appropriately respond to such legislation. In addition, this position establishes and maintains "relationships with elected and appointed individuals at the state, county and municipal levels of government" to ensure that the "state president and state leadership team are properly and effectively positioned with key elected/appointed individuals . . . ." Exhibit TJS-6, page 8 of 18. Further, the description provides that this position "[i]s poised to lead state lobbyists for the company charged with helping to change or support key legislation on water, wastewater or utility/business issues that may have an adverse or positive impact on the company." Exhibit TJS-6, page 9 of 18. Finally, the Central Region External Affairs employee [i]mplements and directs all lobbying activities on behalf of the company[]" and "[c]reates and manages a state-focused [Political Action Committee] . . . ." Exhibit TJS-6, page 10 of 18.

Based on the evidence presented, the Commission is not convinced that government affairs is more or something other than a lobbying group, and Indiana American has not convinced the Commission that lobbying activities are beneficial to the provision of utility service to its customers. Accordingly, the Commission accepts Schererville's proposed disallowance.

The Commission next addresses the request for a management audit of Service Company charges. We note that the OUCC and Schererville have given us little guidance as to what they believe such an audit should look like. The Commission also notes that an extensive audit of the Service Company has already been conducted in conjunction with the Stratified Management and Operation Audit conducted of Pennsylvania-American Water Company by Schumaker and Company in Docket No. D-06MGT029 completed August 2008. Also, the Commission notes that the Tennessee Regulatory Authority in Docket No. 06-00290 ordered Tennessee-American Water to conduct a management audit to review costs allocated to it by the Service Company. In Docket No. 09-00086, the Tennessee Regulatory Authority approved the performance of the management audit specific to Tennessee American Water by Shumaker-Work.

Much of any audits that the Commission might conduct may be duplicative of the work that has been done in these audits. Rather than ordering another independent audit at this time, the Commission directs Indiana American to submit to the Commission and all parties copies of all reports and other information that are supplied to the Pennsylvania Public Utility Commission and the Tennessee Regulatory Authority pursuant to such audits. However, the Commission is not precluded from considering the performance of an audit of American Water or Indiana American at a future date.

Finally, the Commission notes that Petitioner included an adjustment to non-payroll related costs for an inflation factor of 2.5%, or \$192,340. No party objected to Indiana American's adjustment for inflation. However, the Commission notes that Indiana American did not adjust any other support services expense or any other expense in this Cause for inflation. Petitioner provided no explanation or support for its adjustment for inflation to non-payroll related costs only. As a result, the Commission finds that Indiana American's adjustment for inflation should be excluded from support services expense. The Commission finds *pro forma* support services expense to be \$18,685,694.

(4) Depreciation Expense on Contributions in Aid of Construction.

(a) OUCC's Position. Ms. Stull testified that the OUCC recommends amortizing CIAC. She explained that the amortization of CIAC is the practice of reducing the net amount of CIAC at the same rate that the corresponding asset is being depreciated and noted that Indiana American does not follow this practice. Public's Exhibit No. 1 at 18. Ms. Stull stated that accounting standards do not require depreciating all depreciable assets and opined that eliminating the depreciation on contributed property for ratemaking purposes is necessary because the utility owner has no basis or "cost" in the asset. Public's Exhibit No. 1 at 18. She explained that depreciation is charged against earnings on the theory that the use of capital assets is a legitimate cost of doing business.

Ms. Stull acknowledged that that the NARUC system of Accounts states that the account for accumulated amortization of CIAC is used "if recognized by the Commission." Public's Exhibit No. 1 at 18–19. She acknowledged that Indiana is one of a handful of states that does not require the amortization of CIAC. Public's Exhibit No. 1 at 19. Ms. Stull stated that the Federal Energy Regulatory Commission ("FERC") and the Federal Communications Commission ("FCC") require electric, gas, and telephone utilities to reduce the plant account balances to which contributions from customers are made by the amount of contributions—

before applicable depreciation rates are applied. She opined that Indiana's policy has a significant drawback in that it depends on the premise that depreciation is provided so that the utility may replace infrastructure at the end of its useful life but imposes no obligation on a utility to re-invest money received through depreciation. Public's Exhibit No. 1 at 19–20.

Ms. Stull believed that the better policy is to prohibit depreciation on CIAC because it represents a “return of” capital that was never provided by the investors. Public's Exhibit No. 1 at 20. She testified that prohibiting depreciation on CIAC also assured that rate base will never be negative. Since Petitioner has not been recording accumulated amortization of CIAC in reliance on the Commission's previous policy, Ms. Stull recommended implementing CIAC amortization on a going forward basis. Her calculation was based on one year's worth of amortization of CIAC using the average mains and hydrant depreciation rates. Public's Exhibit No. 1 at 20–21.

(b) Petitioner's Rebuttal. Mr. VerDouw opposed the amortization of CIAC. He pointed out that this is the fourth time the OUCC has proposed to change the Commission's long-standing practice of not requiring an amortization of CIAC as an offset to depreciation expense on contributed property. Petitioner's Exhibit GMV-R at 7. The Commission's position has remained constant through its December 7, 1983 Order in Cause No. 37182, its February 2, 1994 Order in Cause No. 39595 (the “1994 Order”) and the 2004 Rate Order. Mr. VerDouw noted that the 1994 Order concluded that “the customers and the Company benefit from the Commission's current practice of allowing depreciation on contributed property.” In the 2004 Rate Order, the Commission recognized that new evidence should be presented to justify changing this long-standing policy.

Mr. VerDouw testified that customers still benefit from not amortizing CIAC as an offset to depreciation. Petitioner's Exhibit GMV-R at 7. He explained that by allowing the recovery of full depreciation expense without an offset for amortization of CIAC, the Company is provided access to capital at zero cost. Mr. VerDouw believed this additional capital is extremely beneficial to both the Company and its customers, particularly in light of the size of the Company's five-year construction budget. Petitioner's Exhibit GMV-R at 7. Mr. VerDouw noted that Ms. Stull provided no new evidence concerning this issue and failed to acknowledge that the OUCC is proposing a change to this long-standing policy. Petitioner's Exhibit GMV-R at 7–8.

(c) Commission Discussions and Findings. The Commission addressed the OUCC's proposal to amortize CIAC in our 2004 Rate Order and reached the following conclusions:

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

independent decisions on what is best for Indiana.

2004 Rate Order at 92. Ms. Stull has offered no new evidence or circumstances that warrant departure from Commission precedent. We have previously rejected her arguments that allowing depreciation on CIAC without amortization allows a utility return on capital that was never provided by the investor and could result in negative rate base. Her first argument fails to consider that the capital resulting from depreciation on CIAC can be used to replace the assets using zero cost capital rather than more costly external funding. Her second contention about the possibility of negative rate base is not a concern for Indiana American, as we have previously found. *E.g.*, 2004 Rate Order at 92–93. The Commission notes, however, that if a utility were troubled or had a small rate base, we could consider and address the amortization of CIAC. *Id.*; In the Matter of the Petition of Twin Lakes Utilities, Inc., Cause No. 43128, 19–20 (IURC 1/16/08). For the foregoing reasons, we again reject the OUCC’s proposal to amortize CIAC.

(5) Purchased Power and Fuel.

(a) Petitioner’s Position. Petitioner’s Witness Thakadiyil sponsored three adjustments to fuel and power costs during the test year. The first adjustment, in the amount of \$483,032, was to annualize fuel and power increases. Petitioner’s Exhibit PJT at 5–6. Mr. Thakadiyil stated that Petitioner annualized base rate increases and fuel adjustment charges to reflect known changes in fuel and power charges. He stated that several of the Company’s facilities are served by Indiana Michigan Power Company (“I&M”), which was authorized to increase its rates and charges on March 4, 2009. Petitioner’s Exhibit PJT at 6. Mr. Thakadiyil stated that other Company facilities are served by Northern Indiana Public Service Company (“NIPSCO”), which filed for a 9.8% rate increase in August 2008.

Mr. Thakadiyil stated that Indiana American also annualized fuel adjustment charges for 2008, and obtained 2009 increases in fuel adjustment charges from individual suppliers and annualized the increases. Petitioner’s Exhibit PJT at 6. Mr. Thakadiyil stated that Johnson County Rural Electric Membership Corporation (“Johnson County REMC”) is projecting an increase of 7.2%, Rush Shelby Energy (“RSE”) a 2.3% increase, and Richmond Power & Light (“RP&L”) is projecting a 6% increase.

Mr. Thakadiyil then discussed the second adjustment to fuel and power expenses, which was made to reflect the *pro forma* system delivery calculated by Mr. VerDouw. Petitioner’s Exhibit PJT at 7. Mr. Thakadiyil stated that Mr. VerDouw’s adjustment reduces the amount of volume assumed for this rate case. The adjustment was calculated by dividing the annualized fuel and power cost by the test year system delivery, resulting in a cost per thousand gallons. The cost per thousand gallons was then multiplied by the *pro forma* system delivery, resulting in an adjustment to decrease fuel and power by \$19,042. Petitioner’s Exhibit PJT at 7. Finally, Mr. Thakadiyil proposed an adjustment to normalize the test year by adjusting out items included in fuel and power test year expenses that are not representative of a typical test year. Mr. Thakadiyil explained that this adjustment included accruals and minor miscellaneous charges for other expenses. The result is a decrease to fuel and power of \$144,908. Petitioner’s Exhibit PJT at 8.

(b) OUCC’s Position. OUCC Witness Charles Patrick accepted Mr.

Thakadiyil's proposed increase for rates paid to I&M, but he disagreed with the proposal to adjust expenses for rates paid to NIPSCO, Johnson County REMC, RP&L, and RSE. Public's Exhibit No. 3 at 10. Mr. Patrick stated that some of the power utilities that service Petitioner's facilities provided Petitioner with estimates of what its projected fuel costs will be in 2009 and 2010. Mr. Patrick asserted that such estimates are not fixed, known, and measurable. Mr. Patrick added that the fact that electric companies have a quarterly fuel adjustment cost tracker and gas companies have a quarterly gas cost adjustment is evidence that the costs fluctuate so unpredictably that they must be adjusted on a quarterly basis. Public's Exhibit No. 3 at 10. Mr. Patrick described the steps taken by the OUCC to verify Petitioner's proposed estimates, which included contacting senior company representatives at each of the power companies that Petitioner indicated would have a rate increase. Public's Exhibit No. 3 at 11. Based on his analysis, Mr. Patrick proposed an increase to fuel and power of \$7,634, reflecting the authorized rate increase of 3.7% for I&M. Public's Exhibit No. 3 at 11; CEP Attachment 10.

Mr. Patrick also proposed a reduction of costs for RP&L for the power used at the Richmond Call Center (Corporate) of \$9,494. According to a response provided by Petitioner in discovery, these costs were charged to the wrong account and should not be included in the revenue requirement. Public's Exhibit No. 3 at 12. Mr. Patrick did, however, accept Petitioner's adjustment for accruals and miscellaneous fuel and power charges.

(c) Industrial Group's Position. Industrial Group Witness Brian Collins testified that, based on his understanding of the testimony of Mr. Thakadiyil, of the utilities identified by Mr. Thakadiyil only I&M's rates have actually increased. Industrial Group's Exhibit No. 1 at 11. Mr. Collins therefore recommended that the Company's purchased power and fuel expense be increased only to reflect the increase in purchased power expense for facilities served by I&M. Mr. Collins stated that none of the other electric rate increases identified by the Company have gone into effect during the twelve-month adjustment period following the test year. Industrial Group's Exhibit No. 1 at 11. For example, Mr. Collins pointed out that although NIPSCO's proposed electric rate increase is currently before the Commission, it is the position of some parties involved in that rate case that NIPSCO's rates should in fact be decreased. Industrial Group's Exhibit No. 1 at 11–12. Mr. Collins recommended an increase in purchased power and fuel expense of \$5,197, which reflects the increase in I&M's electric rates only.

(d) Schererville's Position. Schererville's Witness Mann testified that Petitioner's *pro forma* power costs made some assumptions about the future cost of power based on discussions with power providers and petitions for rate increases before the Commission. Schererville's Exhibit BJM at 9. Ms. Mann stated that the rate proceeding for NIPSCO continues to be active before the Commission, and that it is unlikely that the increase could occur before the end of the fixed, known, and measurable period. As a result, Ms. Mann recommended that the Commission deny the requested increase in purchased power for the NIPSCO power costs. Schererville's Exhibit BJM at 9–10.

(e) Petitioner's Rebuttal. Petitioner's Witness Thakadiyil testified in rebuttal that all parties accepted the proposal to reflect a greater expense because of I&M's rate increase. He agreed to withdraw requests for increases for NIPSCO and RP&L. Petitioner's Exhibit PJT-R at 2–3.

Mr. Thakadiyil stated that the rates for Johnson County REMC and RSE are not forecasts as Mr. Collins had contended. Petitioner's Exhibit PJT-R at 4. Mr. Thakadiyil testified that Indiana American contacted these utilities and asked them to determine the increase the Company would face from 2008 to 2009, and he believed these estimates are fixed, known, and measurable. After reviewing the other parties' evidence, Mr. Thakadiyil sought to substantiate the rate increases by Johnson County REMC and RSE by contacting these utilities to obtain copies of their tariffs during the test year and in 2009. Petitioner's Exhibit PJT-R at 4. These tariffs demonstrated that Johnson County REMC and RSE both implemented general rate increases after the close of the test year; RSE's increase went into effect in April 2009 and Johnson County REMC's on January 1, 2009. Mr. Thakadiyil provided copies of these tariffs (both before and after the rate increases) as Petitioner's Exhibit PJT-R1.

Mr. Thakadiyil also prepared an additional analysis for one month in 2008 to compare the impact of the general rate increases for Johnson County REMC and RSE. Mr. Thakadiyil provided a worksheet, Petitioner's Exhibit PJT-R2, that took one month in 2008 and calculated what the bill would have been under the 2009 rates. Petitioner's Exhibit PJT-R at 4-5. He testified that in both cases, the calculated increase for the applicable months was actually greater than the utilities' estimations. Johnson County REMC projected a rate increase of 7.2%, but Mr. Thakadiyil stated that his calculations show the increase could be as high as 18.43%. Petitioner's Exhibit PJT-R at 5. For RSE, Mr. Thakadiyil stated that the projected increase was 2.3%, but an actual application of their bill suggests the increase could be as high as 22.37%. Mr. Thakadiyil surmised that part of the difference may be attributed to the fact that he also factored in the higher demand billing rate resulting from higher usage during these periods. Even without this factored in, however, the analysis shows that the rates have increased. Mr. Thakadiyil stated that Indiana American continues to base its adjustment on the percentage increases provided by Johnson County REMC and RSE. Petitioner's Exhibit PJT-R at 5.

With respect to the OUCC's contention that the variability in purchased power costs makes it impossible for these costs to be fixed, known, and measurable, Mr. Thakadiyil responded that, first, the increases for Johnson County REMC and RSE exist even without the purchased power adjustment. Petitioner's Exhibit PJT-R at 5. Second, Mr. Thakadiyil expressed concern regarding the OUCC's claim that these costs are too volatile to warrant adjustment for demonstrated increases because this effectively results in Indiana American's shareholders incurring the costs of these increases. Petitioner's Exhibit PJT-R at 5-6. Mr. Thakadiyil pointed out that the Company proposed in its last rate case to track these costs, but the OUCC opposed that relief. Finally, Mr. Thakadiyil indicated that Petitioner agreed with the various adjustments made by the OUCC to annualize fuel and power increases, adjust for accruals and miscellaneous charges, and to eliminate fuel and power charges associated with the Richmond Call Center. Petitioner's Exhibit PJT-R at 6.

(f) Commission Discussion and Findings. The parties agreed on some adjustments related to Petitioner's purchased power costs. All parties accepted Petitioner's system delivery adjustment, which the Commission finds should be accepted.

All parties also agreed that Indiana American properly estimated I&M's increase. Therefore, Petitioner's requested adjustment related to I&M's rate increase is reasonable and is approved. Petitioner also agreed not to pursue an adjustment for rate increases for NIPSCO and

RP&L. Indiana American also accepted the OUCC's proposals to annualize fuel and power increases, adjust for accruals and miscellaneous charges, and to eliminate fuel and power charges associated with the Richmond Call Center. Thus, the remaining dispute among the parties concerns the adjustments proposed by Petitioner relating to the other electric utilities providing service to Petitioner, namely Johnson County REMC and RSE.

In its rebuttal testimony, Petitioner clarified that Johnson County REMC and RSE both had base rate increases that became effective within twelve months of the close of the test year. Petitioner contacted these utilities and asked them to determine the percentage increase. The Commission believes that it is reasonable for Petitioner to rely on determinations from energy utilities with respect to the impact of rate increases they have implemented. The Commission expects utilities that have implemented rate increases to provide accurate data about the percentage increase expected from a base rate increase. Accordingly, we approve Petitioner's proposed increases for purchased power of \$65,153. It is not necessary to reach the dispute about recovery of variations in power costs attributable to fuel adjustment costs because Petitioner has clarified that the increases it is seeking relate to base rate increases.

(6) Chemical Expense.

(a) Petitioner's Position. Petitioner's Witness Thakadiyil testified that three adjustments were necessary for chemical expense. He explained that the first adjustment was necessary to reflect a 92% increase in chemical costs that occurred after the test year. Petitioner's Exhibit PJT at 8-9. He stated that many chemicals experienced increases in price over 2008 levels, but that Phosphoric Acid, Zinc Orthophosphate, and Aluminum Sulfate experienced particularly large increases of 500%, 50%, and 70%, respectively. Mr. Thakadiyil testified that the Petitioner solicited bids from a number of different suppliers to try and secure the best price. Petitioner also worked with the Service Company to leverage American Water's size to negotiate concessions from suppliers. Petitioner's Exhibit PJT at 9.

Mr. Thakadiyil also explained that chemical expense should be adjusted consistently with Mr. VerDouw's adjustments for customer growth annualization and changes in the number or usage levels of large accounts. This has the effect of decreasing chemical expense by \$8,644 because chemical usage varies with the amount of water produced. Petitioner's Exhibit PJT at 9. Mr. Thakadiyil also adjusted out miscellaneous charges to represent a normal test year. He noted an inventory return for Phosphoric Acid as an example of this adjustment. He proposed to increase chemical expense by \$38,679 to reflect these miscellaneous charges. Petitioner's Exhibit PJT at 10.

On cross-examination, Mr. Thakadiyil was asked about the chemical expense increase in American Water's 10-Q for the period ending June 30, 2009. The 10-Q showed an increase for American Water of 31.4%. Mr. Thakadiyil testified this increase was not representative of Indiana American's increase because it covered a different period. Tr. E-36-37.

(b) OUCC's Position. OUCC Witness Riceman did not agree with Petitioner's *pro forma* level of chemical expense. He stated that Petitioner's response to an OUCC discovery request indicated that August 2009 year-to-date chemical expense is \$1,507,481, compared to August 2008 year-to-date chemical expense of \$1,128,608. Public's

Exhibit No. 2 at 7; Attachment HHR 11. Mr. Riceman stated that, assuming essentially the same consumption, a comparison of these numbers indicated that chemical expense increased 33.57%. He then multiplied this percentage increase by test year chemical expense to yield a *pro forma* chemical expense adjustment of \$570,699.

(c) Industrial Group's Position. Industrial Group Witness Collins opined that the Company did not provide any credible argument that supported its projected level of increase in chemical expense. Industrial Group's Exhibit No. 1 at 13. Mr. Collins stated that data provided by the Company in discovery indicated a smaller increase in the cost of chemicals as compared to the increase projected by Petitioner at the time of its filing. Mr. Collins further stated that according to one discovery response, chemical market prices were weakening, which indicated a lower increase than forecasted by the Company for its adjusted test year chemical expense. Industrial Group's Exhibit No. 1 at 13. According to Mr. Collins, Indiana American's chemical expense on a total Company basis for July and August 2009 was \$384,202, or a 21.5% increase in chemical expense on a per unit basis as compared to the actual test year expense for the twelve months ending November 2008. Industrial Group's Exhibit No. 1 at 13. Mr. Collins recommended that the chemical expense be held at its current level as of July and August 2009, which is \$0.04180 per ccf for the test year. Industrial Group's Exhibit No. 1 at 14. This resulted in a total Company adjusted test year expense of \$2,063,414, or a 21.5% increase. Mr. Collins stated that this recommendation reduced the Company's revenue requirement by approximately \$1,116,839 on a total Company basis. Industrial Group's Exhibit No. 1 at 14.

(d) Schererville's Position. Schererville Witness Mann expressed her concern that the amount of chemical expense included in the rate case may be higher than Petitioner incurred due to cost saving steps Petitioner has taken that are not included in its rate case. Schererville's Exhibit BJM at 8. Ms. Mann stated that all water utilities experienced a large increase in the cost of chemicals at the beginning of 2009 and that this increase in cost was the basis for most of Petitioner's adjustment to its chemical cost in this rate case. However, Ms. Mann noted that Petitioner revealed in discovery that it has taken steps to reduce the cost of chemicals and in fact the cost of chemicals has come down since the filing of this rate case. Schererville's Exhibit BJM at 9. Ms. Mann stated that in response to a discovery request from the Town of Schererville, Petitioner stated, "In 2009 chemicals were sent out to bid multiple times for the various states, twice specifically for Indiana taking advantage of the weakening chemical market." Based upon this response, Ms. Mann opined that the level of chemical costs included in the rate proceeding did not accurately reflect the chemical costs being incurred by Petitioner and recommended that Petitioner's adjustment be removed from revenue requirements. Schererville's Exhibit BJM at 9.

(e) Petitioner's Rebuttal. Petitioner's Witness Thakadiyil agreed that chemical prices have decreased since Indiana American's initial filing. He stated that the Service Company aggressively pursued lower chemical costs through re-bidding and generated reduced costs for Indiana American. Petitioner's Exhibit PJT-R at 7. Mr. Thakadiyil did not agree, however, with Ms. Mann's recommendation that the proposed adjustment be eliminated because the costs paid by the Company were lower than in the earlier bids. Mr. Thakadiyil stated that Ms. Mann's approach amounts to penalizing Indiana American and the Service Company for continuing to work to secure lower chemical costs. Petitioner's Exhibit PJT-R at 7. Mr. Thakadiyil stated that the best approach, which was adopted by Messrs. Riceman and

Collins, is to reduce the adjustment to the lower prevailing price the Service Company has been able to obtain.

While Mr. Thakadiyil agreed that the prevailing lower cost should be reflected in the adjustment, he took issue with Mr. Riceman's calculation. Petitioner's Exhibit PJT-R at 7–8. Mr. Thakadiyil stated that Mr. Riceman's adjustment incorrectly assumes that consumption for the eight-month periods ending August 2008 and 2009 are the same. In fact, stated Mr. Thakadiyil, consumption for the eight months ending 2009 was substantially lower than the same period in 2008. Petitioner's Exhibit PJT-R at 8. Mr. VerDouw explained in his rebuttal testimony that using a period with lower consumption has the effect of understating the increase in chemical costs. Mr. Thakadiyil explained that chemical expenses fluctuate with the amount of water that is treated; as more water is treated, costs go up and vice versa. Petitioner's Exhibit PJT-R at 8. The August 2009 YTD consumption was 1,068,762 thousand gallons less than the eight-month period ending August 2008. Thus, stated Mr. Thakadiyil, a portion of the smaller increase that Mr. Riceman has calculated resulted simply from the fact that usage declined in 2009 and fewer chemicals were required to treat the smaller amount of water used by customers.

Mr. Thakadiyil then expressed some additional concerns with the adjustments proposed by Mr. Riceman and Mr. Collins. He stated that both use water consumption to calculate the chemical expense, but that consumption is a measure of water sales and does not make up the entirety of treated water. Petitioner's Exhibit PJT-R at 8. Mr. Thakadiyil opined that a more appropriate way to price chemicals would be to use system delivery. He also noted that Mr. Collins calculated his chemical expense increase based on his weather normalized usage level, which Mr. Heid's rebuttal testimony explains should be rejected. Petitioner's Exhibit PJT-R at 8–9.

Mr. Thakadiyil defined system delivery as the volume of water that has been treated and pressurized to provide service to customers. He explained that the difference between the eight months ended in August of 2008 verses August 2009 was 1,835,877 thousand gallons or 6.2%. Petitioner's Exhibit PJT-R at 9. He then revised Mr. Riceman's adjustment to reflect August 2009 YTD lower system delivery and, based on the test year chemical expense of \$1,700,027, determined that a \$721,041 increase would result using proper system delivery. Petitioner's Exhibit PJT-R at 9.

Mr. Thakadyil did not endorse Mr. Riceman's methodology. Instead, he multiplied the currently effective chemical prices resulting from the re-bidding to test year chemical usage levels to generate a more accurate picture of chemical expense. Petitioner's Exhibit PJT-R at 10. This resulted in an \$827,803 increase to test year chemical expenses. In addition, as with fuel and power expense, Mr. Thakadiyil incorporated the OUCC's revenue normalization adjustment with the Company's adjustment to large accounts with a change in status, which resulted in a \$20,266 reduction in chemical expense. Petitioner's Exhibit PJT-R4. Finally, Mr. Thakadiyil stated that it is imperative to remove miscellaneous charges so that chemical expense is representative of a normal year. Mr. Thakadiyil noted that the test year included non-recurring miscellaneous charges such as an inventory return for Phosphoric Acid, which needed to be removed to ensure the level is representative of expected future expenses. Mr. Thakadiyil's adjustment for miscellaneous chemicals was to increase chemical expense by \$38,679. Petitioner's Exhibit PJT-R at 10.

(f) Commission Discussion and Findings. No party disputed that Indiana American experienced increased chemical costs since the close of the test year. Indiana American also acknowledges that its efforts to mitigate those increases substantially tempered the need for the increase proposed as part of its case-in-chief. The Commission rejects Ms. Mann's proposal to eliminate chemical expenses increases because Indiana American was able to secure lower prices. Disallowing known increases because the eventual amount of the increase was not as large as originally proposed would discourage utilities from pursuing lower prices during a rate case. Moreover, no party seriously disputes that the evidence presented demonstrates that chemical costs are higher.

The Commission is confronted with three alternatives for calculating the *pro forma* cost for chemicals. Mr. Collins' methodology is based on his weather normalization adjustment that the Commission previously rejected. Mr. Riceman's alternative proposal is based on a methodology that assumes consistent consumption in the first eight months of 2008 and 2009. The evidence demonstrates that consumption was not the same during these periods but in fact declined in 2009. His methodology, therefore, understates the cost of chemicals. The Commission believes that Mr. Thakadiyil's approach, which multiplies the prevailing chemical costs by the test year usage, produces the most accurate *pro forma* chemical expenses because it uses both actual chemical expenses and test year usage. The result is an increase of \$827,803 in chemical expense. The Commission accepts Indiana American's adjustment to eliminate non-recurring expenses, which increases chemical expenses by \$38,679. The Commission also accepts Petitioner's reduction in chemical expenses by \$20,266 to reflect usage levels for large accounts. Consequently, the Commission concludes that Indiana American's *pro forma* chemical expense should be increased by \$846,216.

(7) Insurance.

(a) Group Insurance.

(i) Petitioner's Position. Mr. VerDouw sponsored an adjustment of \$1,513,904 to group insurance. The first component was for cost increases associated with health, life, dental, and long-term disability insurance coverage Indiana American provides for each associate. Petitioner's Exhibit GMV at 23. Mr. VerDouw stated that the *pro forma* cost of these types of insurance was based upon the level of coverage available and the cost rates per units of coverage for all employees included in *pro forma* labor expense.

Mr. VerDouw explained that the second part of the adjustment to group insurance related to the accrual cost of OPEBs under SFAS 106. Mr. VerDouw explained that depending on their start date, some Indiana American associates are eligible for OPEBs upon retirement. Petitioner's Exhibit GMV at 23–24. Associates hired after January 1, 2003 are not eligible for post retirement benefits. For those associates hired prior to January 1, 2003, the Company provides basic life insurance coverage at the time of retirement for a period of one year or until the retiree reaches the age of sixty-five. Mr. VerDouw stated that at this point the life insurance coverage will be reduced by 10% and the same amount for each of the next four anniversaries. Dental coverage is discontinued at the age of sixty-five, while prescription drug benefit coverage continues after retirement. Petitioner's Exhibit GMV at 24.

Mr. VerDouw stated that for those eligible Indiana American associates, the Company recognizes the cost of OPEBs on an accrual basis in accordance with the provisions of SFAS 106, which prescribes the accounting and financial reporting requirements for OPEBs under Generally Accepted Accounting Principles. He further stated that the actuarial cost was determined by Towers Perrin, the Company's actuary, in periodic valuations.

While Petitioner originally included the amortization of its proposed regulatory asset resulting from the proposed Pension/OPEB Balancing Account, this requested amortization was withdrawn on rebuttal. Accordingly, the Pension/OPEB Balancing Account discussed later has no impact on the *pro forma* level of group insurance expense in this case.

(ii) OUCC's Position. OUCC Witness Riceman testified that Petitioner's health insurance rates have remained virtually unchanged since January 2007. Public's Exhibit No. 2 at 7; Attachment HHR 8. Mr. Riceman concluded that the number of employees participating in the various health insurance components was the driver of higher costs. He stated that comparing the Horizon BlueCross/BlueShield premium statement for December 2007 (\$333,696) to the premium statement for November 2008 (\$345,279) resulted in an increase of 3.471%. Mr. Riceman then multiplied this percentage by test year health insurance expense of \$2,669,223 to arrive at his adjustment of \$92,649. Public's Exhibit No. 2 at 7; Attachment HHR 9. OUCC Witness Stull made an adjustment of \$836,184 for current OPEB expense as depicted on OUCC Schedule 6, page 1 of 4. The OUCC's total adjustment for group insurance is \$928,833.

(iii) Petitioner's Rebuttal. Petitioner's Witness VerDouw disagreed with Mr. Riceman's calculation of *pro forma* health insurance expense. Mr. VerDouw stated that Mr. Riceman is correct in assuming that the rates have not increased and that the increase is due to an increase in employees. Petitioner's Exhibit GMV-R at 26. However, Mr. VerDouw testified that Mr. Riceman's method of calculating the increase has nothing to do with calculating the increase based on the number of employees included in the health insurance calculation. He stated that Mr. Riceman's methodology would seem more consistent with calculating an average annual increase in insurance costs for a static number of employees. As Mr. Riceman acknowledged, the driver in this case was an increase in the number of employees, not an average annual increase in the cost of the plan. Petitioner's Exhibit GMV-R at 26.

Mr. VerDouw explained that the Company calculated the various health insurance components (medical, dental, prescriptions, life insurance, and disability insurance) using actual benefits received for existing employees and using an average per person health insurance component cost for those employees that were hired after the end of the test year and included in *pro forma* labor expense. Petitioner's Exhibit GMV-R at 26–27. Mr. VerDouw believed that the approach used by Indiana American in calculating the health insurance component is a very sound and more accurate approach to arriving at *pro forma* health insurance expense. He stated that Petitioner's Exhibit GMV-2R shows *pro forma* health insurance component expense and the reduction in the health insurance component for each position not included in the rebuttal totals. Based upon this, Mr. VerDouw stated that Petitioner's *pro forma* expense for this health insurance component of group insurance would be reduced by \$94,110. Petitioner's Exhibit GMV-R at 27.

(iv) Commission Discussion and Findings. The Commission believes Mr. VerDouw's calculation of group insurance was a more accurate methodology to determine the cost. Mr. VerDouw multiplied the actual cost by the number of full-time employees set forth in Petitioner's rebuttal testimony. In contrast, Mr. Riceman sought to compare two periods and simply calculate the percentage increase and apply it to test year levels. As demonstrated by Mr. VerDouw's different result, this methodology does not produce an increase that correlates to the actual group insurance cost multiplied by the number of employees. Consequently, we find that Petitioner's *pro forma* group insurance for health, life, dental, and long-term disability insurance coverage, as well as OPEBs, should be \$5,530,388.

(b) Insurance Other Than Group. Petitioner proposed a total adjustment to insurance other than group of \$525,707.

(i) OUCC's Position. OUCC Witness Corey accepted Petitioner's adjustment of \$70,345 for workers' compensation and \$88,180 for personal property insurance expense. However, Mr. Corey proposed to eliminate \$77,305 of Petitioner's proposal for a general liability insurance expense line item labeled "retrospective adjustment" because Petitioner provided no explanation or support demonstrating that these insurance premiums will benefit future periods. Mr. Corey stated that the OUCC does not believe that it is appropriate for Petitioner to retroactively recover insurance expense from a prior period. Public's Exhibit No. 4 at 3.

(ii) Petitioner's Rebuttal. According to Mr. Thakadiyil, the OUCC accepted all of Petitioner's adjustments for insurance other than group except for the adjustment labeled "retrospective adjustment." Mr. Thakadiyil explained that the naming convention in the workpapers for this line item was incorrect and that it should have been named "retrospective accrual." Petitioner's Exhibit PJT-R at 14. He testified that the retrospective accrual is a prospective review of expected future insurance claim costs based upon current insurance other than group insurance premiums for general liability, auto liability, and workers compensation.

(iii) Commission Discussion and Findings. The only dispute to be decided by the Commission is the adjustment in the amount of \$77,305 for Indiana American's retrospective adjustment or, as described by Mr. Thakadiyil, retrospective accrual. According to Mr. Thakadiyil, this adjustment is prospective and for that which is anticipated to occur in the future. Such an adjustment is speculative and not fixed, known, and measurable. The Commission therefore rejects Petitioner's proposed adjustment and accepts the OUCC's proposed adjustment.

(8) Taxes.

(a) Utility Receipts Tax. OUCC Witness Stull proposed to exclude \$8,460,453 in sales for resale in the calculation of the utility receipts tax. Ms. Stull's exclusion was higher than Petitioner's because of Petitioner's exclusion of one sale for resale account and its failure to classify its DSIC revenue normalization adjustment as sales for resale. Petitioner agreed with Ms. Stull's proposal. The Commission finds that Petitioner should include all sale for resale accounts and its DSIC revenue normalization adjustment as deductible for purposes of

calculating the utility receipts tax.

(b) IDEM Safe Drinking Water Fee. Both Petitioner and the OUCC proposed an adjustment to reflect the IDEM safe drinking water fee. For purposes of calculating the fee, Petitioner counted fire service connections separately from other customers. Ms. Stull testified that IDEM represented to the OUCC that fire service customers do not count as additional connections for purposes of safe drinking water fee assessment. Petitioner accepted Ms. Stull's adjustment. Consequently, the Commission finds the *pro forma* IDEM safe drinking water fee should be \$268,007.

(c) State and Federal Income Taxes.

(i) OUCC's Position. The OUCC accepted Petitioner's methodology for calculating federal income taxes. OUCC Witness Stull maintained that Petitioner's calculation of Indiana state income tax expense should include an allocation of "parent company interest expense." Public's Exhibit No. 1 at 55. She explained that the Indiana corporate income tax calculation begins with Federal taxable income and that interest expense is not an add-back required by Indiana. She believed that if one included the interest as an expense that would be rightfully deducted from revenue to establish Federal taxable income, the interest expense should also be recognized when calculating Indiana taxable income.

(ii) Petitioner's Rebuttal. Mr. VerDouw testified that Ms. Stull was in error in deducting parent company interest expense from the Indiana income tax calculation. He explained that Petitioner followed the methodology prescribed in the Commission's September 16, 1981 Supplemental Order on Remand in Cause No. 34571 by deducting the parent company interest only in the determination of Federal income taxes. Petitioner's Exhibit GMV-R at 20. According to Mr. VerDouw, the Commission rejected the OUCC's position that parent company interest should be deducted in the State income tax calculation in its November 11, 1990 Supplemental Order on Rehearing in Cause No. 34571 and in the 2004 Rate Order.

Mr. VerDouw testified that the OUCC's adjustment was inappropriate because parent company interest deduction for Federal income taxes is intended to reflect for ratemaking purposes the benefits to Indiana American in joining in a consolidated Federal income tax return. Petitioner's Exhibit GMV-R at 21. Since Indiana American's state income tax return is filed separately (not on a consolidated basis), there are no benefits derived from the parent company interest.

(iii) Commission Discussion and Findings. The Commission has twice rejected the OUCC's proposal to deduct parent company interest from state income tax. While we are not averse to changing prior positions when there is a reason to do so, the OUCC did not provide any justification for deviating from those conclusions. The Commission previously found:

We accept Petitioner's methodology to calculate pro forma state income taxes. The OUCC's proposal to deduct parent company interest in the state income tax calculation is rejected. We rejected

this same proposal from the OUCC in our Supplemental Order on Rehearing in Cause No. 38880. (*Ind.-Am. Water Co.*, Cause No. 3880 (Indiana Utility Regulatory Commission, Date Issued Nov. 28, 1990).) We noted in that Order that “the Commission’s calculation of state income taxes in the [34571] Order did not treat the parent company interest as tax deductible for state income tax purposes.” (*Id.* at p. 7.) This conclusion is likewise valid in this proceeding because Petitioner does not file a consolidated state income tax return.

2004 Rate Order at 116. The Commission finds these conclusions continue to be valid. Mr. VerDouw explained that Indiana American does not file a consolidated state income tax return. Therefore, we reject the OUCC’s proposal to allocate parent company interest for purposes of calculating state income tax.

(d) Payroll Taxes. While no party disputed the methodology for calculating payroll taxes, disagreement over the number of employees on which payroll taxes would be paid led to different calculations. Based on the Commission’s findings that the full-time employee count should be 366 and temporary employee count should be twelve, we find Indiana American’s *pro forma* payroll tax expense to be \$1,255,314.

(9) Waste Disposal Expense. OUCC Witness Stull proposed to adjust test year expenses to eliminate non-recurring sludge removal, which resulted in a reduction to costs in the amount of \$378,815. Petitioner accepted Ms. Stull’s adjustment on rebuttal, but noted that in eliminating non-recurring accrual adjustments, Ms. Stull omitted two non-recurring accrual adjustments in the Northwest District. Petitioner’s Exhibit PJT-R at 12. Accounting for these additional adjustments, Mr. Thakadiyil proposed an adjustment to reduce test year expenses by \$367,568, rather than the \$378,815 proposed by the OUCC. The Commission finds that test year expenses should be reduced by \$367,568 to eliminate non-recurring waste disposal costs.

(10) General Office Expenses.

(a) Petitioner’s Position. Petitioner proposed a total adjustment to general office expense of \$124,298. This consisted of an adjustment to relocation expense to a three-year average and a slight reduction of \$7,229 related to labor expense included in general office expense.

(b) OUCC Position. Ms. Stull accepted Petitioner’s proposed relocation expense adjustment but proposed two different adjustments to test year general office expense. First, she eliminated \$37,429 of miscellaneous test year labor expenses recorded as general office expense. Second, she proposed to eliminate \$15,303 in what she characterized as “non-allowed” expenses that provide no material benefit to ratepayers and are not necessary to provide utility services. She testified that these expenses included, among other things, sports sponsorships, memberships in civic organizations, and donations. Public’s Exhibit No. 1 at 44. Her overall proposal was *pro forma* general office expense of \$1,363,145.

(c) Petitioner’s Rebuttal. Mr. VerDouw explained that the \$37,429 in

expenses Ms. Stull believed were related to labor expenses were in fact reimbursement of employee out of pocket expenses that are reimbursed via a line item on an employee's bi-weekly paycheck. Examples of the types of costs that were reimbursed included safety shoe purchases, overtime meals, personal mileage, and miscellaneous charges incurred when traveling. Mr. VerDouw explained that the reimbursements were coded as a "Payroll Labor Distribution" in the general ledger because that is how the payment would be made to the employee. He stated that all of the reimbursed expenses are allowable expenses for Company employees. Petitioner's Exhibit GMV-R at 12-13.

Mr. VerDouw also did not agree with Ms. Stull's elimination of \$15,303 of general office expenses and did not agree that these expenses were improper to include in rates. He said these expenses were for memberships in civic organizations and home builders associations, which he believed benefitted ratepayers. He stated these activities allowed Petitioner to participate in organizations that guide building and construction standards and provided a forum to discuss plans, coordinate building activities, and promote such programs as water conservation. Mr. VerDouw also explained that what Ms. Stull categorized as donations were payments made to floral shops for flowers sent to employees who were hospitalized or for funerals. He believed that showing employees an employer cares during a time of need is a routine and very necessary cost of doing business. He also pointed out that the OUCC's schedule did not support Ms. Stull's assertion that these expenses included sports sponsorships because no expense included such a description. Petitioner's Exhibit GMV-R at 13-14.

(d) Commission Discussion and Findings. The Commission believes that Ms. Stull's proposal to eliminate \$37,429 of miscellaneous test general office expense is based on a misunderstanding about the nature of these costs. Mr. VerDouw has explained that these costs were not labor costs but were to reimburse employees for legitimate costs such as safety shoes and personal mileage for business. We can understand the confusion based on the label applied to the item in the general ledger, but based on Mr. VerDouw's clarification, the Commission rejects the OUCC's proposed adjustment and concludes that these costs are proper expenses to recover through rates. The Commission therefore accepts Petitioner's proposed adjustment of \$7,229 to eliminate labor expense included in general office expense.

The Commission, however, accepts Ms. Stull's proposed adjustment to eliminate \$15,303 for non-allowed general office expense. According to Mr. VerDouw, the expenses relate primarily to civic activities and involvement in builders associations. But, Petitioner failed to convince the Commission that the purchase of flowers for employees and memberships in builders associations and civic organizations are necessary to the provision of utility service to Indiana American's ratepayers. The Commission finds that \$15,303 should be excluded from general office expenses. Accordingly, based on the evidence presented, the Commission finds that the adjustment for Indiana American's general office expense should be \$108,995.

(11) Customer Accounting.

(a) Petitioner's Position. Mr. Thakadiyil testified that Petitioner's *pro forma* adjustment for customer accounting expense is an increase of \$483,704. The first adjustment he made was to normalize Indiana American's uncollectable expense. Mr. Thakadiyil applied a three-year average of charge-offs as a percentage to revenues at present

rates. He testified that this is consistent with Commission Orders in Cause Nos. 40103, 40703, 42029, and 42520. The *pro forma* adjustment to uncollectable expense was an increase of \$420,653. The second adjustment Mr. Thakadiyil made to customer accounting expense was to annualize 2009 postage rates. Effective May 11, 2009, the U.S. Postal Service increased rates for first class mail. The *pro forma* adjustment to annualize postage expense is \$63,051.

(b) OUCC's Position. Mr. Corey accepted Mr. Thakadiyil's adjustment for postage expense. He also accepted Mr. Thakadiyil's methodology to determine Petitioner's charge-off rate. He applied Mr. Thakadiyil's charge-off rate of 1.2505% to the OUCC's calculations for Indiana American's present water and sewer operating revenues. Also, unlike Petitioner, Mr. Corey removed uncollectable expense of \$76,406 for miscellaneous invoices. He explained that "other" revenues are not subject to the uncollectible expense adjustment. Mr. Corey then revised this number to \$2,605 for expenses associated with income recorded "below the line" and associated with non-customer related receivables.

(c) Petitioner's Rebuttal. Mr. Thakadiyil agreed that the calculation for uncollectible accounts should apply only to water and sewer operating revenues. However, he disagreed with Mr. Corey's elimination of receivables that Mr. Corey described as "below the line." Mr. Thakadiyil explained that these receivables are high value receivables, which are amounts due from customers for high cost and low volume services. For example, these receivables are for payments associated with O&M services, property rental, and bulk water sales and not related to water and sewer billings.

(d) Commission Discussion and Findings. The parties agreed on Indiana American's adjustments for postage expense and its methodology used to calculate the charge-off rate. The parties also agreed that the charge-off rate should be applied to Petitioner's water and sewer operating revenues only. Therefore, the only issue to be determined by the Commission concerns the elimination of \$2,605 in high value receivables from Petitioner's uncollectible expense.

The Commission notes that Mr. Corey admitted on cross-examination that Indiana American agreed to treat certain revenue earned from activities not directly related to the provision of water service in its *pro forma* revenues. He acknowledged that if the revenues are counted but the associated receivables are excluded, the result would be a mismatch of revenues and costs. Tr. F-29-31.

The high value receivables are associated with revenues that Indiana American has treated as above the line revenue in this proceeding. Consequently, appropriate offsets for accounts receivable should be matched with this revenue. The Commission finds that the OUCC's proposed elimination of the associated receivables causes a mismatch and should be rejected. The Commission also finds that based on the evidence presented, Indiana American's adjustment for customer accounting expense should be \$463,721.

(12) Miscellaneous Expense.

(a) OUCC Position. Ms. Stull first testified that Indiana American made two minor adjustments related to non-allowed expenses. The first was for the elimination

of a charitable contribution in the amount of \$3,500 and the second was for the elimination of an advertising expense in the amount of \$450. Based on her review of Petitioner's test year expenses, which included 29,000 entries, Ms. Stull eliminated \$199,045 in miscellaneous expenses. Public's Exhibit No. 1 at 48. She eliminated these expenses she deemed non-allowed and non-recurring because they provide no material benefit to ratepayers and are not necessary for the provision of utility service. Ms. Stull stated that these expenses include items such as sports sponsorships, memberships in civic organizations, employee awards, image building, sports tickets, and donations. She stated that the Commission disallowed these types of expenses in prior Indiana American rates Cases including Cause Nos. 42029, 42520, and 43187. She eliminated any donations to the Chamber of Commerce that were for sports sponsorships because she did not believe the Commission's allowance of Chamber of Commerce fees should be used as a guise to recover these types of expenses.

(b) Petitioner's Rebuttal. Mr. VerDouw did accept \$25,482 in exclusions for certain community relations and lobbying expenses. He contested the remainder of Ms. Stull's adjustments. He disagreed with Ms. Stull's statement that many of the adjustments provide no material benefit to ratepayers and are not necessary for the provision of utility service. Mr. VerDouw repeated that memberships in community organizations and builders' associations enable Indiana American to forge professional relationships that benefit ratepayers. He also repeated that expenses for flowers for ill employees and family members or purchases for Company gatherings help to strengthen employee relationships and thus benefit ratepayers.

Mr. VerDouw testified that \$3,800 of her proposed adjustments were items that Petitioner already removed as part of its case-in-chief. Petitioner's Exhibit GMV-R at 16-17. The \$1,587 of expenses labeled as "PCard Undistributed" is a month-end entry to record employee purchase card transactions that would have an offsetting credit entry that reverses out those expenses. Petitioner's Exhibit GMV-R at 17. Mr. VerDouw disagreed with Ms. Stull's exclusion of \$4,123 in expenses for Thomas Rose Advertising and \$21,110 in expenses for Opinion Research Corporation. Ms. Stull categorized them as "image building" because these vendors provided employment ads and customer surveys. Mr. VerDouw explained the customer surveys are done quarterly and annually to identify areas of service that need to be improved. Petitioner's Exhibit GMV-R at 18.

Mr. VerDouw accepted exclusions for items located at the bottom of Petitioner's GMV-1R totaling \$25,492.<sup>3</sup> Mr. VerDouw also accepted Mr. Stull's adjustments for labor expense, contract services, legal expenses, lobbying expense, amortization of security expense, penalties, vehicle insurance expenses, and adjustment for the cost of leased vehicles.

(c) Commission Discussions and Findings. The Commission finds that \$25,492 of Ms. Stull's proposed adjustment, to which Petitioner agrees, should be accepted, as well as the amounts Petitioner already proposed to remove. Petitioner's removal of \$300 for advertising expense and \$3,500 for charitable contributions should also be accepted. The OUC proposes to remove \$199,045 in expenses characterized as non-allowed and non-recurring. Ms.

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<sup>3</sup> Mr. VerDouw's prefiled testimony uses the amount of \$25,482, however his schedule GMV-R1 correctly uses \$25,492 to calculate this adjustment.

Stull asserted that these expenses provide no material benefit to ratepayers and are not necessary for the provision of utility service. The Commission agrees that expenses identified by the OUCC as sports sponsorships, memberships in civic organizations, employee awards, sports tickets, and donations should be excluded. The evidence presented failed to support Petitioner's assertion that these expenses are necessary and benefit ratepayers and are necessary for the provision of utility service.

However, the Commission disagrees with the OUCC position that expenses relating to Thomas Rose Advertising and Opinion Research Corporation are simply image building and should not be recovered. Mr. VerDouw explained that these expenses are for employment ads and customer opinion surveys. The Commission agrees that such expenses are necessary for the provision of utility service and benefit ratepayers. Therefore, \$25,233 for these expenses should be recovered.

Based on the evidence presented, the Commission finds that a total \$168,424 in non-allowed and non-recurring expenses should be eliminated. Petitioner's total miscellaneous expense adjustments result in an increase of \$149,789.

(13) Maintenance Expense. All parties' testimony was in agreement with respect to proposed adjustments to maintenance expense except with respect to the amortization of tank painting costs in the Warsaw District. Ms. Stull proposed to eliminate the tank painting amortizations of the Winona and West Tanks in the Warsaw District because both have been recently repainted. Public's Exhibit No. 1 at 45. She believed that including both the amortization of the prior tank painting costs and the depreciation of the new costs would be double recovery. Mr. VerDouw agreed to eliminate the amortization of the Winona Tank because its amortization ended in August 2009. He disagreed with eliminating the amortization of the West Tank, which does not end until June 2013. Petitioner's Exhibit GMV-R at 15.

The Commission disagrees that continued recovery of the West Tank painting cost amortization constitutes double recovery of costs. Petitioner has already incurred these costs and should fully recover them through June 2013, which is the end of its amortization period. Eliminating recovery would essentially eliminate Petitioner's ability to recover this prudently incurred cost. The Commission therefore finds that the total adjustment to maintenance expense is a decrease of \$6,636,845.

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

### Pro-Forma Operating Income Statement

<u>OPERATING REVENUES:</u>	Test Year Ended 11/30/08	Adjustments	Pro-Forma Present Rates
Operating Revenues:	\$154,867,115		\$159,986,294
Sales Revenues		\$5,119,179	
Other Revenues	2,350,363	(152,202)	2,198,161
Total Operating Revenues	<u>157,217,478</u>	<u>4,966,977</u>	<u>162,184,455</u>
<u>OPERATING EXPENSES:</u>			
Operations & Maintenance:	73,986,997		73,853,778
Labor Expense		2,980,645	
Management Fees		(1,240,261)	
Group Insurance		1,301,320	
Pension Expense		1,486,804	
Regulatory Expense		101,419	
Miscellaneous Expense		149,789	
Purchased Water Expense		62,273	
Purchased Power Expense		65,153	
Chemical Expense		846,216	
Waste Disposal Expense		(367,568)	
Insurance Expense		448,402	
Rent Expense		96,719	
Maintenance Expense		(6,636,845)	
General Office Expense		108,995	
Customer Accounting Expense		463,721	
Depreciation Expense	20,499,272	10,962,927	31,462,199
Amortization Expense	453,202	1,121	454,323
IURC Fee	166,843	7,278	174,121
Other General Taxes:	12,824,981	2,830,344	15,896,658
Payroll Taxes		177,679	
Utility Receipts Tax		63,654	
State Income Tax	3,286,038	(935,019)	2,351,019
Federal Income Tax	10,278,963	(4,312,244)	5,966,719
Total Operating Expenses	<u>121,496,296</u>	<u>8,662,522</u>	<u>130,158,817</u>
Net Operating Income	<u>\$35,721,182</u>	<u>(\$3,695,545)</u>	<u>\$32,025,638</u>

In summary, the Commission finds that with appropriate adjustment for ratemaking purposes, Petitioner's annual net operating income under its present rates for water/sewer service would be \$32,025,638. We previously found that the fair value of Indiana American's utility property is \$945,522,592. A return of \$32,025,638 is insufficient to represent a fair return on the fair value rate base. The Commission therefore finds that Petitioner's present rates are unreasonable.

**11. Authorized Rate Increase.** Based on the evidence presented, the Commission finds that Petitioner should be authorized to increase its rates and charges to produce additional operating revenue of \$31,542,729, or a 19.72% increase in water/sewer revenues, resulting in

total annual operating revenue of \$193,727,184. This revenue is reasonably estimated to afford Petitioner the opportunity to earn a net operating income of \$50,262,867, as follows:

	Pro-Forma Proposed
<u>OPERATING REVENUES:</u>	<u>Rates</u>
Operating Revenues	\$191,529,023
Other Revenue	2,198,161
	<hr/>
Total Operating Revenues	193,727,184
<u>OPERATING EXPENSES:</u>	
Operations & Maintenance	74,248,220
Depreciation Expense	31,462,199
Amortization Expense	454,323
IURC Fee	207,563
Other General Taxes	16,309,470
State Income Tax	4,995,782
Federal Income Tax	15,786,759
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Total Operating Expenses	143,464,316
	<hr/>
Net Operating Income	<u><u>\$50,262,867</u></u>

The calculation of Indiana American's authorized percent increase is depicted below:

Total Original Cost Rate Base	\$ 655,932,517
Required Rate of Return	7.53%
NOI Required before Fair Value Increment	\$ 49,391,718
Fair Value Increment	871,149
Required Operating Income	50,262,867
Less: Adjusted Net Operating Income (NOI)	32,025,638
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Increase in NOI	18,237,229
Gross Revenue Conversion Factor	1.7296
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Recommended Revenue Increase	\$ 31,542,729
	<hr/>
Percentage Increase	<u><u>19.72%</u></u>

## **12. Cost of Service Study and Single Tariff Pricing.**

A. Petitioner's Position. Petitioner conducted a cost of service study ("COSS") prepared by Kerry A. Heid under which it proposed to move its rate design to full, STP for all categories of service except the volumetric rates for general water service, for which it proposed two rate groups. Mr. Baker explained that approximately twelve years ago, the Commission approved pursuant to the 1997 Rate Order a gradual move from fourteen separate

rate groups across Indiana American's service area to a single tariff structure for all districts. Petitioner's Exhibit DKB at 14. In that case, Indiana American moved from fourteen separate rate groups to five. He said that Indiana American has made progress with respect to STP but has groups that still need to transition to STP.

Mr. Baker testified that for volumetric rates for General Water Service, Indiana American is not proposing a move to STP. Instead, Petitioner proposes two rate groups: Area 1 and Area 2. Area 2 consists of Indiana American's operations in Wabash, Warsaw, Winchester, Mooresville, and Lafayette. Area 1 consists of the remaining operations.

Mr. Baker testified Indiana American was faced with a unique set of circumstances in this case where the proposed transition towards STP produced a rate increase that is not significantly more than would be produced by an across-the-board increase for almost all of its customers. Petitioner's Exhibit DKB at 15. Mr. Baker further explained that for some customers, such as residential customers in the Northwest Operation, the move produces rates below what would be produced on an across-the-board basis. Petitioner's Exhibit DKB at 15. Petitioner has not proposed a complete movement to STP in this case because of the impact on a few customers in the former United operations, which is Area 2. These operations have very old rate structures where the tail block rates kick in at a low level of consumption that is significantly below that in Petitioner's other operations. The proposed rate group for Area 1 and Area 2 was set to mitigate the impact of the increase that would occur with full STP for these customers. Petitioner's Exhibit DKB at 15.

B. OUCC's Position. The OUCC raised concerns with Petitioner's movement towards STP in this proceeding. OUCC Witness Dahlstrom testified that Indiana American's proposed rate structure does not recover the cost to serve the Industrial—Large, Industrial, and Sale for Resale customers and over-recovers the cost to serve the Residential and Commercial customers. Public's Exhibit No. 5 at 9. According to Mr. Dahlstrom, Mr. Heid stated that the subsidization of the Industrial—Large, Industrial, and Sale for Resale customers by the Residential and Commercial customers is a result of the rate design implemented to move to STP and not intentional. Public's Exhibit No. 5 at 11. He concluded that Petitioner's move to STP is too aggressive and recommended Petitioner moderate its proposed move to STP in a way that significantly lessens or eliminates the subsidy. For example, the transition to STP proposed in this Cause could be accomplished over two rate cases. Mr. Dahlstrom indicated that his proposal was consistent with the OUCC's desire to have cost-based rates. Public's Exhibit No. 5 at 11.

C. Schererville's Position. Schererville Witness Sommer testified that continued move to STP in this Cause resulted in one of the largest increase requests in Indiana American's history. In Mr. Sommer's opinion, the effects of the transition to STP will create rate shock. He stated that the Commission should balance the interests of the Company and the ratepayer especially in the current economic times. He recommended that any rate change be implemented on an across-the-board basis. Schererville Exhibit TJS at 19.

D. Petitioner's Rebuttal. Mr. Heid disagreed with Messrs. Sommer's and Dahlstrom's recommendations to either eliminate or further moderate the movement to STP in this proceeding. He testified that Mr. Sommer provided no evidence of rate shock as a result of

the movement to STP proposed in this proceeding. Mr. Heid noted that the Northwest District, where Schererville was located, would receive an overall increase of 30.2% without the move to STP, very close to the overall system average increase of approximately 29%. Northwest District residential customers would receive an average increase of 32.2% absent the move to STP, and Sale for Resale customers, including Schererville, would receive an average increase of 34%. Petitioner's Exhibit KAH-R at 29.

Mr. Heid opined that the residential and commercial subsidies are not excessive or indicative of an overly aggressive move to STP. He noted that the Commission routinely approves subsidies of this magnitude or larger, typically with the residential customers as the beneficiaries of subsidies by other customer classes. Petitioner's Exhibit KAH-R at 6–7. Mr. Heid also refuted Mr. Dahlstrom's contention that Indiana American's movement to STP was overly aggressive, as evidenced by the intentionally slow movement intended to mitigate bill impacts to the extent practicable. He concluded that the benefits of STP outweigh such results.

E. Commission Discussion and Findings. Based on the evidence presented, the Commission finds that Indiana American's movement towards STP in this proceeding is appropriate. The Commission notes that Indiana American's proposed transition towards STP produces a rate increase that is not significantly more than would be produced by an across-the-board increase for almost all of its customers. For some customers, STP produces rates below what would be produced by an across-the-board rate increase. The Commission also notes that Petitioner attempted to mitigate the significant increase that would have been experienced for volumetric rates for general water service by proposing different rates for Area 1 and Area 2. As a result, the Commission rejects Mr. Sommer's general claim that Indiana American's proposal produces rate shock.

The Commission believes that rates should be cost based, but we do not pursue this objective blindly and without consideration of other objectives. While we are sympathetic to the OUCC's desire for cost-based rates, the Commission believes the small subsidies that result from the movement to STP are outweighed by the benefits that accrue to customers. Residential and commercial customers provide a 2.64% and 1.02%, respectively, subsidy to other customers. The Commission first approved Petitioner's STP in 1997, and Indiana American has gradually implemented STP since our approval granted in the 1997 Rate Order. When originally approving STP, the Commission stated, "[W]e believe that in the long-term all areas will benefit by increased rate stability and mitigation of the impact of construction projects in their communities." 1997 Rate Order at 77. We find this to still be true; these considerations outweigh the general objection raised by Schererville and concern expressed by the OUCC with respect to the small subsidy provided by residential and commercial customers.

Other specific issues were raised with respect to the mechanics of Mr. Heid's COSS and Petitioner's proposed rate design. The Commission addresses each issue separately.

(1) Capacity Factor. OUCC Witness Dahlstrom expressed concern that a significant amount of time has passed since Petitioner's capacity factors were last analyzed and recommended a new capacity factor study in its next rate case. Mr. Heid agreed to Mr. Dahlstrom's recommendation. The Commission finds that Indiana American should conduct and provide a new capacity factor analysis in its next rate case.

(2) Equivalent Hydrant Ratios. OUCC Witness Dahlstrom urged recalculation of equivalent hydrants to match prior recommendations by the OUCC if doing so does not cause additional rate shock to customers. Public's Exhibit No. 5 at 8. Mr. Heid acknowledged the need to eventually change to more traditional ratios for equivalent hydrants but stated that implementing such a change here would result in rate shock. Petitioner's Exhibit KAH-R at 5. The change would result in a 33.79% decrease for the private fire protection class and a 76.37% increase for the public fire protection class. The Commission finds that Mr. Heid's explanation to be satisfactory and so no change is required at this time. However, the Commission finds that Petitioner should be prepared to discuss this issue in its next rate case.

(3) Sewer Subsidy.

(a) Petitioner's Position. For sewer rates, Mr. Baker stated that Indiana American is asking for full STP but that the economies of scale enjoyed by the water portion of the business be shared with the sewer portion. Mr. Baker explained that Petitioner has two sewer systems: Farmington and Somerset. He opined that as a result of needed investment into Farmington, the age of Somerset, and the small customer base, sewer rates are becoming unaffordable. Mr. Baker stated that he asked Mr. Heid to design rates that will fairly and reasonably share economies of scale experienced by the water division.

Mr. Heid testified a flat monthly rate for Petitioner's sewer districts would be \$84. According to Mr. Heid, senior management at Indiana American decided that this rate would be too high considering the current economic times. Therefore, he designed a sewer rate that would be on par with Muncie's water bill for the average residential customer. As a result, Indiana American would recover from sewer customers \$271,983 less than the sewer revenue requirement. This amount would be recovered from water customers. Absent this subsidy, Mr. Heid stated that sewer customers' flat monthly charge would exceed \$84.37. The subsidy saves sewer customers \$48.37 per month and costs residential water customers slightly more than \$0.05 per month.

(b) Industrial Group Position. Industrial Group Witness Gorman testified that Indiana American is proposing to allocate costs of its two sewer utilities to its water customers. Mr. Gorman said this subsidization is contrary to basic rate making theories and is not good regulatory policy. Industrial Group's Exhibit No. 2 at 76.

(c) Petitioner's Rebuttal. Mr. Heid testified that the subsidy paid by water customers to keep sewer customers' rates lower is slight and should be implemented because of the concern over a significant rate increase to sewer rates. Mr. Heid characterized the impact on industrial water customers as immaterial, particularly in light of the current inter-class subsidy being proposed for industrial customers. Specifically, industrial customers received \$1,221,000 in subsidies from other customers and paid only \$17,925 towards a subsidy of the sewer customers. Petitioner's Exhibit KAH-R at 27-28.

(d) Commission Discussions and Findings. Indiana American is requesting STP with respect to sewer rates but expresses concern over the impact of a potential rate increase. Therefore, Mr. Baker asked Mr. Heid to design a more acceptable rate for its sewer customers. The Commission has several concerns with Mr. Heid's methodology and final

conclusion.

Mr. Heid testified that his objective was to design sewer rates that correspond to Muncie's residential water rates. But, Mr. Heid offered no support or explanation for his choice of Muncie's water rates as a proxy for Farmington's and Somerset's sewer rates. In this case, Petitioner also failed to explain how water rates are an appropriate comparison for the design of sewer rates. In addition, Petitioner is not proposing a subsidized rate increase for its sewer customers. Rather, Indiana American is proposing an approximate 41% decrease in sewer rates, which is greater than the water revenue increase proposed in this Cause. Indiana American failed to provide evidence supporting the need for a 41% decrease in sewer rates to be subsidized by water customers. The Commission finds that Petitioner's request with respect to sewer rates should be denied and sewer rates should remain at their current level.

(4) Allocation of Transmission and Distribution Mains.

(a) Industrial Group's Position. Mr. Gorman testified that Indiana American affiliates in Illinois and Missouri separated total distribution and transmission mains as Mr. Heid indicated he did for the Petitioner but that the affiliates' allocation was radically different. While Mr. Heid's analysis found that the length of transmission mains for Petitioner is 53.8% of total mains and only 46.2% is distribution, Missouri's ratio was 20% transmission mains and 80% distribution mains, while Illinois' ratio was 43% transmission mains and 57% distribution mains. Industrial Group Exhibit No. 2 at 73. Mr. Gorman opined that Mr. Heid reversed these percentages in his cost study and incorrectly assigned too much cost to large transmission mains and too little cost to small distribution mains. Mr. Gorman recommended reversing Mr. Heid's allocations percentages.

(b) OUCC Position. Mr. Dahlstrom testified it appears that the costs related to transmission and distribution mains were allocated only to small customers. He stated that a formulaic error in the COSS appeared to be causing a misallocation of transmission and distribution mains common to small customers and not common to all. Mr. Dahlstrom recommended correcting the formulaic error and allocating transmission and distribution mains in the same manner used to allocate transmission and distribution mains plant.

(c) Petitioner's Rebuttal. Mr. Heid agreed with Mr. Dahlstrom that a formulaic error in his COSS caused a misallocation of transmission and distribution mains, and he corrected this error. Petitioner's Exhibit KAH-R at 4, Petitioner's Exhibit KAH-1R. Mr. Heid disagreed with Mr. Gorman's assertion that he switched the proposed breakdown of investments between smaller distribution mains and larger transmission mains. He stated that he did not transpose the percentages for distribution and transmission mains. Petitioner's Exhibit KAH-R at 20-21. Mr. Heid stated that workpapers included the breakdown of distribution and transmission mains.

Mr. Heid emphasized that it is the dollar investment in transmission and distribution mains that is important, but the Indiana American affiliates used relative footage of mains rather than investment. Petitioner's Exhibit KAH-R at 21. Mr. Heid testified that using footage of mains is a very poor indicator of relative investment because the larger size mains are more costly than the smaller size mains. He indicated that relative footages was used by the affiliates

because the data necessary to make the allocation based upon investment was not available for some properties. Petitioner's Exhibit KAH-R at 22.

(d) Commission Discussion and Findings. Petitioner agreed with the formulaic error identified by Mr. Dahlstrom and revised that error. The Commission finds the final rates approved by this Order should be calculated with the formulaic error corrected as has been done by Mr. Heid. With regard to Mr. Gorman's proposal to reverse Mr. Heid's allocation of transmission and distribution mains, Mr. Heid confirmed that the allocation percentage did not result from an error. Mr. Heid also explained why the allocation percentages resulting in Illinois and Missouri resulted from a less reliable method than what Mr. Heid used because of unavailability of data relating to the dollar investment in the distribution and transmission mains. The Commission rejects Mr. Gorman's proposal to reverse the percentages for transmission and distribution mains.

(5) Allocation of Purchased Power Costs.

(a) Industrial Group's Position. Mr. Gorman believed that power costs should be allocated more on a factor for base, max day, and max hour rather than primarily base as proposed by Mr. Heid. Industrial Group Exhibit No. 2 at 74. Mr. Gorman's review of NIPSCO and Duke Energy Indiana, Inc. electric tariffs, which he stated were Petitioner's major suppliers, indicated that electric rates were 45–50% demand and 50–55% energy. Because demand charges for NIPSCO and Duke Energy are based on the highest peak in the billing month, Mr. Gorman believed peak hour demand would be the appropriate allocation for power demand costs. Industrial Group Exhibit No. 2 at 74.

Mr. Gorman proposed to allocate 100% of purchased power cost using Factor 4, which allocates cost based on 44% base volumes and 56% peak day and peak hour demands. Mr. Gorman stated that use of Factor 4 is also consistent with the allocation factor Mr. Heid used for Petitioner's pumping equipment. He testified that pumps use large amounts of electrical power and are a major contributor, if not the primary contributor, to Indiana American's total power expense and should be allocated to customers in the same way the actual investment cost of that pump is allocated. Industrial Group Exhibit No. 2 at 75.

(b) Petitioner's Rebuttal. Mr. Heid disagreed with Mr. Gorman's recommendation to allocate 56% of power costs to the maximum hour and maximum day "extra capacity" cost function and the other 44% to the "base" cost function. Petitioner's Exhibit KAH-R at 23–24. Mr. Heid stated that Mr. Gorman did not review Indiana American's electric bills to determine the actual demand and energy cost breakdown and to determine the electric rate schedules under which the various Indiana American facilities take service. Mr. Heid noted that even if this analysis had been done, Mr. Gorman's logic was flawed. Mr. Heid explained that the "base" cost function includes not only variable costs but also a portion of demand or capacity costs. In other words, base costs include a portion of capacity costs and it is only the extra capacity costs that are assigned to the "extra capacity" cost functions. Petitioner's Exhibit KAH-R at 25. Mr. Heid concluded that a significant portion of the electric power demand costs would still appropriately be classified as base costs.

Mr. Heid also believed Mr. Gorman's recommendation was inconsistent with the AWWA Water Rates Manual M1. According to Mr. Heid, the AWWA Water Rates Manual M1 states, "The demand portion of power costs should be allocated to extra capacity to the degree that it varies with the demand pumping requirements." Mr. Heid concluded from this statement that allocating 100% of the demand portion of power costs to the "extra capacity" cost functions was not consistent with this provision of the AWWA Water Rates Manual M1. Petitioner's Exhibit KAH-R at 25. Mr. Heid also pointed out that Mr. Collins treated purchased power costs as if they are 100% a base cost, in direct conflict with Mr. Gorman's position for cost allocation that only approximately 50% of electric power costs are volumetric. Petitioner's Exhibit KAH-R at 25–26.

(c) Commission Discussion and Findings. The Commission rejects Mr. Gorman's proposal to allocate purchased power costs on a factor for base, max day, and max hour rather than primarily base as proposed by Mr. Heid. The Commission disagrees that it is appropriate to allocate all power demand charges to peak day and peak demand charges. The base cost function includes not only variable costs but also a portion of demand or capacity costs. A demand cost is a cost associated with providing facilities to meet demands placed on the system by customers. Indiana American is assessed demand charges even during months for which there is no max day and max hour because the demand charge is intended to compensate the electric utility for the cost of constructing the infrastructure to provide electricity every day and during peak usage. While some portion of this charge results from the need to have facilities in place to serve periods of peak usage, the bulk of the charge is related to meeting base demands. The Commission accepts Petitioner's allocation of purchased power costs.

(6) Northwest Volume Issue.

(a) Industrial Group's Position. Mr. Collins believed that there may have been an error in Petitioner's accounting for the water usage volumes of residential and commercial customers who previously paid a minimum bill for water service in the Northwest District. Industrial Group Exhibit No. 1 at 14. He explained that an estimate of the water usage volumes associated with these minimum bill customers should now be included in the calculation of the Company's proposed revenues at proposed rates due to the proposal to assess a customer charge and volumetric charge to all residential and commercial customers. Mr. Collins did not believe that these volumes had been accounted for in determining proposed revenues at proposed rates and that the Company would collect \$1,232,622 more in revenues at proposed rates from these customers.

(b) Petitioner's Rebuttal. Mr. Heid reviewed Mr. Collins' concerns and concluded that the Northwest volumes are correct. He explained that the misunderstanding was due to limitations in Petitioner's bill tabulation software that results in billing data being presented in an unconventional format. Petitioner's Exhibit KAH-R at 17–18. Typically, under a minimum bill rate structure, the bill tabulation software would tabulate the total number of minimum bills, which includes the water volume allowance for the minimum bills. The billing volumes then would only reflect the non-minimum volumes, or the volumes not otherwise already included in the minimum bill. However, because of the limitations in Indiana American's bill tabulation software, Mr. Heid testified that bill tabulations reflect total volumes rather than non-minimum volumes, and a corresponding adjustment is applied to the

number of minimum bills. One might observe that the billable volumes were the same for present rates (i.e., under the minimum bill rate structure) as for proposed rates (i.e., under the customer charge rate structure) and conclude that this was indicative of an error instead of a presentation issue. Mr. Heid noted that the OUCC contacted him with the same concern but were satisfied with Mr. Heid's explanation.

(c) Commission Discussion and Findings. Mr. Heid explained that Mr. Collins' concerns about Petitioner's accounting for water usage volumes of certain residential and commercial customers in the Northwest District resulted from a misunderstanding about how the data was presented. Based on Mr. Heid's explanation, the Commission finds that Mr. Collins' adjustment should be rejected.

(7) Public Fire Protection.

(a) Petitioner's Position. Mr. Baker explained Petitioner's proposal with respect to public fire protection. He proposed that public fire protection rates be moved to full STP at this time. He explained that over the course of almost twenty years, numerous municipalities have adopted ordinances to move from paying directly billed hydrant charges to a customer surcharge based upon meter equivalency. There are now only eight municipalities that have not made this decision. Petitioner is requesting that with the move to STP, these remaining few municipalities also be moved to customer surcharges calculated on a single tariff basis. He explained why this proposal is being made. First, it is consistent with STP. Second, with the size of the increase and its impact on these remaining municipalities he expects that the eight remaining municipalities will very quickly adopt the ordinance requesting the change which would result in the filing of eight separately docketed cases all seeking the same determination Petitioner is seeking now.

(b) Schererville's Position. The only party to take issue with Petitioner's proposal was the Town of Schererville. Mr. Sommer testified that he was uncertain as to whether the Commission has authority to implement such an approach without the eight remaining municipalities adopting the ordinance under IC 8-1-2-103.

(c) Petitioner's Rebuttal. Mr. Baker responded to Mr. Sommer by pointing out that Schererville is not impacted at all by this proposal. The only party that would be impacted is the City of West Lafayette, which took no position on the proposal. Mr. Baker requested that, assuming the Commission determines it has the authority to implement the requested change, the Commission not base its decision on the position of a party who would not be impacted.

(d) Commission Discussion and Findings. Indiana American asks the Commission to amend the way fire protection surcharges are billed to eight municipalities served by Petitioner. Currently, these municipalities pay charges that Indiana American bills directly to it. Indiana American asks the Commission to find in this Order that it should begin to include the surcharge in the bills sent to individual customers instead of billing the municipalities directly. However, IC 8-1-2-103(d) requires the governing body of a municipality to adopt an ordinance that provides that such charges shall be included in the basic rates of customers served by the utility within the municipality. Petitioner did not submit to the

Commission ordinances adopted by the eight utilities providing for the change in the way costs for public fire protection are to be charged. Thus, the Commission finds that Indiana American's request should be denied.

(8) DSIC. Petitioner proposed in this case that future DSICs be implemented on a single tariff basis. Presently, Petitioner computes its DSIC by rate group. With the move nearly to STP, Petitioner is now proposing that future DSICs be computed as a single percentage of bills applied across all districts. No party opposed this change and the Commission finds it should be approved.

### **13. Pension/OPEB Balancing Account.**

A. Petitioner's Position. Due to the volatility in pension and OPEB expense described by Mr. Grubb, Petitioner proposed to implement a Pension/OPEB Balancing Account. Petitioner proposed to defer under- or over-recovery in Pension/OPEB expense as a regulatory asset/liability for future recovery or refund to customers. For instance, Mr. Grubb explained, if in the year following approval of rates in this case the actual Pension/OPEB expense is \$500,000 less than the *pro forma* expense that is included for recovery in this case, this "over-recovery" would be deferred as a regulatory liability. Conversely, if actual expense is greater than the *pro forma* expense that is included for recovery in this case, the "under-recovery" would be deferred as a regulatory asset. Petitioner's Exhibit EJJ at 32. Mr. Grubb explained that in future cases, Petitioner would propose to amortize the net amount deferred over a three-year period and that the balance would be reflected as either a rate base addition or offset as the case may be in that particular Cause. Petitioner originally proposed to commence the deferral as of January 1, 2009 and to reflect the amounts that would be deferred through June 30, 2009 in rate base in this case and to amortize such deferred amounts for recovery in this case. Petitioner's Exhibit EJJ at 33.

Mr. Grubb testified that it is a general ratemaking precept that a regulated utility should have the opportunity to recover prudently incurred costs. Normally this is accomplished through timely filing of rate cases. Pension and OPEB costs do not fit the normal expense because of their fluctuation. Implementing the Pension/OPEB Balancing Account would assure ratepayers and Petitioner that Petitioner recovers only the actual pension and OPEB expense which is incurred. Petitioner's Exhibit EJJ at 33–34. Mr. Grubb proposed that the Pension/OPEB Balancing Account would apply not only to Petitioner's direct Pension/OPEB expense but also apply to the component of Support Services expense that is represented by pensions and OPEB. Petitioner's Exhibit EJJ at 34.

B. OUC's Position. Ms. Stull did not oppose the concept of the Pension/OPEB Balancing Account. She did oppose commencement of the deferral before the date of the Order in this Cause and contended that to commence the deferral at an earlier date would be retroactive ratemaking. She opposed the recovery in this Cause of any deferred amounts or the recognition in this case of any deferred amounts in rate base.

C. Schererville's Position. Ms. Mann also did not oppose the Pension/OPEB Balancing Account, but she did oppose the recovery in this case of any deferred amounts. She proposed that the deferral commence with the Company's last rate case to include years when Petitioner allegedly over-collected its pension expense.

D. Industrial's Position. Mr. Gorman also did not oppose the Pension/OPEB Balancing Account. He proposed that the deferral commence with the issuance of an Order in this case and there be no recovery in this case of any deferred amounts.

E. Petitioner's Rebuttal. On rebuttal, Mr. Grubb explained that Petitioner was modifying its original request. Petitioner no longer requested to commence the deferral as of January 1, 2009 but was instead proposing to commence the deferral as of the filing of the Petition in this Cause with the deferral to begin May 1, 2009. Petitioner's Exhibit EJG-R at 8. The Company also withdrew its request to recover in this case any deferred amounts or to include in rate base in this case any deferred amounts. The future recovery and inclusion in rate base of deferred amounts commencing as of May 1, 2009 will be addressed in Petitioner's next rate case.

Mr. Grubb disagreed with Ms. Stull's argument that the proposal was retroactive ratemaking. He cited to the Commission's Order in Northern Indiana Public Service Company, Inc., Cause No. 43396-S1 (IURC 2/18/09) where the Commission found that deferred accounting treatment could begin prior to the issuance of an Order granting the treatment. Petitioner's Exhibit EJG-R at 7. While this was a settled case, the issue of the starting date of the deferral was not settled. He noted that a rule prohibiting the commencement of a deferral before a Commission Order is received would be inconsistent with the concept of a deferral. In Mr. Grubb's opinion, the very concept of a deferral presupposes that it begins with something extraordinary and unexpected. He stated that using the OUCC's argument as a reason for denial would preclude any utility from ever deferring for future recover any extraordinary increase in cost. Petitioner's Exhibit EJG-R at 7-8.

F. Commission Discussion And Findings. Indiana American's pension expense has fluctuated in recent years, and Petitioner's proposal attempts to mitigate that instability. The Commission notes that no party opposed the creation of the Pension/OPEB Balancing Account. Nevertheless, the Commission finds that Petitioner's proposal with respect to a Pension/OPEB balancing account should be denied.

Factors such as stock market fluctuations, pension asset allocation decisions of the Company, or ERISA funding requirements for rate determination purposes can affect Pension/OPEB costs. If the Commission were to grant Petitioner's request, the ratepayers, not Petitioner, would bear the risk inherently involved with the funding of Pension/OPEB accounts, such as market fluctuations, Company decisions, and funding requirements. Since the ratepayers bear these risks, it is possible that decisions concerning Pension/OPEB funding would not be carefully made.

Prudent management of pension and OPEB funds is American Water's responsibility, and prudent investment decisions are a part of that responsibility. When deciding how to invest pension and OPEB funds, a utility may choose to invest aggressively or conservatively. Utilities that choose to properly diversify investments should not need the creation of a Pension/OPEB balancing account, which avoids inappropriately shifting the risk of investment decisions to ratepayers.

Accordingly, based on the evidence presented in this Cause, the Commission finds that it is not in the public interest to require ratepayers to bear this risk. In addition, the Commission finds that Indiana American failed to adequately explain how the creation of a Pension/OPEB balancing account would benefit the provision of water and sewer service to its ratepayers. Indiana American's request to implement a Pension/OPEB balancing account is denied.

#### **14. Comprehensive Planning Studies.**

A. Petitioner's Position. Petitioner requested authority on a going forward basis to capitalize the cost of Comprehensive Planning Studies. Petitioner's Witness Stacy S. Hoffman testified that significant major construction projects are identified through Comprehensive Planning Studies prepared for each of the Indiana American operations. Petitioner's Exhibit SSH at 17. Mr. Hoffman believed that the comprehensive planning for American Water's utility subsidiaries is unmatched in terms of thoroughness and expertise because it provides a fifteen-year planning horizon, taking into account demand projections, regulatory requirements, and the replacement of aged infrastructure. Petitioner's Exhibit SSH at 17-18. Mr. Hoffman explained that American Water utilizes various agencies and information to project growth over a fifteen-year planning horizon. The Company then undergoes a very thorough evaluation of each component of a utility operating system and a plan is developed resulting in the identification of specific projects to assure that reliable and quality service will be maintained. Petitioner's Exhibit SSH at 18. Mr. Hoffman provided the current five-year capital program in Petitioner's Exhibit SSH-2.

Mr. Hoffman testified that capital improvements are scheduled so that needs driving the improvements are addressed in a time frame dictated by the circumstances. For example, if infrastructure capacity is needed to address system growth, the capacity improvement project is scheduled based upon when demand projections indicate need. Petitioner's Exhibit SSH at 18. Capital improvement projects addressing environmental regulations are scheduled for delivery as close as practical to compliance deadlines while allowing adequate time for operation of new facilities and performance monitoring ahead of compliance deadlines to ensure compliance and to ensure any necessary process adjustments can be successfully implemented during varying conditions. Petitioner's Exhibit SSH at 18. Mr. Hoffman stated that rehabilitation projects can address reliability, regulatory compliance, and customer service issues. The scheduling of rehabilitation projects usually includes an assessment of risks and impacts of failures and service disruptions. Petitioner's Exhibit SSH at 18.

Mr. Hoffman next described the costs incurred by Indiana American associated with the development of these capital improvement plans. Mr. Hoffman explained that the capital improvement plans are fed by the comprehensive planning studies, which are conducted periodically for each operation and are updated based upon demand projections and other circumstances. Petitioner's Exhibit SSH at 21. The preparation of the comprehensive planning study includes demand projections, distribution system evaluations, source of supply and treatment evaluations, and consideration of new regulations. Mr. Hoffman testified that these costs represent a part of the cost of bringing Indiana American's property to its present state of efficiency. Petitioner's Exhibit SSH at 21.

Mr. Hoffman explained that Indiana American proposed to capitalize the costs of the plan and depreciate them over a five-year period. Petitioner's Exhibit SSH at 21. Mr. Hoffman explained that if these costs are not capitalized, Indiana American will lose the time value of money associated with these expenditures. Mr. Hoffman further explained that in Cause No. 40703, the Commission approved Indiana American's proposal to capitalize comprehensive planning studies costs over objections raised by other parties. Petitioner's Exhibit SSH at 21. The Commission noted that the plan made existing and future plant more efficient and that capitalizing the costs was not shown to be contrary to generally accepted accounting principles. Mr. Hoffman acknowledged that the Commission did take a different view of capitalizing comprehensive planning studies in a subsequent order based on an interpretation of accounting terms. Petitioner's Exhibit SSH at 21–22. Mr. Hoffman concluded that, as explained by Mr. VerDouw, the Company believes the Commission's prior interpretation is the correct one.

Petitioner's Witness VerDouw provided testimony from an accounting perspective as to why it is appropriate to capitalize these costs. According to Mr. VerDouw, the Commission requires water utilities to maintain their books and records in accordance with the 1996 edition of the Uniform System of Accounts ("USOA") promulgated by NARUC. Petitioner's Exhibit GMV at 57. Mr. VerDouw stated that accounting Instruction 19 of the USOA specifies that cost of construction properly includible in the utility plant accounts shall include engineering services paid by utilities to "plan, design, prepare estimates, supervise, inspect, or give general advice and assistance in connection with construction work." Mr. VerDouw believed that the Company's comprehensive planning studies fall within this category. Mr. VerDouw explained that the costs associated with the comprehensive planning studies do not constitute a maintenance expense because the purpose of the comprehensive planning studies process is principally to identify the need for new infrastructure. Petitioner's Exhibit GMV at 57. Consequently, Mr. VerDouw opined that it is more appropriately categorized as a cost of construction.

B. OUC's Position. OUC Witness Stull disagreed with Petitioner's proposal to capitalize the comprehensive planning studies. According to Ms. Stull, amendments to comprehensive planning studies and tank inspection reports are not considered capital in nature and should not be included in rate base. Public's Exhibit No. 1 at 21. Ms. Stull stated that the USOA does not contain a description under components of construction costs that would allow Petitioner to treat these costs as capitalized items. Public's Exhibit No. 1 at 21.

C. Petitioner's Rebuttal. Petitioner's Witness Gary M. VerDouw responded to Ms. Stull's position that costs associated with the comprehensive planning studies should be expensed and not capitalized. Mr. VerDouw repeated that the Commission requires water utilities to maintain their books and records in accordance with the 1996 edition of the USOA promulgated by NARUC. Petitioner's Exhibit GMV-R at 9. Mr. VerDouw also repeated the specifics of Accounting Instruction 19 of the USOA. Mr. VerDouw opined that the Company's comprehensive planning studies falls within this category. He explained that the comprehensive planning studies do not address maintenance issues; they address future capital needs for the Company. Petitioner's Exhibit GMV-R at 9–10. He stated that they are truly comprehensive capital planning studies, not comprehensive maintenance planning studies, and as such the costs associated with the comprehensive planning studies should be capitalized. Petitioner's Exhibit GMV-R at 10.

As to Ms. Stull's testimony that the USAO does not contain a description under components of construction costs that would allow Indiana American to treat these costs as capitalized costs, Mr. VerDouw responded that he cited to this provision of the USAO in his direct testimony and explained that he believed it enabled the treatment of Indiana American's comprehensive planning studies as a capitalized cost. Petitioner's Exhibit GMV-R at 10. Mr. VerDouw testified that Ms. Stull did not respond to this explanation in her testimony. Mr. VerDouw agreed with Ms. Stull that in Cause No. 42520 the Commission concluded Indiana American's comprehensive planning studies should not be capitalized, but noted that Ms. Stull failed to acknowledge (as was explained in Indiana American's direct testimony) that the Commission previously reached a different result in its December 11, 1997 Order in Cause No. 40703. Petitioner's Exhibit GMV-R at 10. Mr. VerDouw testified that despite objections from the OUCC, the Commission concluded that the comprehensive planning studies should be capitalized. According to Mr. VerDouw, part of the rationale for this conclusion was that these costs represent a part of the cost of bringing Indiana American's property to its present state of efficiency, which is a component of the rate base pursuant to IC 8-1-2-6. Petitioner's Exhibit GMV-R at 10.

Mr. VerDouw then explained how proposing a change from the decision reached in Cause No. 42520 on this issue is consistent with his criticism of Ms. Stull for proposing a change to the Commission's policy on depreciation as it relates to CIAC. Petitioner's Exhibit GMV-R at 11. Mr. VerDouw stated that the Commission is willing to reconsider its past positions, but someone advocating for such a change must present new facts which demonstrate that a change is warranted—facts that the Commission has not previously considered. With respect to comprehensive planning studies, Mr. VerDouw stated that the Company has presented new facts and has explained why the Commission was correct in Cause No. 40703 and should therefore change its policy announced in Cause No. 42520. Mr. VerDouw stated that it is appropriate to ask for a change in Commission precedent so long as you acknowledge that is what you are doing and present new facts and reasoning that the Commission did not consider when it reached its earlier decision. Petitioner's Exhibit GMV-R at 11. Otherwise, according to Mr. VerDouw, the Commission's regulatory policy will lack the necessary stability and predictability, which is the point the Commission made when it rejected the OUCC's argument about CIAC in 2004. Petitioner's Exhibit GMV-R at 11.

D. Commission Discussion and Findings. Our 2004 Rate Order found that comprehensive planning studies are not "components of construction" and, therefore, should neither be capitalized nor should they accrue allowance for funds used during construction ("AFUDC"). 2004 Rate Order at 19. The Commission's finding was premised on Indiana American's definition of maintenance expense and the Accounting Instructions contained in the NARUC Uniform System of Accounts for AFUDC. The Commission explained that comprehensive planning studies perform engineering functions that can lead to the construction of capitalized projects. But, the Commission noted that these engineering functions can be performed to fulfill maintenance functions. Id.

Mr. VerDouw stated that Accounting Instruction 19 of the USOA specifies that cost of construction properly includible in the utility plant accounts shall include engineering services paid by utilities to "plan, design, prepare estimates, supervise, inspect, or give general advice and assistance in connection with construction work." Mr. VerDouw stated that the comprehensive

planning studies address Indiana American's future capital needs and not maintenance needs. Mr. Hoffman stated that the capital improvement plans are fed by the comprehensive planning studies, which are conducted periodically for each operation and are updated based upon demand projections and other circumstances. Mr. Hoffman also stated that the studies take into account demand projections, regulatory requirements, and the replacement of aged infrastructure.

Even though Mr. VerDouw asserts that the capital improvement plans are not maintenance plans, Petitioner has not provided the Commission with sufficient specific detail to reverse our finding made in the 2004 Rate Order. A review of Mr. Hoffman's testimony in the previous paragraph leads the Commission to the conclusion that Indiana American's comprehensive planning studies contain engineering functions that lead to capital projects and contain maintenance functions to ensure reliable operations. Indiana American did not delineate those items in its comprehensive planning studies that pertain to the planning of capital projects and to maintenance functions. While Accounting Instruction 19 of the USOA is useful in guiding the Commission as to whether construction costs should be capitalized, based on the evidence presented, the Commission is unable to determine whether Indiana American's comprehensive planning studies should be capitalized at this time. Accordingly, Petitioner's adjustment is denied.

#### **15. Tank Painting.**

A. OUCC's Position. OUCC Witness Rees described the OUCC's concerns with Indiana American's tank painting program. Mr. Rees testified that Indiana American has 111 steel storage tanks in its tank painting program. Eighty-seven of these tanks are in its distribution system and the remainder are used for water treatment. He stated that quality coatings are needed for water storage tanks to help maintain water quality and to protect the assets.

He explained that in a tank painting program, a water utility usually schedules tanks to be painted within a particular number of years. As the scheduled time for painting draws nearer, management may determine more accurately the need for painting by reviewing each tank's condition and estimating what the painting will cost. Public's Exhibit No. 7 at 11–12. Indiana American advised the OUCC that a tank painting is expected to last between ten and fifteen years and that the actual need to repaint a particular tank is based on a physical inspection of the tank. Public's Exhibit No. 7 at 12.

Mr. Rees did not believe that Indiana American kept pace with its tank painting needs. He noted that the Glen Park Tank had not been painted for twenty-three years and its scheduled 2008 blasting and painting was delayed as part of capital investment prioritizations. Mr. Rees believed the exterior of the tank is in poor condition. Public's Exhibit No. 7 at 12–13. He further noted that thirty-one of the 111 steel tanks have not been painted for sixteen years or more and that the Jefferson Tower in Warsaw had not been painted since 1980. Public's Exhibit No. 7 at 13. Concern was also raised about tanks with lead concentrations greater than 0.06% in the paint. Mr. Rees acknowledged that there may not be any immediate problem if the lead paint has been treated to encapsulate the lead, but that these tanks had not been repainted for more than twenty years. Public's Exhibit No. 7 at 13.

Mr. Rees also observed that Indiana American's expenditures for tank painting vary from year to year from about \$296,000 in 2004 to nearly \$3,400,000 in 2007. Public's Exhibit No. 7 at 13. Mr. Rees believed that some variance was to be expected. However, he added that Indiana American should consistently paint a number of tanks each year in light of the number of tanks to be maintained. Mr. Rees also noted that the 2009 tank painting expense was \$0.

Mr. Rees criticized Indiana American's practice of capitalizing its tank painting expense because he believed tank painting should be considered maintenance. Public's Exhibit No. 7 at 14. He indicated that Indiana American was the only Indiana utility he was aware of that capitalizes and therefore earns a return on its tank painting, which Mr. Rees believes increases the costs to rate-payers of Indiana American's tank maintenance. Mr. Rees acknowledged that delaying capital improvements may be appropriate in these tough economic times but stated that timely maintenance of tanks should be performed in a timeframe that does not risk the safe and efficient delivery of water. Public's Exhibit No. 7 at 14. Mr. Rees also recommended that Indiana American obtain data for the year of each tank's last painting that is missing for nine tanks.

B. Petitioner's Rebuttal. Messrs. Hoffman and VerDouw offered responses to Mr. Rees's testimony. Mr. Hoffman, a licensed engineer, responded to Mr. Rees's concerns about Indiana American's tank painting practices. Mr. Hoffman testified that Indiana American's practices with regard to its storage tank investments did not jeopardize the safe and efficient delivery of water. Petitioner's Exhibit SSH-R at 4. He pointed out that Indiana American has invested \$5.682 million in tank painting since January 2007. He acknowledged that there are tanks with aging paint systems and that Petitioner intends to continue to invest in tank painting to extend the life of these critical assets. However, Mr. Hoffman explained that Indiana American prioritizes capital investments and has focused efforts on the highest capital investment priorities. Petitioner's Exhibit SSH-R at 4. He testified that delaying painting of these tanks in no way jeopardized the safe and efficient delivery of water. Instead, it allowed finite capital to be directed to those projects with the greatest immediate need thus ensuring the safe and adequate delivery of water. Petitioner's Exhibit SSH-R at 4-5.

Mr. Hoffman acknowledged that the paint in some of the tanks contained lead. However, he testified that the presence of lead in the paint presented no concerns for delivering finished water that meets all water quality regulations. Indiana American was aware of the process required to repaint these tanks. Petitioner's Exhibit SSH-R at 5.

Mr. Hoffman conceded that in a perfect world the tanks with painting systems older than twenty-one years would have been improved, but that capital is finite. Petitioner's Exhibit SSH-R at 5. Mr. Hoffman found it ironic that the OUCC supported Indiana American's reduction in capital investments in response to the difficult economic times but criticized the Company for deferring investment in tank painting. He testified that tank painting can generally be deferred for some reasonable time without jeopardizing the safe and adequate delivery of water and emphasized that funding was always directed to ensure the safe and adequate supply of water. Petitioner's Exhibit SSH-R at 6.

Mr. Hoffman addressed Mr. Rees's concerns about the unknown re-paint date for nine of the tanks. He stated that the data was unavailable because these tanks were acquired as part of

water utility acquisitions wherein the former utilities' records did not identify the date of the last tank painting. Petitioner's Exhibit SSH-R at 6. Mr. Hoffman disagreed that this data was necessary for a proper management of tank painting because Indiana American makes tank painting decisions based on current physical inspections of tanks. He explained that physical inspection of tank paint systems is the single best and most useful basis for planning and budgeting tank painting because the life of a specific paint system cannot be predicted with accuracy to a precise number of years. Petitioner's Exhibit SSH-R at 7. Rather, the life of tank paint systems vary from tank to tank because the paint system life is a function of many factors including local environmental conditions, air emissions from industries, seasonal moisture conditions in different regions, paint product technology used, and quality and type of work performed.

Mr. Hoffman also testified that increasing expenditures on tank painting beyond the level proposed by Indiana American in this proceeding will, in the long run, increase the rates paid by customers. Petitioner's Exhibit SSH-R at 8. He noted that the OUCC and most intervenors were asserting that the rate increase proposed by Indiana American is too high. But, the OUCC's proposal for additional tank painting investment would require an upward adjustment to cover the additional tank painting.

Mr. VerDouw responded to Mr. Rees's contentions that Indiana American's practice of capitalizing tank painting increased the cost to ratepayers. He noted that this practice was approved by the Commission over the OUCC's objections in the Commission's May 30, 1996 Order in Cause No. 40103 after determining:

[T]he Company's capitalization of tank painting costs to utility plant in service is an acceptable accounting procedure. This approach is consistent with the approach used in our five previous Indiana-American rate orders, and we find it reasonably compensates Petitioner for its cost of painting tanks.

Petition of Indiana-American Water Co. Inc., Cause No. 40103, 1996 Ind. PUC LEXIS 126, at 68–69. Mr. VerDouw disagreed that this practice increases the cost to ratepayers. Petitioner's Exhibit GMV-R at 37. By way of example, he pointed to Mr. Rees's testimony that Indiana American's tank painting expenditures in 2007 were nearly \$3,400,000 and \$2,400,000 in 2008. Mr. VerDouw explained that if those expenditures were treated as a maintenance expense, they would be included in this rate case as an additional \$2,400,000 in maintenance expense for the test year. However, by capitalizing tank painting expense, the return on investment and depreciation expense amounts to \$480,000 in earned return on investment and approximately \$218,000 in depreciation expense for a total of \$698,000. Mr. VerDouw disagreed that ratepayers paid more when the recovery in the current year under the capitalization methodology was \$1,700,000 less than treating the expenses as a maintenance expense.

Mr. VerDouw also addressed the shortcomings with Mr. Rees's proposal to compute annual tank painting expense based on assumptions about the life of the paint. Petitioner's Exhibit GMV-R at 38. He explained that for a utility like Indiana American with more than 100 storage tanks, a rigid schedule would not necessarily produce the actual tank painting cost needed because of variances in the actual time between repainting from the estimates. Mr.

VerDouw believed this proposal would lead to greater uncertainty for the utility and would not be appropriate for ratemaking.

C. Commission Discussions and Findings. The heart of Mr. Rees's concern about Indiana American's tank painting frequency is whether it jeopardizes the safe and adequate supply of water to customers. The Commission shares this concern. Mr. Rees does not testify that Indiana American should repaint its tanks every fifteen years nor does he disagree with Indiana American that the decision to repaint the tanks should be driven by tank paint inspections to evaluate the actual condition of the tanks. According to Mr. Hoffman, Indiana American's capital investment decisions have not jeopardized the safe and adequate supply of water. He also testified that the lead paint in some of Indiana American's tanks have not jeopardized the safe supply of water. The Commission believes that Indiana American has addressed Mr. Rees' concerns and does not believe further action is required from us at this time regarding tank painting management.

The Commission also declines to depart from our prior practice of authorizing Indiana American to capitalize its tank painting expense and recover its investment through depreciation expense and earning a return on the unamortized expenditure. The Commission previously explained:

Tank painting expense is a major expense that prevents rust and corrosion and thereby inhibits the deterioration of a tank. The benefits of tank painting exist for more than one year. Therefore, it is reasonable to mitigate the impact of this expense by extending the recognition of this cost for ratemaking purposes. We have stated before that if the improvement lasts for several years and it is not one of regular maintenance and it serves to extend the life of the capital asset or the life of the improvement itself is of a long-term nature, matching the recovery of the cost to the life of the improvement or extension of the life of the capital asset is appropriate.

Id. at 66 (citation omitted). The Commission also stated that "the water utility would lose the financing costs related to these investments if the unamortized tank painting costs are not included in rate base." Id. at 27. The evidence presented does not lead the Commission to conclude that our previous findings with respect to Indiana American's tank painting program should be amended. We continue to believe that Indiana American's capitalization of tank painting costs is appropriate and Petitioner should continue to earn a return on investments in tank painting and depreciation expense associated with those investments. The Commission finds that Petitioner's adjustment with respect to tank painting is appropriate.

## **16. Non-Revenue Water.**

A. OUCC's Position. OUCC Witness Rees expressed concern with Indiana American's non-revenue water ("NRW") in specific service districts. Public's Exhibit No. 7 at 7. Mr. Rees explained that the OUCC considers it appropriate for a utility to take corrective action when non-revenue water exceeds 15% and that several of Petitioner's operating areas

have NRW in excess of 15%. Mr. Rees recommended that Petitioner be required to file a report with the Commission and the OUCC within 120 days following the Final Order in this proceeding to identify the seven Districts with NRW in excess of 15%. Mr. Rees also suggested that Petitioner list the actions the utility is currently taking and/or plans to take in the future to lower the NRW levels below 15%.

B. Petitioner's Rebuttal. Mr. DeBoy disputed the OUCC's implications that Indiana American was not adequately managing leakage or water loss. First, he noted that there appeared to be confusion between NRW and unaccounted for water ("UFW"). Petitioner's Exhibit AJD-R at 2. While Mr. Rees stated that the OUCC considers it appropriate for a water utility to take corrective action when NRW exceeds 15%, Mr. DeBoy noted that the 15% rule is typically applicable to UFW, not NRW. He explained that UFW is a subset of NRW. NRW is the entire volume difference between the sales and the system delivery. Petitioner's Exhibit AJD-R at 2. Within the universe of NRW volume, Mr. DeBoy noted that there are portions that can be accounted for and portions that cannot be accounted for. Leaks in water mains and service lines that do not reach the ground surface cannot be measured or estimated and therefore are deemed UFW. Water from fire hydrants for fighting fires, filling street cleaners, or flushing water mains can be estimated or measured and therefore is not considered UFW because it is observable. Petitioner's Exhibit AJD-R at 2-3.

Mr. DeBoy also explained that concerns with an arbitrary 15% UFW standard had been replaced by a more accurate standard now being used by Indiana American. He testified that the AWWA noted that an arbitrary 15% standard (1) is mathematically skewed; (2) is impossible to reliably represent multiple types of NRW typically occurring in a water utility with a single simplistic percentage; and (3) a simple percentage reveals nothing about water volumes and costs, which are the two most important factors in water loss assessments of water utilities. Petitioner's Exhibit AJD-R at 3.

Mr. DeBoy stated that in response to these problems with an arbitrary 15% UFW standard, the current industry approach is the application of the Infrastructure Leakage Index ("ILI") performance indicator, which is an output of the International Water Association/AWWA best practices audit methodology developed during the period 1997-2000. Mr. DeBoy testified that the ILI features robust performance indicators that allow for an objective gauging of loss levels. It draws on the best practices of the various water auditing approaches used around the world and drafted them into a single, standard best management practice methodology that could be applied across the differing system characteristics. Mr. DeBoy explained that the concept behind the ILI is that no water should be unaccounted-for by measuring or estimating all NRW as either authorized consumption or losses. Petitioner's Exhibit AJD-R at 4.

The data is used to calculate an ILI performance indicator, which is designed for reliable benchmarking of leakage standing among water utilities. Petitioner's Exhibit AJD-R at 5-6. It is a ratio of the current annual real losses to the unavoidable annual real losses ("UARL"). Mr. DeBoy noted that the UARL represents a distribution system's theoretical low limit of leakage that could be achieved if all of today's best leakage management efforts could be exerted. Petitioner's Exhibit AJD-R at 7.

Mr. DeBoy explained that the ILI requires Petitioner to conduct an audit identifying components of the volumes of water that enter a distribution system and measure or estimate each of these water volumes to allow a more refined analysis of the drivers of loss from a distribution system and understanding of what actions, if any, should be taken to reduce those losses. Petitioner's Exhibit AJD-R at 5. Mr. DeBoy stated that Indiana American completed such audits of its distribution systems in October 2009. He explained that conclusions from these results require a comparison with the AWWA Water Loss Committee—Leakage Management Target Setting Guidelines table, which was attached to Mr. DeBoy's testimony as Petitioner's Exhibit ADJ-R1. The table suggests approximate target levels using the ILI, water resources, operational, and financial considerations that utilities typically encounter. Petitioner's Exhibit AJD-R at 8. Mr. DeBoy believed that the ILI values for all of Petitioner's districts, when compared to considerations such as water resources and costs, are equal to or below the target ILI scores. Based on this weighting, Mr. DeBoy believed that all of Petitioner's districts have a current ILI that either falls within or is better than the target range.

Mr. DeBoy indicated that notwithstanding these results, Indiana American has taken action to reduce leakage in its distribution system. The Kokomo district's NRW has declined from 23.5% in 2008 to 22.6% for the latest data in 2009. Muncie's NRW for the similar period dropped from 23.2% to 22.6%, and Richmond's decreased from 34.8% in 2005 to 24.8% currently. Mr. DeBoy explained Petitioner's efforts to maintain sound service connections, hydrants, and valves in these territories and to conduct regular inspections of fire services to identify leaks. These efforts have resulted in the repair of several leaks. Petitioner's Exhibit AJD-R at 11. Mr. DeBoy indicated that Indiana American also regularly calibrates plant discharge meters and regularly exchanges customer meters to ensure accurate readings. He stated that leaks discovered in all operating districts are addressed in a timely fashion by making repairs or replacing water main segments and that an active obsolete main replacement program is in place to address aged buried infrastructure to further reduce leakage. Petitioner's Exhibit AJD-R at 11.

C. Commission Discussion and Findings. The Commission declines, at this time, to require the Petitioner to file a report with the Commission and the OUCC detailing its plans to address UFW in seven of its districts. First, we note that the OUCC's concern over Indiana American's leakage was based on a 15% NRW level, not a 15% UFW level. As Mr. DeBoy noted, the Commission's historical practice is to take action when the UFW rate is above 15%. NRW captures both UFW and other water that does not generate revenue but which can be accounted for and inflates any perception of concern. Undoubtedly, the UFW level would be below the percentages with which Mr. Rees expressed concern.

In addition, Mr. DeBoy described the investments the Petitioner has already made in Kokomo, Muncie, and Richmond to reduce water leakage and the resulting reduction in NRW. These three systems experienced the highest NRW. Mr. DeBoy also explained that Petitioner already takes many low-cost steps to minimize UFW, such as calibrating plant discharge meters and regular replacement of customer meters. Petitioner has also implemented an obsolete main replacement program to address aged infrastructure to further reduce leakage. The Commission does not believe further reporting on additional steps to address UFW is warranted at this time.

17. Dishonored Checks. Mr. VerDouw explained Petitioner's proposal with respect

to customers who pay multiple times with checks that are dishonored. Petitioner proposed to add language to its tariff requiring that any customer who, during a twelve-month period, twice attempts to pay his or her bill with a check that is dishonored will be placed on a cash-only basis for the next twelve months. During this time, the customer would be required to pay the bill with cash, a postal money order, or certified check. Customers who repeatedly pay with dishonored checks cause added costs in handling the checks and additional disconnection trips. Petitioner's Exhibit GMV, pp. 58–59. No party opposed Petitioner's proposal, and the Commission approves this modification to Petitioner's tariff.

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

1. Petitioner shall be and hereby is authorized to adjust and increase its rates and charges for water and sewer utility service by approximately 19.72% in accordance with the findings herein. Such rates and charges shall be designed to produce total annual operating revenues of \$193,727,184, which are expected to produce annual net operating income of \$50,262,867.

2. Petitioner shall file new schedules of rates and charges with the Water/Sewer Division of the Commission on the basis set forth in Finding Paragraph No. 11. Petitioner shall simultaneously file its cost of service study and revenue proof based upon the findings set forth in this Order. Petitioner's new schedules of rates and charges shall be effective upon filing after approval by the Water/Sewer Division and shall apply to water and sewer usage from and after the date of filing.

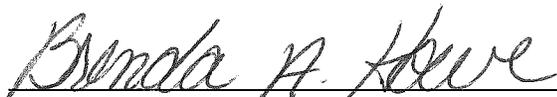
3. Petitioner's proposed modification to its tariff applicable to customers who pay for service with multiple dishonored checks as described in Finding Paragraph No. 17 shall be and hereby is approved.

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

**ATTERHOLT, LANDIS AND ZIEGNER CONCUR; HARDY AND MAYS ABSENT:**

APPROVED: APR 30 2010

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



**Brenda A. Howe,  
Secretary to the Commission**