STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF UTILITY CENTER, INC. D/B/A AQUA INDIANA, INC., TO INCREASE RATES AND CHARGES FOR WATER AND SEWER SERVICES PURSUANT TO COMMISSION'S MINIMUM STANDARD FILING REQUIREMENTS; TO APPROVE THE DEFERRAL AND AMORTIZATION OF CERTAIN COSTS FOR PURPOSES OF SETTING RATES AND CHARGES IN THIS AND FUTURE CAUSES; TO IMPLEMENT NEW RATE SCHEDULES REFLECTING THE INCREASED RATES AND CHARGES APPROVED IN THIS CAUSE AND RELATED RELIEF; AND TO ADOPT NEW SERVICE RULES AND REGULATIONS

CAUSE NO. 43874

APPROVED: APR 13 2011

On March 24, 2010, Utility Center, Inc., d/b/a Aqua Indiana, Inc., ("Petitioner" or "Utility Center") filed its Petition requesting authority to increase the recurring monthly rates and charges it collects for water and sewage disposal utility services provided to the public pursuant to the Commission's Minimum Standard Filing Requirements ("MSFRs") set forth at 170 lAC 1-5 and for other related relief.

On April 19, 2010, the City of Fort Wayne, Indiana ("Intervenor" or "Fort Wayne") petitioned for leave to intervene as a party to this Cause, which was granted by Docket Entry dated April 27, 2010.

Pursuant to notice given as provided by law, proof of which was incorporated into the record by reference and placed in the official files of the Commission, a public hearing was conducted on July 1, 2010, in Room 222, PNC Center, 101 West Washington Street, Indianapolis, Indiana 46204. Petitioner, Indiana Office of Utility Consumer Counselor ("OUCC" or "Public"), and Intervenor appeared and participated at the hearing, but no member of the general public appeared or participated in the evidentiary hearing. The testimony and exhibits constituting Petitioner's case-in-chief were admitted into the record without objection and Petitioner's witnesses were presented for cross-examination.

Pursuant to notice given as provided by law, proof of which was incorporated into the record by reference and placed in the official files of the Commission, the Commission conducted on August 4, 2010 a field hearing at Summit Middle School, 4509 Homestead Road, Fort Wayne, Indiana, 46814, beginning at 6:00 p.m. During this public field hearing, members of the public provided oral and/or written testimony in this Cause. The OUCC made a part of the record of the field hearing certain correspondence received by it.
The public hearing resumed on October 5, 2010, in Room 222, PNC Center, 101 West Washington Street, Indianapolis, Indiana 46204. The testimony and exhibits constituting the OUCC’s and Intervenor’s cases-in-chief were admitted into the record and their witnesses were presented for cross-examination. Intervenor’s cross-answering testimony, as well as Petitioner’s rebuttal testimony and exhibits, also were admitted into the record, and their respective witnesses were presented for cross-examination.

Based upon applicable law, and the evidence presented herein, and being duly advised in the premises, the Commission now finds:

1. **Notice and Jurisdiction.** Due, legal and timely notice of the hearings conducted in this Cause were provided as required by law. Petitioner is a “public utility” as defined in Ind. Code § 8-1-2-1. The Commission has jurisdiction of the parties and the subject matter of this proceeding.

2. **Petitioner’s Characteristics.** Petitioner is an Indiana corporation, with its principal office and place of business at 1111 West Hamilton Road South, Fort Wayne, Indiana, 46814. Petitioner owns, operates and controls utility plant, property, equipment and facilities used and useful in the production, treatment, distribution and sale of water and other water services, including fire protection, as well as in the collection, transportation, treatment and disposal of sewage.

   Utility Center provides both water and sewage utility services to customers located in Aboite and Wayne Townships in Allen County and a portion of Jefferson Township in Whitley County. There were approximately 12,022 sewer customers and 12,105 water customers served by Utility Center’s facilities as of September 30, 2009.

3. **Existing Rates.** The Commission approved Utility Center’s current monthly recurring rates and charges for both its water and sewage disposal operations in its August 27, 2008 Order in Cause No. 43331. The Commission approved the non-recurring fees and charges Utility Center currently collects from its water and sewage disposal customers through a 30-Day Filing approved by the Commission on January 30, 2009. Additionally, Utility Center has implemented a distribution system improvement charge (“DSIC”) pursuant to the Commission’s April 7, 2010 Order in Cause No. 42416 DSIC 5.

4. **Relief Requested.** Petitioner requested in its March 26, 2010 testimony and exhibits authority to increase on an across-the-board basis the recurring monthly rates and charges it collects for the water and sewer utility services by approximately 17.23% and 18.53%, respectively. The increases in operating revenue associated with those rate increases are 16.64% and 18.48% for Utility Center’s water and sewer operations, respectively. Utility Center also is seeking Commission approval to: (i) allow deferral of certain legal costs as a regulatory asset and to amortize the same over an appropriate period and reflect the same among Aqua Indiana’s operating expenses; (ii) approve revised Rules and Regulations for the operation of Utility Center’s water and sewage disposal utilities; and (iii) allow the deferral of depreciation and capitalization of interest and equity costs on certain capital improvement projects subsequent to their in-service date.
5. **Test Year and Rate Base Cutoff.** As approved by the June 8, 2010 Docket Entry, the period used for determining the revenues and expenses incurred by Petitioner to provide water utility and sewage disposal services to the public was the twelve months ended September 30, 2009. With revenue and expense adjustments for changes that were fixed, known and measurable for ratemaking purposes and occurring before September 30, 2010, this test year is sufficiently representative of Petitioner’s normal operations to provide reliable information for ratemaking purposes. Pursuant to the Commission’s MSFR, general rate base cutoff was September 30, 2009, except for major projects, which was 10 business days prior to October 5, 2010.

6. **Petitioner’s Rate Base.**

   **A. Test Year Plant in Service.** There was no dispute that the water and sewage disposal utility properties reflected on Petitioner’s books as being in service on September 30, 2009, are actually devoted to, and used and useful in, providing water and sewer service to the public. Further, there is no dispute concerning the September 30, 2009 utility plant balances, which were $34,483,213 and $52,867,837 for Petitioner’s water and sewage disposal utilities, respectively.

   **B. Major Projects.** As allowed by 170 IAC 1-5-4, Petitioner supplemented its September 30, 2009, plant balances for its water and sewage disposal utilities to reflect the following four major projects:

   - **Chestnut Water Treatment Plant Softening Project** – This project involved the addition of a 1,750 gallon per minute softening system to the Chestnut WTP to reduce water hardness. This project consisted of installing six 7.5 foot diameter softening tanks and brine tanks.

   - **Covington Water Treatment Plant Softening Project** - This project involved the addition of a 700 gallon per minute softening system to the Covington WTP to reduce water hardness. This project consisted of installing three 7.5 foot diameter softening tanks and brine tanks.

   - **Aboite Meadows Water Treatment Plant Reconstruction** - This project involved the reconstruction of the Aboite Meadows WTP to replace facilities that have exceeded their useful life and to improve water quality. The project consisted of removing existing softening facilities and installing a 625 gallon per minute softening system consisting of three 7.5 foot diameter softening tanks, two 7,500 gallon brine tanks, interior piping, electrical connections and a chlorination system. In addition, a new 1,250 gallon per minute iron removal system consisting of two 10 foot diameter by 22 foot long horizontal iron filters was added. The existing building was also expanded and remodeled.

   - **Billing System / Call Center Project** - This project (commonly referred to as “Meritage”) involved the Petitioner’s conversion to a fully automated common customer information system that consolidated aspects of both its customer
information system and the customer service functions (including call center, collections, and billing functions) into a shared service organization. As a result, Petitioner is now served by a regional call center with backup provided by two other regional call centers.

Petitioner asserted that it satisfied the requirements of 170 IAC 1-5-4 in connection with the above-described major projects; namely: (1) each project was identified in the Verified Petition; (2) estimates of Petitioner’s investment in each project was included in Petitioner’s case-in-chief; (3) the amount that Petitioner seeks to include in its rate base does not exceed those estimates; (4) monthly investment updates were filed during the course of the proceedings; (5) each project 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 project was more than 1% of Petitioner’s proposed rate base.

The OUCC agreed that Petitioner’s plant in service should be supplemented as proposed to reflect the four major projects and, together with associated depreciation, reflected in Petitioner’s original cost rate base. However, Intervenor Fort Wayne, while not disputing that the major projects were in service and devoted to providing service to the public, requested that the Commission not allow Petitioner to reflect the major projects in its original cost rate base. According to Intervenor’s witness Mr. Thomas Theodore Nitza, Jr., the inclusion of the major projects in Petitioner’s rate base should depend on customer satisfaction with them.

In response to Intervenor’s position that the Commission should disallow the three major projects involving water softening improvements, Petitioner’s witness Mr. William L. G. Etzler testified that Utility Center made those improvements in order to address the hardness of Utility Center’s finished water, which had been a concern of Utility Center’s customers for a long period of time. Mr. Etzler also described that Utility Center has had water softening facilities at its Aboite Meadows WTP for quite some time and those facilities had only been refurbished as part of the larger reconstruction of the plant that the Commission had directed Utility Center to pursue in its August 27, 2008 Order in Cause No. 43331.

In regard to the Meritage project, Mr. Etzler’s testimony disputed Mr. Nitza’s assertion that there was not a need for an upgrade. The old billing system was antiquated, unreliable and needed to be replaced. Initially, Mr. Etzler stated that the two quotations from his testimony at the July 1 hearing relied upon by Mr. Nitza misrepresented the evidence before the Commission. Mr. Etzler pointed out that, contrary to the quotations selected by Mr. Nitza, he testified that Utility Center’s previous billing system was using outdated software.
The Commission finds that Petitioner has met the requirements of 170 IAC 1-5-4 and that the Major Projects should be included in rate base. No evidence suggests that the projects are not used and useful for the provision of service, nor was evidence presented that the decision to implement the major projects were imprudent. While the Commission is cognizant of customer comments concerning the effect, or lack thereof, on quality of service or water quality, we address those concerns *infra.*

C. **Gross Utility Plant in Service.** The amounts of the specific increases in Petitioner’s plant values associated with each of the major projects are as follows:

<table>
<thead>
<tr>
<th>Project</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chestnut WTP Softening Project</td>
<td>$655,321</td>
</tr>
<tr>
<td>Covington WTP Softening Project</td>
<td>$1,010,478</td>
</tr>
<tr>
<td>Aboite Meadows WTP Reconstruction</td>
<td>$1,996,588</td>
</tr>
<tr>
<td>Meritage Project</td>
<td>$971,585</td>
</tr>
</tbody>
</table>

All of the three water treatment plant projects are fully allocable to Petitioner’s water utility, while the cost of the Meritage project should be divided between Petitioner’s water and sewage disposal utilities. Petitioner and the OUCC agree that $487,491 of the cost of the Meritage project is allocable to Petitioner’s water utility and $484,094 to its sewage disposal utility.

In addition to adjusting the test year plant values for these major project amounts, Petitioner and the OUCC are in agreement that a few additional adjustments are necessary in order to establish the total or gross values for Petitioner’s utility plant in service. Petitioner and OUCC agree that Petitioner’s test year value for Petitioner’s water utility plant should be increased by $1,555 to reflect the addition of a capitalized operating expense, as well as reduced by $405,049 to reflect plant retirements related to major projects. Petitioner also agreed with the OUCC that the test year value for Petitioner’s sewage disposal utility plant should be increased by $6,860 of the $10,625 increase proposed by the OUCC, but explained that the $3,766 associated with a refurbished starter has already been capitalized. This adjustment is needed to reflect the addition of capitalized operating expense. Petitioner and the OUCC also agreed that the test year value for Petitioner’s sewage disposal utility plant should be reduced by $37,542 to reflect plant retirements related to one of the major projects and by $127,547 to reflect the value of land the Commission directed be removed from Petitioner’s rate base in Cause No. 43666.

At the October 5, 2010 hearing, OUCC Witness Corey agreed with Petitioner’s rebuttal Witness Kopas that test year plant values should not be reduced to reflect the retirement of property used as part of Petitioner’s former billing system. Accordingly, the Commission finds that values of Petitioner’s gross utility plant in service for its water and sewage disposal utilities should reflect Petitioner’s investments in the major projects, as well as the other adjustments agreed to by the parties. The gross utility plant in service values for Petitioner’s water and sewage disposal utilities are $38,229,597 and $53,193,702, respectively.

D. **Working Capital.** Petitioner proposed reflecting as part of its rate base $332,121 in working capital for Petitioner’s water utility and $345,380 for its sewage disposal utility. The Public, however, only allowed for $286,498 for the water utility and $280,248 for the sewer disposal utility.
The differences between Petitioner and the OUCC primarily arise from their different calculations of appropriate O&M expenses used as the starting point for calculating the working capital allowance.

Mr. Corey explained that working capital is the net amount of money needed on an ongoing basis to fund daily utility operations. He stated that working capital is the money a utility needs to pay its operating expenses necessary to provide service until the revenues from that service are collected. He added that working capital is considered an investment necessary to provide utility service and is included in rate base for investor-owned utilities. Mr. Corey noted that Petitioner’s calculation failed to exclude purchased power expense, which is paid in arrears (after related revenues have been collected). Since the expense is paid in arrears, Mr. Corey indicated it should not be included in the calculation of working capital for rate making purposes.

Petitioner’s rebuttal witness, Robert A. Kopas acknowledged that purchased power expense is paid in arrears, but considered the OUCC’s adjustment to be inappropriate. He noted that other expenses, such as postage, were paid for in advance. Mr. Kopas testified that the percentage of O&M methodology used in this proceeding was designed to take an average of all expenses rather than conducting a lead lag study where all items are looked at individually. During cross-examination by the OUCC, Mr. Kopas testified that the exclusion of purchased power expense from O&M expenses for purposes of determining working capital was inconsistent with his experience in other states. However, Mr. Kopas acknowledged he had no experience in Indiana and further, that so far as he knew, the OUCC may be following the same methodology it has followed in every other case. Tr. at F-64-65.

As the OUCC noted in its case, the purpose of working capital is to allow utilities to pay operating expenses incurred to provide service to its customers before the revenues for those services have been received. Working Capital is included in a utility’s rate base because such monies are captive to this use. The OUCC used the “FERC 45-day” methodology for calculating working capital. Integral to this methodology are certain assumptions, including adjustments for expenses known to be paid in arrears, such as utility bills and taxes, and the lag time between when service is provided until the associated revenues are received (45 Days). When an expense such as purchased power is paid in arrears, that expense is met by revenues collected in exchange for the services the purchased power was used to produce. In such cases, working capital is not needed to meet that expense. It is consistent both with the purpose of working capital and Commission practice that expenses paid in arrears are excluded from the working capital calculation. The Commission’s practice is longstanding, and we agree with the OUCC that purchased power paid in arrears is properly excluded from Petitioner’s working capital calculation.

Therefore, considering our specific findings regarding pro forma operating expenses discussed below, the proper working capital allowances for Petitioner’s water and sewage disposal utilities should be $295,275 for Petitioner’s water utility and $287,507 for its sewage disposal utility.

E. Acquisition Adjustment. Petitioner and the OUCC also disagree on the amount of the acquisition adjustment net of accumulated amortization that should be reflected in
its rate base. According to Petitioner, the net acquisition adjustment for its water utility is $1,843,396 and $2,382,564 for its sewage disposal utility. The OUCC, on the other hand, maintains that those amounts should be $1,766,468 and $2,003,431, respectively.

Petitioner and the OUCC disagree as to the proper amount of the net acquisition adjustments to be reflected in Petitioner’s rate base. More specifically, the parties disagree over when the amortization of the acquisition adjustment began. According to Petitioner, amortization of the acquisition adjustment should be recognized as beginning in March 2003, when it first implemented the rates that reflected the inclusion of the acquisition adjustment in its rate base. The OUCC maintains the amortization of the acquisition adjustment began January 31, 1999, the date of the acquisition.

In support of the OUCC’s position, OUCC witness, Richard Corey refers to the Commission’s Final Order in Cause No. 41968 where the Commission authorized an acquisition adjustment of $7,690,332 to be allocated among the water and wastewater operations. Mr. Corey explained that Petitioner’s position deviates from this order and good regulatory practice.

According to Mr. Kopas, in order for a utility to have a legitimate opportunity to earn a fair, just and reasonable return on its investments, revenues must be generated to offset reasonable and accepted expenses associated with those investments. Mr. Kopas stated that this “matching principle” is a critical foundation of ratemaking and, consistent with it, it is a common and a typically-accepted practice to begin an allowed amortization when the rates intended to collect the revenues associated with the amortization are implemented. Mr. Kopas stated that to begin the amortization before the associated revenues are received is “to guarantee that the company will not earn its allowed rate of return, all else being equal.” To support the assertion that the amortization should be considered to have begun when the rates established in Cause No. 41968 were first effective, Mr. Kopas noted the amortization of rate case and deferred depreciation expenses reflected in Petitioner’s current rates began when those rates were implemented. He added that amortization of certain expenses related to a hydraulic analysis and mapping study originally approved in Cause No. 41968 began about March 2003, contemporaneous with the implementation of the new rates that included the matching revenues.

The Commission addressed this issue in Cause No. 41968 when it first authorized Utility Center an acquisition adjustment. The pertinent portion of the order (Nunc Pro Tunc, October 23, 2002, p.15) is set forth immediately below:
We consider the foregoing to demonstrate that the Commission recognized that, as of September 30, 2000, 20 months of amortization of the acquisition adjustment had already taken place, and began on January 31, 1999. If Utility Center disagreed with this finding, it could have sought post-hearing relief. In the alternative, Utility Center could have sought deferral of the amortization until its next rate case. However, as it did neither, its argument is untimely and we will not readdress our prior determination.

While we agree with the OUCC as to the initiation of the amortization period, the OUCC did not adequately support its calculation of the appropriate acquisition adjustment or include a workpaper setting forth its methodology for its calculation. The Commission calculated the net acquisition adjustment to be used in ratesetting as set forth below:

<table>
<thead>
<tr>
<th>Water</th>
<th>Wastewater</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cause No. 41968 Approved Acquisition Adjustment</td>
<td>$4,417,137</td>
</tr>
<tr>
<td>Less: Accumulated Amortization through 12/31/07</td>
<td>1,009,902</td>
</tr>
<tr>
<td>Net Acquisition Adjustment as of 12/31/07</td>
<td>3,407,235</td>
</tr>
<tr>
<td>Less: North System Allocation (Cause No. 43331) - Net</td>
<td>1,511,790</td>
</tr>
<tr>
<td>Acquisition Adjustment for Aboite System as of 12/31/07</td>
<td>$1,895,445</td>
</tr>
<tr>
<td>Annual Amortization agreed to in Cause No. 43331</td>
<td>63,007</td>
</tr>
<tr>
<td>Monthly Amortization (Annual Amort./12 mos)</td>
<td>5,251</td>
</tr>
<tr>
<td>Less: Accumulated Amortization (Mo. Amort.* 21 mos)</td>
<td>110,271</td>
</tr>
<tr>
<td>Acquisition Adjustment - Net as of 9/30/09</td>
<td>$1,785,174</td>
</tr>
</tbody>
</table>

Consistent with our findings on the acquisition adjustment amortization and the appropriate working capital allowances discussed above, the Commission finds that Petitioner’s original cost rate base for its water and sewage disposal utilities are $24,612,895 and
$31,583,010 respectively. The calculation of those amounts is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Water</th>
<th>Sewer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Utility Plant in Service</td>
<td>$38,229,597</td>
<td>$53,193,702</td>
</tr>
<tr>
<td>Add: Net Acquisition Adjustment</td>
<td>1,785,174</td>
<td>2,026,967</td>
</tr>
<tr>
<td>Less: Reserve for Accum. Depreciation</td>
<td>6,186,867</td>
<td>10,703,705</td>
</tr>
<tr>
<td>Net Utility Plant in Service</td>
<td>33,827,904</td>
<td>44,516,964</td>
</tr>
<tr>
<td>Add: Deferred Charges</td>
<td>501,696</td>
<td>1,285,480</td>
</tr>
<tr>
<td>Materials &amp; Supplies</td>
<td>118,477</td>
<td>101,284</td>
</tr>
<tr>
<td>Working Capital</td>
<td>295,275</td>
<td>287,507</td>
</tr>
<tr>
<td>Less: Customer Advances</td>
<td>506,628</td>
<td>688,374</td>
</tr>
<tr>
<td>Contributions in Aid of Construction</td>
<td>8,656,503</td>
<td>12,272,952</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>967,326</td>
<td>1,646,899</td>
</tr>
<tr>
<td>Original Cost Rate Base</td>
<td>$24,612,895</td>
<td>$31,583,010</td>
</tr>
</tbody>
</table>

**F. Rate Base Determination.** The parties presented no evidence establishing fair value rate bases for Petitioner's water and sewer disposal utilities other than in connection with supporting their respective proposed original cost rate bases. On the basis of the evidence presented in this Cause and the findings made above, therefore, the Commission finds that the original cost rate bases for Petitioner's water and sewage disposal utilities should be accepted as their respective fair value rate bases. Accordingly, the fair value of Petitioner's water and sewage disposal properties in service and used and useful for the convenience of the public are $24,612,895 and $31,583,010, respectively.

7. **Rate of Return.** Petitioner requested the Commission to authorize it the opportunity to earn an overall rate of return of 8.195% for both the water and wastewater operations based upon a capital structure consisting of 50% long-term debt and 50% common equity at a debt cost rate of 5.14% and a recommended common equity cost rate of 11.25%. The OUCC recommended an overall rate of return of 7.008% for both the water and wastewater operations based upon a capital structure consisting of 54% long-term debt and 46% common equity at a debt cost rate of 5.14% and a recommended common equity cost rate of 9.2%.

**A. Capital Structure.**

(i) **Petitioner's Position.** Ms. Ahern proposed using a 50% long-term debt / 50% common equity hypothetical capital structure. Ahern direct at 3. Ms. Ahern maintained that such a hypothetical capital structure is reasonable to use and consistent with the
range of common equity ratios maintained, on average, by the companies in the two proxy
groups that she and the OUCC used to develop cost of common equity recommendations.

(ii) **OUCC Position.** OUCC witness Korlon Kilpatrick disagreed with
Ms. Ahern’s recommended hypothetical capital structure. Mr. Kilpatrick proposed using the
actual capital structure of Petitioner’s parent company Aqua America. In Mr. Kilpatrick’s view,
the capital structures of the proxy companies used by Ms. Ahern to determine an appropriate cost
of equity for Petitioner trended towards either debt- or equity-heavy structures and noted that
several members of the proxy groups are on opposite ends of the debt-equity spectrum. Mr.
Kilpatrick also expressed the opinion that, contrary to Ms. Ahern’s testimony, it was important to
review the capital structure on a year-by-year basis and not on the basis of a 5- or 10-year
average. According to Mr. Kilpatrick, using averages only serves to smooth yearly variances
and does not provide any insight into the financing strategies or optimal structures that each
company is using.

Mr. Kilpatrick noted that applying Aqua America’s capital structure (54% long term debt
and 46% equity at test year end) to Petitioner also had the advantage of being determined from
publicly available information. Mr. Kilpatrick testified that the best representation of how
Utility Center funds its rate base is the same ratio of debt to equity that is employed by its parent
company. Based on statements made by Aqua America’s CFO, Mr. Kilpatrick testified that
Aqua America will continue to trend towards more debt in their capital structure in the near
future.

(iii) **Petitioner’s Rebuttal.** Ms. Ahern reiterated her position that a
hypothetical capital structure consisting of 50% long-term debt and 50% common equity should
be utilized. Ahern rebuttal at 11-14. Ms. Ahern disagreed with the OUCC’s recommendation to
use Aqua America’s consolidated capital structure. She argued that a majority of the debt at the
Aqua America level is restricted to certain future capital improvement projects and unavailable
to Utility Center. According to Ms. Ahern, there is $1,246,207,000 of long-term debt
outstanding and $216,000,000 of non-controlling interest held on the balance sheets of
subsidiaries of Aqua America and not at the parent level. These funds are not available to Aqua
America to invest in the utility plant of other Aqua America’s subsidiaries, including Utility
Center. She claimed that when adjusted for funds not available for investment in Utility Center,
the resulting capital structure ratios become 6.43% long-term debt, 0.63% non-controlling
interest and 93.54% common equity.

Ms. Ahern testified, however, that a common equity ratio in excess of 90% is
inappropriate to use for ratemaking because such a structure contains a higher percentage of
common equity capital than is necessary if Utility Center’s capital structure were market-based,
i.e., if it raised debt capital directly in the marketplace. Ahern rebuttal at 10. Moreover, a capital
structure which contains a higher than necessary common equity ratio results in the need for an
excessive level of revenues in order to support the higher common equity ratio, which ultimately
burdens ratepayers.

Ms. Ahern also pointed out that Utility Center’s ratemaking capital structure ratios of
50% long-term debt and 50% common equity are consistent with Standard & Poor’s (“S&P”) revised
utility financial guidelines for a utility whose bonds are rated in the A bond rating
category and which has been assigned a business risk profile of “Excellent” and a financial risk
profile of either “Intermediate” or “Significant”, like the companies in both of the two proxy
groups. Ms. Ahern testified that, if anything, a common equity ratio of 50% is conservative as it
falls below the bottom of the range of implied common equity ratios for utilities assigned an
“Intermediate” financial risk profile and at the bottom of the range for utilities assigned a
“Significant” financial risk profile.

(iv) **Capital Structure Discussion and Findings.** We are faced with a
somewhat unusual situation in which all parties agree that the actual capital structure of the
petitioning utility is not appropriate for ratemaking. Instead, Petitioner has proposed utilizing a
hypothetical capital structure, while the OUCC proposes utilizing the capital structure of the
ultimate corporate parent as a proxy for Petitioner’s capital structure.

Petitioner’s proposal is easily dismissed. Hypothetical capital structures have long been
held to be contrary to Indiana law. See *Pub. Service Comm’n of Ind. v. Ind. Bell Tel. Co.*, 235
Ind. 1, i30 N.E.2d 467 (Ind. 1955). In the absence of a settlement agreement or stipulation among
the parties, the capital structure used to set rates must be an actual capital structure, based on
facts in existence. In this case, the uncontradicted evidence is that Petitioner’s proposed capital
structure is hypothetical.

As Mr. Kaufman discussed during questions from the bench, Utility Center receives all of
its capital from its parent company. He explained that Petitioner’s parent raises both equity and
debt, but does not make a distinction between equity and debt when it infuses funds down to its
subsidiaries. Both Mr. Kaufman and Ms. Ahern agreed that it would be improper to treat the
capital that Aqua America had invested into Utility Center as 100% equity. We agree. We also
agree that where the Petitioner does not present an actual, utility-specific capital structure for
ratemaking purposes, the parent company’s capital structure may represent a) how investment is
funded at the subsidiary level and b) the costs actually incurred to raise that capital.

Ms. Ahern asserts that “most” of Aqua America’s debt is “not available for investment in
Utility Center’s jurisdictional rate base” and therefore should be excluded from our consideration
of an appropriate capital structure for Petitioner. We agree that the Aqua America capital
structure is too overly weighted with debt to be an appropriate proxy for Utility Center.

Instead, the Commission finds that the capital structure of Aqua Indiana, rather than
Aqua America, does represent a reasonable proxy to what Utility Center’s capital structure
should be. Mr. Kopas included Aqua Indiana’s capital structure in RAK-2, Schedule D-1, page 2
of 2, of 48.89 percent equity and 51.11 percent debt. Based on the evidence in this Cause, we
conclude that the actual capital structure employed by Petitioner’s Indiana parent company best
represents the costs incurred to raise capital.

B. **Cost of Common Equity.**

(i) **Petitioner’s Position.** In developing her recommended cost of
common equity of 11.25%, Ms. Ahern noted that as a wholly-owned subsidiary of Aqua
America, Utility Center’s common stock is not publicly traded. Therefore, a market-based
common equity cost rate cannot be determined directly for Utility Center. Consequently, Ms.
Ahern assessed the market-based cost rates of companies of relatively similar risk, i.e., proxy

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1 The use of this ratio also concludes that the major projects will be funded with debt and equity in amounts that
generate the same ratio.
groups, for insight into a recommended common equity cost rate applicable to Utility Center and suitable for cost of capital purposes. Ms. Ahern testified that using other utilities of relatively comparable risk as proxies is consistent with the principles of fair rate of return and adds reliability to the informed expert judgment necessary to arrive at a recommended common equity cost rate. However, Ms. Ahern noted that no proxy groups can be selected to be identical in risk to Utility Center. Therefore, the proxy groups’ results must be adjusted if necessary, to reflect the greater relative business and/or financial risk of Utility Center.

Ms. Ahern testified that the water companies comprising one of her proxy groups were selected based on the following criteria: they are included in the Water Company Group of AUS Utility Reports (February 2010); they have Value Line or Reuters consensus five-year EPS growth rate projections; they have a positive Value Line five-year EPS growth rate projection; they have a Value Line adjusted beta; they have not cut or omitted their common dividends during the five years ending 2008 or through the time of the preparation of her testimony; they have 60% or greater of 2008 total net operating income derived from and 60% or greater of 2008 total assets devoted to regulated water operations; and which, at the time of the preparation of her testimony, had not publicly announced that they were involved in any major merger or acquisition activity.

Because of the small number of publicly traded water companies available for use as proxies for Utility Center, as well as the limited availability of comprehensive investment analyst coverage for those companies, Ms. Ahern explained that she also utilized a proxy group of gas distribution companies. Like water companies, these gas distribution companies deliver a commodity, i.e., natural gas, to customers through a similar distribution system whose service rates of return are set by the regulatory ratemaking process. The basis of selection for the proxy group of eight natural gas distribution companies was similar to that used to select the water company proxy group.

Ms. Ahern’s cost of equity recommendation results from the application of four cost of common equity models, the Discounted Cash Flow (“DCF”) approach, the Risk Premium Model (“RPM”), the Capital Asset Pricing Model (“CAPM”), and the Comparable Earnings Model (“CEM”). Ms. Ahern explained that all of these models were market based. The DCF model is market-based in that market prices are utilized in developing the dividend yield component of the model. The RPM is market-based in that the bond ratings and expected bond yields used in the application of the RPM reflect the market’s assessment of bond/credit risk. In addition, the use of betas to determine the equity risk premium also reflects the market’s assessment of market/systematic risk as betas are derived from regression analyses of market prices. The CAPM is market-based for many of the same reasons that the RPM is market-based, i.e., the use of expected bond (Treasury bond) yields and betas. The CEM is market-based in that the process of selecting the comparable risk non-utility companies is based upon statistics which result from regression analyses of market prices and reflect the market’s assessment of total risk.

Ms. Ahern asserted that no single common equity cost rate model should be relied upon exclusively in determining a cost rate of common equity and the results of multiple models should be taken into account. Specifically, she stated that she employed all four cost of common equity models because: no single model is so inherently precise that it can be relied upon solely, to the exclusion of other theoretically sound models; all four models have application problems associated with them; all four models are based upon the Efficient Market Hypothesis (“EMH”),
which requires the assumption that investors rely upon multiple cost of common equity models; and as demonstrated previously, the prudence of using multiple cost of common equity models is supported in both the financial literature and regulatory precedent. According to Ms. Ahem the academic literature provides substantial support for the need to rely upon more than one cost of common equity model in arriving at a recommended common equity cost rate.

Based upon her analysis using the four identified models, Ms. Ahem concluded that common equity cost rates of 11.35% and 10.10% are indicated for the water and gas distribution proxy groups. However, Ms. Ahem testified that those common equity cost rates are applicable to the larger, less risky proxy water companies and proxy gas distribution companies. Because Utility Center has greater business risk than the average of both proxy groups due to its relatively smaller size measured by book capitalization or the market capitalization of common equity, it was necessary to upwardly adjust the common equity cost rates. Based on data contained in 2010 Risk Premia Report, Ms. Ahem considered a business risk adjustment of 4.17% to be indicated due to Utility Center’s size relative to the proxy water companies and an adjustment of 4.55% is indicated relative to the proxy gas distribution companies. However, she only made adjustments of 0.20% (20 basis points) to the water proxy group and 0.30% (30 basis points) to the gas distribution company proxy group to reflect Utility Center’s greater relative business risk.

The results of Ms. Ahem analyses are summarized below:

<table>
<thead>
<tr>
<th>Proxy Group of Six</th>
<th>Proxy Group of Eight</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUS Utility Reports</td>
<td>AUS Utility Reports Gas Distribution Companies</td>
</tr>
<tr>
<td>Water Companies</td>
<td></td>
</tr>
<tr>
<td>Discounted Cash Flow Model</td>
<td>11.77%</td>
</tr>
<tr>
<td>Risk Premium Model</td>
<td>10.85%</td>
</tr>
<tr>
<td>Capital Asset Pricing Model</td>
<td>11.00%</td>
</tr>
<tr>
<td>Comparable Earnings Model</td>
<td>14.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Indicated Common Equity Cost Rate Before Adjustment for Business Risk</th>
<th>11.35%</th>
<th>10.10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indicated Risk Adjustment</td>
<td>.20%</td>
<td>.20%</td>
</tr>
<tr>
<td>Indicated Common Equity Cost Rate After Adjustment for Business Risk</td>
<td>11.55%</td>
<td>10.40%</td>
</tr>
<tr>
<td>Recommended Common Equity Cost Rate</td>
<td>11.25%</td>
<td></td>
</tr>
</tbody>
</table>

(ii) **OUCC Position.** Mr. Korlon Kilpatrick estimated cost of equity for the OUCC. Mr. Kilpatrick’s overall cost of equity recommendation for Utility Center ranged from 7.41% to 9.43%. His specific recommendation was 9.2%, which included a 20 basis point upward adjustment to account for Petitioner’s company specific risk relative to the
proxy group, the same as that made by Ms. Ahern. Mr. Kilpatrick’s analysis considered the same proxy groups as Ms. Ahern, but he concluded that it was not necessary to use the gas proxy group and therefore based his estimated cost of equity on the results of his water company analysis. Mr. Kilpatrick relied on both a CAPM and DCF analysis. Unlike Ms. Ahern, Mr. Kilpatrick did not use either the Risk Premium or Comparable Earnings models.

Mr. Kilpatrick’s CAPM analysis for his water company proxy group produced results ranging from 7.29% to 9.23%. Mr. Kilpatrick relied on long-term, 30-year US Treasury bonds to estimate his CAPM risk-free rate. To estimate the risk premium, Mr. Kilpatrick used both a historical risk premium and a forecasted (market-based) risk premium. His historical risk premium reflected the difference in total returns between large company stocks and long-term government bonds from the Ibbotson analysis using both the arithmetic and geometric mean returns. Mr. Kilpatrick explained that he used both the arithmetic and geometric means based on several reasons, including the Commission’s Orders in Cause Nos. 42520 and 43680 and Dr. Ibbotson’s Stocks, Bonds, Bills and Inflation and Analysis of Equity Investments: Valuation by the Association of Investment Management and Research (1982). Mr. Kilpatrick derived his forecasted (market-based) risk premium using estimated market returns and the risk-free rate of return from several sources (The Schwab Center for Financial Research, Global Business Outlook Survey by Duke University and the Survey of Professional Forecasters by the Federal Reserve Bank of Philadelphia).

Next Mr. Kilpatrick testified why it is appropriate to use total returns (instead of income returns) to estimate the CAPM risk premium. Mr. Kilpatrick explained that by investing in Treasury securities (or any security), investors knowingly accept the inherent associated price risk. Thus the total return is the actual return that investors can expect from Treasury securities. Given this, when deriving a market risk premium, the most reasonable estimate is determined using a total return on Treasury bonds. Mr. Kilpatrick also explained why it is inappropriate to use income returns and that price risk only exists if the investor does not hold the bond to maturity.

Mr. Kilpatrick’s second analysis employed a constant growth DCF model. To estimate the DCF growth rate (g), Mr. Kilpatrick analyzed historical and projected growth rate estimates of earnings per share, dividends per share and book value per share. Mr. Kilpatrick also reviewed sustainable growth rates as measured by the proxy group companies’ respective retention rates and earned returns on common equity. Mr. Kilpatrick’s DCF analysis for his water utility proxy produced cost of equity estimates ranging from 7.21% to 9.18%.

Mr. Edward Kaufman also filed cost of equity testimony for the OUCC. Mr. Kaufman demonstrated that Mr. Kilpatrick’s estimated cost of equity was reasonable by citing four diverse and independent financial sources which provided long-term forecasted returns for the market:

1. The Survey of Professional Forecasters published by the Philadelphia Federal Reserve Bank. The forecasters estimated a 10-year average return for the S&P 500 of 7.0%.

2. Duke’s CFO Magazine Global Business Outlook Survey contains the results of survey asking CFOs of each S&P 500 company for their
estimated return of the S&P500 for the next ten years. The average result was 6.85%.

(3) Schwab’s Center for Financial Research estimated a long term return for large company stocks of approximately 7.3%.

(4) J.P. Morgan Asset Management estimated a 10-15 year compound annual return of 7.5% for U.S. Large Cap equities and 7.75% for U.S. Small Cap equities.

Mr. Kaufman also testified that the return figures discussed in his analysis were for the overall market. He concluded that Mr. Kilpatrick’s 9.2% recommendation, which is more than 150 basis points above the average of the four studies, was more reasonable than Ms. Ahern’s 11.25%.

Mr. Kaufman critiqued Ms. Ahern’s analysis and summarized his concerns. He noted Ms. Ahern’s estimated cost of equity is approximately 200 basis points greater than Mr. Kilpatrick’s and explained that the majority of their differences are caused by Ms. Ahern’s inputs to her models and the weight she gives her models. For an example, Mr. Kaufman pointed to Ms. Ahern’s CAPM and Risk Premium analyses, which rely exclusively on an arithmetic mean risk premium, as compared to Mr. Kilpatrick’s use of both the arithmetic and geometric means. Mr. Kaufman also highlighted Ms. Ahern’s reliance on the Comparable Earnings model, which Mr. Kilpatrick rejected.

Mr. Kaufman’s concerns with Ms. Ahern’s DCF analysis focused on her estimate of the growth (g) component. He explained that the goal in estimating growth in the DCF model is to derive a reasonable, sustainable, long-term estimate of growth in dividends. Mr. Kaufman pointed out that Ms. Ahern’s analysis relied exclusively on intermediate term forecasts in Earnings Per Share and cited to an article from the NRRI that explained why intermediate term forecasts can lead to unreasonably high estimated growth rates. He testified that Ms. Ahern’s estimated growth rates for the water industry were both well above historical norms and did not appear to be sustainable. In support of his position he offered a recent article by Brad Cornell and Rob Arnott, The Basic Speed Law for Capital Market Returns, that concluded long run earnings growth cannot exceed growth in the overall US economy. He concluded that Ms. Ahern’s optimistic growth rates cause overstated DCF results, while OUCC’s growth estimating method was consistent with the Commission’s Order in Cause No. 43680, Indiana American Water.

Mr. Kaufman disagreed with Ms. Ahern’s CAPM analysis, particularly her 7.61% market risk premium estimate. To derive the 7.61% figure, Ms. Ahern averaged a historical market risk premium of 6.6% and a forecasted market risk premium of 8.61%. Mr. Kaufman disputed both the historical 6.6% and forecasted 8.61% risk premiums based on errors in both the market returns and risk free rates used by Ms. Ahern to calculate these figures.

Ms. Ahern’s 6.6% historical market risk premium was based on an historical arithmetic mean market return of 11.8% and a historical risk free rate of return of 5.2%. Mr. Kaufman explained that Ms. Ahern’s historical risk premium should have considered both the arithmetic mean market return of 11.8% and the historical risk free rate of return of 5.2%.
and geometric mean, citing several texts as well as past Commission orders. He criticized Ms. Ahern’s historical risk-free rate because it should have been calculated using total returns instead of income returns, citing the Order in Cause No. 42520, Indiana American Water, at 59.

Mr. Kaufman also disagreed with Ms. Ahern’s reliance on Dr. Ibbotson’s theory that income returns were appropriate. Mr. Kaufman testified that Dr. Ibbotson’s argument implies that because of capital losses bond income returns exceeded bond total returns and therefore, bond total returns are biased downward. He argued that Dr. Ibbotson’s assertions require that the measure of bond income returns should be higher than bond total returns, but this is not the case. Mr. Kaufman concluded that if total returns were downwardly biased as Dr. Ibbotson’s analysis asserts, then total returns should be lower (not higher) than income returns and the use of income returns should result in a lower risk premium and not a higher risk premium.

Regarding Ms. Ahern’s 8.61% prospective market risk premium, Mr. Kaufman was particularly concerned with her use of Value Line’s 3-5 Year Median Appreciation Potential to estimate total market returns. Mr. Kaufman explained that Value Line’s forecast is an intermediate term forecast and is not intended to be a long term forecast. Next, he asserted Value Line’s 3-5 year Median Price Appreciation Potential overstates anticipated market returns. Based on Value Line’s 3-5 year Median Price Appreciation Potential, Ms. Ahern’s analysis forecasts a market return of 13.49%. Given the current outlook of low inflation and the articles discussed earlier in his testimony, Mr. Kaufman expected market returns to be lower in the future than they have been in the past. Moreover Value Line’s 3-5 year Median Price Appreciation Potential is too volatile to be used as a reliable forecast of market expectations.

Ms. Ahern’s use of forecasted interest rates in her CAPM (and Risk Premium models) was another input disputed by Mr. Kaufman. He testified that Ms. Ahern’s source (Blue Chip Financial Forecasts or “BCFF”) typically shows a trend of forecasting increasing interest rates. Mr. Kaufman supported his concern by citing to prior BCFF and pointing out that each of these reports forecasted increasing interest rates even when rates were declining. He explained that his point was not that these forecasts turned out to be wrong, but that BCFF appear to regularly forecast increases in interest rates. Given this tendency to forecast increasing interest rates, he did not believe these forecasts form a reasonable basis to estimate cost of equity. Mr. Kaufman described how purchasers of long-term debt are making a forecast. The purchaser anticipates factors such as inflation over the life of the loan and uses those factors to determine the appropriate purchase price and subsequent yield of his or her investment. The purchase price produces a yield that the investor is willing to accept over the life of the loan. Thus, a current yield is already a forward-looking yield over the investment horizon. He argued that if one forecasts predicting increasing interest rates are, in effect, predicting that the price of the bond will decrease. Mr. Kaufman argued that if a buyer strongly believed that the bond price is going to decrease in the near term, the purchaser would decrease his current purchase price and the spread between the forecasted yield and current yield would decrease. Mr. Kaufman also opined that there is a tendency among some analysts to take a “conservative” approach and assume that when interest rates are low the same interest rates are more likely to increase in the future. But Mr. Kaufman emphasized the best indication of what investors think interest rates will do is how they vote with current dollars. The current purchase price represents a statement with dollars as to what the investor believes will happen over his or her investment horizon.
Mr. Kaufman disputed the appropriateness of Ms. Ahem’s use of the ECAPM. Mr. Kaufman explained the ECAPM is a modification to the traditional CAPM based on the opinion that the results of a CAPM analysis are biased downward for companies with a beta of less than 1.0 and biased upward for companies with a beta that is greater than 1.0. The ECAPM addresses this supposed bias by altering the CAPM formula to have a similar effect as adjusting beta so that cost of equity is increased for companies with betas below 1.0 and decreased for companies with a beta above 1.0. Mr. Kaufman testified that it was important to understand that Ms. Ahem’s ECAPM analysis uses Value Line betas, which Value Line adjusts through the following formula:

\[
\text{Adjusted beta} = 0.35 + 0.67 \times \text{raw beta}
\]

He explained that by using Value Line adjusted beta, Ms. Ahem’s ECAPM effectively makes an inappropriate double beta adjustment, thus overstating the resulting cost of equity. Mr. Kaufman also quoted from page 48 of the Commission’s Order in Cause No. 42359, PSI Energy (May 18, 2004), in which this Commission rejected the ECAPM analysis.

Mr. Kaufman took issue with Ms. Ahem’s Risk Premium analysis, explaining how the flaws in her CAPM analysis that he had described previously also applied to her Risk Premium analysis. In particular, Mr. Kaufman disagreed with Ms. Ahem’s sole reliance on the arithmetic mean risk premium to estimate a historical return and her use of Value Line’s 3-5 Year Median Price Appreciation Potential to estimate a forecasted market return.

Mr. Kaufman then reviewed Ms. Ahem’s Comparable Earnings (“CE”) methodology. He testified that Ms. Ahem did not screen for either dividends or percentage of long term debt to form her comparable earnings proxy groups. Mr. Kaufman explained that water utilities tend to have low business risk, which allows them to incur a larger degree of financial risk. Thus, water utilities tend to carry a large proportion of long term debt in their capital structure. Mr. Kaufman further explained that regardless of any other screening criteria used by Ms. Ahem, a company that has no or little long term debt is not comparable to her water company proxy group. He stated that the same theory applies to dividends. Water utilities pay a relatively large percentage of their earnings as dividends to their shareholders. Large dividend payments reflect the lower risk of the water industry. Regardless of any other screening criteria employed by Ms. Ahem, a comparable earnings analysis that includes companies that pay no or little dividends will not be comparable to the water company proxy group used by Ms. Ahem in her analysis. Mr. Kaufman also noted that while Ms. Ahem’s CE analysis removes companies she believed were outliers, her CE analysis still included companies with projected returns that exceed 25.0%. Mr. Kaufman emphasized that a forecasted return of 25.0% is not representative of the anticipated returns for the water industry and should not be considered to estimate Utility Center’s cost of equity.

Discussing his theoretical concerns with Ms. Ahem’s Comparable Earnings approach, Mr. Kaufman explained how a change in market conditions - such as interest rates influences investor expectations and the results of both a CAPM and/or DCF analysis - will, in turn, quickly react to reflect the change in investor expectations. He testified that a CE model may not reflect such changes as rapidly since forecasted earned returns are updated quarterly and there is no other component in the model that reacts with market conditions. Mr. Kaufman also testified that in past cases, he had seen the comparable earnings methodology produce increasing returns.
during periods of declining capital costs. Mr. Kaufman noted that Ms. Ahern’s analysis assumes that operating returns (accounting returns) can be used to estimate market returns. Mr. Kaufman was not convinced it is appropriate to rely on accounting returns to estimate cost of equity.

Mr. Kaufman concluded his CE critique by citing the Commission’s Orders in Cause Nos. 42029 and 43680 (both involving Indiana American Water). Mr. Kaufman stated in those cases the Commission concluded that the CE approach “does not measure the appropriate return” and that Ms. Ahern’s CE approach in this cause is similar to that rejected by this Commission in Cause No. 43680.

(iii) Petitioner’s Rebuttal. On rebuttal, Ms. Ahern claimed that Mr. Kilpatrick’s 9.2% recommended common equity cost rate is among the lowest, if not the lowest, recommended common equity cost rate that she had seen. Given today’s severely and persistently strained environment, and the significant volatility in the stock market, Ms. Ahern asserted a 9.2% common equity cost rate was insufficient to maintain the integrity of presently-invested capital and to permit the attraction of needed new capital at a reasonable cost in competition with other firms of comparable risk. Ms. Ahern noted that Mr. Kilpatrick’s recommended equity cost of 9.2% is 80 basis points lower than the Commission-approved 10% equity cost awarded Indiana American Water Company just five months ago in Cause No. 43680.

Ms. Ahern cited a number of sources recognizing that a company’s authorized return on equity is fundamental to its ability to attract capital and finance capital expenditures. According to Ms. Ahern the investment community considers the regulatory climate and awarded returns on equity in each state that Aqua America has operating companies in order to fully analyze their investment decisions. Ms. Ahern stated that the OUCC’s proposal could have a significant negative impact on Utility Center and its customers over the long run in that it will contribute to placing Aqua America at a competitive disadvantage in the capital markets, making it more difficult and costly to obtain the capital necessary to finance future infrastructure improvements.

Ms. Ahern also testified as to particular problems in the analyses underlying Mr. Kilpatrick’s testimony recommending a cost of equity of 9.2%. Ms. Ahern asserted that Mr. Kilpatrick’s application of the CAPM and DCF models utilized outdated information in that Mr. Kilpatrick relied upon the April 23, 2010 Ratings & Reports for his water proxy group for both the betas for his CAPM application and projected growth rate data for his DCF application. According to Ms. Ahern, at the time of the preparation of his direct testimony, the July 23, 2010 Ratings & Reports for his water proxy group were available and should have been used.

Ms. Ahern also asserted four flaws in Mr. Kilpatrick’s application of the CAPM. First, Ms. Ahern testified that, since ratemaking and the cost of capital are prospective, it is inappropriate to use historical yields as the risk-free rate in a CAPM analysis as done by Mr. Kilpatrick. According to Ms. Ahern, while Mr. Kilpatrick correctly utilized a long-term U.S. Treasury yield as the risk-free rate, the appropriate yield to use is the prospective yield on long-term U.S. Treasury bonds (notes), rather than relying upon a recent 7-month historical yield. Ms. Ahern testified that the current forecasted consensus yield on long-term U. S. Treasury notes by

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2 At the hearing, Mr. Kaufman adopted Mr. Kilpatrick’s testimony.
the nearly 50 economists reporting in Blue Chip Financial Forecasts dated September 1, 2010 is 4.22% for the six quarters ending with the fourth quarter 2009, rising 90 basis points (0.90%) from an estimated 3.8% in the third quarter 2009 to 4.7% in the fourth quarter 2011. Mr. Kilpatrick’s recommended 4.43% historical average yield stands in contrast to the expected yield of 4.7% at the end of 2011.

Second, Ms. Ahem testified that Mr. Kilpatrick’s range of historical market equity risk premiums of 4.40% to 6.00% is incorrectly derived for two reasons: 1) he incorrectly utilized geometric mean historical returns and 2) he incorrectly utilized the total returns on long-term government bonds rather than the correct income return. Ms. Ahem stated that it is the arithmetic mean return, not the geometric mean return that is appropriate for cost of capital purposes. Additionally, Ms. Ahem states that Mr. Kilpatrick’s use of total returns on long-term government bonds ignores clear recommendations to the contrary made by experts that Mr. Kilpatrick himself relies upon in developing a recommended cost of equity.

The third flaw in Mr. Kilpatrick’s application of the CAPM according to Ms. Ahem relates to his use of “market-based” market equity risk premiums. Ms. Ahem testified as to Mr. Kilpatrick’s limited use of the sources to develop his market risk premiums and his failure to consider Value Line data, which Ms. Ahem believes is more reliable given the current volatility in both the economy and capital markets.

Finally, Ms. Ahem observed that Mr. Kilpatrick had failed to apply the Empirical CAPM to account for the fact that Security Market Line (“SML”), as described by the traditional CAPM, is not as steeply sloped as the predicted SML. According to Ms. Ahem, without application of the Empirical CAPM, Mr. Kilpatrick has failed to adjust for a recognized limitation in the traditional CAPM model.

In regard to Mr. Kilpatrick’s application of the DCF model, Ms. Ahem expressed as a major concern in his development of the growth rate component of the DCF model. According to Ms. Ahem, Mr. Kilpatrick ignored the wealth of empirical and academic literature supporting her analysis, and not utilizing the historical growth or internal growth as Mr. Kilpatrick has done.

Ms. Ahem also took issue with the specific growth rates used by Mr. Kilpatrick in his application of the DCF model. Ms. Ahem testified that Mr. Kilpatrick’s use of both the 5-year and 10-year historical growth in EPS, DPS and BVPS double counts the most recent 5-year period and failed to reflect the current difficult market environment. Ms. Ahem also maintained that Mr. Kilpatrick’s calculated internal growth, based as it is on 2009 data, is not a projected internal growth rate and represents only one-half of the “sustainable growth” method, which has the additional problem of tending to be circular. Finally, Ms. Ahem expressed her disagreement with the range of DCF results that Mr. Kilpatrick’s application of the model yielded.

Ms. Ahem’s rebuttal testimony also addressed Mr. Kaufman’s criticisms of her testimony recommending a cost of equity of 11.25%. In regard to Mr. Kaufman’s criticism of her reliance on forecasted growth rates in earnings per share to estimate growth, Ms. Ahem rejected the contention that analyst forecasts tend to be optimistic. Ms. Ahem pointed out that, under the EMH, investors are aware of the accuracy of and/or any perceived bias in analysts’ forecasts and reflect such awareness in the market prices they are willing to pay. In addition, Ms. Ahem cited
recent research showing that conflicted analysts do not mislead investors with optimistic recommendations. Ms. Ahem re-iterated her view that the use of analysts’ forecasts of EPS growth should receive significant, if not sole, emphasis when estimating the cost rate of common equity capital. Ms. Ahem also testified that Mr. Kaufman’s reliance on a 2003 NRRI study was misplaced since it did not reflect new practices in the security industry.

Ms. Ahem also disputed Mr. Kaufman’s criticism of her application of the DCF model. Ms. Ahem argued that Mr. Kaufman failed to provide any empirical evidence that the long run growth rate of the U.S. economy is an appropriate proxy for a DCF growth rate for any company, let alone utility companies, including water utilities. As Ms. Ahem observed, the average growth in the U.S. economy, as measured by GDP growth, is just that – an average. Accordingly, some sectors/industries/companies will grow faster than the economy and some will grow more slowly. Thus, in Ms. Ahem’s view, there is no basis to implicitly assume, as Mr. Kaufman does, that the earnings of all industries, including the utility/water industry, will grow at the average rate of the economy as a whole as measured by composite GDP growth or that composite GDP growth is an appropriate growth rate for a DCF analysis.

In regard to her application of the CAPM, Ms. Ahem reiterated that, for all the reasons that she previously stated in her direct testimony, the arithmetic mean return, and not the geometric mean return, is appropriate for cost of capital purposes. Similarly, Ms Ahem defended her use of the income return on long-term U.S. Treasury bonds as the risk-free rate in developing an historical market equity risk premium pointing out that Mr. Kaufman’s own sources support her position.

Ms. Ahem rejected Mr. Kaufman’s criticism of her use of a prospective market risk premium. According to Ms. Ahern, Value Line’s 3-5 year Appreciation Potential is no less a reliable forecast of market expectations than are Value Line’s projected five-year growth rates in EPS and DPS relied upon by Mr. Kaufman. Similarly, Ms. Ahem rejected the claim that she overstated the dividend yield in connection with her CAPM analysis. Given that the current yield on the S&P 500 is 2.00% and a recent Value Line median estimated dividend yield is 2.20%, Ms. Ahem insisted that there was little, if any, overstatement of the total market dividend yield in her CAPM analysis.

Ms. Ahem also testified that Mr. Kaufman had an incorrect understanding of the ECAPM, which underlies some of his criticism of her application of the CAPM model. According to Ms. Ahem, once it is understood that CAPM and SML do not describe the same relationship, it should be seen that adjusting betas for regression bias and applying the ECAPM are indeed separate and unrelated adjustments. Ms. Ahem surmised that Mr. Kaufman has confused the slope of the SML with beta.

In regard to her RPM analysis, Ms. Ahem notes that Mr. Kaufman’s objections are the same as those made in connection with her application of the CAPM model. For the same reasons that she stated in that context, Ms. Ahem does not believe that Mr. Kaufman’s objections have merit.

Finally, Ms. Ahem defended her application of CEM. In this regard, Ms. Ahem disagreed with Mr. Kaufman’s analysis that companies in her proxy groups of non-utility
companies were not comparable to those in her utility proxy groups. Ms. Ahern noted that, while there may be differences, it was clear that the non-utility companies used were part of the same population of companies as those in the water company proxy group. Moreover, Ms. Ahern stated that in arriving at a conclusion of CEM derived common equity cost rate, she eliminated outliers by determining if any of the historical or projected returns are significantly different from their respective means at the 95% confidence level.

As part of her rebuttal testimony, Ms. Ahern also updated the analyses reflected in her direct testimony and underlying her recommended cost of equity and overall rate of return. Using more current information, but applying the same four common equity models in the same way in which she previously applied them, Ms. Ahern affirmed her recommendation that a rate of return of 8.195% based on a common equity cost rate of 11.25% was appropriate for Utility Center under current economic conditions.

(iv) Cost of Equity 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 of 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 results under all conditions and circumstances.

The parties disagreed about certain mechanics of the DCF Model. Regarding the estimation of the sustainable growth rate, Ms. Ahern chose the three- to five-year analysts’ forecasted growth rate while Mr. Kilpatrick used both historical and projected growth rates of earnings, dividends and book value per share. The Commission has repeatedly affirmed our view regarding the growth rate:

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.

Indiana American Water, Cause No. 40103, Order at 40-41 (IURC 5/30/1996). We recently reaffirmed this expectation in Cause No. 43680, Indiana American Water (IURC 4/30/2010) and do so once again today. We continue to have serious concerns regarding any witness’ sole reliance on analysts’ intermediate-term forecasts in their 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. We agree with Mr. Kaufman that Ms. Ahern’s exclusive reliance on intermediate-term forecasts results in a growth rate that is unrealistically high.

The parties also disagreed over potential upward bias in analysts’ forecasts. In support of her position, Ms. Ahern’s rebuttal refers to language from an article by Anup Agrawal and Mark Chen titled Do Analyst Conflicts Matter?:

Overall, our empirical findings suggest that while analysts do respond to IN [investment bank] and brokerage conflicts by inflating their stock
recommendations, the markets discounts these recommendations after taking analysts’ conflicts into account.

Ahern Rebuttal at 52. While the Agrawal and Chen article states that investors discount analyst recommendations, our review of Ms. Ahern’s testimony and exhibits reveals no comparable discount when she includes analysts’ recommendations in her cost of equity estimate. Using unadjusted analyst recommendations would increase the probability that Ms. Ahern’s DCF results are overstated.

We also place little weight with Ms Ahern’s CAPM results based on her exclusive use of the arithmetic mean. For two decades, we have repeatedly held that both the arithmetic and geometric means have their strengths and weaknesses, and neither is so clearly appropriate as to exclude consideration of the other. Cause Nos. 39713 / 39843 (IURC 8/10/1994), Order at 9, citing Indiana Cities Water, Cause No. 39166 (IURC 7/8/1992); Indiana Michigan Power, Cause 39314 (IURC 11/12/1993); Gary Hobart Water, Cause No. 39585 (IURC 12/1/1993). In our Order in Cause No. 43680 at 48, we again noted that the use of the arithmetic mean only increases the estimated risk premium (citing Cause No. 42029, Indiana American Water, (IURC 11/6/2002)) and we reiterated that “[t]he debate over the proper use of the arithmetic and geometric means is one we consider resolved.” 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. The Commission will continue to give both the geometric and arithmetic mean risk premiums substantial weight. We also have concerns that Ms. Ahern’s forecasted risk premium can produce unreasonable forecasted market returns.

With respect to Ms. Ahern’s Comparable Earnings approach, the Commission has carefully reviewed this model and Mr. Kaufman’s criticisms. We conclude that the approach as implemented by Ms. Ahern produces unreasonable results well above the results of all other models presented in this Cause, and we accordingly assign little weight to this approach.

The parties have submitted evidence that the cost of equity is within the range of 7.41% to 14.2%, and recommended a cost of equity ranging from 9.2% to 11.25%. We agree that a small utility premium of .20% is appropriate, and that including such a premium, find that, based on the evidence presented, the cost of equity for Utility Center should range from 8.9% to 10.14%.

As we noted in our August 25, 2010 Order in Cause No. 43526, a utility’s “operational and financial performance were appropriate considerations in determining a utility’s cost of equity.” Northern Ind. Pub. Serv. Co., Cause No. 43526, at 32 (Aug. 25, 2010). In Cause No. 43526, we found that customer service and customer satisfaction were criteria that “warranted some consideration in our ultimate cost of equity determination.” Id. Further, we stated that the “Commission has a unique role in regulating its jurisdictional utilities, which at times requires us to send a clear and direct message to utility management concerning the need for improvement in the provision of its utility service. Our determination of the authorized cost of common equity capital can be a very direct means to incent improved service.” Id.

In this Cause, there was substantial evidence, as documented by the consumer comments made at the field hearing and offered by the OUCC, that significant quality of service issues
remain in the Utility Center service territory. Customers continue to receive water that is rusty, or otherwise discolored, despite the ongoing efforts Utility Center has indicated it has made, or is making, to respond to those concerns. While we are mindful that the measures that Utility Center has taken may not have immediate results, we are concerned that Utility Center is not taking customer complaints seriously. Many of the customers stated that the water was not used, or unusable, for drinking or bathing.

Over the past ten years, Utility Center’s rates have included recovery on and of the acquisition adjustment addressed above. The acquisition adjustment represents the premium Utility Center paid to acquire the system from its prior ownership. While current management has made improvements to the utility system over that time period, we believe that customers should be able to recognize improvements in the finished product that they receive and for which they pay.

We have recognized a utility’s obligation to provide adequate service in exchange for recovery of investments through rates. See Twin Lakes Utilities, Inc., Cause No. 43128 S1, at 12 (Nov. 12, 2009) (“Commission would suggest that Petitioner reconsider its duty as a public utility to provide adequate service in exchange for receiving appropriate rate relief--Petitioner appears to be too focused on the second half of that equation.”) If Utility Center cannot provide water to its customers adequate for the purposes reasonably expected by its customers, it is this Commission’s responsibility to speak directly to the utility’s management, through our orders, to send a message that service must improve.

Having considered the evidence at issue, we find that Utility Center’s cost of equity shall be 9.60%. The Commission recognizes that a 9.60% return reflects a lower end of the range appropriate for Utility Center and that a higher return may be appropriate if Utility Center is able to demonstrate improved performance in its next rate case.

C. Debt Cost. Ms. Ahern testified that a long-term debt cost rate of 5.14% represented the cost rate of the allocated debt from the parent company to Aqua Indiana, Inc. and is appropriate for use in a cost of capital determination for Utility Center. According to Ms. Ahern, a long-term debt cost rate of 5.14% is conservative given the average yield of 5.73% for the three months ended January 2010 on Moody’s A rated public utility bonds; the prospective yield of 6.12% on Moody’s A rated public utility bonds; and in light of Utility Center’s small size which exacerbates its credit risk. The OUCC agreed that use of a 5.14% debt rate was appropriate.

D. Net Operating Income. Petitioner’s weighted cost of capital is as follows:

<table>
<thead>
<tr>
<th>Class of Capital</th>
<th>% of Total</th>
<th>% Cost</th>
<th>Weighted Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Term Debt</td>
<td>51.11%</td>
<td>5.14%</td>
<td>4.693%</td>
</tr>
<tr>
<td>Common Equity</td>
<td>48.89%</td>
<td>9.60%</td>
<td>7.320%</td>
</tr>
</tbody>
</table>

Having previously determined that Petitioner’s water and sewage disposal utilities are represented by their original cost rate bases of $24,612,895 and $31,583,010, respectively, the
Commission also finds that Petitioner’s weighted cost of capital is 7.320%. Applying that rate to the original cost rate bases for Petitioner’s water and sewage disposal utilities generates net operating income of $1,801,785 for the water utility and $2,312,032 for the sewage disposal utility.

8. **Operating Results at Present Rates.**

A. **Water Utility.**

(i) **Operating Revenues.** Petitioner and the OUCC are in agreement on Petitioner’s pro forma annual revenues at present rates, except in regard to one issue. They disagree on whether revenues received from allowing cellular telephone antennae to be placed on Petitioner’s water system facilities should be treated as “above the line” operating revenue.

The OUCC accounting witness Richard Corey adjusted revenues to include antennae rental income as above the line operating revenues, thereby reducing Utility Center’s revenue requirement. Mr. Corey explained that the OUCC’s review of Utility Center’s books and records showed Utility Center had received rental income for antennae installed on its water towers. Mr. Corey noted Utility Center had recorded this income “below the line” during the test year and did not reflect this income as an offset to its revenue requirements in this cause. Mr. Corey explained this income is derived from the use of assets included in Petitioner’s rate base, and Utility Center earns a return on and of its investment in this property. Therefore, any revenues derived from these assets should be reclassified “above the line” and reflected as an offset to revenue requirements. Thus, the OUCC maintained that Utility Center’s antenna rental income should be classified as operating revenue.

In its rebuttal case, Petitioner’s witness Robert A. Kopas stated that Utility Center has always reflected these revenues as a non-operating income “below the line” item. Mr. Kopas added that it is his understanding that the Commission has not required utilities to move this revenue above the line. Mr. Kopas stated that in Cause No. 40974-U (Riverside Water Company Inc.) the Commission affirmed the treatment of these types of non-operating income as “below the line.” Mr. Kopas noted the Commission stated that “rental income from cellular towers is not ‘used or useful in the provision of water utility services.’ Although the cellular tower rental does constitute income, it is erroneous to classify it as operating revenue.”

We note that under the Uniform System of Accounts, Account 472 is included in the classification of “Other Water Revenues.” Account 472 provides that “this account shall include rents received for the use by others of land, buildings and other property devoted to water operations by the utility.” We find that Petitioner’s rental income of $102,002 for antennae installed on its water towers is classified as operating revenue for ratemaking purposes. See also Riverside Water Co., Cause No. 42122 at 16.

Consequently, the Commission finds that Petitioner’s pro-forma annual revenue at present rates is $6,378,194.

(ii) **Operating Expenses.** Petitioner proposed in its case-in-chief pro forma operating expenses of $4,837,921. The OUCC, however, proposed total operating expenses of $4,791,135. The OUCC’s position reflected its acceptance of many of Petitioner’s
proposed adjustments to its test year expenses. Further, Petitioner accepted on rebuttal a number of the adjustments the OUCC had proposed in its case-in-chief. The pro forma adjustments on which there still is disagreement between Petitioner and the OUCC are addressed below.

(a) **Salaries and Wages.** Petitioner proposed to increase its test year payroll expenses by $50,419 while the OUCC proposed an increase of $22,926. The parties disagree regarding the appropriate merit increase, overtime and capitalization rates and the inclusion of a position filled after the end of the test year.

(1) **Merit Increase.** Both parties proposed a 3% merit increase in base wage rates. As discussed below, Petitioner’s adjustment also included adjustments to overtime and labor capitalization rates. OUCC witness Mr. Corey testified that, even though Petitioner’s stated merit increase was 3%, the actual increase it proposed to payroll expense was approximately 5.7%. In rebuttal, Mr. Estep stated there had been two, not just one, 3% wage increases since the beginning of the test year.

Ultimately, it is Petitioner’s burden to show that proposed adjustments are appropriate. Petitioner has not adequately explained the basis for including a second merit increase after increasing employee pay in the prior year. Therefore, we find that only one of the two 3% raises shall be included in rates to be recovered from ratepayers. Since a portion of the first 3% raise has been reflected in the test year for six months, we do not need to increase test year expenses by 3%. In order to annualize the first 3% merit increase, we find that adjusted test year payroll expenses should be decreased by 1.5% to derive “Payroll Costs Prior to The Merit Increase”. The 3% merit increase is then applied to the payroll costs prior to the merit increase to normalize the 3% merit increase that occurred during the test year.

(2) **Overtime and Capitalization Rates.** Mr. Corey noted that, although not stated in Petitioner’s case-in-chief, Petitioner’s pro forma payroll expense also included the assumption of a higher projected overtime rate and a lower labor capitalization rate. Mr. Corey further stated that Petitioner provided no support for the overtime and capitalized labor amounts reflected in its proposed adjustment. Petitioner’s witness Mr. Bobby D. Estep disagreed with Mr. Corey stating that Petitioner had provided the OUCC with a detailed schedule showing the capital and overtime labor amounts for each employee reflected in the adjustment.

Again, it is Petitioner’s burden to show that proposed adjustments are appropriate. Although Petitioner detailed the amount of adjustments for each employee, the basis for increasing overtime rates and decreasing capitalization rates was unclear. We find that Petitioner’s proposed adjustments to overtime and labor capitalization rates were not sufficiently supported and decline to make any adjustment.

(3) **New Position.** In its rebuttal case, Petitioner modified its proposed payroll adjustment to reflect the hiring of a financial analyst rather than the accounting clerk assumed in its case-in-chief. Mr. Estep further stated that Mr. Corey’s proposed adjustment, which relied on test year payroll expense, failed to reflect the filling of a new position within twelve months of the test year. We agree with Petitioner that the OUCC’s adjustment excluded the new position. The OUCC provided no explanation for this exclusion.
In its proposed order, the OUCC no longer excluded the position from its proposed revenue requirement. We accept this new position and its cost as reasonable.

(4) Summary. Based on the evidence presented, the normalization of the test year to reflect one 3% merit increase and the adjustment for the new financial analyst position resulted in a payroll adjustment of $31,580. The amount of Petitioner’s pro forma salary and wages expense is $564,814.

(b) Pensions and Benefits. Petitioner proposed to adjust its test year employee benefit expense by $56,249 to reflect increased level of benefit expenses. The OUCC, however, proposed to adjust test year employee benefit expenses by $38,432. Mr. Corey explained that the difference between the two proposals is primarily due to an arithmetic error in Petitioner’s workpaper WP-C2.12 (Exhibit RAK-2). He explained this document lists the pro forma amount to be paid to each employee and the amount net of capitalized benefits. This yielded a net benefit that is then allocated among Utility Center Water, Utility Center Wastewater, other Aqua Indiana utilities, and Indiana administrative functions of Aqua Indiana. Mr. Corey stated that the totals of the benefits listed, less the capitalized benefits, total $302,569, not $322,371 as indicated by Petitioner in WP-C2.12. Petitioner’s witness, Mr. Estep acknowledged the error but disagreed the $19,802 should be distributed to water and wastewater equally. He testified that once the correction is made it should result primarily in an expense decrease to sewer.

In addition to correcting this error, the OUCC calculated current health insurance premiums based upon the May 2010 Blue Cross Invoice, which was the most recent insurance premium invoice available. In his rebuttal testimony, Mr. Estep responded that Petitioner’s health insurance benefit not only reflects the Blue Cross premiums, but also includes costs related to an employee prescription drug plan. According to Mr. Estep, the Company self-funds the prescription drug plan so there were no invoices for the OUCC to examine. However, Mr. Estep asserted the prescription drug plan and Blue Cross cost were reflected in Petitioner’s proposed adjustment. Also, Mr. Estep stated that the OUCC assumed an across the board employee contribution of 20% to health care costs, but in actuality, employee contributions vary in amounts ranging from 15% to 25% based on the employee’s pay grade. Mr. Estep stated that the average employee contribution is 17.66%.

We find that Petitioner’s corrected pro forma benefit expense should be approved. In light of the evidence presented, the Commission finds that employee benefits expense should be increased by $56,249. The amount of Petitioner’s pro forma employee benefits expense is $98,095.

(c) Contractual Services – Management Fees. Petitioner proposed an adjustment of $47,109 to reflect increases in the fees it pays for services from certain affiliated companies. The OUCC did not dispute the appropriateness of such fees, but it contended that the adjustment should be limited to $6,941, which reflects the same 3% increase it proposed to make to Petitioner’s test year payroll expense. Petitioner’s witness Robert Kopas disagreed with the OUCC’s proposed adjustment first pointing out that, as was the case with payroll expense, the OUCC failed to recognize there have been two wage increases since the beginning of the test year, not just one. Mr. Kopas also testified that the OUCC’s adjustment
failed to reflect, as Petitioner’s pro forma amount does, a net increase in positions due in part to the filling of vacancies reflected in the test year.

Mr. Kopas also testified concerning the basis for Petitioner’s proposed adjustment for management fees. According to Mr. Kopas, increases in labor-related expenses of the type the OUCC has accepted with regard to employee benefits contribute to the increase in management fees, as do increases in necessary non-labor related costs such as satisfying International Financial Reporting Standards and Sarbanes-Oxley compliance. Mr. Kopas also testified that Petitioner’s proposed adjustment for management fees reflects an updated and more accurate allocation to Aqua Indiana of services and sundry charges based on an updated customer count. Lastly, Mr. Kopas noted that Petitioner had provided support for this allocation to the OUCC.

As previously stated with respect to payroll, we find Petitioner has failed to justify the reasonableness of successive increases in management fees. Therefore, we will increase the test year amounts by 1.5% to normalize for the wage increase reflected in the test year. To the extent Petitioner’s adjustment accounted for the filling of vacancies, we are unable to reflect that change given the lack of detail provided in the workpapers that were filed. Based on the total test year Management Fees reflected in the OUCC’s rate schedules, we find that an adjustment of $3,471 is appropriate. The amount of Petitioner’s pro forma contractual services-management fees expense is $197,987.

(d) Contractual Services – Other. Petitioner used this account to reflect an adjustment to its test year expenses reflecting implementation of the Meritage project discussed above. In this regard, Petitioner proposed an increase to its test year expenses of $23,741 to reflect the net effect of the cost increases and decreases associated with implementing the Meritage project. The OUCC, however, proposed a reduction to Petitioner’s proposed adjustment of $38,779 in order to reflect employee costs associated with two customer service representative positions in Petitioner’s Fort Wayne offices that, according to Mr. Corey, should not be the responsibility of Petitioner’s customers. However, according to Mr. Kopas and Mr. Etzler the positions the OUCC believes should not be reflected in Petitioner’s pro forma expenses are not call center customer service representatives like those that work in the regional call centers that are part of the Meritage project. They are needed as a critical liaison between operations and customer service activities.

According to Mr. Etzler, the transition of functions to the regional customer call centers through implementation of the Meritage project was and is to provide better management of similar functions over the entire company: bill processing; handling billing questions; coordinating customer move-in / move-out; and payment processing. Mr. Etzler testified, however, that there were still significant customer needs that have to be managed at the local office. Mr. Etzler stated that the local office staff handle permits for new home sewer and water connections; work with developers on new subdivision construction, i.e., processing construction drawings, submitting IDEM construction permits, managing developer contracts; processing home owner agreements and payments for its construction loan program; meter rentals and service billing for contractors; coordinate utility locate requests; coordinate and dispatch service orders to field technicians; coordinate service shut offs and turn-ons; handle emergency calls; coordinate meter repairs and replacements; download and analyze meter route notes to create service orders for meter and MXU testing, repair, or replacement; and assist customers that come into the office. Mr. Etzler stated that the work required to handle these functions requires a
supervisor and part time person to effectively manage these processes and therefore will be a continuing responsibility for the local office.

Based on Mr. Kopas’ and Mr. Etzler’s detailed explanation of the need for the positions that the OUCC effectively seeks to eliminate from Petitioner’s costs, the Commission finds that Petitioner’s proposed adjustment of $23,741 associated with the implementation of the Meritage project is reasonable and should be accepted without reduction. Together with an uncontested adjustment of $41,000 associated with well cleaning, the pro forma adjustment for contractual service-other should be $64,741, with the resulting pro forma expense being $178,612.

(e) Rate Case Expense. Petitioner’s and the OUCC’s respective cases-in-chief show a disagreement over the amount of unamortized rate costs from Cause No. 43331 to be included in rate case expenses in this Cause. Mr. Corey testified that the OUCC’s adjustment reflects the balance of unamortized rate case expense from Cause No. 43331 as of June 30, 2010. On rebuttal, Mr. Kopas accepted the OUCC’s position on this issue. While the OUCC did not dispute the total amount of rate case expense proposed for this case, it did disagree with Petitioner on the proper period over which that amount should be amortized. The OUCC argued rate case expense should be amortized over 5 years, which results in an adjustment to test year expense of $11,832. Petitioner’s proposed amortization period of 3.5 years results in an adjustment of $52,573.

Mr. Corey stated that the OUCC proposed a 5-year amortization period because it is more representative of the life of the rates being set and the time within which Petitioner could be expected to initiate its next rate case. In his rebuttal testimony, Mr. Kopas, responded that Utility Center’s proposed 3.5-year amortization period was more representative of the life of the rates to be set in this Cause. According to Mr. Kopas, Utility Center still is faced with the need to make significant improvements to its water and wastewater systems, which he says makes it more likely that Utility Center will have to seek another rate increase sooner than 5 years in the future. Mr. Kopas also asserted history supported the use of a 3.5-year period. Utility Center’s current rates were approved by the Commission’s August 27, 2008 Order in Cause No. 43331, approximately 2.5 years before the procedural schedule adopted in this Cause called for the Commission to enter its Final Order.

We find that 3.5 years is a better approximation of the life of Utility Center’s prospective rates for purposes of determining the amortization of Petitioner’s rate case expense. Further, with respect to the unamortized rate case expense remaining from Cause No. 43331, we calculated the balance remaining as of the date of this Order, versus June 30, 2010.

Based on the evidence presented, the adjustment to test year regulatory expense shall be $28,568. The resulting pro forma expense is $82,074.

(f) Miscellaneous Expense. As part of its miscellaneous expense account Petitioner proposes to remove from its test year expenses certain public relations expenses, as well as certain other expenses identified by the OUCC. The amount of this undisputed reduction in test year expense is $57,740. Petitioner also proposes to adjust other test year expenses related to certain intercompany costs recorded as part of its miscellaneous account. The amount of Petitioner’s proposed additional adjustment to the test year expenses in this
account is $11,659. While the OUCC does not disagree with reflecting this type of expense in Petitioner’s rates, it disagrees with the amount of Petitioner’s proposed additional adjustment. Instead of $11,659, the OUCC proposes the adjustment be limited to $3,223. This amount reflects the same 3% increase in test year expenses the OUCC proposed in other contexts discussed above.

As reflected in Mr. Kopas’ testimony, Petitioner’s opposition to the OUCC’s proposed adjustment rests on the same basis as its objection to the adjustment proposed for contractual services-management fees. Further, Petitioner provided as part of its rebuttal evidence a detailed breakdown of the expenses it anticipates incurring and which are reflected in its proposed adjustment.

In light of prior findings and the information provided by Petitioner in support of its proposed adjustment, we find that the adjustment related to the intercompany costs covered in Petitioner’s miscellaneous account should be $11,659, which when combined with the undisputed adjustment to the balance of the costs reflected in that account result in a total reduction in test year miscellaneous expense of ($46,081) and pro forma expense at present rates of $804,897.

(g) Uncollectible Account Expense. The Parties expressed agreement as to the appropriate bad debt percentage to be used but disagreed about what revenues this percentage should be applied to in order to calculate the pro forma expense adjustment. Petitioner applied the bad debt percentage to total operating revenues while the OUCC only applied the bad debt percentage to water revenues (including late fees), excluding miscellaneous revenues. We note that Petitioner should be experiencing little or no uncollectible account expense related to miscellaneous revenues which consist primarily of non-recurring fees. These fees are collected for particular services provided to the customer, i.e., after hours service, and for which the service will not be provided absent payment. We find that the proper pro forma adjustment should be based only on water revenues which yield an increase of $11,532 with the resulting pro forma expense being $23,842.

(h) Depreciation Expense. Petitioner’s and the OUCC’s proposals concerning depreciation expense are very close. Petitioner proposes an adjustment to test year depreciation expense of $78,194. The OUCC, on the other hand, proposes an adjustment of $77,596. The Commission accepts the OUCC’s adjustment for Petitioner’s former billing system. Therefore, including the updated cost to be included in rates associated with Petitioner’s major projects, Petitioner’s pro-forma depreciation expense should increase by $77,245. The resulting pro-forma expense is $769,461.

(i) Taxes Other than Income. A major point of disagreement between Petitioner and the OUCC as expressed in their respective cases-in-chief related to the proper adjustment to be made for property taxes. Both parties agreed to base the adjustment on updated property tax information (2009 taxes payable in 2010). However, the OUCC also excluded expenses associated with certain properties it said were not related to Utility Center and calculated a different test year property tax expense. At the October 5 hearing, Mr. Corey expressed the OUCC’s agreement with Petitioner’s position regarding these outstanding issues. Accordingly, the proper adjustment to be made to Petitioner’s test year property tax expense is a reduction of $2,596. The resulting pro forma expense is $458,997.
The parties agree with the methodologies to be used to calculate the other items covered by taxes other than income; namely the utility receipts tax, public utility fee and payroll taxes. However, the determinants used to calculate the appropriate adjustments for those expense items are based on our findings above. Therefore, based on the findings above, the Commission finds that the following adjustments should be made to the corresponding test year expenses:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utility Receipts Tax</td>
<td>$23,080</td>
</tr>
<tr>
<td>Public Utility Fee</td>
<td>$3,481</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>$2,539</td>
</tr>
</tbody>
</table>

With these adjustments, Taxes Other Than Income at present rates is $621,380.

(j) **State and Federal Income Taxes.** Mr. Kopas expressed Petitioner’s general agreement with the methodology used by the OUCC to calculate state and federal income taxes. However, as Mr. Kopas noted, the parties disagree on the amount of the determinants reflected in the synchronized interest calculation, i.e., rate base amount and the weighted cost of debt. When the amounts for those determinants found above are used, synchronized interest becomes $646,594 and the adjustments to Petitioner’s state and federal income tax expenses become $33,014 and $76,376, respectively. The total pro forma expense at present rates attributable to state and federal income taxes are $143,406 and $494,620, respectively.

(iii) **Water Utility’s NOI under Present Rates.** Based upon the foregoing findings, we find Petitioner’s pro-forma net operating income under present rates to be as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Revenues</td>
<td>$6,378,194</td>
</tr>
<tr>
<td>O&amp;M Expenses</td>
<td>$2,742,587</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>769,461</td>
</tr>
<tr>
<td>Acq. Adj. Amortization</td>
<td>62,346</td>
</tr>
<tr>
<td>Taxes other than Income</td>
<td>621,380</td>
</tr>
<tr>
<td>State Income Taxes</td>
<td>143,406</td>
</tr>
<tr>
<td>Federal Income Taxes</td>
<td>494,620</td>
</tr>
</tbody>
</table>

Total Operating Expense $4,833,800

Net Operating Income $1,544,394

We further find that the net operating income available to Petitioner for return under its present rates for water utility service of $1,544,394 is insufficient to provide a fair return on the fair value of its properties used and useful in providing water service for the convenience of the public, and is therefore unjust and unreasonable and should be increased.
B. Sewage Disposal Utility.

(i) **Operating Revenues.** Petitioner and the OUCC are in agreement concerning Petitioner’s pro forma annual revenues at present rates and the Commission finds Petitioner’s pro forma annual revenues at present rates are $7,296,467.

(ii) **Operating Expenses.** Petitioner proposed in its case-in-chief pro forma operating expenses of $5,437,882. The OUCC, however, proposed total operating expenses at present rates of $5,266,712. The OUCC’s position reflected its acceptance of many of Petitioner’s proposed adjustments to its test year expenses. On rebuttal, Petitioner accepted a number of the adjustments the OUCC had proposed. The pro forma adjustments on which there still is disagreement between Petitioner and the OUCC are addressed below.

(a) **Salaries and Wages.** For the reasons set forth in Finding No. 8(A)(ii)(a) above, the proper proposed pro forma adjustment amount is $31,957, with the resulting pro forma expense being $601,786.

(b) **Pensions and Benefits.** For the reasons set forth in Finding No. 8(A)(ii)(b) above, the proper proposed pro forma adjustment amount is $36,855, with the resulting pro forma expense being $93,952.

(c) **Contractual Services – Management Fees.** For the reasons set forth in Finding No. 8(A)(ii)(c) above, the proper proposed pro forma adjustment amount is $3,460, with the resulting pro forma expense being $197,471.

(d) **Contractual Services – Other.** For the reasons set forth in Finding No. 8(A)(ii)(d) above, the proper proposed pro forma adjustment amount is $28,345, with the resulting pro forma expense being $152,482.

(e) **Regulatory Expense.** For the reasons set forth in Finding No. 8(A)(ii)(e) above, the proper proposed pro forma adjustment amount is a reduction of $6,506, with the resulting pro forma expense being $89,632.

(f) **Miscellaneous Expense.** For the reasons set forth in Finding No. 8(A)(ii)(f) above, the proper proposed pro forma adjustment amount is a reduction of $36,503, with the resulting pro forma expense being $842,425.

(g) **Uncollectible Expense.** For the reasons set forth in Finding No. 8(A)(ii)(j) above, the proper pro forma adjustment amount is $16,351, with the resulting pro forma expense being $28,652.

(h) **Depreciation Expense.** For the reasons set forth in Finding No. 8(A)(ii)(h) above, the proper proposed pro forma adjustment amount is $21,232, with the resulting pro forma expense being $1,082,037.
(i) **Taxes Other than Income.** For the reasons set forth in Finding No. 8(A)(ii)(i) above, the proper proposed pro forma adjustments are as follows:

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utility Receipts Tax</td>
<td>$21,922</td>
</tr>
<tr>
<td>IURC Fee:</td>
<td>$2,128</td>
</tr>
<tr>
<td>Property Tax:</td>
<td>$18,455</td>
</tr>
<tr>
<td>Payroll Tax:</td>
<td>$6,975</td>
</tr>
</tbody>
</table>

With these adjustments, Taxes Other than Income at present rates is $576,722.

(j) **State and Federal Income Taxes.** For the reasons set forth in Finding No. 8(A)(ii)(j) above, the synchronized interest is $829,703 and the adjustments to Petitioner’s state and federal income tax expenses become $69,081 and $204,917, respectively. The total pro forma expense at present rates attributable to state and federal income taxes are $178,118 and $617,321, respectively.

(k) **Deferred Legal Expense.** Utility Center initially requested the Commission approve the deferral of approximately $437,246 in legal fees and costs it has incurred as a regulatory asset and authorize Utility Center to amortize such legal expenses over a period of ten years. The resulting amortization would equate to $43,725 per year. Petitioner would reflect the annual amortization among its operating expenses for purposes of setting the recurring monthly rates and charges proposed in this Cause and for purposes of future base rate proceedings. Subsequent to the filing of its case-in-chief, however, Petitioner determined that the full amount of the legal fees and costs that it had incurred was approximately $509,661, but indicated that such higher amount should be allowed to be amortized over a slightly longer period of time, i.e., 11.66 years, in order to maintain the annual amortization amount at $43,725 as originally requested.

(1) **Petitioner’s Testimony.** Petitioner’s Witness, Mr. William Etzler, explained these legal expenses were incurred by Utility Center stemming from the action of two homeowner associations in Allen County, which had been attempting to have Utility Center prematurely shut down its Main Aboite WWTP based upon their claim that Utility Center previously agreed to such plant’s closing in 2000. Mr. Etzler noted that Utility Center contested the position of those associations and initiated a proceeding, Cause No. 43666, to obtain a determination from the Commission of the appropriateness of shutting down the Main Aboite WWTP. Mr. Etzler stated these associations also filed a lawsuit against Utility Center in a state court relating to the same alleged agreement. Mr. Etzler explained that all of the legal costs reflected in Utility Center’s proposed deferral relate to the dispute and substantially all were incurred by it in connection with Cause No. 43666. At the time Utility Center filed its case-in-chief, the dispute was pending resolution through mediation and without the need for Utility Center to shut down the Main Aboite WWTP. Subsequently, as reflected in the Commission’s Order issued in Cause No. 43666, Utility Center agreed to pay $2.6 million to these homeowners associations and further agreed that “the 2000 Agreement is valid and enforceable as now amended.”

Mr. Etzler testified that the deferral proposal is appropriate because Utility Center’s Main Aboite WWTP is essential to the continued, cost-effective provision of sewer utility service to
the public in Allen County’s Aboite Township. He added that the expansion and improvement of the Main Aboite WWTP has been part of Utility Center’s master plan for its sewer utility operations which was approved by the Commission pursuant to its August 31, 2005 Order in Cause No. 41187. Further, he noted that if Utility Center were required to shut down the Main Aboite WWTP, Utility Center would incur substantial expense to provide for the treatment of wastewater flows now handled by the Main Aboite WWTP. Thus, he asserted successful efforts to keep that plant in operation will confer a substantial benefit on its sewer utility ratepayers.

(2) OUCC’s Responsive Testimony. OUCC witness Richard Corey testified that the requested regulatory treatment for these legal expenses was associated with the facts described in Cause No. 43666. Mr. Corey also attached to his testimony the petition initiating that Cause. Mr. Corey stated these legal expenses resulted from a unique situation, which is unlikely to reoccur. Consequently, he asserted that such expenses are not representative of a normal expense during the test year and therefore should be excluded from Petitioner’s operating expenses as a non-recurring expense item for which extraordinary deferral treatment has been requested.

Mr. Corey testified that the legal expenses were incurred by Petitioner during its efforts to oppose the closing of the Main Aboite WWTP and seek a Commission determination as to whether the agreement entered into between Utility Center, Woodland Ridge and Hamlets West Homeowners Associations (“HOAs”) should be authorized by the Commission. Mr. Corey noted the litigation resulted in a settlement between the utility and the HOAs and relieved Aqua Indiana of any obligation to close the Main Aboite WWTP. In turn, this settlement provided monetary compensation for the associations’ members by Utility Center and assurances that the parties would be able to work together to address various aesthetic, odor, noise and public health concerns related to the WWTP. Mr. Corey further noted that in the settlement Utility Center agreed that the cash payment to the HOAs would not be recovered in rates.

Mr. Corey acknowledged the settlement did not foreclose Utility Center’s ability to ask for the recovery of its legal expenses in this rate case. However, Mr. Corey maintained that Petitioner should not be authorized to recover these legal expenses in its rates. Mr. Corey testified that if the utility entered into an agreement to shut down a plant that it now describes as “essential to the company’s ability to provide wastewater utility service,” then the utility’s actions in entering into such an agreement should be considered imprudent and any expense caused by such action should not be borne by the ratepayers. Mr. Corey stated that in the OUCC’s testimony in Cause No. 43666, it also asserted that such an agreement by the utility should be considered imprudent. Thus, he testified that ratepayers should not be required to pay for costs incurred due to the lack of diligence or imprudence on the part of utility management. Mr. Corey added that, since ratepayers have no control over management’s behavior, they should not be responsible to pay for the consequences of management’s inaction or imprudent decisions. Mr. Corey further referred to a Commission decision rendered in a previous base sewer rate proceeding involving South Haven Sewer Works in Cause No. 41903, addressing similar issues. Mr. Corey stated that the Commission in that proceeding disallowed that utility’s claim for the recovery of attorney’s fees incurred by that utility relating to an investigation by the Commission in response to deficiencies in the management and operation of that utility.
Mr. Corey also testified that another aspect of Utility Center’s actions argues against recovery of these expenses. He explained that Utility Center’s underlying premise for its Petition in Cause No. 43666 was that the agreement to close the Aboite treatment plant would constitute an encumbrance under Indiana Code sections 8-1-2-83 and 84, requiring Commission approval before any of its utility plant can be encumbered. He stated that if Utility Center had agreed to close its Aboite treatment plant, it should have sought Commission approval for such an encumbrance at the time it sought to enter into such an agreement, not approximately ten years later when the closing was set to occur. Mr. Corey stated that Utility Center’s delay in seeking this authority resulted in much controversy and litigation expense. He reiterated the principle that ratepayers should not be required to bear the cost of the inaction or imprudent decisions of the managers of the utility.

(3) Petitioner’s Rebuttal Testimony. In Petitioner’s rebuttal case, Utility Center’s witness Mr. Kopas stated that legal fees and costs are part of doing business for any utility and are typically included in the normal course of a rate case proceeding. As Mr. Kopas noted, in this instance the legal fees and costs emanated from disputed claims just like other customer complaints and lawsuits often are and the Petitioner is under no obligation to defend itself. Mr. Kopas stated that not defending itself in this instance, however, would have resulted in even greater costs to ratepayers in constructing a significantly more expensive and new wastewater treatment plant. Mr. Kopas drew a distinction between legal fees and costs incurred to prosecute or defend a legal action and the costs incurred as a result of the outcome of the action. Here, he noted, Petitioner is not seeking to recover through rates any part of the substantial costs it has and will incur as part of its settlement with the homeowner associations. Rather, he said Petitioner is only seeking to recover those legal fees and expenses that were incurred in order to achieve that settlement.

Mr. Kopas noted that Petitioner initially proposed an annual amortization of $43,725. He also stated that the amount of legal fees reflected in the rates currently being paid by its wastewater customers annually is $44,748. Thus, the Company’s proposed legal expense in this Cause is slightly less than that which was reflected and recognized in the Company’s prior rate case test year of March 31, 2007. Mr. Kopas testified that in light of the higher amount of deferred legal expense now requested ($509,661), the Company is willing to accept an amortization of the full amount of its legal costs associated with the claim over a longer period in order to keep the proposed annual amortization at $43,725. Mr. Kopas also asserted that Utility Center’s legal expense is fairly constant from year to year, indicating that from 2004 through 2008 the five year average was $50,675. Mr. Kopas stated that the recent legal expense suggests that the nature of operating this wastewater system brings with it numerous typical as well as unforeseen issues which require incurring a reasonable level of legal expenses of no less than the $43,725 annually, which the Company now proposes to recover on a pro forma basis in this proceeding.

(4) Commission Finding on Deferred Legal Expense. Petitioner’s case-in-chief did not propose to reflect in its rates any level of on-going legal expense aside from those related to the disputes over the Main Aboite WWTP. Rather, in its rebuttal case, Mr. Kopas asserted Petitioner’s average legal expense from 2004 through 2008 was $50,675. Mr. Kopas also explained that the amount of legal fees reflected in current rates being paid by its wastewater customers is $44,748.
With respect to the legal expenses associated with the Aboite settlement, we do not dispute that the Aboite treatment plant is essential to Utility Center’s operations and that it is appropriate for Utility Center to endeavor to take action to continue its operations. However, in determining whether the expenditures confer a benefit on the ratepayers so as to justify the creation of a regulatory asset, one must look at the claimed expense in a larger context. The legal expenses were incurred because of a contract Utility Center was alleged to have entered into in the year 2000 and which was said to have required Utility Center to decommission the Aboite WWTP by a date certain.

In Cause No. 41903, the Commission was similarly asked to decide whether attorney fees incurred by the utility in a commission investigation should be treated as a regulatory asset. In that case, we declined to allow such treatment and noted mismanagement by the utility:

“...the issue before the Commission is whether the utility should be permitted to recover costs for an investigation that was begun in response to deficiencies in the management and operating of the utility. The answer is no. The ratepayers should not be penalized for the mistakes of the utility’s management. In addition...if we were to allow Petitioner to recover the costs of the investigation, Petitioner’s management would have less incentive to operate its utility in a responsible manner.” (emphasis added)

*South Haven Sewer Works, Inc.*, Cause No. 41903, at 20 (IURC Jan. 5, 2002).

Aside from agreeing to “prematurely” shut down the operation of the Aboite Wastewater Treatment Plant, another aspect of Utility Center’s mismanagement was its failure to seek Commission approval of the encumbrance it was putting on its plant in 2000 when it apparently entered into the agreement with the homeowners’ associations. While not readily acknowledging having signed the 2000 Agreement, the underlying premise of Cause No. 43666 was Utility Center’s position that the agreement to shut down its Aboite WWTP was an encumbrance that only could be effective if approved by the Commission. OUCC witness Corey stated, and we agree, that if Utility Center had agreed to close its Aboite treatment plant, it should have sought Commission approval for such an encumbrance at the time it sought to enter into such an agreement, not approximately ten years later when the closing was to have occurred. We also agree with Mr. Corey that Utility Center’s delay in seeking this authority resulted in much controversy and litigation expense that Utility Center now seeks to recover as a regulatory asset. Utility Center’s ratepayers should not be required to bear the cost of the inaction or imprudent decisions of the managers of this utility.

According to Utility Center, it incurred approximately $500,000 in legal fees and costs to confer on its ratepayers the benefit of not having a functioning treatment plant removed from service. This expense is separate and apart from the $2.6 million Utility Center agreed to pay in order to enable it to continue to operate this plant. Petitioner noted it does not seek to recover the $2.6 million from its customers. More specifically, Mr. Kopas noted Petitioner is not seeking to recover through rates any part of the substantial costs it has and will incur as part of its settlement with the homeowner associations. Rather, Petitioner is only seeking to recover those legal fees and expenses that were incurred in order to achieve that settlement. In taking such a
position, Petitioner implicitly acknowledges the inappropriateness of charging its customers $2.6 million for a poor decision made by its management. But Petitioner fails to explain why the litigation costs incurred to reach that settlement should not also be considered inappropriate to recover from its ratepayers. Both sets of costs are a result of Utility Center’s unwise decision making and its failure to act in a timely manner.

The Commission hereby denies Petitioner’s request to treat its legal fees incurred as a result of litigation surrounding its 2000 Agreement as a regulatory asset.

(iii) Sewage Disposal Utility’s NOI under Present Rates. Based upon the foregoing findings, we find Petitioner’s pro-forma net operating income under present rates to be as follows:

<table>
<thead>
<tr>
<th>Operating Revenues</th>
<th>$7,296,467</th>
</tr>
</thead>
<tbody>
<tr>
<td>O&amp;M Expenses</td>
<td>$2,814,237</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>1,082,037</td>
</tr>
<tr>
<td>Acq. Adj. Amort.</td>
<td>76,080</td>
</tr>
<tr>
<td>Taxes Other than Income</td>
<td>576,723</td>
</tr>
<tr>
<td>State Income Taxes</td>
<td>178,118</td>
</tr>
<tr>
<td>Federal Income Taxes</td>
<td>617,321</td>
</tr>
<tr>
<td>Total Operating Expense</td>
<td>$5,344,515</td>
</tr>
<tr>
<td>Net Operating Income</td>
<td>$1,951,952</td>
</tr>
</tbody>
</table>

We further find that the net operating income available to Petitioner for return under its present rates for wastewater utility service of $1,951,952 is insufficient to provide the return required, and is therefore unjust and unreasonable and should be increased.

9. Authorized Rate Increase.

A. Water Utility. Petitioner should be permitted to increase its rates and charges to produce additional operating revenues of $435,077, or 7.18%, to produce total annual operating revenues of $6,813,271 and net operating income of $1,801,785:

| Total Operating Revenues | $6,813,271 |
| Less: |        |
| O&M Expenses | 2,744,300 |
| Depreciation & Amortization | 831,807 |
| Taxes Other than Income | 627,965 |
| Income Taxes | 807,413 |
| Total Operating Expense | $5,011,485 |
| Net Operating Income | $1,801,785 |

The determinations in the preceding table reflect the effect of additional revenue on federal and state income taxes, Utility Receipts Tax, Bad Debt Expense and the IURC Fee.
The calculation of Utility Center’s water utility authorized percent increase is depicted below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Original Cost Rate Base</td>
<td>$24,612,895</td>
</tr>
<tr>
<td>Times: Weighted Cost of Capital</td>
<td>7.320%</td>
</tr>
<tr>
<td>Required Net Operating Income (NOI)</td>
<td>1,801,785</td>
</tr>
<tr>
<td>Less: Adjusted NOI at Current Rates</td>
<td>1,544,394</td>
</tr>
<tr>
<td>Net Revenue Requirements</td>
<td>257,392</td>
</tr>
<tr>
<td>Times: Revenue Conversion Factor</td>
<td>1.69033</td>
</tr>
<tr>
<td>Net Revenue Increase</td>
<td>$435,077</td>
</tr>
<tr>
<td>Required Percentage Increase</td>
<td>7.18%</td>
</tr>
</tbody>
</table>

B. Sewage Disposal Utility. Petitioner should be permitted to increase rates and charges to produce additional operating revenues of $608,653, or 8.36%, to produce total annual operating revenues of $7,905,120 and net operating income of $2,312,032:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Operating Revenues</td>
<td>$7,905,120</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>O&amp;M Expenses</td>
<td>2,816,633</td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>1,158,117</td>
</tr>
<tr>
<td>Taxes Other Than Income</td>
<td>585,934</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>1,032,405</td>
</tr>
<tr>
<td>Total Operating Expense</td>
<td></td>
</tr>
<tr>
<td>Net Operating Income</td>
<td></td>
</tr>
</tbody>
</table>

The determinations in the preceding table reflect the effect of additional revenue on federal and state income taxes, Utility Receipts Tax, Bad Debt Expense and the IURC Fee.

The calculation of Utility Center’s wastewater utility authorized percent increase is depicted below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Original Cost Rate Base</td>
<td>$31,583,010</td>
</tr>
<tr>
<td>Times: Weighted Cost of Capital</td>
<td>7.320%</td>
</tr>
<tr>
<td>Required Net Operating Income (NOI)</td>
<td>2,312,032</td>
</tr>
<tr>
<td>Less: Adjusted NOI at Current Rates</td>
<td>1,951,952</td>
</tr>
<tr>
<td>Net Revenue Requirements</td>
<td>360,080</td>
</tr>
<tr>
<td>Times: Revenue Conversion Factor</td>
<td>1.69033</td>
</tr>
<tr>
<td>Net Revenue Increase</td>
<td>$608,653</td>
</tr>
<tr>
<td>Required Percentage Increase</td>
<td>8.36%</td>
</tr>
</tbody>
</table>

C. Ultimate Finding. Based on the evidence and giving appropriate weight to the need for Petitioner to discharge its public duties and to earn a return commensurate with that earned by enterprises of corresponding risk, the Commission finds that rates estimated to produce the results described in Finding No. 9(A) and (B) are just and fair and should allow
Petitioner the opportunity to earn a reasonable return on its property dedicated to providing water and sewage disposal utility services to the public.

10. **Minimum Charge and System Development Charge.** In regard to the minimum usage charge provision, the OUCC recommended that the Commission require Petitioner to perform a rate design study as part of its next rate case. As part of the study, the OUCC recommended that Petitioner compare its current minimum usage with new minimums, so that the Commission and the OUCC can determine how a particular customer would be affected. While agreeing with the OUCC’s recommendation that a rate design study be performed, Intervenor suggested it should be made the subject of a sub-docket proceeding in this Cause.

Petitioner’s witness William Etzler expressed Petitioner’s agreement with the OUCC’s recommendation that it conduct a rate design study of the type the OUCC’s witness Roger Pettijohn described in his testimony. Mr. Etzler was of the opinion that through such a study, the advantages and disadvantages of moving away from the use of a minimum usage charge can be properly assessed. Mr. Etzler, however, disagreed with Intervenor’s suggestion that the rate design study become the subject of a sub-docket in this proceeding. Mr. Etzler testified that given where this case is, conducting a sub-docket proceeding did not make sense.

The Commission agrees with the OUCC’s recommendation and finds no reason to accept the Intervenor’s suggestion. Petitioner should perform a rate design study to be filed as part of its next rate case. As part of the study, Petitioner should compare its current minimum usage with new minimums to determine how a particular customer would be affected by a new minimum usage charge.

Intervenor’s Witness Mr. Nitza also recommended that Petitioner should propose a System Development Charge in its next rate case, and Mr. Etzler agreed, although he stated that the implementation of a System Development Charge would not have affected Utility Center’s need for rate relief in this proceeding. We find that Petitioner shall establish a System Development Charge in its next rate case. Petitioner may also utilize the Commission’s 30-day filing process to establish a System Development Charge.

11. **Rules and Regulations.** As part of the relief requested in this Cause, Petitioner has asked that the Commission approve for use the revised Rules and Regulations appearing as Petitioner’s Exhibits WLGE-9 and WLGE-10. According to Mr. Etzler, Utility Center’s current Rules and Regulations have only been amended once since their original approval in the 1980s and the proposed Rules and Regulations reflect a wholesale revision of the current Rules and Regulations. In addition to bringing Petitioner’s current Rules and Regulations current with Commission requirements and the needs of Petitioner’s customers, Mr. Etzler stated that the differences between Petitioner’s current and proposed Rules and Regulations reflect a reformatting, an update of definitions and corrections to typographical errors and omissions.

Intervenor’s witness Mr. Nitza suggested that the Commission create a sub-docket proceeding in this Cause in order to consider Petitioner’s proposed Rules and Regulations. Mr. Etzler disagreed, however, and testified that a sub-docket proceeding was unnecessary. Mr. Etzler pointed out that Utility Center’s proposed Rules and Regulations, reflect provisions that
the Commission has already approved or the requirements of Commission-promulgated regulations. According to Mr. Etzler, the starting point used by Utility Center to prepare its proposed Rules and Regulations were the rules and regulations approved by the Commission’s June 19, 2002 Order in Cause No. 42190 for Consumers Indiana Water Company (“Consumers”), an affiliate of Utility Center providing service in Lake County, Indiana. Since Consumers’ Commission-approved Rules and Regulations were the starting point for Utility Center’s own proposed Rules and Regulations a great many of the provisions in each are identical.

Mr. Etzler also pointed out that, while containing many identical provisions, Utility Center’s proposed Rules and Regulations do not reflect a wholesale adoption of Consumer’s Rules and Regulations. According to Mr. Etzler, Utility Center’s proposed Rules and Regulations also incorporate provisions from its existing Commission-approved Rules and Regulations. By way of an example, Mr. Etzler identified Section 8 of the proposed Rules and Regulations for Water Service and Section 6 of the proposed Rules and Regulations for Sewer Service, which are identical to provisions of Utility Center’s existing Rules and Regulations approved by the Commission on March 11, 2009. Mr. Etzler also pointed out that some portions of Utility Center’s proposed Rules and Regulations follow current regulations of the Commission. As an example of this, Mr. Etzler identified Section 7 of the proposed Rules and Regulations for Water Service and Section 5 of the proposed Rules and Regulations for Sewer Service, both of which deal with main extensions and track the Commission’s regulations on the subject.

Mr. Etzler was of the opinion that, given that the provisions of the proposed Rules and Regulations have been approved by the Commission at one time or another, a sub-docket was not needed to consider the appropriateness of the proposed Rules and Regulations. Further, Mr. Etzler testified that a sub-docket would entail an unnecessary expenditure of time and other resources on the part of Utility Center and the Commission.

Mr. Etzler also testified that, to the extent any specific provisions of the proposed Rules and Regulations were of concern to the Commission, the Commission could disapprove them and direct they be removed from Utility Center’s proposed Rules and Regulations, or re-written in some way, before the proposed Rules and Regulations are filed with the Commission’s staff after issuance of a Final Order in this Cause. As Mr. Etzler testified, if Utility Center believes any disapproved provision is necessary or should remain in its Rules and Regulations, Utility Center can seek Commission approval for the provision in another proceeding or pursuant to the Commission’s thirty-day procedures. At that time, concerns over the specific provision can be addressed without causing a delay in implementing the other provisions of the proposed Rules and Regulations that have already been addressed by the Commission.

The Commission recognizes that Petitioner’s proposed Rules and Regulations reflect provisions that have already been submitted to Commission for approval. Nevertheless, Sections 1.2.8, 1.2.10, 1.6.1.1, 1.6.1.7 and 2.4 of the proposed Rules and Regulations for Water Service, i.e., Petitioner’s Exhibit WLGE-9, were the subject of questions by the Presiding Commissioner or Presiding Administrative Law Judge at the hearing held in this Cause on July 1, 2010. These questions reflected concern about the appropriateness of those provisions, and Petitioner acknowledged those concerns. Accordingly, Petitioner’s proposed Rules and Regulations
appearing as Petitioner’s Exhibits WLGE-9 and WLGE-10 should be approved, with the exception of Sections 1.2.8, 1.2.10, 1.6.1.1, 1.6.1.7 and 2.4 contained in the Rules and Regulations for Water Service appearing as Petitioner’s Exhibit WLGE-9. Those provisions are not approved and should be removed from the proposed Rules and Regulations for Water Service prior to their filing with the Commission’s Water/Sewer Division. If Petitioner believes any of the disapproved provisions are necessary and should appear in its Rules and Regulations, Petitioner can seek Commission approval for the provisions in another proceeding or pursuant to the Commission’s thirty-day filing procedures. At that time, concerns over those specific provisions, and any others that the OUCC or other party of record may identify, can be addressed.

12. **Post-in-service AFUDC and Deferred Depreciation.**

A. **Evidence.** According to Mr. Etzler, Utility Center projects the need to install a one million gallon water storage tank in western Aboite Township at an estimated cost of $1,963,000 in order to maintain adequate flows for fire protection and supply water for the growth it projects. Mr. Etzler also testified that Utility Center is planning to divert wastewater flows that would be treated at its Main Aboite WWTP to its Midwest WWTP in order to balance flow between the two plants and provide capacity at its Main Aboite WWTP. This diversion will be accomplished at an estimated cost of $5,380,000 by constructing a new pump station and new force main to the Midwest WWTP, with an interconnection to an existing pump station, which will be upgraded and interconnected to the new force main.

Petitioner requests authority to defer depreciation and capitalize interest and equity costs on the two capital improvement projects for the period subsequent to their respective in-service dates and for up to 24 months or the date of a final order in Petitioner’s next general rate case, whichever occurs first. According to Mr. Etzler, under the proposal the amount of the depreciation deferral would be calculated using Utility Center’s Commission-approved depreciation rate, which is currently 2%, and recorded as a regulatory asset. Beginning at the time Utility Center’s rates and charges reflect as part of Utility Center’s rate base any utility properties associated with the projects, the deferred amount would be amortized over 50 years. Mr. Etzler also explained that capitalized interest and equity costs on the projects would be calculated utilizing the pretax rate of return approved by the Commission and included in the value of Petitioner’s utility plant in service.

In his testimony, Mr. Kopas asserted the requested deferral and capitalization is an accepted practice utilized by regulators to enable companies to avoid erosion of their financial position as a result of completing necessary major projects that are not timed with a rate proceeding. Mr. Kopas noted that the Commission authorized Utility Center to defer depreciation and interest only on certain significant capital improvements in Cause No. 41968 for that purpose. Mr. Kopas also stated that the deferral and capitalization of costs proposed by Petitioner in this Cause would only apply to the two identified projects, be reasonably limited to 24 months and will be calculated using Commission-approved determinants, i.e., Utility Center’s 2% depreciation rate and approved rate of return. Further, Mr. Kopas testified that, while the projects will be included in the Company’s next general rate filing, the proposed deferral will keep the Company from having to seek a rate increase due solely to those projects during the 24 months the deferral in place.
OUCC Witness, Mr. Corey described Petitioner's request as a request for post-in-service allowance for funds used during construction or post-in-service AFUDC. Mr. Corey's testimony made two main points -- first, that Petitioner did not support its assertion with respect to earnings erosion and second, that Petitioner's request is otherwise too broad. Instead of asking for deferral of its depreciation expense and debt costs, Petitioner requests authority to include an equity return on the funds used during construction.

In his testimony, Mr. Corey explained why utilities request post-in-service AFUDC by noting that AFUDC generally relates to the cost of debt used to finance construction projects. He noted these amounts are normally accrued during the period of construction and capitalized as a part of the total cost of the utility plant. Mr. Corey explained that pursuant to generally accepted accounting principles ("GAAP") and the Uniform System of Accounts for Class A Water Utilities ("USoA"), unless special authorization is obtained, when plant or a portion thereof previously under construction is placed in service, the accrual of AFUDC on such property ceases. He added that the recording of depreciation begins on the in-service date and continues over the anticipated life of the plant. Mr. Corey noted that utilities request post-in-service rate making treatment to avoid earnings erosion that may result from the immediate recognition of significant and new interest and depreciation expenses. Additionally, until the utility's next rate case, its capital structure will not include any debt incurred to build the construction project. Mr. Corey noted that, while Petitioner maintained the deferral is necessary to avoid erosion of its financial position, Petitioner did not quantify or explain in its case how its earnings will be eroded as a result of the projects it intends to build and place in service before its next general rate case.

Mr. Corey acknowledged that in Cause No. 41968, the Commission authorized Utility Center to defer depreciation and interest on certain significant capital improvements. However, Mr. Corey noted that in this Cause Petitioner is not merely seeking to defer depreciation and interest expense as it did in Cause No. 41968. Petitioner also seeks authority to include an equity component in its deferral of AFUDC. Mr. Corey stated that even if the Commission were to find Utility Center will suffer earnings erosion and otherwise qualify for post-in-service AFUDC, Petitioner should not be permitted to extend the provision of post-in-service AFUDC to defer a return on the equity component in addition to recovering depreciation and interest expense. Mr. Corey explained that, while debt and depreciation create additional expenses for Petitioner after the project is placed in service, equity does not. Mr. Corey noted that Petitioner did not explain in its case-in-chief why it should be authorized to accrue post-in-service AFUDC on the equity portion. Utility Center has not justified why such treatment is appropriate. Mr. Corey stated that Petitioner should only be able to accrue post-in-service AFUDC, if at all, on the debt portion. Mr. Corey considered Mr. Kopas to suggest that in Cause No. 41968, the Commission authorized Utility Center to apply the total pre-tax rate of return to its deferred costs. Mr. Corey stated that an examination of the Commission's Order in Cause No. 41968, at 28, reveals that the weighted cost of debt is the correct rate applicable to the deferral approved in that Cause. Mr. Corey stated that if the Commission finds Petitioner would experience material earnings erosion if it does not receive post-in-service AFUDC, it should authorize such treatment only on the weighted cost of debt as it did in Cause No. 41968.
In Petitioner's rebuttal case, Mr. Kopas testified that denial of the proposed capitalization of equity for these projects could result in Utility Center filing a rate increase application sooner than would otherwise be planned. Mr. Kopas responded to Mr. Corey's statement that the company has not explained how and to what extent it would experience earnings erosion as a result of the storage tank in Western Aboite Township. Mr. Kopas said he could not state to what extent earnings will erode because the timing of the two projects is somewhat unclear at this time. However, he said he could opine that when a company invests money in an asset, and that asset is placed in service, the associated carrying costs and depreciation will increase expense on the company's books and decrease earnings. This added expense erodes the company's earnings until new revenues are received for that asset in the next company rate case. An exception to this would be DSIC eligible projects which enable companies to recover these associated carrying costs and depreciation expense prior to the next rate case.

The OUCC presented no testimony disputing the appropriateness of Petitioner's proposed diversion project for which it is seeking deferral and capitalization treatment. In fact, OUCC witness Harold Rees agreed generally that the planned diversion project will meet the need for more capacity at Petitioner's Main Aboite WWTP. In his testimony, Mr. Rees agreed that this will relieve the Aboite Plant and allow the sewer system to meet future demand. He also testified that he had not found any evidence that Petitioner had considered diverting the sewage flow to either of the City of Fort Wayne WWTPs. Mr. Rees noted that, whereas Utility Center's diversion plan calls for approximately four miles of main extension, the estimated distance to the Fort Wayne Brunner Wastewater Treatment Plant is nine miles.

In regard to the planned water storage tank, however, the OUCC's witness Roger Pettijohn testified that he did not believe that the planned tank was needed at this time. On rebuttal, Mr. Etzler did not dispute Mr. Pettijohn's testimony, but did point out that Utility Center is not seeking to have the Commission address the need for a tank or approve its construction. Further, Mr. Etzler stated that the planned tank will not be constructed until there is a need for it that establishes that it is not excess capacity. According to Mr. Etzler, if the tank is not constructed due to the lack of any need for it, no deferral or capitalization will occur. If the tank is built, Mr. Etzler stated, the requested deferral and capitalization treatment will permit Petitioner to reflect in future rates, subject to Commission approval, the post in-service depreciation and interest and equity costs associated with the tank.

Intervenor Fort Wayne's witness Mr. Nitza suggested that, as an alternative to the planned storage tank, Petitioner could make wholesale water purchases from Fort Wayne. On rebuttal, Mr. Etzler disputed Mr. Nitza's claims. Mr. Etzler noted that Fort Wayne has raised this issue before the Commission and on each occasion the Commission had declined to give it credit. According to Mr. Etzler, Utility Center already possesses sufficient production capacity to supply it customers and does not require additional water resources and, based on prior experience with purchases of water from Fort Wayne, can produce its supplies of water at a lower cost. Mr. Etzler also testified that water storage facilities are designed to provide uniform pressure, a "one day" supply of water based on system demand and excess water in case of a major fire. Purchasing water from Fort Wayne, as testified to by Mr. Etzler, would not address these needs. Mr. Etzler also disputed whether purchases from Fort Wayne would improve water quality. As stated by Mr. Etzler, any water quality problems that Utility Center may have relate to its distribution system, not its production facilities, and the condition of those distribution
facilities will affect water obtained from Fort Wayne as it affects the water produced by Utility Center. Finally, Mr. Etzler testified that he believed the requirements of the Great Lakes Compact would make the type of water sales suggested by Mr. Nitza unlawful.

In regard to the planned sewer diversion project, Mr. Etzler testified that Fort Wayne’s own system does not represent an alternative to the Aboite diversion. According to Mr. Etzler, the cost to construct the infrastructure needed to connect to Fort Wayne’s facilities would increase the rates to Petitioner’s customers and, more importantly, would do so unnecessarily. Mr. Etzler pointed out that Utility Center’s plants have more than sufficient capacity to treat wastewater flows. Mr. Etzler also pointed out that during wet weather events, Fort Wayne cannot treat all of its own sewage and must discharge untreated wastewater through combined sewer overflows. In Mr. Etzler’s opinion, this was not a situation that should be aggravated by adding wastewater flow from Utility Center, especially when Utility Center’s own Midwest plant has the capacity to treat that flow in full compliance with its NPDES permit.

B. Discussion and Findings. We first address Petitioner’s request to include “deferral” of an equity return on the funds it would use during construction. Rather than requesting a post-in-service deferral of its depreciation expense and debt costs, as it received in Cause No. 41968, Petitioner would include an equity return on the funds it uses. This would be accomplished by applying Petitioner’s current weighted cost of capital, as opposed to the cost of debt, to the cost of these projects. Tied to Utility Center’s request for extraordinary treatment through post-in-service AFUDC is the more extraordinary request of being permitted to include an equity return on the funds used during construction. Petitioner did not adequately explain in its case-in-chief or in its rebuttal case why such an extraordinary treatment should be permitted or is otherwise appropriate.

As Mr. Corey explained, debt and depreciation on plant placed in service create additional expenses for a utility. Deferring these expenses allows recovery of those expenses. With respect to deferral of an equity return, we note there is no corresponding expense. Moreover, there is nothing inherent in Petitioner’s planned projects or its request that indicates there would be any equity capital investment in these projects. In other words, Petitioner may borrow all or substantially all of the funds needed for these two projects. (During cross-examination by the OUCC, Mr. Etzler could not say whether Utility Center was going to borrow the money for the projects or rely on retained earnings. He further acknowledged there is nothing in Utility Center’s request for post-in-service AFUDC that would restrict the ability of Utility Center to borrow or have its parent borrow all the money used to construct the water storage tank. (Hr. Tr. F-13.) In such a case, applying Utility Center’s current weighted cost of capital could result in a mismatch between the weighted cost of capital applied and the weighted cost of capital that would otherwise be indicated by the substantial borrowing made to build the projects.

Post-in-service AFUDC is an extraordinary remedy. Petitioner has not explained why Post-in-service AFUDC, such as it received in Cause No. 41968, would not be adequate to achieve the purpose underlying post-in-service AFUDC. In light of the foregoing, we decline to authorize Petitioner’s equity portion of post-in-service AFUDC.

We next address whether Petitioner’s evidence supports the receipt of any post-in-service
AFUDC or deferred depreciation. Utilities request and receive post-in-service rate making treatment to avoid earnings erosion that may result from significant and new interest and depreciation expenses. The evidence presented to justify post-in-service AFUDC does not allow us to determine whether and to what extent Petitioner’s earnings will be eroded. In so noting, it is not enough to rely on the fact of a project being completed, even if the cost of the project is estimated. If such proof was sufficient, there would be no basis to deny post-in-service AFUDC on any project presented to the Commission in a rate case. All projects have associated costs that would not otherwise be recovered before the next rate order. What is necessary to show in addition to such facts is that the utility will suffer earnings erosion without the requested post-in-service AFUDC. This carries with it some obligation to quantify the level of earnings erosion. Also, earnings erosion should be viewed in the context of the utility’s operations as a whole. In this case, Petitioner’s description of the projects indicates the projects are required in part to meet demand caused by customer growth.

With respect to the one million gallon water storage tank, the Commission notes that the Petitioner has system demands that approximately match the needs of its storage tank. However, we agree with Mr. Pettijohn that additional storage is unnecessary at this time. Further, Mr. Etzler testified Utility Center projects the need to install the tank to maintain adequate flows for fire protection and supply water for the growth it projects. Thus, this raises the possibility that the utility’s “earnings erosion” would be offset in whole or in part by customers who could be added as a result of the new tank.

With respect to the diversion project, the Commission agrees with Mr. Rees that the project is appropriate and rejects Mr. Nitza’s suggestion that the conclusion of need is flawed because treatment by the Intervener was not considered as a viable option. Mr. Rees’ crude cost estimation of transmission facilities as well as the challenges presented under the terms of the City of Fort Wayne’s Consent Decree and the Great Lakes Compact would reasonably eliminate this as a viable option that is in the best interest of the Utility and ratepayers.

However, Mr. Etzler stated the diversion project will provide capacity at its Main Aboite WWTP. Again, this suggests additional customers may serve to offset any “earnings erosion” that may occur. Just as the costs of any projects will not be recovered in rates before the next rate order, any added customers would not be reflected until the next rate order. In its proposed order, Petitioner acknowledged the earnings erosion was not quantified, but would be significant.

In conclusion, we do not agree that the evidence, when viewed as a whole, indicates a material erosion in earnings. As a result, we deny Petitioner’s request for post-in-service AFUDC and deferred depreciation.

13. Additional Matters Raised by the OUCC. OUCC witness Roger Pettijohn made several recommendations in his testimony that have not yet been addressed in this Order. Specifically, Mr. Pettijohn recommended that, in light of the numerous water quality complaints expressed by customers, Petitioner should continue to file as required in Cause No. 43331 quarterly reports on the complaints it receives from its customers; that Petitioner should be prepared to inform its customers about sodium levels in its finished water; and that Petitioner include sodium levels in its annual Consumer Confidence Report sent to its customers.
Petitioner expressed a willingness to comply with all of Mr. Pettijohn’s recommendations. Further, we agree implementing them is appropriate. Accordingly, Petitioner shall again file the quarterly complaint reports as it has in the past pursuant to the direction of Cause No. 43331 for an 18-month period comparable to that required in that proceeding. Petitioner shall also explore making that information available to its customers on its website and, if determined to be feasible, do so. Finally, Petitioner shall file with its next annual report to the Commission a report on the magnitude and causes of the water losses described in Mr. Pettijohn’s testimony.

14. Other Matters. Petitioner has developed masterplans for both water and wastewater systems which have guided the development of both systems. Mr. Etzler acknowledges in his direct testimony that the current plans are approaching the ends of their useful lives and that updates are required.

Fort Wayne Witness Mr. Nitza suggests Petitioner should be compelled to update their masterplan with increased emphasis on including a review of partnerships and regional opportunities. In his direct testimony Mr. Etzler agreed to update the masterplans but disagreed with Fort Wayne’s approach. Mr. Etzler noted that options of looking at outside sources of water or providers of wastewater treatment are a prudent function of a masterplan, those options have already been examined in the existing plan, and he questioned reexamining that same option with every revision conducted.

The Commission finds that Petitioner’s existing masterplans are a reasonable example of a moderate range planning effort. However, the Commission recommends that Utility Center take more of a long range view of system development and revisit those plans on an annual basis and revise them accordingly. Such a format would insure that the plan is both reviewed and updated every year to address the needs of a continuously evolving utility and in theory they would never reach the end of a useful life. The Commission would encourage Petitioner to refine its planning process and be diligent with respect to regular revisions. Such annual reviews and updates of the plan will prevent Utility Center from the need to make wholesale revisions.

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

1. Consistent with Paragraph No. 9 of this Order, Petitioner is hereby authorized to increase its recurring monthly rates and charges in order to have the opportunity earn additional operating revenues for its water and sewage disposal utilities of $435,077 and $608,653, respectively.

2. Petitioner shall file with the Water/Wastewater Division of the Commission new schedules of rates and charges consistent with Paragraph No. 9, which schedules of rates and charges shall be effective on and after the date of approval.

3. Petitioner shall file with the Water/Wastewater Division of the Commission new Rules and Regulations consistent with Paragraph No. 11 of this Order, which Rules and Regulations shall be effective on and after the date of approval.
4. Petitioner shall comply fully with the directions of Paragraph Nos. 13 and 14 of this Order.

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

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

APPROVED: APR 13 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