

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

JOINT PETITION OF INDIANA-AMERICAN)
WATER COMPANY INC. ("INDIANA-)
AMERICAN") AND THE TOWN OF RILEY,)
INDIANA ("RILEY") FOR APPROVAL AND)
AUTHORIZATION OF: (A) THE ACQUISITION)
BY INDIANA-AMERICAN OF RILEY'S)
UTILITY PROPERTIES (THE "RILEY)
SYSTEM") IN VIGO COUNTY, INDIANA ("THE)
RILEY AREA"); IN ACCORDANCE WITH THE)
PURCHASE AGREEMENT THEREFORE; (B))
APPROVAL OF ACCOUNTING AND RATE)
BASE TREATMENT; (C) APPLICATION OF)
INDIANA-AMERICAN'S RATES AND)
CHARGES FOR PETITIONER'S WABASH)
VALLEY OPERATION TO WATER SERVICE)
RENDERED BY INDIANA-AMERICAN IN THE)
AREA SERVED BY THE RILEY OPERATION;)
(D) ALL NECESSARY LICENSES, PERMITS,)
AND FRANCHISES FOR INDIANA-AMERICAN)
TO PROVIDE WATER SERVICE IN THE)
RILEY AREA; (E) APPLICATION OF)
INDIANA-AMERICAN'S DEPRECIATION)
ACCRUAL RATES TO SUCH ACQUIRED)
PROPERTIES; AND (F) THE SUBJECTION OF)
THE ACQUIRED PROPERTIES TO THE LIEN)
OF INDIANA-AMERICAN'S MORTGAGE)
INDENTURE.)

CAUSE NO. 43855

APPROVED: APR 05 2011

BY THE COMMISSION:

James D. Atterholt, Chairman
Angela Rapp Weber, Administrative Law Judge

On February 5, 2010, Indiana-American Water Company, Inc. ("Indiana-American") and Town of Riley ("Riley") (collectively, "Joint Petitioners") filed a Joint Petition and prepared testimony and exhibits constituting their case-in-chief with the Indiana Utility Regulatory Commission ("Commission"). The Joint Petition sought various approvals related to the proposed acquisition by Indiana-American of the water utility owned by Riley pursuant to an Asset Purchase Agreement executed between Joint Petitioners. On May 21, 2010, the Indiana Office of Utility Consumer Counselor ("OUCC") filed the testimony of Margaret A. Stull, utility analyst. On May 28, 2010, the Joint Petitioners filed their rebuttal evidence.

Pursuant to the Prehearing Conference Order dated March 10, 2010 and notice of hearing given as provided by law, proof of which was incorporated into the record by reference and placed in the official files of the Commission, an evidentiary hearing in this Cause was held at 2:30 p.m. on June 9, 2010 in Room 222, 101 West Washington Street, Indianapolis, Indiana. Joint Petitioners and the OUCC appeared and participated in the evidentiary hearing. No members of the general public appeared or attempted to participate in this Cause.

Based upon the applicable law and evidence, the Commission now finds:

1. **Notice and Jurisdiction.** Due, legal, and timely notice of the public hearing conducted in this Cause was given by the Commission as required by law. Indiana-American is a “public utility” within the meaning of that term in Indiana Code § 8-1-2-1 and is subject to the jurisdiction of the Commission in the manner and to the extent provided by law. Riley is a municipality located in Vigo County, Indiana and withdrew from Commission jurisdiction on July 5, 1996 for purposes of rates and charges and financing. Joint Petitioners filed the Joint Petition pursuant to Indiana Code §§ 8-1-2-6, -12, -19, -38, -39, -83, and -84. As a result, the Commission has jurisdiction over Joint Petitioners and the subject matter of this proceeding.

2. **Joint Petitioners’ Characteristics.** Indiana-American is an operating public utility incorporated under the laws of the State of Indiana with its principal office and place of business at 555 East County Line Road, Greenwood, Indiana. Indiana-American is engaged in the provision of water utility service to the public in and around numerous communities throughout the State of Indiana, including Vigo County, and sewer utility service in Wabash and Delaware Counties. Indiana-American owns, operates, manages, and controls, plant, property, equipment, and facilities for the production, treatment, transmission, distribution, and sale of water for residential, commercial, industrial, other public authority, and sale for resale purposes; for the provision of public and private fire protection service; and for the provision of sewer service.

Riley owns and operates water utility properties (the “Riley System”) serving 633 individually metered customers. The Riley System abuts and is interconnected with Indiana-American’s existing distribution system in its Wabash Valley Operations. The Riley System is currently operated by Indiana-American under an Agreement for Operation and Management Services executed between Riley and Indiana-American dated January 6, 2010, filed as *Petitioners’ Exhibit CGW-1*, which was attached to *Joint Petitioners’ Exhibit CGW*.

3. **Relief Requested.** Joint Petitioners requested that the Commission (1) approve accounting and rate base treatments which reflect the full purchase price plus transaction costs in Indiana-American’s net original cost rate base; (2) grant such approvals as may be necessary to consummate the acquisition of the Riley System by Indiana-American and permit the operation thereof by Indiana-American on the terms described in the Joint Petition and the Asset Purchase Agreement; (3) find the public convenience and necessity require water service by Indiana-American in the areas now served by the Riley System; (4) authorize the application of Indiana-American’s rules and regulations and rates and charges generally applicable to Indiana-American’s Wabash Valley Operations, as the same may be changed from time to time, to service to be provided by Indiana-American in the areas currently serviced by the Riley System;

(5) approve the accounting entries as described in the direct testimony of Susan S. Lee, Finance Manager for American Water Works Service Company, an affiliate of Indiana-American, to reflect Indiana-American's acquisition of the Riley System; (6) authorize Indiana-American to apply its existing depreciation accrual rates to the Riley System; and (7) approve the encumbering of the properties comprising the Riley System with the lien of Indiana-American's Mortgage Indenture.

4. Description of the Riley System. As stated in the direct testimony of Jeffrey C. Henson, Indiana-American's Senior Business Development Manager, Riley owns and operates a water system serving 633 customers in an area southeast of Terre Haute in Vigo County, Indiana. Riley is a wholesale customer of Indiana-American, receiving water supplied through a connection in Terre Haute. The distribution system consists of approximately eleven miles of mains (ranging from two-inch to twelve-inch), thirty-eight fire hydrants, and a 50,000 gallon elevated tank. All customer accounts are metered. The Riley System is currently operated by Indiana-American under Agreement for Operation and Management Services executed between Riley and Indiana-American dated January 6, 2010, as well as by part-time employees of Riley.

5. Evidence Presented.

(a) Joint Petitioners' Evidence. The complete terms and conditions of the purchase and sale of the Riley System are set forth in the Asset Purchase Agreement, attached to the testimony of Jeffrey Henson as *Petitioner's Exhibit JCH-3*. Mr. Henson testified Indiana-American proposes to acquire the water storage tank, water mains, service lines, meters, hydrants, equipment, real estate, easements, and permits and all other assets located within the Riley System, which are part of the transmission and distribution system utilized to provide water service to customers, excluding: (a) liabilities, contingent or otherwise; (b) customer service connections, which are and shall remain the property of the customer; (c) furniture; (d) transportation equipment; (e) tools, shop, and garage equipment; (f) communication equipment; (g) certain miscellaneous equipment; (h) cash and accounts receivable; and (i) customer deposits.

Mr. Henson described the Asset Purchase Agreement executed between Indiana-American and Riley. He stated it provides for the acquisition by Indiana-American of the utility assets of the Riley System for a purchase price of \$1,025,500. The purchase price was determined following a statutorily-required appraisal and public hearing process set forth in Indiana Code §§ 8-1.5-2-4 through -6.

Mr. Clay G. White, an elected Member and President of the Riley Town Council, testified that Riley decided to sell the water utility due to Riley's lack of time, technical expertise, and resources to manage a water utility in the current environment of increasing drinking water regulation. Mr. White also noted the need for capital improvements that would require Riley to raise its rates. He also testified that because Riley is already a wholesale customer of Indiana-American and does not have its own water plant, it only makes sense to enter into a sale transaction with Indiana-American. Having initially made the determination to investigate a sale, Riley retained Hannum, Wagle & Cline ("HWC") to prepare an inventory of Riley's assets. Since Riley does not retain fixed asset records, HWC first determined what it would cost currently to construct the Riley System using current construction cost estimates and

system maps. HWC then determined the current reproduction cost new less depreciation by deducting depreciation to reflect the current percent condition. HWC thereafter attempted to estimate what could be the net original cost of the system to Riley by using trend factors and estimating when the parts of the system were originally constructed. *Petitioners' Exhibit CGW-2* (the "HWC Inventory").

Mr. White described a public process where the Town Council approved the proposed sale. Riley hired appraisers Ms. Judith M. Cleland, Mr. Patrick Goodwin, and Mr. John T. Newlin to conduct an appraisal to establish a value for the Riley System assets. They ultimately determined that the estimated current cost less depreciation to construct the system as set forth in the HWC Inventory was the just and true value. *Petitioners' Exhibit SSL-2*. After it was determined that the appraisers (and the HWC Inventory) had excluded a recent addition to the Riley System, the appraisal was returned to the appraisers to include the additional assets. *Petitioners' Exhibit SSL-3*. Mr. White explained that after the revised appraisal was returned, there were two public hearings, which were well attended. Indiana-American made a presentation at the hearings and numerous questions were asked and answered. During that time and thereafter, no customers have objected to the proposed sale. At the conclusion of the second public hearing, the Town Council unanimously adopted an ordinance directing that the utility be sold.

Ms. Lee provided testimony concerning the accounting and ratemaking treatment proposed by Indiana-American in connection with its acquisition of the Riley System. *Petitioners' Exhibit SSL-5* sets forth the proposed journal entry, which shows a recorded net original cost of the Riley System assets as equal to the purchase price plus estimated transaction costs. Mr. Henson asserted that this accounting treatment is appropriate given the unique circumstances present in connection with the sale of a municipally-owned system where the statutory procedure requires an independent appraisal of the assets and prohibits a sale for less than the appraised value. Mr. Henson opined that because of the statutory procedure involved, such a sale will always be the result of an arm's-length negotiation. He stated that the unique circumstances present in this case included the lack of books and records reflecting the net original cost of the assets in the Riley System. Mr. Henson referred to the Commission's Order dated April 4, 2001 in Cause No. 41655 (approving Indiana-American's acquisition of the water system owned by the City of Seymour serving the Freeman Field Municipal Airport) and the Commission's Order dated September 23, 2009 in Cause No. 43671 (approving Indiana-American's acquisition of the water system owned by the Town of Waveland) as support for the proposed journal entry in this Cause.

The accounting entries proposed by Indiana-American would record the original cost of the Riley System as a debit to Account 101 – Utility Plant in Service and would record all associated accumulated depreciation as a credit to Account 108 – Accumulated Depreciation. Ms. Lee further stated that the net original cost of the Riley System as reflected on Indiana-American's books would be the gross cost to Indiana-American of the facilities, including adjustments for closing and transaction costs (i.e., the \$1,025,500 purchase price plus an estimated \$35,000 in transaction costs, to be adjusted for actual costs). Ms. Lee testified that the depreciation accrual rates to be applied to the Riley System assets would be the rates approved by the Commission in Cause No. 43081 on November 21, 2006, as included in the calculation of

rates with the approval of Indiana-American's rate case in Cause No. 43187 on October 10, 2007.

Deron E. Allen, Indiana-American's Vice President of Operations, testified that the customers of the Riley System and Indiana-American's existing customers will benefit from the acquisition. Riley customers will have consistent access to trained and experienced operational resources and will not have to be concerned with their water supply meeting water treatment regulations. In addition, being part of the American Water system also provides an advantage in economies of scale that will directly benefit these customers as environmental, water quality, and operational issues become the responsibility of Indiana-American.

Mr. Henson stated that Riley System customers will gain full-time management of their water system including, but not limited to, a full-time operations staff, 24/7 customer service and emergency response, along with full-time functional specialists such as engineering and water quality. Mr. Henson further testified that Riley System customers will benefit from many programs that Indiana-American uses to ensure customer satisfaction. For example, customers will benefit from routine valve operating programs, hydrant flushing and inspection, meter replacement, and plant security. Further, Mr. Henson testified Indiana-American's existing customers will benefit from expanded economies of scale and an extended service area that could result in additional future growth. He stated the added customers and potential to serve a larger service area in the Terre Haute area will provide a larger base over which Indiana-American can recover fixed costs and increase efficiencies.

Ms. Lee testified regarding the impact of Indiana-American's proposed acquisition of the Riley System on the average monthly bill for a Riley residential customer. The average monthly bill for a residential customer using 6,000 gallons would increase from \$28.02 under Riley's current rates to \$41.02 under Indiana-American's approved rates in Cause No. 43680. However, Ms. Lee stated in her testimony that an analysis conducted by Crowe Chizek and Company LLC ("Crowe Chizek") at Riley's request indicated that a rate increase would be necessary for Riley if it were to continue to own the Riley System. The rates proposed by Crowe Chizek would result in an average residential customer monthly bill of \$39.52 based on usage of 6,000 gallons.

Ms. Lee described Indiana-American's intention to apply the tariff rates, rules, and regulations on file and applicable to Indiana-American's Wabash Valley Operation to the customers of the Riley System. Ms. Lee explained the Riley System is physically connected to Indiana-American's Terre Haute water system, which is part of the Wabash Valley Operation, and the water used in the Riley System is produced in the Terre Haute system. In addition, the Wabash Valley Operation's service area is directly contiguous to the Riley System's current service area. Further, upon consummation of the transaction, the Riley System will be managed by personnel from the Wabash Valley Operation. Ms. Lee stated that utilizing Indiana-American's existing Wabash Valley rates is also consistent with the approach taken in past Commission Orders (including most recently, Cause No. 43680) to simplify Indiana-American's overall rate structure with a goal of having single tariff pricing for the entire state of Indiana.

Ms. Lee also testified regarding the encumbrance that would be placed on the Riley System assets as a result of the acquisition under Indiana-American's General Mortgage, which

secures most of Indiana-American's utility property for the benefit of Indiana-American's bond holders. Ms. Lee testified that Indiana-American has access to all of the necessary funds to support the acquisition. Initially, Ms. Lee explained, those funds will come from internally-generated funds and/or short-term debt, but when appropriate, the short-term debt will be funded with permanent common equity and long-term debt financing, upon approval from the Commission. The short-term debt for the initial financing would be funded through Indiana-American's cash management arrangement with American Water Capital Corporation, an affiliate of Indiana-American. Ms. Lee testified that the acquisition will not impair Indiana-American's ability to raise necessary capital on reasonable terms while maintaining a reasonable capital structure. According to Ms. Lee, the projected investment to acquire the Riley System is equal to less than 0.2% of Indiana-American's total capital structure.

(b) OUCC's Evidence. The OUCC's witness Margaret A. Stull, a utility analyst in the OUCC's Water/Wastewater Division, testified concerning Joint Petitioners' proposed acquisition. Ms. Stull stated that while the OUCC does not oppose Indiana-American's acquisition of the Riley System, it does have several issues with the ratemaking treatment of the purchase price.

Ms. Stull said the OUCC has no objections to the Joint Petitioners' request for (1) approval of the acquisition on the terms described in the Asset Purchase Agreement, (2) a finding that the public convenience and necessity require water service by Indiana-American in the areas now served by the Riley System, (3) the application of Indiana-American's Wabash Valley Operation's rules, regulations, rates, and charges to the existing customers of the Riley System, (4) the application of Indiana-American's existing depreciation accrual rates to the Riley System assets, and (5) the approval of the encumbrance of the Riley System by subjecting the properties to the lien of Indiana-American's Mortgage Indenture.

According to Ms. Stull, the OUCC only opposes Joint Petitioners' request for (1) authority to include the full purchase price plus transaction costs (\$1,060,500) in net original cost rate base for both accounting and rate base purposes for Indiana-American and (2) approval of the accounting entries as described by Ms. Lee.

Ms. Stull stated the proposed ratemaking treatment of the acquisition seeks a return on and return of an acquisition adjustment consisting of the difference between the purchase price and the net book value as should be reflected on Riley's books and records. Ms. Stull testified the OUCC disagrees with the proposed ratemaking treatment because the purchase price does not accurately reflect the fair value of the assets to be acquired so as to qualify for a return on the acquisition adjustment. Ms. Stull also testified the Joint Petitioners have not established the criteria necessary to qualify for depreciation of the entire purchase price (i.e., a return of the acquisition adjustment). Ms. Stull based her determination that an acquisition adjustment was included in the purchase price on the difference between the purchase price (equal to the just and true value as determined by the appraisers) and the estimated net book value reflected in the HWC Inventory.

Ms. Stull testified the purchase price does not meet the criteria to merit a return on the acquisition adjustment or a return of the acquisition adjustment. First, she stated the purchase

price does not reflect the fair value of the Riley System. Ms. Stull explained the fact that the purchase price is the result of an appraisal does not make it the result of an arm's-length transaction where the parties agreed on a negotiated purchase price. Ms. Stull stated the Commission should consider whether the appraisal took into account the correct factors in a manner consistent with Indiana law. Those factors include whether a portion of the assets were contributed to the utility as well as whether any going concern value was included in the purchase price. Ms. Stull stated that neither of those two factors was taken into account in the appraisal.

Ms. Stull also expressed concern with respect to the appraisal that, in her opinion, should cause the Commission to question its use to establish the Riley System's fair value. Ms. Stull identified two contributions of utility plant in the schedule "Replacement Cost Depreciated" in *Petitioner's Exhibit CGW-2*. She stated the contributed plant comprises 36%, or \$367,152, of the purchase price. These included a transmission main and interconnection with Indiana-American's water system that had been installed in 1985 with an Indiana Department of Commerce grant and assets contributed by a developer. Ms. Stull testified the transmission main funded by the grant is comprised of 17,852 linear feet of eight inch PVC pipe with a current value of \$128,063 and a depreciated replacement value of \$247,548. The developer-contributed plant in the Lakewood Subdivision has a depreciated replacement value of \$119,604.

Ms. Stull stated that this contributed plant should be recorded as contributions in aid of construction ("CIAC") for ratemaking purposes, effectively excluding it from rate base and precluding Indiana-American from earning a return on investment in these assets. Since Indiana-American does not amortize its contributed plant, it would be authorized depreciation expense on the gross book value.

Ms. Stull also identified other issues regarding the valuation of the assets, including (1) the "staleness" of the valuation, (2) the lack of a technology adjustment applied to the depreciated replacement cost the valuation is based upon, (3) whether the current state of the Riley System assets was considered, (4) the disparate value between the depreciated original cost and the depreciated replacement cost, and (5) the lack of testimony from the persons preparing the appraisal. Further, Ms. Stull expressed concern with the fact that the valuation has not been updated since September 2008, the public hearings to review the transaction were not held until March 2009, and this Cause was not filed with the Commission until February 2010. Ms. Stull stated this timing affects whether the valuation should be considered a current "just and true valuation of the property."

Ms. Stull then stated a technology adjustment should have been made to the fair value determination to recognize the difference in current construction costs technology compared to that existing when the assets were originally constructed. Ms. Stull compared this to the technology adjustment that was made with respect to the valuation of Indiana-American's utility plant in connection with its rate case in Cause No. 43680. According to Ms. Stull's testimony, the condition of the assets would also be relevant to determine whether appropriate comparisons were made by the appraisers to verify if the value determined was reasonable. She did not believe the current condition of the Riley System assets was properly taken into account by the appraisers and cited a reference in the appraisal that mentioned the deterioration of the water

tank. Ms. Stull testified that this statement, coupled with Joint Petitioners' witness statements regarding the utility's current lack of ability to maintain the water assets, suggests the current state of the Riley System's assets is not good. Ms. Stull also noted the appraisers calculated some "check" valuations for comparative purposes. None of these valuations provided a valuation greater than 74% of the depreciated replacement cost, yet the appraisers concluded that the value developed based on the depreciated replacement cost is reasonable and represents the Riley System's market value. Ms. Stull noted there was no explanation provided in the appraisal report for why a utility in an arguably deteriorated state would merit a value at the extreme high end of the valuation range.

Ms. Stull testified that the Joint Petitioners' assertions regarding the lack of asset records seem incongruous given HWC's ability to obtain a detailed list of water assets to use in its valuation report. Further, Ms. Stull stated some level of asset records or valuations must have been available while Riley was under the Commission's jurisdiction in order for Riley to comply with Commission reporting requirements. Finally, Ms. Stull expressed concern that, despite the State Board of Accounts audit findings of inadequate fixed asset records, Riley did nothing to alleviate this situation. Ms. Stull estimated a net book value of \$449,575 for Riley's assets based on the net book value of utility assets asserted in Cause No. 39272 and including assets added to the Riley system since that Cause. She noted this compares favorably with the \$423,570 net book value estimated by HWC in the HWC Inventory.

Ms. Stull recommended that, if the Commission agrees all issues identified in her testimony should be considered in a "just and true" valuation of the acquired assets, then the Commission should order Indiana-American to provide an updated valuation, which takes these factors into account, in its next rate case for determination at that time. Ms. Stull further recommended that, if the Commission only excludes the portion of the plant which was contributed, the value of the acquired assets for purposes of earning a return on the plant should be \$658,348 (purchase price less identified CIAC). For purposes of earning a return of the gross original cost of the utility plant being acquired, Ms. Stull recommended the total estimated original cost of \$837,196.03 per the HWC Inventory should be used.

Finally, according to Ms. Stull, Joint Petitioners have overstated the benefits of the acquisition to Riley's and Indiana-American's existing customers. Ms. Stull said the rate comparison presented to Riley customers at the March 2009 public hearings does not accurately portray the impact on Riley customers' rates. She stated that, as a result of the rate increase granted under the Commission's Order in Cause No. 43680, Riley customers will not receive immediate improvements to their own system. Rather, they will be paying for past improvements made by Indiana-American to other operations in the State of Indiana. Ms. Stull also expressed concern about Joint Petitioners' stated benefits of the proposed acquisition to existing Indiana-American customers. The acquisition could result in increased costs to Indiana-American's customers.

(c) Joint Petitioners' Rebuttal Evidence. In rebuttal, Mr. Henson responded to Ms. Stull's testimony regarding the proposed accounting and rate base treatment of the purchase price for the proposed acquisition of the Riley System. Mr. Henson testified there is no way to determine that an acquisition adjustment results from the purchase price, or to determine the

amount of any such adjustment. He stated Riley has no fixed asset records, and he quoted from a prior State Board of Accounts Audit Report to support his assertion.

Mr. Henson stated how trend factors were used in the HWC Inventory to provide an estimate of net original cost. Trend factors are used to start with a known construction cost at one point in time and to estimate what the cost would be at another point in time. He then discussed how the use of trend factors in the HWC Inventory and the technological change adjustment identified by Ms. Stull would work in the reverse to how they are usually used in the typical rate case. He stated the HWC Inventory began by estimating the current cost to build the Riley System using current construction cost estimates and then used trend factors to work backward to calculate original cost. He also noted any adjustment for technological change would have had no impact on the appraised value.

Mr. Henson further testified that even if an acquisition adjustment were found to exist, favorable ratemaking treatment of any acquisition adjustment would be warranted in this case since the relevant criteria had been met, namely (1) that the purchase price be reasonable and result from an arm's-length transaction and (2) that the acquired utility be small or troubled. Mr. Henson stated that the purchase price must be considered a fair and reasonable price since it was determined in compliance with the statutorily required independent appraisal process. The General Assembly has dictated how the purchase price for the sale of a municipally-owned system is to be determined, namely that three independent appraisers be appointed. Mr. Henson stated a purchase price equal to this appraised value must be a fair and reasonable price because it is the minimum amount by law for which the utility may be sold.

Mr. Henson next described the small or troubled nature of the Riley System. He stated the Riley system has only 633 customers. He testified that until Indiana-American agreed to do so under the Agreement for Operation and Management Services, the system had no operator. In addition, Riley personnel did not know how to properly operate its valves, resulting in pressure problems; proper fluctuations had not been maintained in the levels of the elevated storage tank, resulting in freezing during cold weather; the Indiana Department of Environmental Management had indicated that without this acquisition another elevated storage tower would be needed; meters were not read during bad weather, there were several non-working meters, and Riley had no meter testing or replacement program; the disconnection policy was not being enforced; and the Fire Department reported six non-working fire hydrants. Mr. Henson again highlighted the deficiencies in the Riley System's books and records. He testified these are serious operational concerns that rise to the level of being troubled, in his opinion.

Mr. Henson also responded to Ms. Stull's concern that there must be some deduction made for CIAC. He stated that there are two sources of CIAC on the books of the typical municipal system: government grants and customer contributions. In Mr. Henson's opinion, all of the equity in a municipally-owned system is supplied by customers. Thus, Mr. Henson said Ms. Stull's proposal would effectively deny municipalities of any value for their systems in excess of their debts. Mr. Henson asserted the Order in Cause No. 41655 stands for the proposition that municipalities do not take the proceeds from a sale and provide them to shareholders. The proceeds are used by the unit of government to provide governmental services which are enjoyed by the residents and taxpayers of the municipality and customers of the utility.

Mr. Henson testified that in this Cause, the proceeds are to be used by Riley to set up a trust that will fund annual capital improvements.

Mr. Henson stated Indiana-American will not engage in transactions that do not make good business sense. If it will cause rates to existing customers to be higher, then generally it will not be a good consolidation. Mr. Henson explained Indiana-American presently has invested in rate base an amount of approximately \$2,400 per customer. If an acquisition causes that number to increase, then it will likely cause rates for existing customers to be higher, and Indiana-American will not be likely to engage in such a consolidation absent unusual circumstances. In the present case, the cost per customer to be added is \$1,620, thus decreasing Indiana-American's total investment per customer and producing lower overall rates.

Mr. Henson stated that if the Commission were to accept the position of the OUCC in this case, pursuant to the terms of the Asset Purchase Agreement, a precondition to closing would not be satisfied. Indiana-American would not pursue the internal process for determining whether it would be willing to waive that condition until after an Order has been issued which fails to satisfy the conditions for closing. He stated if the OUCC's position were accepted it would have a dramatic impact on Indiana-American's willingness to pursue further consolidations and if a portion of the dollars Indiana-American must invest to close future acquisitions are to be disregarded, this would negatively impact Indiana-American's willingness to engage in those future consolidations. Mr. Henson also testified if Indiana-American is unable earn a full return on and of the minimum purchase price required by law, Indiana-American would be unwilling to pursue such transactions. He likened the sale of a municipal utility to the State of Indiana's lease of the Indiana Toll Road, the proceeds of which are providing the funds for Major Moves. He argued that the OUCC's position in this case would be akin to an agency of the State complaining that the amount being paid in the Toll Road Lease was too high, or amounts which had been funded with federal highway dollars should be excluded and a technological adjustment should have been made.

Although Indiana-American currently serves Riley on a wholesale basis, Mr. Henson testified this has very limited impact on the analysis of the benefits of the acquisition to the existing Indiana-American customers because Indiana-American has no long-term contract with Riley. Mr. Henson stated Riley could develop its own source of water supply and may not purchase water from Indiana-American indefinitely. He also identified other benefits to Indiana-American's existing customer base from this acquisition. The Riley System will allow Indiana-American to better grid its system in the southeastern area of Terre Haute and will open up other potential growth areas.

Mr. Henson then discussed Ms. Stull's contention that the appraisal is stale. He stated the appraisal was returned to the Town Council on February 2, 2009, and Riley then held the required public hearings within forty-five days of that date. He attributed the passage of time since Riley's decision to proceed with the sale to Riley's consideration as to whether to proceed with the sale at all.

Mr. Henson said Ms. Stull had no basis for her allegation concerning the condition of the Riley System assets other than a reference made in response to a discovery request to damage to

the elevated storage tank that is currently under repair. As for the absence of any going concern value, Mr. Henson argued that adding additional dollars for “going concern” is not appropriate in all acquisitions and should only exist if the purchase price exceeds the fair market value of the assets being acquired, which is not the case here based on the appraisal. The appraised value only considered the value of the physical assets and made no addition for “going concern” value.

Finally, Mr. Henson addressed Ms. Stull’s concerns about the notice to Riley customers of the impact of the proposed acquisition on their rates. He stated that at the time of the public hearings in Riley, no detailed information was available about Indiana-American’s rate case (which had not yet been filed at that time). Upon receipt of the Order in Indiana-American’s rate case, notice was sent to Riley customers regarding the impact on the average customer’s monthly bill. Mr. Henson disagreed with Ms. Stull’s conclusion that the rates (including the increase under Indiana-American’s recent rate case) exceed the rates projected by Riley if it continues to own the system.

6. Commission Discussion and Findings.

(a) Public Convenience and Necessity. The evidence demonstrates that the Riley System can be easily integrated into Indiana-American’s existing system. The public now served by the Riley System will benefit from Indiana-American’s financing capability, management and technical expertise. As a result of this acquisition, certain necessary capital improvements will be made and at less cost to customers of the Riley System than if the system was to remain under Riley’s ownership. Riley System customers will also gain access to programs that Indiana-American uses to ensure customer satisfaction. Based on the evidence of record, the Commission finds that the acquisition and operation of the Riley System by Indiana-American is supported by public convenience and necessity and is in the public interest. Furthermore, following the closing, Indiana-American shall be authorized to serve in the areas currently served by the Riley System.

(b) Rates and Rules. Indiana-American currently has on file with the Commission a schedule of rates and charges and rules and regulations applicable to water utility service provided by Indiana-American in the Wabash Valley Operation. Consistent with the Asset Purchase Agreement, we find that, on and after the closing, Indiana-American’s generally applicable rates and charges and rules and regulations for water service and private and public fire service applicable in Indiana-American’s Wabash Valley Operation on file with and approved by the Commission should apply to services provided by Indiana-American through the Riley System, as the same are in effect from time to time.

(c) Accounting Treatment. The Commission’s authority over the accounting procedures utilized by public utilities in Indiana is governed by Indiana Code §§ 8-1-2-12 and -14. Indiana-American proposes that it be permitted to book an amount for net original cost rate base equal to the purchase price plus reasonable transaction costs. This effectively allows Indiana-American to recover a return for ratemaking purposes equal to its weighted cost of capital as applied to the purchase price and to recover through depreciation expense the full purchase price. The OUCC disagrees with this proposed treatment.

According to the evidence submitted in this matter, HWC prepared the HWC Inventory and valuation for Riley. HWC used two methods to develop a current value, asserting that both methods are considered valid and acceptable by industry standards. *HWC Inventory* at 4-1. The first method is original cost less depreciation for which the value was determined to be \$423,570. The second method used is replacement cost less depreciation with a value of \$1,015,920. *Id.* at 5-1. The HWC engineers selected the replacement cost less depreciation valuation as the value of the Riley System. *Id.* at 6-1. The three appraisers subsequently hired to complete an appraisal adopted the value recommended by HWC in the HWC Inventory.

The Commission has concerns with the appraisal submitted as evidence in this Cause. For example, the largest component of the valuation is meters and services with a replacement value of \$949,500. This amount was determined by assigning a value of \$1,500 to 633 meters and services. However, the Commission notes that the actual cost for most utilities is closer to \$1,000 to install a meter, meter pit, and service line.¹ If \$1,000 were used to calculate the value of meters and services, this component of the valuation would be overstated by \$316,500 (\$949,500 - \$633,000). Further, the HWC Inventory assigns a replacement value for the 50,000 gallon elevated storage tank at \$250,000. However, the HWC Inventory notes the tank contains lead-based paint on both the interior and exterior coatings. According to the evidence, the replacement value for the tank as determined by the HWC Inventory does not consider the liability associated with lead paint removal and disposal. Thus, the Commission is concerned that the value of \$1,025,500 for the Riley System, which was based on the HWC Inventory, may be overstated.

Joint Petitioners rely on *Ind.-Am. Water Co., Inc.*, Cause No. 41655, 2001 Ind. PUC LEXIS 292 (Apr. 4, 2001) (“Freeman Field”) to support their position that Indiana-American should be permitted to book as net original cost the purchase price of \$1,025,500 plus reasonable transaction costs of \$35,000. Joint Petitioners assert essentially that in accordance with Freeman Field, Riley’s failure to maintain books and records should result in the recording of the purchase price, as determined by the appraisers, as the net original cost on Indiana American’s books. In Freeman Field, the Commission, instead of requiring the municipality to recreate the books and records, permitted Indiana American to record the purchase price as the net original cost on its books. Freeman Field at *28.

The valuation method used by the appraisers to determine the purchase price in Freeman Field was original cost less depreciation, which was based on comprehensive original cost data. The records for capital expenditures for the water system at issue in Freeman Field were extensive, even containing records for the actual costs of the original system installed in 1943. Further, documentation concerning the costs for the improvements made after the initial installation was thorough. As a result of good documentation, the appraisal in Freeman Field made few assumptions in reaching its valuation.

The Commission also has concerns with the value assigned for the Riley System using the original cost less depreciation methodology. The HWC Inventory estimated the original cost by applying the construction cost index factors from the Engineering News Record (“ENR”) to

¹ See, e.g., the thirty-day filings for tap fees filed with the Commission by Rhorer, Harrell & Schacht Roads Water Corporation on October 4, 2009; Kingsford Heights Municipal Water Utility on August 25, 2009; Southern Monroe Water Corporation on September 23, 2009; and Town of Cedar Lake Water Utility on September 3, 2010.

the estimated replacement values. Construction cost indexes from Handy-Whitman Index (“HWI”) are typically used in matters before the Commission rather than ENR. HWI provides cost trends specific to water utility construction. It is not clear how the use of ENR cost indexes (compared to HWI cost indexes) would affect the original cost estimate. The valuation based on original cost less depreciation may be overstated to the extent components of the replacement value is overstated. However, the original cost less depreciation methodology is more conservative than the replacement cost less depreciation methodology adopted by the appraisers. The Commission finds it appropriate to use the estimated original cost less depreciation valuation methodology used in the HWC Inventory. Accordingly, the appropriate value for the Riley System is \$423,570 plus the value for land in the amount of \$5,600 and for improvements in the amount of \$4,000, as depicted on page 10 of the appraisal, for a total of \$433,170, which is consistent with the evidence presented by the OUCC.

Joint Petitioners argue that CIAC should not be deducted from the Riley System’s value for ratemaking purposes, and the OUCC disagrees. The Commission, based on the applicable law, agrees with the OUCC concerning the deduction of CIAC from the Riley System’s value for ratemaking purposes.

In Freeman Field, Indiana-American acquired a portion of the City of Seymour’s system that served the Freeman Field Seymour Municipal Airport and adjoining industrial park. Indiana-American is an investor-owned utility, while the City of Seymour is a municipally-owned utility. The portion of the system being acquired by Indiana-American contained two forms of CIAC: assets funded by customers’ direct contributions and a storage tower funded by a grant from the State of Indiana. *Id.* at *23. The appraisers’ valuations did not include the assets funded by customers’ direct contributions. *Id.* In Freeman Field, the Commission permitted Indiana-American to record on its books the purchase price as determined by the appraisal, less the customer-contributed CIAC, as the original cost of the plant for rate base purposes. *Id.* at *31.

In *City of South Bend v. Users of the Sewage Disposal Facilities of Clay Utilities, Inc.*, 402 N.E.2d 1267 (Ind. Ct. App. 1980), the City of South Bend (“City”) appealed the Public Service Commission’s (“PSC”)² determination that lease rental payments were unfair and unreasonable. The City entered into a lease/purchase agreement with Clay Utilities, Inc. (“Clay”) for Clay’s water and sewer facilities. *Id.* at 1269. The lease payment to be paid by the City to Clay for the water and sewer facilities was based on a purchase price that the City argued was the utility plant’s fair market value. *Id.* at 1271. The appraised value of Clay’s facilities, however, included CIAC. *Id.* at 1269, 1271. Thus, the PSC determined the lease payments to be unfair and unreasonable because of the inclusion of CIAC in the price. *Id.* at 1271–72.

The Court of Appeals noted that a witness defined CIAC as “an account which includes donations or contributions in cash, services, or property from states, municipalities, governmental agencies, individuals, and others for construction purposes.” *Id.* at 1272. A utility also books as CIAC plant donated to the utility by individuals (who paid for the plant) for the purpose of receiving service from that utility. *Id.* (quoting *State ex rel. Utilities Comm’n v.*

² The Public Service Commission is the Indiana Utility Regulatory Commission’s predecessor.

Heater Utilities, Inc., 219 S.E.2d 56, 58–59 (N.C. 1975). The Court of Appeals stated in Indiana, CIAC is deducted when a utility’s rate base is determined. *Id.* at 1272.

The City argued that CIAC should only be deducted for rate base purposes when the transfer is from one investor-owned utility to another investor-owned utility. Since the City is a municipality, consideration of rate base is irrelevant because a municipality’s rate structure is based on operating expenses. *Id.* at 1273. The Court of Appeals noted that according to the City’s argument, the value of the plant is based on whether a municipality or an investor-owned utility buys it, and observed:

The private investor, who reaches into his own pocket for the purchase money, can earn no return on the contributions in aid of construction and will assess the value of the utility accordingly. The municipality, which looks not to itself but rather to the users for payment of the purchase price (the very persons who directly or indirectly made the contributions in aid of construction), can make whatever charges are necessitated by the lease purchase agreements and conveniently can assess the value from a viewpoint which is significantly different from that of the private investor.

Id. In order for the municipality’s rates to be lawful, they must be sufficient to pay for the lease rental payments. *Id.* The Court of Appeals affirmed the PSC’s conclusion that the lease rental payments were unfair and unreasonable because of the inclusion of CIAC and stated, “[T]he lease-purchase agreements negotiated by the [City] would be repugnant to a private investor, and they are likewise repugnant to the users who must pay the negotiated price.” *Id.* at 1275. Thus, regardless of whether the transfer involves a municipally-owned utility or an investor-owned utility, plant not funded by the utility is CIAC and must be excluded from the valuation.

According to the evidence in this Cause, the appraisal does not exclude any portion of contributed plant. Ms. Stull stated CIAC is comprised of \$247,548 for the 1985 transmission main funded by a grant from the Indiana Department of Commerce and \$119,604 for the 2006 developer-contributed mains in the Lakewood Subdivision. She used the replacement cost depreciated to determine the amount of CIAC for the Riley System. The Commission used the original cost less depreciation method to determine the Riley System’s value, and will therefore use original cost less depreciation to determine the amount of CIAC. According to the Town of Riley, Indiana Water Utility Valuation March 2008 (revised September 2008) provided in Appendix B of the HWC Inventory, the original cost less depreciation value for the 1985 transmission main is \$128,063 and the Lakewood Subdivision mains is \$123,167, for a total CIAC amount of \$251,230. While we recognize that customer-contributed CIAC in Freeman Field was excluded from the utility valuation and ultimately from rate base, a grant from the State of Indiana was included. *City of South Bend* supports the exclusion of property funded by grants received from the State. The amount for the transmission main funded by a grant from the Indiana Department of Commerce should be excluded from Indiana-American’s rate base, in addition to the developer-contributed mains.

When CIAC in the amount of \$251,230 is deducted from \$433,170, the resulting value of the Riley System is \$181,940. The Commission finds that Indiana-American should earn a return

on \$216,940, which is determined by adding \$35,000 for transaction costs to the Riley System value of \$433,170 and subtracting \$251,230 for CIAC. Further, the Commission finds Indiana-American should earn a return of \$876,196, which is determined by adding to the Riley System's value of \$433,170 the amount of \$251,230 for CIAC and \$4,000 for improvements because improvements are depreciated and long-standing Commission policy allows depreciation of CIAC without amortizing it. *See, e.g., Ind. Am. Water Co., Inc.*, Cause No. 43680, 2010 Ind. PUC LEXIS 155, at *251–*53 (IURC Apr. 30, 2010)(quoting *Ind. Am. Water Co., Inc.*, Cause No. 42520, 2004 Ind. PUC LEXIS 351, at *242–*43 (IURC Nov. 18, 2004)).

Finally, Joint Petitioners argue the purchase price, which it must pay by law pursuant to Indiana Code §§ 8-1.5-2-4 through -6, plus transactions costs, is the amount that should be included in rate base for the purposes of earning a return on the acquired assets. The Commission rejects Joint Petitioners' suggestion that appraisals conducted under Indiana Code §§ 8-1.5-2-4 through -6 establish the fair value rate base of such assets. Rather, these sections of the Indiana Code outline the statutorily required appraisal and public hearing process concerning the sale of municipal utilities and the amount for which municipal utilities may be sold. The Commission is not constrained, however, by Indiana Code §§ 8-1.5-2-4 through -6 in determining the value of such assets for ratemaking purposes. Instead, Indiana Code § 8-1-2-6 governs what the Commission is to consider when valuing utility assets or property.

The Commission is aware that if Indiana-American chooses to pay the purchase price of \$1,025,500 plus transaction costs of \$35,000, an acquisition adjustment of \$843,560 ($\$1,025,500 + \$35,000 - \$216,940$) would occur. When determining whether to allow an acquisition adjustment, the Commission examines three criteria: (1) whether the purchase price is reasonable, (2) whether the transaction was at arm's-length, and (3) whether the acquired utility is small or troubled. *E.g., Utility Center, Inc.*, Cause No. 41968, 2002 Ind. PUC LEXIS 411, at *7 (IURC Oct. 10, 2002). As a result of the Commission's concerns regarding the HWC Inventory and resulting appraised value of the Riley System discussed above, the Commission finds that the purchase price is not reasonable. Accordingly, the Commission need not address whether the transaction was at arm's-length and whether the acquired utility is small or troubled. Based on the evidence presented in this Cause, Indiana-American is not permitted a return on and return of the acquisition adjustment of \$843,560.

(d) Depreciation Rates. The Commission finds that Indiana-American's existing depreciation accrual rates approved by the Commission in Cause No. 43081 on November 21, 2006 and as included in the calculation of rates with the approval of Indiana-American's rate case in Cause No. 43187 on October 10, 2007 should be applied on and after the closing date of the acquisition to depreciable property purchased from Riley pursuant to the Asset Purchase Agreement.

(e) Encumbrance. The Commission finds that the encumbering of the properties comprising the Riley System by subjecting such properties to the lien of Indiana-American's General Mortgage as of the closing should be approved.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION, that:

1. Public convenience and necessity justify the acquisition and operation of the Riley System by Indiana-American on the terms and conditions described in the Asset Purchase Agreement, and Indiana-American shall be and hereby is granted an indeterminate permit to provide water service in the area currently served by the Riley System effective upon consummation of the acquisition by Indiana-American of the Riley System.

2. Joint Petitioners are hereby authorized to consummate the acquisition of the Riley System by Indiana-American and permit the operation thereof by Indiana-American on the terms described in the Asset Purchase Agreement, including all necessary licenses, permits, and franchises to provide utility service through the Riley System following closing.

3. Indiana-American is hereby authorized to charge customers currently served by the Riley System the current rates and charges and apply the same rules and regulations for water service and private and public fire service applicable in Indiana-American's Wabash Valley Operation on file with and approved by the Commission, as the same are in effect from time to time.

4. Subject to the findings of this Order, Indiana-American is hereby authorized to reflect the acquisition of the Riley System on its books and records.

5. The proper values to be used for accounting, depreciation, and rate base valuation purposes after closing shall be as described in Finding No. 6(c) above.

6. Indiana-American shall be and hereby is authorized to apply its depreciation accrual rates on and after the closing date of the acquisition to depreciable property purchased from Riley pursuant to the Asset Purchase Agreement.

7. Indiana-American is hereby authorized to encumber the properties comprising the Riley System with the lien of Indiana-American's Mortgage Indenture.

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

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

APPROVED: APR 05 2011

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



Brenda A. Howe
Secretary to the Commission