

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE PETITION OF)
THE DEPARTMENT OF WATERWORKS OF)
THE CONSOLIDATED CITY OF)
INDIANAPOLIS, INDIANA, FOR)
AUTHORITY TO INCREASE ITS RATES)
AND CHARGES FOR WATER UTILITY)
SERVICE ON BOTH EMERGENCY AND)
NON-EMERGENCY BASES, FOR)
APPROVAL OF A NEW SCHEDULE OF)
RATES AND CHARGES APPLICABLE)
THERETO, AND FOR APPROVAL OF A)
MECHANISM TO ANNUALLY IMPLEMENT)
RATE CHANGES BASED ON THE ANNUAL)
ADJUSTMENT TO THE DEPARTMENT'S)
PAYMENTS UNDER THE MANAGEMENT)
AGREEMENT WITH VEOLIA WATER)
INDIANAPOLIS, LLC)

CAUSE NO. 43645

APPROVED: FEB 02 2011

BY THE COMMISSION:
Larry S. Landis, Commissioner
Loraine L. Seyfried, Administrative Law Judge
Angela Rapp Weber, Administrative Law Judge

FINAL ORDER

INDIANA UTILITY REGULATORY COMMISSION

CAUSE NO. 43645

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On February 24, 2009, the Department of Waterworks of the Consolidated City of Indianapolis, Indiana (“Petitioner” or “Department”) filed its Petition with the Indiana Utility Regulatory Commission (“Commission”) for authority to increase its rates and charges for water utility service, for approval of a new schedule of rates and charges and for approval of a mechanism to annually implement rate changes based on the annual adjustment to the Department’s payments under the management agreement, as amended, with Veolia Water Indianapolis, LLC (“Veolia”) (“Management Agreement”).

Pursuant to notice duly given and published as required by law, the Commission held a hearing in the emergency phase of this Cause on May 18-19, 2009, in Room 222, 101 W. Washington Street, Indianapolis, Indiana. In addition to the Department, the Indiana Office of Utility Consumer Counselor (“OUCC”), the Town of Pittsboro (“Pittsboro”) and the Indianapolis Water Industrial Group (“Industrial Group”) appeared and participated in this Cause. The Commission issued its Interim Emergency Order and Prehearing Conference Order in this Cause on June 30, 2009 (“June 30 Order”).

On September 30, 2009, Petitioner pre-filed its direct testimony and exhibits. On October 16, 2009, Petitioner pre-filed its cost of service and rate design testimony and exhibits and on February 5, 2010, Petitioner pre-filed the supplemental testimony and exhibits of Ronald J. Miller, Jr. The Industrial Group and the OUCC pre-filed their respective testimony and exhibits with the Commission on February 16, 2010. On February 24, 2010, the Industrial Group and the OUCC pre-filed their cost of service and rate design testimony and exhibits. The Industrial Group also pre-filed its cross-answering testimony on March 16, 2010. Petitioner pre-filed its rebuttal testimony and exhibits on March 25, 2010. Each party with pre-filed evidence submitted corrected or supplemental testimony and exhibits at various points in the procedural schedule.

A field hearing was also conducted in this Cause on January 11, 2010, at 6:00 p.m., in the auditorium of Broad Ripple High School, 1115 Broad Ripple Avenue, Indianapolis, Indiana. Petitioner, the OUCC and members of the public appeared and participated at the field hearing.

On April 19, 2010, the Commission convened an evidentiary hearing at 9:30 a.m., in Room 222, 101 W. Washington Street, Indianapolis, Indiana. The evidentiary hearing continued through April 30, 2010. Proofs of publication of the notice of the evidentiary hearing were incorporated into the record and placed in the official files of the Commission. The Department, the OUCC and the Industrial Group appeared and participated in the evidentiary hearing. Pittsboro waived its right to participate in the hearing and to cross-examine witnesses. At the hearing, the Department’s pre-filed direct testimony and exhibits and rebuttal testimony and exhibits supporting its request for a new schedule of permanent rates and charges for water service were offered and admitted into evidence. The respective pre-filed testimonies and exhibits of the OUCC and the Industrial Group were also offered and admitted into evidence.

Based on the applicable law and evidence presented in this Cause, the Commission now finds as follows:

1. **Notice and Jurisdiction.** Due, legal and timely notice of the public hearings held in this Cause was given and published by the Commission as required by law. Petitioner is a “municipally owned utility” as defined in Ind. Code § 8-1-2-1(h), and exists and operates under the authority of Ind. Code § 8-1.5-4-1, *et seq.*, and Ind. Code § 36-3-4-23. In accordance with the Commission’s March 28, 2002 Order in Cause No. 41821, Petitioner is subject to the jurisdiction of the Commission for approval of rates and charges and Petitioner’s operation of its system is to be in accordance with the Commission’s rules of service and main extensions for water utilities contained in 170 IAC 6-1 and 6-1.5.

2. **Petitioner’s Characteristics.** Petitioner is a Department of Waterworks formed by the City-County Council of the Consolidated City of Indianapolis and Marion County, Indiana (“City”) to manage and oversee the operation of the water utility. Petitioner owns and operates plant and equipment for the production, transmission, delivery and furnishing of water utility service throughout most of Marion County and portions of Boone, Brown, Hamilton, Hancock, Hendricks, Johnson, Morgan and Shelby Counties.

Matthew T. Klein, the Executive Director of the Petitioner who was hired on March 30, 2009, testified that the Petitioner’s system serves more than 305,000 service connections and a population of approximately 1.1 million people. The waterworks system (“Waterworks” or “System”) consists of over 4,200 miles of water mains, more than 36,000 fire hydrants, 12 treatment plants, 19 pumping stations and 19 storage tanks. Average daily production of finished water is approximately 145 million gallons per day (“mgd”). The System has a total rated capacity of 220 mgd with a demonstrated peak daily production of 228 mgd. A small portion of the Petitioner’s raw water supply is purchased from the City of Westfield. Some finished water is also purchased from the Town of Plainfield.

Petitioner acquired the Waterworks by purchasing the assets of the former Indianapolis Water Company (“IWC”) from NiSource in 2002 upon approval from the Commission in Cause No. 41821. On March 21, 2002, Petitioner entered into the Management Agreement with Veolia¹ to manage the day-to-day operations of the utility. The Management Agreement was amended on June 26, 2007 (“First Amendment”). Unless the context requires otherwise, references to the Management Agreement shall mean the Management Agreement as amended by the First Amendment.

Marvin B. Scott, Ph.D., a member and Chair of the Board of Directors (“Board”) of the Department testified regarding the role of the Board in the operation and management of the utility. Dr. Scott testified that the Board establishes overall policy directives for the operation of the System and oversees Veolia’s performance.

3. **Relief Requested.** In the June 30 Order, the Commission granted an emergency rate increase to the Department. The Commission authorized a 12.27% increase to produce additional operating revenue of \$14.675 million to meet Petitioner’s annual revenue requirements. The Commission placed several conditions on the granting of the emergency rate

¹ More specifically, the Management Agreement was entered into by USFilter Operating Services, Inc., which later changed its name to Veolia Water North American Operating Services, Inc., then assigned its interest under the Management Agreement to a newly formed affiliate, Veolia Water Indianapolis, LLC.

increase. On August 17, 2009, the Department filed Petitioner's Tender of True-Up Report and Motion to Retain Rates Approved by the June 30 Order. In Petitioner's True-Up Report, the amount of the increase in rates was decreased to 10.8% based on the Department's refinancing of its variable-rate debt. The Department moved that the Commission retain the 12.27% rate increase rather than adjusting the rate increase for the refinancing of the Department's variable-rate debt. The Commission denied the Department's request on September 8, 2009 and in the same entry approved the Department's tariff reflecting a 10.8% rate increase.

Petitioner now requests approval of a schedule of rates and charges for water service on a permanent basis. Specifically, Petitioner requests a single-phase increase in rates and charges of 33.36% on a cost of service basis. Mr. Klein testified that the revenue increase will adequately fund the Department's expenses, provide for a reasonable level of debt service requested by the Department, provide for E&R to fund Department capital projects and allow the Department to meet its financial obligations and covenants.²

4. Test Year. Pursuant to the June 30 Order, the test year to be used for determining Petitioner's actual and *pro forma* operating revenues, expenses and operating income under present and proposed rates is the 12 months ended December 31, 2008. The financial data for such test year, when adjusted for fixed, known and measurable changes occurring in the 12 month adjustment period ending December 31, 2009, fairly represents the annual operations for Petitioner. We conclude, therefore, that the 12 months ended December 31, 2008, is a proper basis for fixing new rates for Petitioner and testing the effects thereof.

5. Identification of Contested Issues. The primary issues of contention among the parties were operation and maintenance ("O&M") expenses, including adjustments for Management Agreement expense and post-retirement healthcare benefits expense, and the Petitioner's proposed working capital. Although Petitioner's proposed capital program was not contested, the manner of funding it and the proportion of bond-funded capital versus the amount of E&R ("E&R") was disputed. The Industrial Group's proposed operating revenue adjustments, including a customer growth adjustment and a weather normalization adjustment, were contested by Petitioner. Compliance with the Settlement Agreement from Cause No. 43056, the Petitioner's last general rate case, was also contested concerning the Petitioner's National Association of Regulatory Utility Commissioners ("NARUC") accounting conversion and certain elements of the cost of service study.

6. Compliance with June 30 Order and Order in Cause No. 43056.

A. Petitioner's Direct Evidence. Dr. Scott testified concerning the Department's compliance with the June 30 Order. He testified the Board adopted a resolution that authorized all actions necessary to promote compliance with the June 30 Order. He testified that representatives from the Department met with Veolia to discuss areas of concern with the Management Agreement. Dr. Scott also testified the Board adopted a fiscal policy to limit the Department's exposure to variable rate debt. He stated the Department understands the

² Although Petitioner initially requested approval of a mechanism to adjust for changes in fees paid to Veolia under the Management Agreement, Petitioner subsequently withdrew this request. Pet. Ex. MTK at 36. Therefore, we do not further address this issue herein.

Commission does not have jurisdiction over the Department's issuance of bonds, but that it is willing to develop a process to advise the Commission of future issuances of debt. Dr. Scott also testified that the Board believes that the rate increase is reasonable and necessary, and that the Department is requesting to include in rates only the highest priority capital projects.

Dr. Scott testified as to the Department's financial, managerial and technical ability to operate the System. More specifically, Dr. Scott stated that the Board has resolved to hire more, experienced personnel for the Department and that the Department is taking steps to address its finances. Dr. Scott testified that he believed the Board needed to increase its oversight of Department operations and to ensure Veolia is meeting its obligations.

Mr. Klein testified that the Petitioner takes very seriously its obligations under the June 30 Order and offered evidence in support of the Department's compliance with the June 30 Order and of its technical, managerial and financial ability. Specifically, Mr. Klein testified that the Department contacted Veolia, discussed cost reductions and filed a cost reduction plan with the Commission. The Department filed monthly E&R reports, cash flow projections, audited and unaudited financial information, notices of transactions and adoption of various policies. Mr. Klein also testified the Department had refunded its variable rate debt and timely filed its True-Up Report and revised tariff.

With respect to the requirements from the Settlement Agreement approved in Cause No. 43506, Mr. Klein testified that the Department has implemented the NARUC accounting standards, provided bond reports to the OUCC, developed a cost of service study that includes capacity factors and a meter sizing analysis, and updated its conservation plan. Mr. Klein also testified the Department has taken other steps demonstrating its ability to manage the utility, including improving collections of accounts receivable, obtaining revenue rulings from the Indiana Department of Revenue on Petitioner's Utility Receipts Tax ("URT") obligations, considering possible claims against financial advisors, and pursuing public bidding of capital projects to verify market prices. Mr. Klein also testified the Department had reviewed its meter reading logic for estimated billing and was proposing an amendment to its rules.

Mr. Skomp testified the Department was holding Veolia's compensation at 2008 levels until further order of the Commission and had also deferred a \$1.67 million payment to Veolia. Mr. Skomp also testified that the Department has complied, and will continue to comply, with the Commission's restrictions on its Renewal and Replacement Funds account to projects designed to increase System capacity.

The Department's evidence concerning compliance with several major issues is further summarized below.

1. Management Agreement Review. Mr. Klein testified that one of the conditions in the June 30 Order was an independent review of the Management Agreement and that the Department hired CH2M HILL for that specific purpose. Alan B. Ispass, Vice President with CH2M HILL and Global Director of Utility Management Solutions in the Water Business Group, testified regarding the Management Agreement Review. In reviewing the Management Agreement, Mr. Ispass testified that he compared the agreement with similar full contract

operation agreements in the water industry. He also compared it to the agreement for the City's wastewater treatment facilities and collection systems. He testified that the Management Agreement contained the elements of a typical public/private partnership contract for full contract operations in the water industry, including scope of work, compensation structure, stipulations on the division of responsibilities, and risk allocation between the parties. Mr. Ispass testified that CH2M HILL concluded that, with the caveat that no evaluation of the actual compensation paid to Veolia was conducted, the Management Agreement is reasonable, appropriate and in the public interest, but several areas should be revisited.

Mr. Ispass testified consideration should be given to revising the Incentive Fee criteria to relate more directly to accomplishments above and beyond basic compliance with the Management Agreement, and to also revising the payment date of any Incentive Fee to an annual payment at the end of each contract year. Mr. Ispass also recommended the Department explore whether penalties or liquidated damages for substandard performance may be an appropriate addition to the Management Agreement.

With respect to electrical and chemical costs, Mr. Ispass recommended the Department analyze possible cost savings related to these costs. He stated it is not uncommon for an operations contractor to be responsible for all costs above a specific budget amount for certain categories, such as those for chemicals or electricity. Another option he noted was for the Department to retain responsibility for electrical and/or chemical costs, whereby the Department may elect to pay these costs directly, or may elect to compensate Veolia for these items as a pass through cost, without markup. He indicated yet another option was for the parties to tie the contract responsibilities to the Incentive Fee utilizing the shared cost savings.

Mr. Ispass also recommended eliminating the letter of credit that Veolia has in the amount of \$40 million. He testified it is not common for a water system operator to maintain a letter of credit for the nature of the work covered by the Management Agreement. Instead, a contract operator typically provides a performance and/or payment bond as security for operator services.

Mr. Ispass also testified that consideration should be given to clarifying the scope of the Coordination Committee to reduce the number of day-to-day issues being heard by that Committee, as well as clearly defining the process to be used and outlining how decisions will be rendered. Mr. Ispass added that the absence of competitive bids for capital projects creates a lack of transparency and clarity in the capital project process. He concluded that consideration should be given to altering the capital project process by designating certain classes of projects or projects above a certain estimated cost to be publicly bid, and for the Department to provide additional staff to manage the capital program.

After receiving CH2M HILL's Management Agreement Review, Mr. Klein testified the Department met with Veolia on September 22, 2009 to discuss the Management Agreement. He testified the Department discussed with Veolia several issues, including the structure of the Incentive Fee; the Fixed Fee; cost sharing for expenses such as power and chemicals; and the public bidding of proposed projects, among others. Mr. Klein testified he generally agreed the

Management Agreement is reasonable and in the public interest, but indicated he thought there were issues with the Management Agreement and the relationship that needed to be addressed.

2. Management Structure Review. Mr. Ispass presented the Management Structure Review, which generally concluded the Department has not developed adequate staffing to assure proper, timely and reasonable management of utility operations. Mr. Ispass testified the management structure of the Department was not fully developed following the City's acquisition of IWC's assets. He stated the City relied on the Board, Veolia and outside consultants rather than Department staff to ensure safe and efficient operation, maintenance and management of the utility. He concluded the Department never developed an internal institutional structure sufficient to maintain direct accountability for the managerial, financial and technical capacity that is central for long-term ownership and operation of a utility enterprise.

Mr. Ispass testified it is the Department's responsibility as the owner to provide direction to Veolia and make cost-benefit decisions related to management and funding of the utility, particularly in the technical areas of long-term water supply, capital programs and asset management. He stated the Department must have sufficient technical staff qualified to make these decisions and should not rely exclusively on outside consultants. Mr. Ispass recommended the Department conduct an organizational design study to identify specific roles, responsibilities and qualifications for each department staff position.

Mr. Klein also testified to the Department's staffing needs. He stated he does not believe the Department currently possesses the correct number and type of staff to support its obligations under the Management Agreement. Mr. Klein noted that since the June 30 Order, the Department had extended an offer to a new Chief Financial Officer, Mr. Miller, and intended to employ an engineer and a hydrogeologist to help address oversight of Veolia. Mr. Klein testified the Department's budget includes a line item for conducting the organizational design study outlined and recommended by CH2M HILL.

3. NARUC Accounting System and Financial Guidelines. Mr. Miller, Chief Financial Officer of the Department, described certain fiscal policies and other initiatives that the Department has implemented. Mr. Miller testified that the accounting system in use by the Department primarily met the needs of the City by using fund accounting principles. Interim monthly financial information was only available to the Department on a cash basis, and only adjusted to accrual basis at year-end. He testified the Department has created a computerized general ledger system that addresses this issue by providing NARUC-compliant accrual basis balance sheets, income statements and many other reports, which provide useful management information and a clear audit trail. Mr. Skomp also testified that the Department is now able to produce financial statements that are in accordance with NARUC, but acknowledged that some issues with the accounting system still had yet to be addressed.

Mr. Miller also testified that the Department has adopted two formal policies to address these financial issues. First, the Board approved a new policy with respect to reconciliation of the trust accounts containing the debt service reserve and other restricted funds. Pet. Ex. RJM-S1. He stated the Department's trust accounts are now reconciled on a monthly basis to ensure

timely recording of interest earned and other related transactions. Second, the Board approved a new policy requiring month-end closing process and financial statement preparation. Pet. Ex. RJM-S2. Additionally, he stated the Department has assumed responsibility for final review and approval of all Department payments. At the hearing, Mr. Skomp and Mr. Klein each testified that Mr. Miller has made substantial progress in restoring the Petitioner's financial reporting and recordkeeping processes to levels where they need to be. Tr. at K-60, T-40.

4. Cost Reduction. Mr. Klein testified the Department, with Veolia's assistance, agreed upon certain cost-reduction measures and filed a Cost Reduction Status Report detailing its cost reduction efforts. The Department's Cost Reduction Status Report included such measures as: a vendor letter initiative; an atrazine monitoring initiative; an Initial Distribution System Evaluation initiative; a vehicle initiative; a Payment in Lieu of Taxes ("PILT") initiative; a URT initiative; and a water contracts initiative. The Department also conducted an energy audit to find ways to save on energy costs; deferred cost of living and merit pay raises for all Department staff in 2010; spent approximately \$180,000 less than the 2009 budgeted amount for property damage claims; spent approximately \$50,000 less than the 2009 budgeted amount for settlements of pending litigation; and worked with Veolia to reduce the costs in connection with the Septic Tank Elimination Program. Finally, the Department initiated an accounts receivable plan to reduce the overall accounts receivable due to the Department.

David Gadis, President and Operations Manager of Veolia, echoed the Department's testimony regarding the cost saving measures Veolia identified for the Cost Reduction Status Report. Ms. Baumes, Veolia's Vice President of Finance, explained that Veolia's cost control efforts have included: using alternative energy sources to decrease electrical costs; utilizing Veolia's purchasing power for various goods and services to attempt to receive the lowest, best price; utilizing Veolia's national technology expertise to share information with the intent that such information sharing will lead to process improvements; investing in new technology to reduce power demands; investing in new laboratory equipment to improve process monitoring and control; utilizing technology that allows real-time water quality monitoring for the early identification of any problems so that the cost of correction will be minimized; constantly analyzing Veolia's costs to evaluate performance and potentially identify new areas in which service can be rendered more efficiently and waste eliminated. She added that additional, cost-cutting efforts for 2009 included: no salary increases for exempt (*i.e.*, non-union) employees; a reduction in salary increases for union employees; a 60% reduction in employee bonuses; elimination of 11 full time employee positions; a 47% reduction in corporate contributions; institution of a hiring freeze except on critical positions; elimination of employee cafeteria; elimination of holiday party and all employee events; negotiated fuel price reduction; reduced consultant and chemical management fees; and reduced outside services and professional fees in information technology and call center.

5. Conservation Plan. Dan Moran, Senior Water Process Engineer for Veolia Water North America Operating Services, provided background regarding the Indianapolis Water Conservation Plan and the development of the 2009 Conservation Plan. He explained that the Conservation Plan helps the System because current system demand on maximum demand days approaches the treatment and delivery capacity of the System. Mr. Moran explained system demand has steadily increased over the years and is projected to increase as additional customers

are added to the Department's service territory. Mr. Moran testified that the primary goal of implementing water conservation measures is to reduce the rate of increase in system demand in order to decrease or delay the implementation of capacity upgrades. He testified that a secondary benefit is to improve water accounting and minimize lost water, which results in a higher percentage of the water produced being sold. Mr. Moran also testified that increasing the public's awareness of water conservation increases the public's preparation for, and minimizes the impact of, potential drought conditions.

Mr. Moran testified the 2009 Conservation Plan uses the "median" demand forecast projected in the 2008 Yield Demand Study as a baseline forecast. This forecast projects an average day demand of 154.8 mgd in 2010 and 162.5 mgd in 2020 and a maximum day demand of 245.7 mgd in 2010 and 258.1 mgd in 2020. He testified that this forecast is considered to represent the expected demand growth if additional conservation measures are not implemented.

Mr. Moran explained that the 2009 Conservation Plan added five new measures for consideration: bulk water fill stations; automatic meter reading; increased community events and outreach; enhanced water recovery in treatment plants; and large customer voluntary load shifting. He stated that the 2009 Conservation Plan included a cost benefit analysis that follows guidelines provided in the American Water Works Association ("AWWA") Manual M52: Water Conservation Programs. Mr. Moran testified that the Department has implemented several conservation measures over the past several years, including the "Be Water Wise" customer education campaign; an extensive school program; a leak detection program; supply side water conservation measures; and an emergency water ban ordinance. Finally, the 2009 Conservation Plan includes a recommended implementation schedule with long-term recommendations and near-term recommendations. The near-term water conservation measures consist of: (1) a lead for conservation program coordination; (2) a conservation rate study; (3) an automatic meter reading pilot; (4) a voluntary maximum day reduction/load shifting program with large customers; (5) additional conservation messaging on water bills; (6) a water main replacement program; and (7) enhanced well monitoring to enhance supply availability.

B. OUCC's Evidence.

1. Management Agreement Review. Mr. Bell testified the Department hired CH2M Hill to prepare the review of the Management Agreement required by the June 30 Order and CH2M Hill found the Management Agreement to be "reasonable, appropriate and in the public interest," but also provided several suggestions for improvement. He noted those areas included the Incentive Fee criteria, penalties, electrical and chemical costs, risk allocation, dispute resolution clauses and the handling of capital projects. Mr. Bell also noted the Department met with Veolia on September 22, 2009 to discuss CH2M Hill's suggestions for improving the Management Agreement and the parties have established a framework to proceed with further discussions about potential amendments.

Mr. Bell discussed CH2M Hill's findings regarding the Incentive Fee criteria and penalties. He stated the OUCC believed CH2M Hill's recommendations were worth exploring and recommended the parties discuss the development of a revised contract that truly rewards Veolia for outstanding service quality and penalizes it when more basic criteria are not met. Mr. Bell also noted that Veolia, in its August 21, 2009 response to the City of Indianapolis' Request

for Expression of Interest (“REI”), suggested the current benchmarks “be reviewed and modified to reflect an appropriate level and integrated as part of the agreement, modifying the fixed fee and removing the incentive-based compensation.”

With respect to CH2M Hill’s recommendations concerning electrical and chemical costs, Mr. Bell agreed with Mr. Ispass that the current method of handling these costs could be improved. He recommended the Department and Veolia discuss the options Mr. Ispass described and examine the benefits of alternative methods.

Mr. Bell noted Mr. Ispass’s discussion that it is uncommon for a system operator to maintain a letter of credit as Veolia is required to do under the Management Agreement. He also noted that Veolia, in response to the City of Indianapolis’ REI, indicated the letter of credit was very costly and could be replaced with a Performance Bond. Based on this, Mr. Bell recommended the Department and Veolia discuss modifications to the Management Agreement to allow the use of Performance Bonds instead of the line of credit. Mr. Bell stated that any modification should be structured to not only decrease Veolia’s costs, but also decrease fees paid by the Department to benefit ratepayers.

Mr. Bell also described how any dispute or controversy between the Department and Veolia is referred to a Coordination Committee consisting of an equal number of representatives from the Department and Veolia. He stated virtually all disagreements are brought before the Coordination Committee because the Management Agreement does not clearly define controversy or dispute. He also stated the Management Agreement does not clearly define the process for presenting matters to, or how they are to be resolved by, the Committee. Mr. Bell agreed with the CH2M Hill recommendation that the Department and Veolia work collaboratively to more clearly define the process of presenting disputed matters, including what will constitute a dispute and when disputes should be routed directly to a third party mediator.

Mr. Bell discussed CH2M Hill’s findings regarding capital projects and the Department’s historical selection of Veolia to construct almost all of the Department’s capital projects. Mr. Bell agreed with Mr. Ispass’s recommendation that the Department consider bidding certain capital projects. He also agreed the absence of competitive bids creates a lack of transparency and clarity in the process, and indicated competitive bidding would provide assurance that capital projects are being completed at a reasonable price. Mr. Bell concluded the Department can competitively bid some or all of the capital projects, as long as the issue is raised in a Coordination Committee meeting before publicly bidding the capital project as required by the First Amendment.

Mr. Bell also discussed Mr. Gadis’s claims that it is beneficial to the Department for Veolia to perform capital improvements. He agreed Veolia has an incentive to execute capital projects in a reliable way that will minimize failure and decrease maintenance costs. However, he indicated it is unknown whether a competitive bidding process in the past could have reduced the cost associated with the capital projects completed by Veolia since 2002, and whether the absence of a competitive bidding process in the future would provide the Department and its customers the best value for their investment. He concluded by expressing his belief that competitive bidding would result in a more competitive cost without compromising quality.

2. Management Structure Review. Mr. Bell summarized CH2M Hill's findings concerning its evaluation of the Department's management structure, noting the principal finding was that "the Department never developed an internal institutional structure sufficient to maintain direct accountability for the management, financial, and technical capacity that is essential for long-term ownership and operation of a utility enterprise." Mr. Bell agreed with Mr. Ispass's recommendation to conduct an organizational study to develop a revised organizational chart, and develop specific roles, responsibilities, and qualifications for each Department staff position. He stated that once this organizational study is complete, the Department should have a clear guide to determining the necessary staffing positions to address the deficiencies identified in the Management Structure Review.

3. NARUC Accounting System and Financial Guidelines. The OUCC's witness, Mr. Patrick, stated that unlike most utilities, which keep their books and records generally in accordance with NARUC's Uniform System of Accounts, Petitioner keeps its books and records using fund accounting. He noted that within fund accounting there are "proprietary" funds which are accounted for using double entry accounting just like a business, which should be used for municipal water utilities, but that Petitioner does not use this type of accounting.

Mr. Patrick testified the Commission has come to rely on the NARUC Uniform System of Accounts as the standard accounting system to be used by Indiana utilities. He stated that generally, municipal utilities initially record utility transactions according to NARUC or some similar system using proprietary fund accounting. Then, if necessary for governmental accounting purposes, the utilities' books are "converted" to fund accounting. He stated it is easier to translate from the NARUC Uniform System of Accounts to fund accounting than it is to do the opposite.

Mr. Patrick testified that Petitioner used the financial statements from its 2008 IURC annual report as its test year financial statements. He noted Petitioner was able to provide a general ledger based on account information from the City's accounting system. He testified that Mr. Miller was able to "map" the City's accounting system transactions to the NARUC chart of accounts, which reconciled to the rate case filing. However, he noted several flaws in the recording of transactions into the City's system in the test year. He also expressed concern with the level of detail in the accounting transactions to provide a reasonably reliable balance sheet.

Mr. Patrick recommended Petitioner continue to review its accounting policies and improve its accounting system to ensure that it is complying with generally accepted accounting principles and with NARUC's Uniform System of Accounts. He stated Petitioner's extraction programs should also be set up to generate automatic reports of financial and statistical information required for the IURC annual report. He stated these two changes would provide transparency and avoid many of the issues related to accounting encountered in this case.

4. Conservation Plan. Mr. Bell referred to the terms of the Settlement Agreement approved in Cause No. 43056 concerning implementation of water conservation measures and expressed his opinion that the Department's 2009 Conservation Plan complied with the requirements of the settlement agreement. Mr. Bell stated the Department analyzed the

identified conservation measures to determine the benefit and costs associated with implementing each measure. He also noted that the 2009 Conservation Plan was based on updated demand, supply and capacity forecasts, and included identifiable water conservation goals. He recommended the Department and Veolia work together to implement the 2009 Conservation Plan and develop a “systematic plan” to respond to drought conditions.

C. Petitioner’s Rebuttal Evidence. Dr. Scott testified the Department had met with Veolia to discuss amending the Management Agreement, and the Department and Veolia had agreed to create an Incentive Review Subcommittee to review amending the incentive provisions. Dr. Scott stated he believed the Department should publicly bid more projects to determine whether the capital projects undertaken by Veolia are competitive with public bids for similar projects. He also indicated his agreement with Mr. Bell that the Department should conduct an organizational design study. Finally, Dr. Scott explained his belief that the Department had improved its financial, managerial and technical abilities to operate the utility since the filing of its direct testimony in this Cause.

Mr. Klein testified that the Department has complied and will continue to comply with the June 30 Order. He testified that the Department has conducted initial meetings to begin implementation of (1) a filter optimization study; (2) a residuals management study; and (3) a conservation rate study. He stated the Department is investigating and addressing the operation, maintenance and testing of hydrants; reviewing Veolia’s maintenance of meters and its large meter replacement programs; exploring the implementation of bulk water filling stations; and working on revising the capital project approval process.

Mr. Klein also testified that the Department continues to pursue its commitment to publicly bid certain proposed capital projects. He noted the Board passed Resolution No. 57, 2009 requesting statements of qualifications from professionals seeking to perform engineering design work on nine different proposed capital projects. He also testified at hearing that the Department intends to publicly bid approximately \$48 million worth of its 2010 capital projects. Tr. at K-4.

Mr. Klein stated he hopes to obtain funding for the organizational design study in the rate case. He testified that such a study would help the Department in furthering its technical, managerial and financial ability.

Mr. Miller responded to Mr. Patrick’s testimony regarding the Department’s NARUC accounting system. Mr. Miller testified the Department is annually accounted for as an enterprise-type proprietary fund in accordance with U.S. generally accepted accounting principles. Additionally, he stated the Department’s use of fund accounting does not preclude the Department from complying with NARUC accounting guidelines. He stated the level of detail provided by the general ledger system is a function of creating the appropriate number of accounts, and is not a function of the use of fund accounting. Mr. Miller testified that by May 15, 2010, the Department will be able to produce monthly financial reports that are fully compliant with NARUC standards. Mr. Miller also testified that the use of fund accounting does not preclude the use of double-entry accounting, which he stated the Department is using. Mr.

Miller concluded by stating that the Department is willing to provide monthly unaudited financial information and monthly cash flow forecasts by the 15th of each month.

Mr. Malone responded to Mr. Bell's recommendation that the Department should take advantage of the ability to bid certain capital projects and should work with Veolia and other utility construction managers to build capital projects by stating Veolia facilitates many of the projects in the Capital Plan by utilizing a design-build versus a design/bid/build delivery model. He explained that Veolia seeks to identify cost savings, improvements in overall system reliability and cost effectiveness for all improvements undertaken.

Mr. Malone testified that Veolia incorporates continuous improvement in project development and execution. He asserted that Veolia's ability to facilitate projects and modify how the System is operated allows improved efficiency in project delivery. He explained that the current project delivery method allows the schedule to be adjusted to ensure that water quality or production is not impacted during construction. He explained that Veolia self-performs a portion of network and facility projects. In addition, he stated that other work is performed under a teaming agreement or bid out by Veolia. Mr. Malone asserted that Veolia has been successful in negotiating contracts that provide multiple cost benefits and compliance with established capital program management procedures.

D. Commission Discussion and Findings. As clearly indicated in the Management Structure Review and reflected by the evidence presented, the Department has lacked the necessary staff and expertise to effectively manage the utility and oversee Veolia's operation under the terms of the Management Agreement since the inception. In addition, while it appears that for most of the past eight years the Board has operated as a group of well-regarded civic and professional leaders who were motivated by the highest of intentions, it also appears that they were overmatched, understaffed and inadequately supported by the City. We commend Petitioner for the significant efforts that have been made during this proceeding, through Matt Klein, Ron Miller and others, in taking the necessary steps to proactively manage the Waterworks.

Based on the evidence presented, we find that Petitioner has substantially addressed the requirements of the Commission's Order in Cause No. 43056 and the June 30 Order, and taken significant steps to address issues necessary to ensure that it has the managerial, technical and financial ability to own and appropriately manage the Waterworks. While we recognize the considerable efforts that Petitioner has recently undertaken, it is also clear that the work is not done. Therefore, to the extent the Department remains the owner of the Waterworks, we direct the Department to continue to take the steps necessary to exercise greater oversight and responsibility to ensure the utility is operated and managed in a reasonable and cost-efficient manner.

1. Management Agreement Review. In our June 30 Order, the Commission directed the Department to undertake a comprehensive review of the Management Agreement "for the purpose of determining whether the terms of the Management Agreement and the First Amendment are reasonable, appropriate, and in the public interest." We did so based upon the concerns noted in the June 30 Order, the concerns expressed at the hearing by Petitioner's then

Executive Director, Mr. Steele, and the perceived inability of the Department to approach Veolia and renegotiate the contract based on exigent circumstances. The Department was required to contact Veolia to discuss any issues identified in the review. We concluded by stating that “the results of the Department’s review and any amendment(s) to be made to the Management Agreement shall be addressed in the Department’s request for permanent rates.” June 30 Order at 18.

As Mr. Klein testified, the Department procured a review of the Management Agreement by CH2M HILL. The Department also contacted Veolia to discuss issues identified in the review. We find that Petitioner has made substantial progress in complying with the Commission’s June 30 Order.

Notwithstanding this finding, based upon the evidence presented during the course of this proceeding, several concerns remain. First, the review did not include an evaluation of the actual compensation paid to Veolia. Consequently, there is nothing in the review upon which we may rely to conclude that the actual compensation paid to Veolia under the Management Agreement should be considered reasonable or prudent. Second, the review of the Management Agreement resulted in a report making constructive observations that we, like the OUCC, consider beneficial, but did not result in any amendments to the Management Agreement being presented in the Department’s case. Despite the urgency expressed by the Department of the need for action on its rate requests and the great concern expressed by the Commission in its June 30 Order that Veolia be called upon to participate in formulating a solution to the Department’s financial troubles, Veolia and the Department met to discuss the Management Agreement review only twice during the pendency of this permanent rate case. This lack of interaction between the Department and Veolia, who were envisioned to be partners with a common goal of providing reliable and adequate water service at just and reasonable rates, is extremely troubling.

Furthermore, throughout the course of this case, we heard much evidence regarding the Management Agreement and the First Amendment that gives us additional cause for concern. For example, Mr. Hudson, a former Board member of Petitioner, testified that he was surprised Veolia accepted some of the provisions it did in the original Management Agreement, that he did not think Veolia’s chief negotiator had much experience in the water utility business, that he was not surprised that Veolia expressed financial concerns at the time of the First Amendment, and that Veolia threatened litigation if Petitioner did not negotiate an amendment. Pet. Ex. SMH-R at 5, Tr. at K-112 to K-114. Mr. Gadis, in contrast, testified that Veolia’s negotiating team was experienced and numerous and that Veolia did not threaten litigation. Pub. Ex. CX-18, Tr. at M-25 to M-26). Another example concerns the performance of maintenance (for which Veolia is financially responsible) and capital projects (for which the Department is financially responsible), which were discussed at length during the hearing. While Mr. Klein expressed concern with Veolia’s maintenance practices based upon issues noted in DLZ audits, it was clear that Mr. Gadis believed such issues may be related to the need for capital expenditures, and questioned the objectivity of the DLZ audits. *See e.g.*, Tr. at K-11, N-32, N-39 to N-41, and O-17. And, while the Coordination Committee was created to assist in resolving such disputes that would arise, we are uncertain how well the committee functions – particularly when members of the committee are not even sure whether they serve on the committee. Tr. at H-65. We also find it noteworthy that Mr. Klein, and for the short time that he has been employed by Petitioner,

believes the entity performing operation and maintenance of the System should not be the one also performing capital projects. Tr. at K-71.

In addition, CH2M HILL's findings concerning the Incentive Fee are further illuminated by Mr. Klein's testimony that the Department has commenced an accounts receivable initiative because of the significant amount of money outstanding and owed to Petitioner. Tr. at J-33. Mr. Klein expressed his lack of understanding as to why Veolia was earning almost 100% of the Incentive Fee for "collection rate" but had millions in accounts receivable outstanding. Tr. at K-42 to K-43. We agree that an extensive, transparent review of the fee structure is overdue as it is certainly questionable whether the Incentive Fee is based on the correct metrics to assure exceptional performance by Veolia, rather than to merely meet industry standards, as Mr. Ispass noted.

Consequently, should the Waterworks not be acquired by Citizens Energy Group,³ we find that the Department shall take the necessary steps to review, at a minimum, the areas identified by CH2M HILL, those pointed to by the other parties to this proceeding, and those identified by the Commission in its June 30 Order (such as the ability to make adjustments to the contract based upon exigent circumstances such as those faced by Petitioner), and make any appropriate revisions to the Management Agreement to ensure the System is reasonably operated and adequately maintained at just and reasonable rates. Any amendments to the Management Agreement shall be filed with the Commission within 10 days of their execution and served on the parties to this Cause. In order to ensure that the Department complies with the Commission's directive to explore possible improvements to the Management Agreement, the Department shall make quarterly filings in this Cause providing a detailed summary of the discussions with Veolia regarding the issues mentioned above. The summary shall also include the dates each meeting took place, the individuals involved with the discussions, any agreements reached and any impasses where no agreement was reached.

2. Management Structure Review. In the June 30 Order (at 26), the Commission ordered the Department to undertake a comprehensive review of the Department's management structure "to identify appropriate management policies and procedures that need to be in place to assure proper, timely and reasonable management of utility operations." The Commission found that the public interest requires this to be addressed as part of this rate proceeding along with the completion of a strategic plan. We further found that any rate relief will depend, at least in part, on satisfactory responses to concerns raised in our Interim Order and a demonstration that the Department's Management Structure is appropriate.

We find Petitioner has substantially complied with our directive. This finding is not to absolve the Department of any further responsibility with respect to its management structure. On the contrary, Petitioner has identified many areas where it can and should make improvements to its management structure. We consider many of the financial difficulties it has experienced (such as those related to the lack of monitoring the swap arrangements and assumption of significant variable rate debt) as well as certain issues with Veolia (such as the maintenance issues discussed above) to be caused in part by its poorly designed management

³ On August 11, 2010, a Petition was filed with the Commission in Cause No. 43936 concerning the proposed transfer of the Waterworks to Citizens Energy Group.

structure. While we consider the Management Structure Review to be a significant step in the right direction, it is clear additional work remains to be done.

However, given the uncertainty of continued ownership of the Waterworks by the Department, the Commission finds that the Organizational Design Study (“Study”) proposed by CH2M HILL and supported by Mr. Klein should not be undertaken at this time. If the System is acquired by Citizens Energy Group, management of the System is quite likely to change. Therefore, we do not find it to be in the public interest at this time for the Department to expend the funds required to complete an organizational design study. Should the Waterworks not be acquired by Citizens Energy Group, the Department shall undertake an organizational design study and file with the Commission in this Cause a copy of the Study within 30 days of its completion. Within 90 days from the completion of the Study, Petitioner shall also adopt and file with the Commission in this Cause (1) a long-term financial plan and any fiscal controls necessary to properly monitor the financial performance of the utility; and (2) a capital project policy that requires utility management to control and oversee all capital planning and provides guidelines regarding public bidding of capital projects.

3. NARUC Accounting System and Financial Guidelines. As noted in the June 30 Order, the Commission approved a settlement between the Department and the OUCC in the Department’s last rate case, Cause No. 43056, in which the Department agreed to revise its accounting system and policies to comply with the NARUC Uniform System of Accounts, and to revise its computer system to generate reports and statistical information for Commission reports. Two years later, Petitioner still had not complied with the terms of the settlement approved by the Commission’s Order.

Mr. Miller joined Petitioner as CFO in the fall of 2009, and wrote a program to “map” transactions posted to the City’s FAMIS system to the NARUC Chart of Accounts. He further testified that by May 15, 2010, the Department would be able to produce monthly financial reports which are fully compliant with NARUC standards.

The record in this proceeding was closed prior to the date by which Mr. Miller testified that Petitioner would be in full compliance with the Commission’s Order in Cause No. 43056. Petitioner is therefore directed to provide a compliance filing in this Cause indicating that full compliance has been achieved.

4. Conservation Plan. The evidence presented demonstrates that the Department continues to move forward with water conservation plans and continues to look for new ways to enhance this program. Water conservation is not something that has a discrete endpoint, and it is appropriate and reasonable for the Department to continue to pursue and to demonstrate a commitment to water conservation. In addition, as the Conservation Plan identified concerns with current system treatment and delivery capacity and system sustainable supply yields, the Commission directs Petitioner to prioritize the measures that offer the highest water conservation outcome to respond to water shortage conditions, and to work toward the development of a “systematic plan” to respond to drought conditions.

We find the Department's presentation of the 2009 update to the Water Conservation Plan to satisfy its obligations under the Settlement Agreement approved in Cause No. 43056. The Department, with the condition set forth below, shall pursue the additional near-term water conservation measures delineated by Mr. Moran to: (1) establish a lead for conservation program coordination; (2) undertake a conservation rate study;⁴ (3) undertake an automatic metering pilot ("AMR"); (4) establish a voluntary maximum daily reduction load shifting program with large customers; (5) implement additional conservation messaging on water bills; (6) implement a water main replacement program; and (7) implement enhanced well monitoring to enhance supply availability. In its next general rate case, the Department shall update the Commission on the implementation of these measures.

With respect to the automatic metering pilot, Petitioner's witnesses at the hearing indicated a lack of familiarity with the National Broadband Plan developed and released by the Federal Communications Commission ("FCC") in March of 2009.⁵ In that document, a full chapter is devoted to the use of "Smart Grid" broadband-based technologies not only in the electricity sector but also other sectors, conceptually including natural gas and drinking water. We are concerned that Petitioner may be contemplating investment of in excess of \$1 million for a "pilot" AMR program without examining "Smart Grid" alternatives, both because selection of a "pilot" technology could predispose Petitioner to opt for full-scale implementation of that technology before fully evaluating alternatives, and because the FCC Plan suggests significant potential for multiple-sector cost sharing of infrastructure costs could be realized.

Consequently, before effectuating an AMR pilot or an alternate pilot utilizing broadband based "smart grid" technology, Petitioner shall explore the possible options, including whether selecting one technology may foreclose other options; and within 30 days of completing its evaluation, file in this Cause a compliance report summarizing Petitioner's findings.

5. Cost Reduction. In the June 30 Order, the Commission expressed its concern with the emergency financial condition in which the Department found itself and the inability, or "perceived inability," of Petitioner to take appropriate cost cutting efforts based upon the Management Agreement and ordered additional steps be taken. June 30 Order at 14-18. In the proceeding to establish permanent rates, Mr. Klein outlined the Department's efforts to reduce costs in accordance with the June 30 Order in a Cost Reduction Status Report. Pet. Ex. MTK-3. At the hearing, Mr. Klein also testified concerning his personal "cold calls" to entities with large accounts receivable balances that netted approximately \$10,000 for the Department. Tr. at J-37.

While we find it is necessary and important to recognize the significant efforts Petitioner made to reduce its costs during this time of emergency, we also find it necessary to express our continuing concern with the inability of the Department to obtain and secure *all* appropriate and reasonable cost reductions in times of emergencies, based on the evidence presented by Veolia. First, while we recognize a utility has an obligation to provide safe, reliable water service

⁴ We note that the record reflects that the Department has launched a conservation rate study with its consultant, CDM. Tr. at K-57; see also Exhibit MTK-R1, Tab K.

⁵ Fed. Comm'n Comm'n, *The National Broadband Plan: Connecting America*, available at <http://www.broadband.gov>.

regardless of the state of the economy, we also fully expect a utility to consider the economy as a factor in determining the reasonableness or necessity for either continuing or embarking upon specific activities related to providing water service. For example, a project beneficial (as opposed to essential) to the provision of water may appear more prudently undertaken in times when the economy is booming, rather than when the economy is taking a downturn. Mr. Gadis' statement that "[w]e simply cannot roll back operations until the economy improves" leaves an impression that Veolia believes it need not trim costs because it provides a vital service or that it is so efficiently operated that no improvements can be made. Pet. Ex. DG at 26. Neither of which we believe to be true. Second, Ms. Baumes testified that based on the structure of the Management Agreement, as there is no direct pass through of costs to ratepayers, there is also no direct pass through of savings to ratepayers. Tr. at V-51 to V-52. So, while Veolia identified a number of cost reductions and investment options that allegedly led to cost reductions which amounted to approximately \$2.3 million, Ms. Baumes acknowledged that such savings would not directly benefit the Department or the ratepayers. Tr. at V-85 to V-86. Veolia alone enjoyed the benefits of these cost reductions, virtually offsetting the effect of the Commission's June 30 Order freezing Veolia's compensation.

Consequently, we continue to believe that the ability of the Department to appropriately address emergency conditions facing the utility is another area of the Management Agreement that the parties should be required to explore and find that this should be added to the list of issues to be considered in reviewing the Management Agreement or any amendments that might be contemplated.

7. Petitioner's Proposed Revenue Requirement.

A. Operating Revenue Adjustments.

1. Petitioner's Direct Evidence. Petitioner made three adjustments to operating revenue. First, Mr. Skomp adjusted test year revenues to reflect additional revenues from the 10.8% increase that was granted as part of the emergency phase in this Cause. The 10.8% increase was applied to test year revenues from sales of water to calculate the increased revenues that could be expected as a result of the newly approved rates and charges. Pet. Ex. JRS-5. Second, Mr. Skomp adjusted System Development Charge revenues to remove \$2,513,000 of collections for System Development Charges from the operating section of the income statement and to move it to the non-operating section. *Id.* Finally, Mr. Skomp moved \$796,000 of collections for Merchandising, Jobbing and Contract Work from the operating section of the income statement to the non-operating section. *Id.*

2. OUCC's Evidence. The OUCC agreed that an adjustment was necessary to reflect the 10.8% rate increase ordered during the emergency portion of this rate case, but disagreed with the Department's calculation of this increase. Mr. Patrick testified the OUCC proposed to apply the 10.8% emergency rate increase to a larger amount of water revenue, increasing the adjustment from Petitioner's proposed \$12,771,000 to \$12,956,000. Mr. Patrick testified the OUCC first included forfeited discounts of \$1,090,000 in revenues subject to the 10.8% increase. Next, the OUCC increased water revenues subject to the 10.8% increase for bad debt expense and sales tax penalties that were incorrectly charged against revenues during the

test year. He stated, after adjusting for these three items, the total revenue increase related to the emergency rate order is \$12,956,000. *See*, Pub. Ex. 2, Schedule 4, Adjustments 3, 4, 5.

As noted above, the OUCC proposed additional water revenue adjustments to reflect misclassifications of both bad debt expense and sales tax penalty charges against revenues. Mr. Patrick stated the OUCC first reclassified bad debts that were charged off against revenue in the amount of \$559,864. Second, the OUCC reclassified sales tax penalty charges that reduced revenue in the amount of \$63,982. He further noted although the bad debt expense was reclassified to operating expenses, sales taxes were not reclassified since sales taxes are a liability and not an O&M expense.

Mr. Patrick also testified that the OUCC had reviewed Petitioner's contracts and determined that Other Income should be \$48,500 based on four contracts indicating Petitioner was receiving revenue from antenna rentals, an encroachment agreement, and an annual disconnect fee. Public's Exhibit 2, Schedule 4, Adjustment 8 reflects the increase of \$15,914 (\$48,500 minus \$32,586) over test year operating revenues.

Mr. Patrick testified that the OUCC reclassified \$796,000 in merchandising, jobbing and contract work from operating revenues to non-operating revenues "below the line." He stated although these revenues are not included in net operating income, they are included as an offset to the OUCC's proposed total revenue requirement.

Finally, Mr. Patrick testified that the OUCC proposed two additional adjustments to water revenues related to customer growth. The first adjustment was to annualize test year residential customer growth. Public's Exhibit 2, Schedule 4, Adjustment 6 presented the calculation for this adjustment, which yielded an increase in revenue of \$230,000. The second adjustment was for residential customer growth during 2009. Public's Exhibit 2, Schedule 4, Adjustment 7 presented the calculation for this adjustment, which yielded an increase in revenue of \$686,000. Therefore, the OUCC's total customer growth adjustment was \$916,000.

The OUCC's witness, Mr. Jon Dahlstrom testified that as part of his review of the billing data workpapers of Petitioner's witness, Mr. Heid, he noted significant billing errors and customer misclassifications. Mr. Dahlstrom specifically discussed one billing volume error in account #C000150730, which amounted to more than 4.4% of the total Residential Billings quantities during the test year. Although Mr. Dahlstrom recommended that these volumes be adjusted and reflected in the allocators used in developing the cost of service, he made no representation as to any affect on the revenues in the test year.

The OUCC proposed test year pro-forma operating revenues of \$133,893,590.

3. Industrial Group's Evidence. Mr. Collins recommended a residential customer growth adjustment and explained that the Department's use of its 2008 sales revenues in the test year, adjusted for the emergency rate increase to determine current operating revenues, understated residential sales volumes because Petitioner failed to account for growth in residential customers. Mr. Collins added that understating sales volumes increased the Department's claimed revenue deficiency. Mr. Collins recommended that the Department's test

year residential sales volumes be adjusted to account for 2009 customer growth and the average projected growth in customers for 2010 and 2011. He explained that adjusting the residential customer counts for the average growth in 2010 and 2011 was consistent with the Department's proposal to adjust its capital expenses to the average of 2010 and 2011 and would synchronize the Department's revenues with expected capital expenses.

Mr. Collins also recommended adjustments to the Department's water sales volumes to normalize for abnormal weather during the test year. He explained that the Department's use of 2008 sales volumes understates residential and commercial sales volumes, understates the revenues received from customers under current rates, and understates the Department's operating income at present rates. Mr. Collins asserted it is important that rates be set based on normalized usage to eliminate the effects of unusual weather variations.

Mr. Collins testified that the weather in 2008 was both wetter and warmer than the 30-year weather average based on 1971 – 2000 data from the National Weather Service for the Indianapolis area. He added that the period of May – September 2008 had much higher rainfall (*i.e.*, 23.99 inches) than compared to the 30-year average for the May – September period (*i.e.*, 19.61 inches). Mr. Collins stated that in a year with above average rainfall, customers tend to use less water in the weather sensitive months of May – September. He said rainfall during this period affects the Department's customers' demand for water used for lawn irrigation and plant watering, thus reducing the average water use per residential customer for the Department on an annual basis.

Mr. Collins also reviewed the number of Cooling Degree Days ("CDD") for the period May – September 2008 compared to the 30-year average. He said for the months of May – September 2008, the Indianapolis area had 1,044 CDD, which is 3% above the 30-year average of 1,015 CDD for the May – September period. He stated this indicates the September – May 2008 period was warmer than the 30-year average.

Mr. Collins testified that, based upon his analysis, 2006 weather for the May – September period is a recent period that approximates the 30-year average. He argued that because weather is the most significant variable affecting residential water usage level, one would also expect the Department's 2006 residential water usage per customer to be average or normal. Citing the Department's response to OUCC Data Request 32, Mr. Collins stated the Department recognized that 2006 was a more representative year in terms of precipitation. Mr. Collins also noted the Commission's findings regarding precipitation and normal weather in the Commission's June 30 Order at page 21.

Mr. Collins also testified that he would not expect customer water usage efficiency to significantly affect the Department's average usage per residential customer between 2006 and 2008 because there is only a two year difference. He added that he examined the Department's total water pumpage for both 2006 and 2008, which revealed that in the non-weather sensitive months (January – April and October – December) total pumpage in 2008 compared with 2006 actually increased by 0.4%. He explained that if efficiency in water usage had increased significantly from 2006 to 2008, he would expect pumpage in the non-weather sensitive months to decrease from 2006 to 2008, which did not happen.

Mr. Collins stated that total pumpage for the weather sensitive months (May – September) decreased in 2008 compared with 2006 by 1.7%. Mr. Collins opined that the decrease in pumpage from 2006 to 2008 was primarily driven by the increased level of rainfall in 2008, which reduced customer water usage for irrigation and plant watering.

Mr. Collins calculated that the actual annual water usage per residential customer from the Department in 2006 was 91.81 CCF, which usage was higher than the 2008 water usage per customer of 85.51 CCF utilized in the Department's test year to calculate water sales volumes and corresponding sales revenues at current rates. Mr. Collins recommended using the 2006 actual annual residential water usage per customer of 91.81 CCF to determine the Department's normal residential sales volumes for the test year. He said utilizing the 2006 average water usage per customer will normalize test year sales volumes for weather. Using his recommended residential water usage increased the annual residential water sales volume by 1,779,832 CCF and increased residential sales revenue under current rates by \$3,171,802. Mr. Collins also noted that his adjustment reflects an estimate of the increase in purchased power and chemical expenses associated with the additional volume of water sales under his weather normalization.

Mr. Collins also recommended an adjustment to the Department's commercial sales revenues at current rates. Mr. Collins noted that many commercial customers use water for outdoor activities, such as grounds irrigation, and therefore are weather sensitive. Mr. Collins recommended using the 2006 actual annual commercial water usage per customer of 963.75 CCF for the same reasons as described above for the residential water sales volume adjustment. He explained utilizing the 2006 average commercial water usage would normalize commercial sales volumes for weather. His recommended commercial water usage per customer increased the annual commercial water sales volume by 1,390,960 CCF and increased commercial sales revenue under current rates by \$2,270,783. Mr. Collins noted his adjustment reflects an estimate of the increase in purchased power and chemical expenses associated with the additional volume of water sales associated with the weather normalization.

Mr. Collins stated he did not recommend any adjustment to the Department's industrial water sales volume to account for weather because water sales to industrial customers are generally not weather sensitive.

Finally, Mr. Gorman noted that the Department removed \$796,000 of revenue related to job and merchandise revenue and included it as a below-the-line item. Mr. Gorman disagreed with that treatment because the Department provided no justification for not reflecting the revenue in determining whether there was a revenue deficiency on its System. He recommended the revenue be included in the Department's cash flow study to determine whether it has a cash flow deficiency.

4. Petitioner's Rebuttal Evidence. Petitioner accepted several of the OUCC's proposed adjustments and only the Merchandising, Jobbing and Contract Work adjustment of the Industrial Group.

In Mr. Heid's rebuttal testimony, he agreed with Mr. Dahlstrom's testimony concerning errors in the raw billing data, including the commercial customers that were improperly labeled as "Res to Com" customers. Mr. Skomp incorporated the billing error adjustment into his testimony and exhibits (*see* Pet. Ex. JRS-R1), but noted the OUCC did not flow through the adjustment to its schedules. Mr. Skomp noted this may have been due to the fact that the OUCC's cost of service testimony was by agreement of the parties filed after revenue testimony. Accordingly, Mr. Skomp decreased test year revenues by \$981,000.

Mr. Skomp rejected both customer growth adjustments proposed by the Industrial Group. Mr. Skomp noted that the Industrial Group's growth adjustments include adjustments in 2010 and 2011, which he believes are highly improper, and are not fixed, known, and measurable. While testifying that he is not a proponent of customer growth adjustments, Mr. Skomp accepted the customer growth adjustments proposed by the OUCC, as they reflect the general approach that has been accepted by the Commission when customer growth adjustments are used. Mr. Skomp testified that he incorporated the OUCC's customer growth adjustment into his operating revenue calculation on Petitioner's Exhibit JRS-R1.

Mr. Heid disagreed with Mr. Collins' usage and normalization adjustment. Mr. Heid testified that there is no generally accepted methodology for calculating a weather normalization adjustment for water utilities. He testified that in past cases where weather normalization adjustments have been approved, the Commission required a direct correlation between water usage, and the independent variables affecting water usage. Mr. Heid argued that Mr. Collins failed to demonstrate that there is any direct correlation between precipitation and average water usage or between CDDs and average water usage per customer. Mr. Heid testified that Mr. Collins had not cited a single case in any regulatory jurisdiction where a public utility commission has found a direct correlation between precipitation and residential or commercial water usage, or between CDDs and residential or commercial water usage. Mr. Heid further testified that a number of factors affect usage, including the rate of precipitation, runoff, conservation and economic considerations.

Mr. Heid also noted the Industrial Group had proposed a usage normalization adjustment in the emergency phase of this proceeding using a different "normal" year than proposed in the instant proceeding, which the Commission rejected. Mr. Heid testified that Mr. Collins has utilized different weather normalization variables and "normal" years between the current case-in-chief and the *Indiana-American* case, Cause No. 43680, in which Mr. Collins filed less than six months before filing his proposed weather normalization adjustments in this Cause. Mr. Heid also noted that the OUCC did not propose a water usage normalization adjustment. For these reasons, Mr. Heid recommended that the Commission reject Mr. Collins' usage and normalization proposal.

Mr. Skomp accepted the Industrial Group's adjustments to the revenue requirement due to jobbing and contract revenue.

5. Commission Discussion and Findings.

a. Billing Errors Adjustment. Petitioner's proposed revenue adjustment for billing errors was made in its rebuttal filing based on the errors discovered by Mr. Dahlstrom in

the raw billing data used by Mr. Heid to prepare his cost of service study. While Mr. Dahlstrom's testimony identified these errors and indicated they would affect the cost of service study, there is no evidence in the record to support a conclusion that the errors identified would have had any effect on the Department's test year operating revenues. Mr. Dahlstrom's testimony does not provide any indication that the identified billing errors would have an impact on operating revenues. His testimony was limited to the influence these errors had on the cost of service study. Nor does Mr. Skomp provide any basis for making the revenue adjustment, other than to note that the OUCC had identified the errors, but did not also propose to adjust revenues.

While one could assume, particularly with respect to utilities where the billing and general ledger systems are integrated, that an error in the billing system would necessarily affect the revenues recorded to the general ledger, such is not the case here. In this instance, the record indicates the billing and general ledger systems are not integrated, but are separately owned by different entities. The billing system is owned by Veolia, while the general ledger system is owned by the Department. There is no evidence in the record to indicate the billing errors identified by Mr. Dahlstrom flowed to the Department's general ledger, or that there is a need to adjust test year operating revenues. Therefore, the Commission finds Petitioner's proposed billing error revenue adjustment to be unsupported by the evidence.

b. Customer Growth Adjustments. Customer growth adjustments are commonly accepted in rate cases. However, as operating revenue adjustments, customer growth adjustments are only to account for test year and adjustment period increases. *See* June 30 Order at 28 (operating revenue adjustments are limited to those that are fixed, known and measurable in 2009). Petitioner agreed with the OUCC's proposed customer growth adjustments, but contested the Industrial Group's customer growth adjustments. We find the OUCC's customer growth adjustments, as agreed to by Petitioner, to be reasonable. The Industrial Group's proposed customer growth adjustments extend beyond the adjustment period and incorporate adjustments for 2010 and 2011. *See* Tr. at U-8 to U-10. Extending the adjustments in the manner set forth in the Industrial Group's evidence is contrary to the Commission's findings in the June 30 Order. Therefore, we find that the customer growth adjustments should be \$230,000 for the 2008 test year and \$686,000 for the 2009 adjustment period, for an aggregate customer growth adjustment of \$916,000.

c. Weather Normalization Adjustments. The Commission first notes that neither the Department nor the OUCC proposed a weather normalization adjustment. Only the Industrial Group proposed a weather normalization adjustment. While the Commission is not necessarily opposed to weather normalization water usage adjustments per se, we do note that unlike weather normalization adjustments for natural gas utilities, there is no generally accepted methodology for a weather normalization adjustment in water utilities. *See* Pet. Ex. KAH-R at 12. This places a greater burden on the party advocating the use of a weather normalization adjustment to establish a sufficiently direct correlation between its selected independent weather variables and water usage for the affected customer classes.

Mr. Collins proposed a weather normalization adjustment similar to one we recently rejected in the emergency phase of this proceeding. The Commission rejected that methodology on the basis that there was no evidence demonstrating that an average of the two years is

representative of “normal weather conditions” or that there was a “sufficient basis upon which to make a reliable adjustment to the test year revenues[.]” June 30 Order at 22. However, in the permanent phase, Mr. Collins proposed the use of different weather variables and a different “normal” year.⁶ More specifically, Mr. Collins now proposes to use summer precipitation and summer CDDs instead of annual precipitation, and to use 2006 as the “normal” year rather than the average of 2007 and 2008.

Based on the evidence presented, we are unable to accept Mr. Collins’ proposed weather normalization adjustment for several reasons. First, Mr. Collins did not offer any evidence demonstrating the existence of a direct correlation, or even a relationship, between CDDs and consumption. Second, and more important, Mr. Collins did not take the test year data and adjust it based on fixed, known and measurable factors, *i.e.*, based on a direct relationship between his assumed weather variables (summer precipitation and summer CDDs) and usage. Instead, Mr. Collins simply swapped out test year water usage for 2006 water usage, stating that 2006 was a “normal” year in terms of precipitation and CDDs.

Utility ratemaking adjustments are typically made by starting with test year data and then adjusting that data based on fixed, known and measurable factors. If an adjustment is fixed, known and measurable, we would expect the test year data to be the beginning data point and the fixed, known and measurable factors would cause that data point to move based on deviations in precipitation and CDDs from the 30-year normal. For example, we might have expected Mr. Collins to determine the change in usage per customer that each inch of precipitation caused. Similarly, we would have expected Mr. Collins to determine the change in usage per customer that each CDD caused. This is the precise methodology used in gas weather normalization adjustments, which have routinely been accepted by the Commission. *See e.g., N. Ind. Pub. Serv. Co.*, Cause No. 38380 (Oct. 26, 1988). Instead, Mr. Collins simply discarded the test year data and replaced it with 2006 water usage data.

Furthermore, the use of a proxy year in place of the test year requires that one assume there are no other differences between the proxy year and the test year than those caused by weather. Mr. Collins argued that because only two years had elapsed between 2006 and 2008, there could not be a significant difference in usage other than that caused by variations in precipitation and CDDs. We disagree for several reasons. First, Petitioner increased its rates nearly 30% in 2007 pursuant to our Order in Cause No. 43056. The evidence presented in this Cause indicates that water has a price elasticity associated with it. Pet. Ex. KAH-R at 15-16; Tr. at T-94 to T-95. Consequently, if prices increase, this may promote less summer usage when customers have greater discretionary usage. Second, in its last rate case, Petitioner agreed to continue with its conservation efforts and planning. In fact, Mr. Bell testified that Petitioner is at the forefront of water conservation in Indiana. Tr. at U-69. Accordingly, it is reasonable to believe that water conservation education by one of the utilities at the cutting edge of water conservation in Indiana would, or at least should, lead to reduced usage. Third, the marked downturn in the economy may also have a role in depressed water usage. Pet. Ex. KAH-R at 16; *See also*, June 30 Order at 22. Finally, Mr. Heid identified several other factors that may affect

⁶ We note that Mr. Collins also presented a similar weather normalization adjustment in Indiana American Water Company’s recent rate case, Cause No. 43680, using yet another weather variable and “normal” year.

water uses, including the rate of precipitation, evapotranspiration, soil recharge rates, runoff and moisture loss from the surface layer. *Id.* at 15-16.

Based on the evidence presented, we find that the Industrial Group has failed to establish a direct correlation between precipitation and usage. Accordingly, we decline to accept Mr. Collins' proposed weather normalization adjustment.

Based on the Commission findings above, Petitioner's operating revenue at present rates is \$133,894,000.

B. Operation and Maintenance Expense. As filed in Petitioner's direct testimony, Petitioner's test year O&M expense is \$62,168,000. Petitioner calculated its *pro forma* O&M expense to be \$63,977,000, while the OUCC calculated *pro forma* O&M expense to be \$58,607,000. The Industrial Group did not calculate *pro forma* O&M expense but rather rejected the Petitioner's proposed O&M adjustment of \$2,507,000 for the Management Agreement and \$1.9 million in post retirement expense.

Petitioner proposed several adjustments to O&M expense. Adjustments were made to the Management Agreement expense, post-retirement healthcare benefits expense, salary and wage expense and several other O&M expenses. The parties did not dispute Petitioner's (\$688,000) adjustment for "Purchase Agreement and Remarketing" fees, nor did Petitioner dispute the OUCC's adjustments; (\$23,552) for Other Employee Benefits, \$120,000 for Contractual Services, \$5,981 for Indiana Department Environmental Management ("IDEM") Fees and \$559,864 for Bad Debt Expense.

1. Management Agreement Expense Adjustments. As discussed below, the Department proposed an adjustment to its test year results to reflect fees payable under the Management Agreement.

a. Petitioner's Direct Evidence. Mr. Klein testified that the day-to-day operation and maintenance of the System is conducted by Veolia under the Management Agreement. Mr. Klein testified that the Department is responsible for supervising Veolia's operation of the System and for all policy making functions. He said among other things, the Department is also responsible for determining, with advice from Veolia, what proposed capital projects will be undertaken. The Department pays Veolia a "Service Fee" under the Management Agreement, which is composed of a "Fixed Fee" and an "Incentive Fee." The Fixed Fee is assessed annually based upon the formula set forth in the Management Agreement. Veolia receives the Incentive Fee to the extent it satisfies specific performance metrics identified in the Management Agreement. The Incentive Fee cannot exceed 25% of the Fixed Fee for any particular calendar year. Mr. Klein also concluded that Veolia is a qualified and competent operator of the System.

Jack Harold ("Hal") Gurkin, the Chief Operations Officer for the Department, testified that his duties include oversight of Veolia's operation and maintenance of the System and the capital improvement programs initiated by the Department. Mr. Gurkin testified regarding the manner in which operational issues are resolved with Veolia. Mr. Gurkin also described the

process that the Department uses to evaluate and approve the capital projects proposed by Veolia and the steps being taken by the Department to increase the level of public bidding for the Department's capital projects.

Mr. Gadis provided an overview of Veolia, its affiliates and parent companies. He explained how the Management Agreement was developed and discussed the services Veolia provides under the Management Agreement. Mr. Gadis explained that the Department's Request for Proposal anticipated the management fee would include a fixed and an incentive component, and payment for the implementation of capital projects. The incentive component was to be tied to the operator's success in satisfying various performance criteria developed by another outside contractor of the Department. Mr. Gadis stated that the performance criteria were developed by the Department's contractors, were based upon industry standards and were intended to improve the performance provided by the former IWC.

Mr. Gadis explained that, pursuant to the terms of the Management Agreement, Veolia performs all aspects of the day-to-day operations of the Waterworks. Mr. Gadis stated that Veolia also pays the portion of employees' post-retirement health benefit costs that is not allocated by the Management Agreement to the Department. He stated that Veolia is also responsible for developing an annual proposal regarding necessary capital projects and added that, while the Department is responsible for the final selection and funding of all capital projects, Veolia has historically implemented the majority of capital projects the Department elected to perform.

Mr. Gadis discussed the compensation structure set forth in the Management Agreement. He explained that the Fixed Fee was negotiated with the Department as part of the competitive bidding process through which the Department selected Veolia to operate the Waterworks. He stated that the Fixed Fee is adjusted annually for inflation. He explained that the inflation index reflected in the original Management Agreement was revised from the Consumer Price Index ("CPI") to a blended average of various relevant cost measures (referred to as the New Composite Price Index ("NCPI")) to more accurately reflect the parties' intention to adjust the Fixed Fee annually to reflect Veolia's actual cost increases. Mr. Gadis explained that the Incentive Fee payment varies depending on Veolia's success in meeting the identified performance benchmarks, but it cannot exceed 25% of the Fixed Fee in any given year. Mr. Gadis stated that if Veolia does not meet an identified performance minimum, it is not paid the Incentive Fee associated with the particular performance metric. He explained that the Management Agreement requires the Department to pay Veolia 60% of the anticipated Incentive Fee for a given year in quarterly installments during that year. Then at the end of year, the Department reviews Veolia's performance to determine the final amount of the Incentive Fee actually earned. Mr. Gadis explained that this payment structure provides Veolia the cash flow necessary for operation of the Waterworks throughout the year. He said it also allows the Department to effectively budget its obligations.

Mr. Gadis also discussed the condition of the Waterworks at the time Veolia began performing under the Management Agreement. He explained that Veolia's initial capital assessment conducted after the acquisition concluded that at least \$90 million in capital expenditures was needed in 2003 with comparable amounts needed in the following years. He

explained that the Department was actually able to invest approximately \$30 million to \$40 million in capital projects each year, most of which was, by necessity, directed to water quality, supply, system reliability, security and safety.

Mr. Gadis also explained that the parties negotiated specific provisions in the Management Agreement to accommodate potential changes and unexpected circumstances. He noted that the inflation adjustment mechanism applicable to the Fixed Fee was one way the parties attempted to ensure that the Fixed Fee did not diminish relative to actual costs as time passed. Mr. Gadis testified that because of the long-term nature of the relationship contemplated by the Management Agreement, the Management Agreement includes built-in triggers that, if tripped, require the parties to renegotiate the Management Agreement's terms, including the compensation due to Veolia.

Mr. Gadis explained that during the first few years of the Management Agreement, growth in the customer base was larger than expected, and this caused unanticipated expenses. He stated that the customer base increased by an amount that met the renegotiation trigger outlined in the Management Agreement. He stated that a number of other unanticipated circumstances increased the cost of providing water utility service above the level expected by the parties when the original Management Agreement was executed. Mr. Gadis explained that the parties used the renegotiation process contemplated in the Management Agreement to address growth of the System, unexpected events and to clarify the contract. Also, Mr. Gadis discussed the changes agreed to in the First Amendment.

Mr. Gadis explained that the actual financial results for the Department and Veolia in 2007 and 2008 were different than either party anticipated when they executed the First Amendment. He stated that chemical, utility and other expenses rose at unprecedented and unpredicted rates. He explained that the mix of work comprising the awarded capital projects differed from that assumed by the parties when they negotiated the First Amendment, with more projects being billed as time-and-material rather than as capital facility projects. He concluded that while the First Amendment moved in the right direction, the Service Fee paid under the Management Agreement, as amended, still did not cover the full cost of operating and maintaining the Waterworks. He stated that Veolia has continued to invest its own money in the operation and maintenance of the Waterworks.

Mr. Gadis testified that because the Management Agreement limits the Department's exposure to cost increases and places this risk on Veolia, Veolia is incented to utilize cost management tools. Mr. Gadis explained that during hard times the obligation to continue to provide reliable water service remains the same regardless of the state of the general economy. Mr. Gadis noted that whether the Department or Veolia operates the Waterworks, one would expect that much of the purchasing would be done via long-term contracts so as to ensure the materials and supplies necessary to provide water utility service are acquired in a cost-effective manner. Consequently, he stated, the obligations imposed by these long-term contracts cannot be avoided to reduce short-term expenses.

Mr. Gadis also explained that approximately half of Veolia's employees are union members whose compensation is determined by a Collective Bargaining Agreement. As a result,

the ability to reduce employee wages during difficult financial times is also limited. He stated that if the Department operated the Waterworks it is likely the same amount of its employees would be unionized and thus the Department would have limited ability to reduce compensation costs. Mr. Gadis added that the Management Agreement is not without safeguards and noted the contract provisions regarding the renegotiation process as an example.

Mr. Gadis also addressed the payment of the \$1.667 million due to Veolia that was suspended by the June 30 Order pending further review. He said that the non-payment of the agreed upon amount will further damage Veolia's financial well-being and that it is in the best interest of the customers, the Department and Veolia to allow the Department to pay Veolia for the services Veolia has performed.

Ms. Baumes discussed the reasonableness of the Service Fee that Veolia is paid under the Management Agreement. Ms. Baumes' testimony compared certain aspects of the operations of IWC in 2001 and 2002 with Veolia's operations in 2008. Ms. Baumes stated that according to IWC human resource records, IWC employed 482 employees (exclusive of student interns) in 2001 and 450 employees (exclusive of student interns) in 2002 to operate the Waterworks. She stated that in June 2008, Veolia operated the Waterworks with 390 employees (exclusive of student interns). She explained that despite customer and system growth and even with the Department's eight employees, who are responsible for administration and oversight, the total amount of personnel used today to operate the Waterworks is less than the amount of personnel utilized by the former IWC to operate a smaller Waterworks system. Ms. Baumes testified that since 2001 the customer base increased, as has the amount of below-ground and above-ground infrastructure.

Ms. Baumes discussed the cost of Veolia's services to the Department compared to relevant inflation from 2002 through 2008. She explained that the major drivers of Veolia's costs are labor, chemicals and utilities. She testified that from 2002 through 2008 Veolia's labor costs increased 20%, its chemical costs increased 166% and its utility expenses increased 49%. She stated that, based on its experience operating the Waterworks in 2007, Veolia has weighted its cost inputs as: 51% labor; 6% chemicals; 10% utilities; and 33% for all other cost inputs. She explained that using these assumptions, and assuming Veolia's "other cost inputs" increased no faster than the rate of inflation (as measured by the CPI and thus increased 22%), Veolia's total weighted cost inflation from 2002 to 2008 was 32%. She added however, that Veolia's Fixed Fee increased by only 22% over this same six year period (due to an increase in the CPI of 22% over these years), for an average price increase of 3.6% each year. She concluded that the structure of the Management Agreement protected the Department (and ultimately the customers) from approximately 10% of cost inflation from 2002 to 2008.

Ms. Baumes provided a comparison of the fees paid to Veolia under the Management Agreement to Veolia's costs to operate and maintain the Waterworks for the years 2002 to 2008 with the costs IWC incurred to operate the Waterworks prior to 2002. She explained that in 2001, the IWC directly incurred all operating and administrative costs for the Waterworks and that according to the 2001 audited financial statements for the IWC, its operating plus administrative costs were \$54.8 million. She stated that from 2002 to 2008 Veolia's cost inputs increased approximately 32%. She explained that if this same cost increase were applied to

IWC's 2001 operating costs, IWC's operating costs in 2008 would have been approximately \$72.3 million. Ms. Baumes testified that in 2008, the Service Fee was \$50.3 million. She added that the Department's 2008 administrative costs were \$12.8 million, for a total 2008 operating cost to the Department of \$63.1 million, which is \$9.2 million less than IWC's inflation-adjusted operating costs if IWC had remained the operator of the Waterworks.⁷

Ms. Baumes also testified that in each year from 2002 to 2008, Veolia spent more in operating and maintaining the Waterworks than it received from the Service Fee paid under the Management Agreement. As a result, she stated water utility rates do not reflect the full cost of operating and maintaining the Waterworks. She concluded that since 2002 the cost to Veolia to operate and maintain the Waterworks has exceeded the Service Fees the Department has paid under the Management Agreement by a total of \$76,923,905, which amount has come from Veolia and its parent entities.

Ms. Baumes explained that the Commission's June 30 Order deferred certain issues regarding the fees due Veolia to the permanent portion of this proceeding and directed the Department to withhold payments due to Veolia in excess of those paid in 2008. She testified the withholding of the payments due has negatively affected Veolia's cash flows. She stated this has required Veolia to obtain additional loans from its parent companies to meet its obligations and that this increases Veolia's total debt obligation, increases its interest costs, and reduces its net income. Ms. Baumes opined that, in her view, Veolia operates the Waterworks efficiently and effectively and has done so despite the unexpected financial and operational challenges experienced under the Management Agreement. She concluded that both the payments due to Veolia under the Management Agreement and the payments that have been temporarily withheld pending the outcome of this proceeding are reasonable and necessary and should be accepted for ratemaking purposes.

With respect to the Service Fee Adjustment, Ms. Baumes discussed the compensation paid to Veolia in the test year and adjustments to this compensation for 2009. She stated that the 2008 Service Fee was \$50,327,619 and the 2009 Service Fee is estimated to be a maximum of \$52.810 million. She explained that the Fixed Fee for 2009 will be \$42,248,170, which was calculated by adjusting the 2008 Fixed Fee for inflation in accord with the NCPI described in the First Amendment, which was 4.25% for 2008. She explained that 100% of the available pool for incentive payments for 2009 equals \$10.562 million, which represents the maximum available to Veolia for an Incentive Fee for 2009.

Mr. John R. Skomp, Partner with Crowe Horwath LLP, testified that the Management Agreement allows for a level of predictability in the Department's O&M expense, but that the Department has little direct control over the expense. He stated that based on current estimates provided by Veolia and the Department, Mr. Skomp testified that the annual cost of the Management Agreement will increase by approximately \$2.507 million during the 2009 calendar year.

⁷ Ms. Baumes indicated this is a conservative cost comparison because IWC's inflation-adjusted operating cost assumes the Waterworks did not change in size or complexity from 2001 to 2008, which she stated was not the case.

Finally, with respect to the outstanding payable to Veolia, Mr. Skomp testified that the Department proposes to amortize its outstanding payable to Veolia of \$1.667 million over two years. This would result in an amortization amount of \$834,000 per year in the revenue requirement. Mr. Skomp testified that the \$1.667 million payment is a contractual liability due under the Management Agreement and that the Department must receive operating revenues that allow for this amount to be paid because the Department does not have operating reserves or excess fund balances that could be used to make this payment. Mr. Skomp also explained that the Department was complying with the Commission's June 30 Order concerning the amount of management fees being paid to Veolia, but stated that to the extent actual payments to Veolia during 2009 were less than what may be owed under the contract, the Department would need to book the unpaid amount as a liability. He testified the incurrence of a liability during 2009 for unpaid expenses would meet the definition of items that are fixed, known and measurable and occurred within twelve months of the end of the test year.

b. OUCC's Evidence. Mr. Richard Corey, a Utility Analyst with the OUCC, testified that the parties executed the original Management Agreement on March 21, 2002 and that the original Management Agreement was properly and timely filed with the Commission on April 4, 2002. Mr. Corey noted the First Amendment was signed by the parties on June 26, 2007, but was not filed with the Commission until February 9, 2009 when the Department filed its request for emergency relief in this Cause.

Mr. Corey testified the original Management Agreement included provisions for amendment or renegotiation of the terms of the Management Agreement. He noted a renegotiation would be caused by (1) an increase or decrease of demand for finished water by five million gallons per day, (2) an increase or decrease in the customer base of 10,000 customers, or (3) a new plant that has a significant impact on O&M costs. Mr. Corey also observed that the Recital section of the First Amendment noted Section 5.02 of the Management Agreement that provided for a renegotiation threshold event of an expansion of territory or disposal of assets that results in a loss or increase of 2,000 or more customers.

Mr. Corey stated that of the potential threshold events noted in the First Amendment, the only one that appeared to apply was the decrease of 2,000 customers due to a loss of territory or plant. In the Recitals section, the First Amendment states DOW sold assets to the City of Carmel, which resulted in a loss of approximately 8,800 customers. He stated the other potential reasons listed in the First Amendment for renegotiating the agreement were not listed as threshold events under the Management Agreement. He testified that the First Amendment noted the need to address issues about the "meaning, application, and enforcement of the Management Agreement" in order "to avoid future disputes and the potential for uncertain litigation." Specifically, he stated that there appeared to be disagreement between the Department and Veolia as to which party was to ultimately bear the cost of installing and replacing valves, meters, hydrants, and service connections and pay certain Retiree Medical Benefits Obligations, and whether an Enhanced Atrazine Monitoring Program required by the IDEM should be considered an Uncontrollable Circumstance under the Management Agreement.

Mr. Corey stated the loss of 8,800 customers would ordinarily suggest a decrease in the fees to be paid Veolia, not an increase. He noted that Mr. Gadis asserted several reasons for Veolia's desire to renegotiate the agreement, including larger than expected growth in the

customer base, defects in the billing system, and a change in the law affecting the number of utility locates Veolia had to perform. Mr. Corey testified that none of the causes listed by Mr. Gadis in his testimony were identified in the First Amendment. He further stated that although Mr. Gadis asserted an increase in the number of customers triggered the renegotiation, the threshold event recited in the First Amendment was a loss of 8,800 customers.

Mr. Corey summarized the changes made in the First Amendment as follows: (1) replaced the CPI with a composite index for the purpose of inflation adjustment; (2) established that certain costs related to meters, hydrants, valves and service taps were defined as capital costs, thereby requiring the Department to reimburse Veolia for these costs; (3) required the Department to pay Veolia \$5 million to reimburse it for expenses incurred by Veolia during 2002 – 2006; (4) required the Department to pay higher Fixed Fee costs to reflect higher O&M expenses asserted by Veolia; (5) required the Department to pay for certain additional services, such as enhancing and reporting on Water Wise Conservation programs and activities, investigating and reporting on best practices of global water quality strategies, investigating and reporting on global water system security strategies and performing such other activities as Veolia and the Department mutually agree; (6) required the Department to incur additional costs related to an Enhanced Atrazine Monitoring Program; (7) required the Department to pay additional funds related to the Retiree Medical Benefit Obligations; and (8) set forth various other miscellaneous provisions, including allowing Veolia to recover fees tied to a previously discontinued incentive criterion. Mr. Corey testified that each change significantly increased the costs borne by the Department.

Mr. Corey testified that the increase to the Fixed Fee totals \$1,839,333 and is to be compounded each year by the NCPI. Of that amount, \$1,473,201 consists of the increase of \$316,690 per year associated with the White River North and Geist Capital projects, \$706,511 associated with the growth of the water works and a \$450,000 increase for reasons that were not specified in the First Amendment to the Management Agreement. The remaining \$366,132 represents the amount the Department agreed to pay for Certain Additional Services.

Mr. Corey stated the initial report of the Water Wise Conservation Program was provided by Veolia before the First Amendment and therefore indicates it is an obligation under the original Management Agreement. He stated that because the Department has already participated in the program and realized its intended benefits, the expenditure of \$366,132 was not warranted. He therefore concluded that allowing this cost to continue to be recovered in rates would be an inappropriate recovery of a non-recurring expense item.

Mr. Corey testified that the First Amendment explains the NCPI would be used to provide a more accurate inflation adjustment mechanism and to comply with Revenue Procedure 97-13. He stated the NCPI adds to the CPI certain weighting factors from the Labor Index, Utilities Index and Chemical Index adjustment. He also noted that in response to cross-examination by the OUCC during the emergency portion of this Cause, Petitioner's acting Executive Director, Mr. Steele, indicated relying on the NCPI as opposed to the CPI would have the effect of increasing the Fixed Fee.

Mr. Corey stated the Department's financial liability under the First Amendment was affected in several other ways. He stated, because the Incentive Fee is based on a percentage of

the Fixed Fee, an increase to the Fixed Fee has the effect of inflating the potential payout of the Incentive Fee. In addition, he stated, the Incentive Fee payout will also be higher than it would otherwise be because of the Department's agreement to apportion its water hardness incentive among all other incentives.

Mr. Corey noted the parties also changed the definition of what constitutes a capital project. As a result of the First Amendment, capital projects are to include all costs associated with the installation or replacement of new meters, hydrants, valves and service taps. He stated these additional costs would now ultimately be paid by the Department. Mr. Corey further testified that the cost to the Department to reimburse Veolia for performing an Enhanced Atrazine Monitoring Program is not set forth in the First Amendment. He stated this change will impose a financial burden on the Department it might not otherwise have had to pay.

Finally, regarding retired employee medical benefits, Mr. Corey stated that it appeared prior to the First Amendment, the Department interpreted the Management Agreement to require the Department to be responsible for payments into the medical benefits plan that represented the portion of liability related to Department and Veolia employees eligible to be vested under the plan as of December 31, 2004. Conversely, Veolia would be responsible for the liability for employees vested into the plan on and after January 1, 2005. He stated that the First Amendment stipulated the liability for employees who were unvested on or after January 1, 2005 would be funded by Veolia only for the remaining term of the contract, or until April 30, 2022. Subsequent to that date, the Department would be liable for the remaining funding of the plan. He noted the Department estimates this cost will be an additional \$2.4 million per year and that multiplying the additional contribution over 20 years would result in an added obligation of \$48 million.

Mr. Corey testified the First Amendment was very one-sided because it shifted various costs to the Department, clarified ambiguities only in favor of Veolia, and significantly increased the Department's costs without any significant benefit to the Department. Mr. Corey testified the OUCC did not consider it prudent and reasonable for the Department to have agreed to the terms of the First Amendment. He stated that, by agreeing to the First Amendment, the Department increased its costs without any material gain to offset the higher costs. While the Management Agreement set forth certain threshold events that may require a renegotiation, he was not aware of any part of the Management Agreement that would require the Department to agree to such a one-sided amendment. Notwithstanding Mr. Gadis' assertion the customer base had increased by an amount that triggered the renegotiation of the Management Agreement, he stated the First Amendment indicated the real trigger was actually a decrease in the number of customers, which would indicate a decrease in the Fixed Fee.

Finally, Mr. Corey, referring to Section II(11), testified that the First Amendment anticipated the Commission might disallow some of the additional expenses agreed to in the First Amendment. Mr. Corey recommended the Commission disallow the increases to the Department's revenue requirements caused by the Department's decision to enter into the First Amendment. More specifically, he recommended the Commission disallow the most readily quantifiable increases to the Fixed Fee of \$1,839,333, which would also require removing the application of the NCPI to the increase. He also recommended the Commission disallow the last

payment of \$1,666,667 that the Department agreed to repay Veolia for valves, meters, hydrants, and service connections previously paid for by Veolia. Mr. Corey opined the agreement to make this payment is imprudent and also violates well-founded principles of ratemaking prohibiting future recovery for past losses.

Charles E. Patrick, the OUCC's accounting witness, addressed Petitioner's proposed adjustment for an increase of \$2,507,000 in the Service Fee for test year operating expenses. Mr. Patrick testified the OUCC proposed three separate adjustments to the test year Service Fee paid to Veolia. The OUCC proposed an increase of \$2,385,000 to reflect the increase to the Service Fee and a decrease of \$1,839,333 to eliminate certain modifications to the Fixed Fee per the First Amendment as described by Mr. Corey. Mr. Patrick explained the OUCC's third adjustment related to the promise Veolia made in the Management Agreement to contribute annually at least \$363,721 toward civic and charitable activities in the Indianapolis area. Mr. Patrick stated the Commission has consistently excluded expenses related to charitable contributions from a utility's rates. Mr. Patrick asserted charitable contributions are not utility operating expenses used to provide utility service and thus ratepayers do not receive a material benefit from these expenditures. Mr. Patrick stated these costs could not be included in rates if paid directly by Petitioner, and therefore should not be included in rates as part of the value received by Veolia through the Management Agreement.

Mr. Patrick also discussed Petitioner's request for authority to make the third \$1.667 million payment to Veolia as outlined in the First Amendment to recognize a portion of Veolia's past unexpected expenses. Mr. Patrick explained Petitioner proposed to include one half of this payment (*i.e.*, \$834,000) as an annual revenue requirement to recover this past contractual obligation. Mr. Patrick stated the OUCC recommends the Commission deny recovery of the requested revenue requirement of \$834,000 per year based upon Ind. Code § 8-1-2-68, the Commission's prior rulings concerning the rule against retroactive ratemaking and the language in Paragraph 11 of the First Amendment.

c. Industrial Group's Evidence. Mr. Brian Collins with BAI, on behalf of the Industrial Group, testified that the Department's proposed test year Veolia contract expense adjustment includes \$1,722,000 for Veolia's Fixed Fee, which is an increase of 4.25% in the Fixed Fee as compared to the test year. Mr. Collins stated the Department has not justified the 4.25% increase in the Fixed Fee. He explained that the Department claimed the 2008 Fixed Fee was adjusted for inflation in accordance with the NCPI described in the First Amendment. Mr. Collins opined the Department provided no credible support for its calculation of the 4.25% increase.

Mr. Collins noted that based on his review of the First Amendment the NCPI is calculated according to the following formula:

$$(W \times \text{Labor Index}) + (X \times \text{Utilities Index}) + (Y \times \text{Chemical Index}) + (Z \times \text{CPI})$$

where:

$$W = 0.51$$

$$X = 0.10$$

$$Y = 0.06$$

$$Z = 0.33$$

Mr. Collins then used the 2009 values of the indices included in the NCPI formula and calculated the value of NCPI per the First Amendment formula as -0.28%. He noted that according to the First Amendment, if the NCPI is negative, the annual increase in the NCPI will be deemed zero. Mr. Collins added that the Department did not rely on an actual increase in Veolia's O&M expense for 2009 to determine the test year contract expense, but rather relied upon a hypothetical increase of 4.25% to the actual 2008 Veolia Fixed Fee expense.

Mr. Collins recommended no increase in the Management Agreement expense because the Department did not justify its NCPI calculation of 4.25%, and using the 2009 indices' values, the current value of the NCPI per the formula contained in the contract amendment is -0.28%. Mr. Collins explained that the Department's rates should reflect its actual cost of service and that an increase in the 2008 actual contract expense for 2009 would not reflect the Department's cost of service. Consequently, he recommended that the Management Agreement expense for the test year be held at its 2008 level. His recommendation decreases the Department's claimed revenue deficiency by \$2,507,000.

Mr. Collins concluded by recommending the Commission review the actual fees charged to the Department under the Management Agreement for reasonableness.

d. Petitioner's Rebuttal Evidence. S. Michael Hudson testified concerning the Department's decision to enter into the First Amendment. Mr. Hudson is a former member of the Department's Board and was involved on behalf of the Board in the negotiation of the Management Agreement and the First Amendment. He was a Board member for approximately seven years, serving as the Board's Secretary-Treasurer during his tenure. Mr. Hudson testified that at the time the Management Agreement was entered into in 2002, he thought that Veolia had been too aggressive in its bid, and that when Veolia asked to reopen the Management Agreement because the renegotiation triggers in the Management Agreement had been tripped, the Board understood Veolia to be under extreme financial pressure.

Mr. Hudson testified that the Management Agreement was not intended to be inflexible; the renegotiation triggers were designed to add flexibility. He said each party knew at the onset that there were unknowns in the future operation of the System, and the renegotiation triggers were designed to allow flexibility to adapt to the unknown issues that would arise. He stated that during the first years of the Management Agreement, Veolia informed the Board that it was losing money and in 2006, Veolia approached the Board concerning amending the Management Agreement. According to Mr. Hudson, Veolia threatened litigation, including rescission and termination of the Management Agreement, if the parties did not renegotiate the Management Agreement. The Department, in turn, threatened litigation if Veolia abandoned its contractual obligations under the Management Agreement. Mr. Hudson testified that Veolia's litigation

threat could have forced the Department to engage in costly litigation, the outcome of which could not be predicted with any degree of certainty.

Mr. Hudson explained that the Department also may have been forced to go through the time-consuming and complex process of selecting another private operator for the System. In addition, the Department had no way of knowing whether it would have been able to secure a suitable replacement operator on terms more favorable than those in the Management Agreement. Mr. Hudson stated the failure to immediately put in place a strong operator for the System would have been potentially catastrophic.

Mr. Hudson testified that the Department benefited significantly from the First Amendment in three ways. First, the Department retained its contractual operator, thereby providing continuity to the Department. Second, the Department avoided diversion of funds from needed capital improvements to litigate to keep the benefit of its original bargain. Finally, the Department gained more clarity in the operation of the Management Agreement. He stated that the First Amendment more clearly defined the parties' roles, which in turn allowed the Department to better oversee Veolia and to improve the Department's technical, financial and managerial capabilities.

Mr. Hudson responded to Mr. Corey's assertion that the loss of Carmel customers should have resulted in a lower Fixed Fee under the First Amendment, by stating that the loss of customers was simply the most visible triggering event for the renegotiation of the Management Agreement. He testified that once a triggering event occurred, all aspects of the Management Agreement were open to negotiation. Additionally, Mr. Hudson testified that the customer base of the Department increased by over 28,000, the 12-month moving average of daily finished water production increased by 6.8 mgd, and significant capital projects were completed for system growth purposes. Mr. Hudson testified that each of these factors increased Veolia's O&M costs.

Mr. Hudson explained that many factors led to the increase in the Fixed Fee payable to Veolia. These factors included the NCPI, the White River North and Geist capital projects, classification of the meters, valves and hydrants as capital projects, modification of the criteria used for the Incentive Fee, the Enhanced Atrazine Monitoring Program, the Water Wise Conservation Program, and post-retirement healthcare benefit obligations. Mr. Hudson testified that the Board concluded it was essential for the Department to have a stable, long-term operator in place with a deep understanding of the System. He testified that retaining Veolia, avoiding expensive and protracted litigation, and the potential for significant damages added a real value to the First Amendment for the Department. Mr. Hudson testified the First Amendment was a reasonable settlement of the claims concerning the Management Agreement.

Ms. Baumes responded to certain assertions by the OUCC and the Industrial Group regarding Veolia's financial performance and other issues arising from the Management Agreement. Ms. Baumes explained the CPI adjustment in Section 5.02(b) of the Management Agreement was intended to provide a mechanism by which Veolia could be compensated for the normal increases to its operating cost base. She explained that the CPI was found not to accurately reflect many of the operating expenses associated with a water utility. She stated that

the CPI is actually an inflationary indicator that measures the change in the cost of a fixed basket of products and services such as housing, food and transportation. She stated that the parties agreed that the CPI did not reflect the evolution of the cost of producing water and in general the CPI understates the expense inflation for the utility. Recognizing the NCPI is not completely reflective of the evolution of the increases in expenses, she stated the mechanism allocates an agreed-upon weight to Labor, Chemical, Utility and other CPI expenses. Therefore, she concluded, the NCPI should not be characterized as an “aggressive” tool for increasing the fees paid to Veolia, but as a mechanism that is more indicative of actual increases in the costs of inputs than the CPI.

Ms. Baumes disagreed with Mr. Corey’s contention regarding the effect of eliminating the water hardness incentive. She explained the variable portion of Veolia’s Service Fee is not higher than it otherwise would be due to the Department’s agreement to allocate the water hardness incentive. She stated the water hardness incentive was deleted and the dollars were spread among the other water quality performance criteria; the available dollars were not increased. She explained this modification was contemplated in Exhibit 12 of the original Management Agreement. She testified the ability to delete the criteria if required capital investments were not approved was inserted in the Management Agreement due to the naturally-occurring hardness in the raw water supply and the capital-intensive solutions required to achieve this performance benchmark. She testified the Department and Veolia agreed to remove the capital requirement from consideration along with the performance criteria because this measure is associated with an aesthetic, non-health related water quality consideration that is nevertheless largely beyond Veolia’s control. Therefore, the percent available was apportioned equally among the remaining performance criteria in the water quality category. She stated the parties further agreed that the performance criteria may be reinserted upon the Department investing in appropriate capital solutions to the hardness issue.

Ms. Baumes disagreed with the Industrial Group’s suggestion that the NCPI calculation was not supported by the Department. She explained that the Department’s proposed revenue requirement adjusts the 2008 Fixed Fee (test year amount) to reflect the amount due as of the end of the adjustment period (12 months ended 2009). She stated that this adjustment is not hypothetical, but was calculated using the exact formula set forth in Exhibit A to the First Amendment. She stated the indices are taken from the Bureau of Labor Statistics website and provided a table detailing the calculation of the 4.25% reflected in the Department’s revenue requirement. Ms. Baumes explained that Mr. Collins’ calculation does not use the 2007 and 2008 data required by the Management Agreement. Rather, she stated he relies on preliminary index data that would be used to calculate the Fixed Fee amount effective January 1, 2010 (a date that occurs outside the adjusted test period). She added that the Management Agreement provides that the increase effective January 1, 2010 must reflect the 2009 indices once they are finalized. She explained the index information Mr. Collins relied on has not yet become final. She stated when the more recent (yet non-final) index data is correctly used in accordance with the formula set forth in the Management Agreement, the Fixed Fee effective January 1, 2010 is not equal to the test year amount.

Mr. Skomp addressed the \$1.667 million payment owed to Veolia under the First Amendment. He testified the Department is contractually obligated to make this payment, but

based on the June 30 Order, the Department has withheld payment. Mr. Skomp asserted that the amount is not retroactive ratemaking because it is a contractual obligation that became due and payable during the accounting adjustment period established in this Cause.

Finally, with respect to the charitable and civic donations required to be made by Veolia under the Management Agreement, Mr. Skomp testified that in his experience these types of expenses are recorded as below-the-line transactions and that these expenses would come out of Veolia's annual profit. Mr. Skomp stated that no evidence has been presented that these costs have been passed along to the ratepayers. Ms. Baumes testified at the evidentiary hearing that corporate contributions are not recovered through the Fixed Fee paid by the Department. Tr. at V-19.

e. Commission Discussion and Findings. The OUCC argues that because the only reason indicated in the First Amendment for amending the Management Agreement was the decrease in 8,800 customers from the sale of assets to the City of Carmel, the First Amendment should have resulted in a decrease, rather than an increase, in the Service Fee. In addition, because the First Amendment was very one-sided in shifting costs to the Department, the OUCC did not believe it was prudent for the Department to have agreed to the terms of the First Amendment. While we are aware that the only reason for amending the Management Agreement identified in the Recitals section is the decrease in customers and agree it would have been reasonable for the parties to have identified all of the reasons for which they were agreeing to amend the contract in the Recitals, the evidence before us demonstrates that there were other reasons the parties agreed to the First Amendment that we simply cannot ignore, such as the increase in 28,000 customers over the base number of customers. In addition, while we recognize that the majority of the items contained in the First Amendment resulted in increased cost to the Department, that mere fact alone does not equate to a conclusion that the Management Agreement as a whole, *i.e.*, the original Management Agreement and the First Amendment, is unreasonable.

As discussed earlier regarding the Management Agreement review performed by the Department, we are not without concerns about the Management Agreement. However, based on the evidence presented, we cannot conclude that the Management Agreement as a whole is unreasonable or not in the public interest. Notwithstanding this conclusion, we address certain contested O&M expenses below.

(i) Service Fee Expense Adjustment. As explained above, Petitioner proposed an adjustment to its test year operating results to reflect an increase in both the fixed and incentive portions of fees paid under the Management Agreement. This adjustment increased test year operating expenses by \$2,507,000. The OUCC objected to \$2,325,000 of this amount. *See* Pub. Ex. 2, Schedule 5 at 3 (Adjustments 5, 6, and 7). As shown by the OUCC's Exhibit 2, Schedule 5 (Adjustment 5), \$1,473,201 of the OUCC's proposed \$2,325,000 total disallowance concerns the increase in the Fixed Fee based on the First Amendment. As also shown by this exhibit, \$366,132 of the OUCC's total proposed disallowance concerns fees for certain additional services purchased by the Department. *Id.* The amount remaining reflects the OUCC's proposal to reduce the Service Fee by an amount equal to Veolia's charitable and civic contributions, and the flow through effect of the OUCC's proposal to reduce the Fixed Fee on the calculation of the incentive portion of the Service Fee. *Id.*

The Industrial Group's witness, Mr. Collins, recommended the Management Agreement fees adjustment be excluded in its entirety. Mr. Collins calculated that the formula in the Management Agreement for the inflation adjustment results in no increase, not a 4.25% increase in the Fixed Fee. Therefore, he recommended that the contract expense be held at its 2008 level. We disagree with the OUCC's and the Industrial Group's proposed disallowances.

The record shows that the inflation index reflected in the original Management Agreement was revised from the CPI to a blended average of various cost measures delineated in the NCPI in an attempt to more accurately depict the parties' intention to adjust the Fixed Fee annually to reflect Veolia's actual cost increases. Although Mr. Collins contended that the formula set forth in the Management Agreement shows no adjustment should be made, Ms. Baumes demonstrated that Mr. Collins' calculation was erroneous. His adjustment relied on data that was outside the adjustment period. Based on the evidence presented, we agree that neither the CPI nor the NCPI accurately reflects cost increases. However, as noted by Ms. Baumes, the NCPI, which allocates an agreed-upon weight to Labor, Chemical, Utility and other CPI expenses, does attempt to better reflect the types of costs incurred by a water utility. Such clauses are not unusual or unreasonable because the parties recognize that the costs associated with the services being provided under the Management Agreement will change over time. In this way, the value of the fee does not become out of sync with the operating costs upon which it is based. Therefore, we believe Petitioner's test year Fixed Fee should increase prospectively based on the 4.25% index factor computed by Ms. Baumes.

As discussed earlier, the First Amendment contained certain modifications and cost increases to "accommodate system growth." Section II.5 of the First Amendment. One of the modifications purported to reflect the increased O&M costs associated with two capital projects. Section II.5(a)(i). Another adjustment purported to reflect the increased O&M costs associated with System growth. Section II.5(b)(i). And, the last adjustment merely indicated an increase to the Fixed Fee, without any explanation. Section II.5(b)(ii). In all three instances, Petitioner's testimony simply advanced the amounts, with no supporting testimony as to how the amounts were arrived at. Was the increase in O&M cost calculated based on the value of the capital expenditures as a percentage of the embedded undepreciated cost of the System? If so, what analysis was undertaken to adjust for the reduced infrastructure burden imposed by brand new infrastructure, as opposed to that imposed by the remainder of the System, given the mean age of the embedded or legacy infrastructure? Was this simply an across-the-board estimate of cost impact, or were calculations made based on the nature of the discrete investments which underlaid the projects identified? Or was some other calculation performed? Petitioner's testimony was devoid of substantive evidence in support of proposed increases. Indeed, as Mr. Corey noted, the \$450,000 increase was included "...for reasons that were not specified..." let alone justified. Pub. Ex. 3 at 8-9. The Commission is not in the business of "wondering" as to the validity of proposals, in the absence of testimony on the record.

The record is insufficient to support recovery of these particular increased costs, and the Commission so finds; recovery of these increased costs of \$1,473,201 is hereby denied.⁸ Once again, the opaque nature of the Management Agreement appears to have contributed to the

⁸ The Commission does not find such costs to be unrecoverable, only that the record was insufficient to recover these costs in this cause, at this time.

impression by Veolia that all they had to do to obtain an adjustment was ask, since all such costs are rolled up into one undifferentiated lump sum in the Management Agreement. The parties are reminded of the clause in the First Amendment (at 13) that "...[Veolia]'s compensation pursuant to the terms of the First Amendment shall be reduced dollar for dollar by the amount the [Commission] disallows such fees or expenses...."

We further note that Petitioner has asked to recover as a revenue requirement 100% of the total possible Incentive Fee that could be payable to Veolia. The record reflects the Department has never paid Veolia 100% of the possible Incentive Fee.⁹ The record also reflects that for the test year, the Department paid Veolia 96.5% of the possible Incentive Fee, which is the highest percentage paid since the inception of the Management Agreement. The average Incentive Fee payout for the two year period 2007 through 2008 is 96.5%. We find the Incentive Fee revenue requirement should be based on 96.5% of the possible Incentive Fee as opposed to the 100% proposed by Petitioner. Based on the authorized revenue requirement for the Fixed Fee, which is \$40,712,358, the maximum possible Incentive Fee would be \$10,178,090. This amount reduced to 96.5% is \$9,821,856. We find the Incentive Fee revenue requirement is \$9,821,856.

Finally, in the June 30 Order, the Commission found that the Service Fee paid to Veolia should be held at the 2008 test year amount based upon Petitioner's failure to provide a reasonable basis for increasing the management fees and the necessity for additional steps to be taken to contain and reduce fees during the time of Petitioner's financial emergency. As noted earlier in Paragraph 6.D.5., both the Department and Veolia have undertaken necessary and appropriate steps to contain and control costs during this time of emergency. Therefore, based upon the evidence presented in this proceeding on the Department's request for permanent rate relief, the Commission finds that the portion of its June 30 Order limiting the Service Fee to the 2008 test year amount should be lifted and that the Department, on a prospective basis, be authorized to pay to Veolia the Service Fee amount authorized herein.

Test Year Fixed Fee		\$40,525,823
Less: Unsupported Increase to Management Agreement		<u>1,473,201</u>
Fixed Fee Subject to NCPI Adjustment		39,052,622
Times: NCPI		<u>1.0425</u>
2009 Fixed Fee Before Adjustment	\$40,712,358	40,712,358
Contract Maximum % Incentive Fee	<u>0.25</u>	
100% of Incentive Fee	10,178,090	
96.5% Average Payout for 2007 & 2008	<u>0.965</u>	
Estimated 2009 Incentive Fee		<u>9,821,856</u>
2009 Service Charge		<u>\$50,534,215</u>

(ii) Veolia Charitable Contribution Expense Adjustment. The OUCS correctly notes that the Commission has not historically approved charitable contributions in the rates of utilities. However, the evidence presented in this Cause indicates that these

⁹ See Pet. Ex. DG at 14-15.

contributions are an obligation of Veolia and a below-the-line expense. No evidence was presented that Veolia's charitable contributions, if not made, would reduce the compensation paid by Petitioner to Veolia. Since no evidence was offered demonstrating that these contributions are included as part of the Service Fee, which is ratepayer funded, we find the OUCC's proposed charitable contribution adjustment should be rejected.

(iii) Outstanding Payable to Veolia. Another expense related to the First Amendment is the payment of \$5 million the Department agreed to pay Veolia at the time the First Amendment was negotiated. Payment of the \$5 million was amortized over three years, and the Department in this Cause seeks to recover the final payment, or \$1.67 million. The Commission's June 30 Order suspended the final payment until now to enable the Commission to determine if it was reasonable. The Department's position is that because it made a commitment to pay Veolia the \$5 million it is obligated to fulfill that commitment. Pet. Ex. JRS at 25, JRS-R at 13. The \$5 million payment by the Department apparently was based on Veolia's assertion of incurring necessary costs due to unexpected circumstances during the first five years of the Management Agreement. Pet. Ex. DG at 28, Tr. at N-25. Prior to this case, the Commission never saw or reviewed the First Amendment.

The First Amendment at issue here provides:

[The Department] shall recognize a portion of [Veolia]'s past unexpected expenses for the years 2002-2006 and will pay [Veolia] a total of \$5 million by making payments of \$1,666,666.67 per year by September 30 of Billing Years 2007, 2008, and 2009. [Veolia] certifies and [the Department] acknowledges that [Veolia] has incurred unexpected expenses in the amount of at least \$5,000,000 for the years 2002-2006. Upon payment of the amounts identified in this subparagraph, [the Department] will have no further obligation for [Veolia]'s unexpected expenses for 2002-2006.

First Amendment at 4. Significantly, the First Amendment states, "[The Department] shall recognize a portion of [Veolia]'s *past* unexpected expenses for the years 2002-2006 . . ." (emphasis added).

The prohibition against retroactive ratemaking is a well-established concept. The Commission has previously stated, "Simply put, the rule against retroactive ratemaking requires that in fixing rates a regulatory commission must fix such rates prospectively and may not fix future rates to compensate a utility's past losses." *N. Ind. Pub. Serv. Co.*, Cause No. 39723, 1994 Ind. PUC LEXIS 548, at *77-78 (Nov. 2, 1994). The two primary purposes for the rule against retroactive ratemaking are to ensure that utilities petition for rate relief before encountering a deficit spending situation and to avoid guaranteeing recovery of stockholder investments. *Narragansett Electric Co. v. Burke*, 415 A.2d 177, 178-79, 37 P.U.R.4th 569 (R.I. 1980).

While we recognize that Veolia asserted that it directly incurred the unexpected \$5 million past expense, as opposed to the Department, and that the Commission does not regulate Veolia, the Department's request to recover the third installment of the expense should be denied. If the Commission directly regulated Veolia, or if the Department directly incurred the expense, the prohibition against retroactive ratemaking would prevent recovery of the expense.

We see no reason that Veolia and the Department should be able to accomplish through a contractual agreement what they would not otherwise be able to accomplish directly.

Further, the Commission notes, Veolia is the Department's utility manager and acts as the Department's agent. With respect to utility management, the Commission has previously stated:

The [chance] of a loss or profit from operations is one of the risks a business enterprise must take. [A company] must bear the loss and is entitled to the gain depending upon the efficiency of its management and the economic uncertainties of the future Were it not so, a premium would be placed upon inefficiency, waste and negligence in management. It is better to encourage thriftiness, saving and frugality on the part of a utility management. Such incentive inures eventually to the benefit of the consumers in succeeding rate hearings.

City of Muncie v. Pub. Serv. Comm'n of Ind., 396 N.E.2d 927, 929 (Ind. Ct. App. 1979). This maxim applies equally to Veolia as the utility manager as if it were the utility itself. The Department and Veolia work closely together on a daily basis to ensure the provision of adequate service to customers. The evidence presented demonstrates that Veolia waited five years to seek recovery of the alleged unexpected past expenses through the First Amendment. The Department waited an additional two years before seeking recovery of the past expenses in a rate case, and without having submitted the First Amendment to the Commission until this case was filed. As such, Veolia's indirect attempt to recover its past losses at the expense of current and future consumers is prohibited by the proscription against retroactive ratemaking.

The Commission is aware the Department agreed in Cause No. 41821 it would not seek an increase in rates, absent exceptional circumstances, for five years as a condition of purchasing the water utility. *City of Indianapolis*, Cause No. 41821, 2002 Ind. PUC LEXIS 302, at *20 (March 28, 2002). Had the Department agreed to an absolute bar to petitioning for rate relief, we might have been more inclined to entertain an exception to the retroactive ratemaking prohibition. *See e.g., Town of Kingsford Heights*, Cause No. 38000, 1987 Ind. PUC LEXIS 272, at *32 (May 13, 1987) ("If a petitioning utility could demonstrate to this Commission that it incurred deficits because it was somehow prevented from obtaining rate relief then this Commission might consider making an exception to the prohibition of retroactive ratemaking."). However, the Department could have sought a rate increase under extraordinary circumstances, but it did not choose to do so.

Finally, not only do we find recovery of the \$1.67 million to be retroactive, but we find that allowing recovery of this amount would be unreasonable and not in the public interest. Under the terms of the 2002 Management Agreement, the \$1.67 million sought by Petitioner represents costs that were to have been paid by Veolia. When two parties negotiate a contract, each evaluates and determines the acceptability of the risks involved with agreeing to certain conditions. Petitioner's agreement to reimburse Veolia for those expenses Veolia had originally agreed to manage and pay results in negating the benefit of the bargain that Petitioner achieved in negotiating the original Management Agreement. We find this to be an unreasonable and imprudent cost that should not be paid by the Department and its ratepayers.

The Commission further notes the \$5 million cost incurred as a result of the First Amendment was not approved by the Commission. In addition, denying the Department's request for funding of the third payment in the amount of \$1.67 million will not result in an undue hardship upon the Department. The First Amendment contains a clause, which states:

In the event that the [Commission] specifically disallows any fee or expense that [the Department] is obligated to remit to [Veolia] pursuant to the terms of this First Amendment, [Veolia]'s compensation pursuant to the terms of this First Amendment shall be reduced dollar for dollar by the amount the [Commission] disallows such fees or expenses if such disallowance has the effect of preventing [the Department] from meeting its payment obligations under the terms of this First Amendment consistent with good or historical utility practice, its debt obligations or any applicable [Commission] order.

First Amendment at 13. Therefore, the Commission concludes the Department's adjustment for the \$1.67 million payment to Veolia constitutes retroactive ratemaking and an imprudent expense that should not be paid by the Department.

2. Post-retirement Healthcare Benefits Adjustment.

a. Petitioner's Direct Evidence. Gary D. Dickson, a retirement actuary and principal of Mercer, testified regarding the Department's Post-retirement Benefit Plan ("Benefit Plan"). He stated the Benefit Plan provides medical benefits to retired employees of IWC and Veolia and to future retirees of Veolia. Mr. Dickson testified that his actuarial analysis was done in accordance with the provisions of Statement of Financial Accounting Standards No. 106, titled "*Employer's Accounting For Post-retirement Benefits Other Than Pensions*" ("FAS 106") as modified by Financial Accounting Standards No. 132(R) and No. 158.

Mr. Dickson testified that the Management Agreement divides the liability for post-retirement welfare benefit costs under the Benefit Plan between the Department and Veolia. The First Amendment added liabilities to the Department (specifically, benefit payments after April 30, 2022, for participants not eligible to retire as of December 31, 2004). Mr. Dickson testified that as of December 31, 2008, the present value of the Benefit Plan's total liabilities ("APBO") was \$65,992,457, and that the Department recognizes \$59,687,339 of this liability. The accrued liability recognized under FAS 106 for the Benefit Plan was \$46,176,177, of which the Department's share was \$40,301,933. The difference between the APBO and the accrued liability is the amount of liabilities not yet recognized, or expensed, through the net periodic benefit cost. He stated this amount is made up of an unrecognized transition obligation of \$3,304,168, of which the Department's share is \$3,022,675, and an unrecognized loss of \$16,512,112, of which the Department's share is \$16,362,731.

Mr. Dickson testified that total Benefit Plan liabilities grow each year as active participants earn a year of additional service toward benefit eligibility and all participants move one year closer to each year of expected future benefit payments (*i.e.*, one less year of discounting). He testified substantial increases in health care costs are assumed in the calculation of the FAS 106 obligation (the trend rate assumption) with larger increases assumed in the initial years decreasing down to a lower assumed ultimate rate in the future.

Mr. Dickson testified that IWC created a Grantor Trust with approval granted by the Commission on April 26, 1995, in Cause No. 39713. The Grantor Trust was to be funded by the Commission-approved annual postretirement benefit funding requirement included in IWC's rates. These funds would then be used by IWC to pay, in full or in part, the postretirement medical benefits for its retirees. The Grantor Trust was transferred to the Department with the Commission's approval when the Department purchased IWC's assets in 2002. Mr. Dickson also noted that FAS 106 requires assets to be segregated and restricted solely for payment of benefits, but that under the provisions of the original trust document, the assets of the Grantor Trust are subject to the claims of the utility's general creditors and therefore not eligible to be counted as assets under FAS 106.

As of December 31, 2008, the Grantor Trust had assets of \$9,213,368 as compared to a liability of \$59,687,339, leaving an unfunded APBO for the Department of \$50,473,971. Mr. Dickson testified that this means the assets in the Grantor Trust cover only about 15.4% of the liabilities attributable to the Department. He stated the unfunded liability has grown significantly since 2005, due primarily to the additional liabilities incurred under the First Amendment, indicating that a larger annual contribution is necessary to adequately fund the benefits owed to employees and retirees. As of December 31, 2008, the liability associated with the Department's responsibility assumed under the First Amendment was \$14.4 million. He noted that prior rate requests would not have included this liability.

Mr. Dickson testified that it was his understanding that the annual funding amount included in rates under Cause No. 43056 was \$3.5 million, and that this level of funding does not adequately fund the Department's obligation.¹⁰ He testified that a 20-year projection of the benefit payments, obligations, and assets for the Department's portion of the plan liabilities, based upon a 4.25% investment return in the Grantor Trust assets and a discount rate of 6.50%, showed that with continued annual contributions of \$3.5 million the Grantor Trust would be able to meet all expected benefit payments for the first 20 years. However, he stated, in year 21 there will be insufficient funds remaining in the trust to pay the expected benefits for the year without additional contributions. Thereafter, the annual contribution would have to increase to between \$6.5 million and \$7.0 million to pay benefits on a "pay-as-you-go" basis.

Mr. Dickson testified that if annual contributions of \$5.9 million were made to the Grantor Trust for the next 20 years, the funded status would grow each year and reach 100% after 20 years. Thereafter, annual contributions of approximately \$1.7 million would still be needed. Mr. Dickson recommended that a 20-year amortization amount of \$5.9 million be included as the FAS 106 component of the revenue requirements determination.

b. OUCC's Evidence. Edward R. Kaufman, Senior Analyst with the OUCC, responded to Petitioner's proposal to increase its annual contribution to the Benefit Plan from \$3.5 million to \$5.9 million per year, an increase of almost 70%. Mr. Kaufman explained the funds included in Petitioner's proposed revenue requirements would provide money to pay benefits due to currently retired employees and to collect for the "expense incurred" in the current period to pay for future retirement obligations. Mr. Kaufman agreed with Petitioner that

¹⁰ We note that in Cause No. 43056, the Commission approved an annual funding of \$4.9 million, not \$3.5 million.

the Department's future benefit obligations exceeded the amount of funds the Department has paid into the Trust. Mr. Kaufman also testified that the First Amendment to the Management Agreement is in large part responsible for the Department's unfunded future benefit obligations.

Mr. Kaufman challenged Mr. Dickson's plan to fully fund the Trust over the next 20 years. Mr. Kaufman disagreed with Petitioner's proposal to increase funding to the Benefit Plan to \$5.9 million in this rate case simply so that contributions could be reduced to \$1.7 million starting in 2029. He stated that the Department failed to provide any support or analysis that fully funding the Grantor Trust within 20 years is appropriate. To address the Department's unfunded future benefit obligation, Mr. Kaufman proposed a more gradual increase to the amount included in rates, from \$3.5 million to \$3.75 million, to fund future obligations. Then, he stated, post-retirement healthcare benefits could be gradually increased in future rate cases.

Mr. Kaufman also discussed the Department's failure to properly fund its post-retirement benefits. Mr. Kaufman criticized the Department for not increasing its contribution to the Grantor Trust once it signed the First Amendment and began incurring additional post retirement benefit expenses related to the First Amendment. Mr. Kaufman testified the Department should have contributed additional payments in 2007 and 2008, but that it failed to increase its contribution. Consequently, he recommended that the Department be required to deposit \$3.35 million into the Grantor Trust within six months of the Commission's Order in this Cause to ensure past obligations are not paid for by future ratepayers.

c. Industrial Group's Evidence. Mr. Michael Gorman, a managing principal with BAI, disagreed with the Department's proposed increase to its Benefit Plan. He said the Department's methodology will significantly overcharge the current generation of customers and undercharge future generations of customers for this expense. Mr. Gorman explained that the Department's Benefit Plan will change with the annual cost of living, which will be reflected in labor expense and payments to retirees, but customers' disposable income will also be adjusted over time based on the same inflationary effect. He said consequently, the Department's analysis to hold contributions level over the next 20 years penalizes current customers and benefits future generation customers.

Mr. Gorman updated the Department's Benefit Plan calculation with two adjustments. First, he increased cash payments to the Grantor Trust at the same rate of increase in payments to beneficiaries of the trust. Second, he increased the expected earned return on the Grantor Trust fund assets up to 5.2%, which he stated was more in line with projected Treasury bond yields, as compared to the 4.25% trust fund return estimate used by the Department.

Under Mr. Gorman's adjustments, the Department's Benefit Plan starts at \$3.5 million in calendar year 2009, increasing to \$3.9 and \$4.0 million in 2010 and 2011, respectively. The two-year average contribution for 2010 and 2011 would be \$3.9 million, which represents a \$2.0 million decrease to the Department's proposed \$5.9 million. Mr. Gorman added that with this lower initial contribution, the Department would fully fund its payments to retirees and its trust fund assets will be equal to its benefit obligations at the end of 20 years.

d. Petitioner's Rebuttal Evidence. Mr. Dickson testified that he disagreed with Mr. Kaufman's proposed funding of the trust because it underfunds the Benefit Plan and makes funding dependent on future rate increases. Mr. Dickson explained that in his opinion employers should strive to fund post-retirement plans so that the benefits to be paid are funded during the working life of the employee. Mr. Dickson testified that such a funding approach directly reflects the economic reality that the employee has agreed to take a lesser amount of compensation in exchange for the promise that the post-retirement benefit will be paid for while the employee is working and adequately funded by the time the employee retires.

Mr. Dickson also disagreed with Mr. Kaufman's suggestion for gradual funding by way of additional rate increase requests. Mr. Dickson concluded that this proposal is based on a lack of understanding of the process and postpones for yet another day the issue of funding post-retirement healthcare benefits. He asserted it also creates a substantial amount of risk for future ratepayers who may be required to fund more of the benefit than they would be required to fund under Mr. Dickson's proposal.

Mr. Dickson testified that he investigated an alternative funding philosophy that would seek to fund the Grantor Trust to 80% after 20 years, rather than fully funding the Benefit Plan. He stated this would decrease the annual revenue requirement to \$5.4 million from \$5.9 million.

Mr. Dickson agreed with Mr. Gorman's approach concerning the funding of the Benefit Plan during the working life of the employee, but disagreed with Mr. Gorman's level of funding because it puts a heavier cost burden on ratepayers between 2022 and 2028.

e. Commission Discussion and Findings. The evidence presented indicates that all parties agree the Grantor Trust must be funded, but the parties approach the obligation from different funding philosophies. Petitioner's direct evidence recommended fully-funding the Grantor Trust. On rebuttal, Petitioner scaled back funding of the Grantor Trust to 80%, but did not recommend that funding approach. Both of Petitioner's proposals kept the contribution amount flat over the funding period. The Industrial Group also proposed fully funding the Grantor Trust, but reduced contributions in the early years and accelerated contributions in the outlying years. The OUCC proposed minimal funding of the Grantor Trust at present, with the matter being subject to further review in future rate proceedings.

Based on the evidence presented, we are not satisfied that the Department's approach to funding the Grantor Trust is reasonable. The Department's witness, Mr. Dickson, acknowledged that the \$5.9 million request was based on a desire to fund the Grantor Trust fully by the end of 20 years. During the proceedings it became clear that over the next 20 years, funding for the Grantor Trust would need to be increased for two reasons. First, the Department agreed to assume approximately \$14.4 million in additional obligations as a result of the First Amendment. In response to a discovery request, Mr. Dickson explained that the liability will eventually grow to approximately \$53.4 million. Tr. at I-47. Second, since the First Amendment, the Department's funding of the Grantor Trust has been inconsistent. Tr. at I-45. The result has been an underfunding of the Trust which necessitates a larger increase in funding to close the deficit.

While the foregoing may indicate an increase in funding is needed, when viewed against the larger background, we cannot justify imposing the added burden on the ratepayers as proposed by the Department for the following reasons. First, and foremost, is the unequivocal testimony that if the Department were to contribute \$3.5 million per year to the Grantor Trust it will be able to meet its expected benefit payments for the next 20 years. *See* Pet. Ex.'s GDD at 11 and GDD-4. In light of that testimony, we would not be justified in imposing an additional \$2.4 million per year. In addition, the evidence does not support the need to fully fund the Grantor Trust at this time. Mr. Dickson testified only between 10% and 20% of his own clients actually fund their own pension obligations fully. Tr. at I-77. During a period of "belt-tightening" in the competitive marketplace, the Commission would serve as a poor substitute for competition if we were to permit full recovery, through rates, of an expense that most other businesses simply book as an accounting expense.

Moreover, based on the evidence presented, we are not satisfied that providing the Department with the requested increase will result in the funding of the Grantor Trust in the manner proposed. During the evidentiary hearing, evidence was presented that revealed the Department was operating the Grantor Trust with only the most marginal of oversight. Indeed, the Department's own witnesses were unable to answer the most basic information regarding the Grantor Trust, such as the identity of the trustees, the location of the trust, and the nature of the investments made. *See e.g.*, Tr. at I-84, K-55, and S-86. Additionally, the Department's funding of the Grantor Trust has been inconsistent and, only in the last year, attained the \$3.5 million level necessary to meet obligations over the next 20 years. Furthermore, as Mr. Dickson testified, the Grantor Trust remains available to satisfy the needs of unsecured creditors. Tr. at I-78. This leads us to the conclusion that even if we were to authorize recovery of \$5.9 million, there is no guarantee such funds will be placed in the Grantor Trust, nor that they will ultimately be available in the future.

As such, we believe that the appropriate funding level should be \$3.5 million as shown on Petitioner's Exhibit GDD-4. Authorizing recovery of \$3.5 million will permit the Department to meet its benefit obligations for the next 20 years, and, at least in the near term, allow the Department to make some headway in closing the gap created by years of underfunding.

We further caution the Department that if it wishes to fully fund the Grantor Trust, our decision to permit such recovery in subsequent rate cases will depend on the Department sufficiently demonstrating that it has improved its oversight of the Grantor Trust, taken reasonable precautions to safeguard those assets allocated to meet its obligations, and shown a commitment to depositing all funds included in rates for post retirement benefits into the Grantor Trust, or successor trust.

In its proposed order, the OUCC suggests Petitioner should be ordered to establish a VEBA Trust and to transfer all of the assets of the Grantor Trust into the VEBA Trust. However, we lack sufficient evidence to determine whether this should be done. The Department has indicated that it does not oppose looking into establishing a VEBA trust to hold plan assets, and we find that investigating the possibility of establishing a VEBA trust is prudent. Therefore, the Department is instructed to investigate the feasibility and reasonableness of establishing a VEBA trust and transferring the Grantor Trust funds into such a trust and to file a

report of its findings in this Cause within six months of the date of this Order. The Department's report shall include its analysis of the implications of establishing a VEBA trust and transferring the Grantor Trust funds into a VEBA trust.

3. Salary and Wage Expense Adjustment.

a. Petitioner's Direct Evidence. Petitioner proposed *pro forma* payroll expense of \$689,000 for salaries and wages. Mr. Skomp testified that the Department had a great deal of turnover in personnel during the test year, which left some of the positions vacant for a period of time. Mr. Skomp also included expenses related to new positions for an engineering manager, a hydrogeologist and the vacant position of director of communications.

b. OUCC's Direct Evidence. Mr. Patrick explained that Petitioner proposed *pro forma* payroll expense of \$689,000 for salaries and wages of its existing six employees – executive director, chief operations officer, general counsel, chief financial officer, financial manager, and executive assistant, and three newly created positions: engineering manager, director of communications, and hydrogeologist. He noted that Petitioner was unable to find suitable candidates and had entered into contracts to fill the engineering manager, hydrogeologist, and communications positions instead of hiring permanent full-time employees. He stated after removing these positions from the *pro forma* salary and wage expenses, the resulting amount of \$497,000 yielded a *pro forma* increase to operating expenses of \$137,000.

c. Petitioner's Rebuttal Evidence. Responding to the OUCC's proposal to remove expense related to the director of communications, Mr. Miller testified that it is unreasonable to assume the Department will not have recurring expenses related to communications. Mr. Miller testified that Petitioner has had recurring expenses of this nature since its inception and that it has entered into a new agreement with Sease, Gerig & Associates that was approved by the Board on January 21, 2010.

In addition, at the evidentiary hearing, Mr. Klein testified that just prior to the rate case, the Department lost its communications director. Tr. at K-38 to K-39. He stated the Department is continuing to work on communications and has retained a communications consultant to assist the Department. *Id.* He further indicated that the Department's Strategic Plan (Pet. Ex. MBS-4) includes a significant public outreach component and that a communications function was needed. Tr. at K-38 to K-40.

d. Commission Discussion and Findings. On rebuttal, Petitioner agreed with the reclassification of the expenses related to a hydrogeologist and engineer from salaries and wages to contract expense. Consequently, the only contested salary and wage adjustment was the OUCC's proposal to eliminate \$33,000 in expense for a director of communications for the Department.

Based on the evidence presented, Petitioner has and will continue to incur recurring expenses for public communications expenses and the Commission finds it is reasonable to include these expenses in Petitioner's operating expense revenue requirement. Therefore, the Commission finds the \$33,000 proposed by Petitioner for a director of communications is

reasonable and should be allowed in rates in this Cause. However, because Petitioner contracted for communication services, such cost should be reclassified from salaries and wages to contract expense.

The Commission finds the *pro forma* increase to salaries and wages is \$137,000 for a total *pro forma* salaries and wages expense of \$497,000. No party disputed the methodology for calculating payroll taxes. Therefore, we find Petitioner's *pro forma* payroll tax expense to be \$38,021.

4. Audit and Accounting Expense Adjustment.

a. Petitioner's Direct Evidence. Petitioner did not propose any *pro forma* adjustments to the test year to exclude non-recurring expenses.

b. OUCC's Evidence. Mr. Patrick proposed to remove \$174,127 of non-recurring expenses that he identified during his general ledger review. Mr. Patrick proposed to eliminate the following non-recurring expenses: (1) prior year audit fees of \$45,895 recorded during the test year; (2) accounting fees related to O.W. Krohn & Associates (\$13,500) and H.J. Umbaugh (\$18,015); (3) fees of \$7,386 related to work performed by Kerry Heid; and (4) expense fees of \$89,331 paid to Mr. Jim Steele, the Department's interim director, during the test year.

c. Petitioner's Rebuttal Evidence. Mr. Skomp disagreed with the OUCC's proposed adjustments. Mr. Skomp testified that although the OUCC characterizes these adjustments as non-recurring expenses, no basis or evidence was offered as to how this conclusion was reached. Mr. Skomp testified that the OUCC is proposing to eliminate the annual cost of the Department's audit. He stated the 2007 audit was performed in 2008 and therefore was billed during 2008. Mr. Skomp testified that the approximate \$46,000 of annual audit expense should not be eliminated from the test year service as this expense is recurring in nature and is important to maintain.

Mr. Skomp also disagreed with Mr. Patrick's proposed exclusion of invoices relating to accounting assistance. Mr. Skomp testified that a certain level of accounting assistance is common and recurring. Mr. Skomp stated that in his opinion, an annual recurring budget of \$32,000 for accounting assistance is reasonable for a utility of Petitioner's size.

d. Commission Discussion and Findings. We agree with Petitioner that an annual audit is important to maintain. However, two years of audit fees were included in Petitioner's test year expense. At the hearing, OUCC witness, Mr. Patrick explained that the \$14,225 shown on the OUCC's Exhibit 2, Schedule 5, Adjustment 8 is related to the 2006 KPMG audit and not the 2007 audit. The balance of the audit fees (\$31,670) are for expenses related to Petitioner's 2007 audit, which should be allowed.

The OUCC also eliminated as non-recurring \$18,015 of test year payments made to Umbaugh related to the conversion of the City's fund accounts to the NARUC Uniform System of Accounts. Mr. Miller explained that the Department now has in place the appropriate

accounting framework to enable it to comply with NARUC accounting and to produce reliable annual financial reports. Pet. Ex. RJM-R at 3. However, the Department is still working on developing underlying processes, and assembling the data required to produce accrual basis NARUC compliant financial statements on a monthly basis. *Id.* Mr. Miller also explained that the City is in the process of selecting a new enterprise resource planning system that will include a more integrated approach to NARUC reporting, and provide many more management tools in the future. *Id.* Therefore, the evidence indicates that Petitioner will still need funding to cover its efforts to improve its accounting system. Thus, we decline to accept the OUCC's proposed elimination of \$18,015 related to improvement of Petitioner's accounting system.

With respect to the \$13,500 of test year accounting invoices from O.W. Krohn and Associates, we find that although Petitioner included additional salary and wage expense related to the hiring of a financial manager, it is reasonable to expect Petitioner to incur fees for "accounting assistance." Therefore, the Commission declines to accept the OUCC's adjustment for \$13,500.

Finally, the Commission accepts the OUCC's uncontroverted adjustments eliminating non-recurring expenses for work performed by Mr. Heid and Mr. Steele. Therefore, the Commission finds that of the \$174,127 the OUCC proposed to disallow as non-recurring costs, \$110,942 should be disallowed.

5. IUPPS¹¹ and Environmental Expense Adjustment.

a. Petitioner's Direct Evidence. Petitioner did not propose any *pro forma* adjustments to test year IUPPS and Environmental Expense.

b. OUCC's Evidence. The OUCC proposed to eliminate the following 2008 Veolia accrued expense items: EPA Sampling, \$175,146; atrazine monitoring, \$219,490; and IUPPS Agreement, \$261,646. Mr. Patrick testified these expenses were accrued on Petitioner's general ledger in December 2008, but no support was offered by Petitioner for these expenses. He stated that these expenses are separate and apart from the Fixed Fee or Incentive Fee payments to Veolia and it is unclear where the liability exists for these expenses.

c. Petitioner's Rebuttal Evidence. Mr. Miller took exception to Mr. Patrick's proposed elimination of the IUPPS and environmental expense items from the Department's operating expense. Mr. Miller testified that there is ample support for the inclusion of these items and that the OUCC did not request any such supporting evidence during its field audit. Mr. Miller attached copies of invoices to his rebuttal testimony as support for these annually recurring expenses.

At the evidentiary hearing, Mr. Klein also testified that the enhanced atrazine monitoring would continue. Tr. at K-41 to K-42.

d. Commission Discussion and Findings. As presented by Mr. Miller, the evidence demonstrates that the Department incurs costs in connection with IUPPS for

¹¹ Indiana Underground Plant Protection Service

underground infrastructure locates and environmental expenses for sampling required by the Environmental Protection Agency (“EPA”) and the Enhanced Atrazine Monitoring Program. Both Mr. Miller and Mr. Klein testified that these expenses are recurring. Therefore, we find it is reasonable to include these expenses in Petitioner’s O&M expense component of its revenue requirement.

6. Regulatory Costs. The June 30 Order imposed several compliance filings upon Petitioner, including but not limited to the completion of a Management Agreement Review and a Management Structure Review. Petitioner provided the contract with its consultant CH2M Hill to complete these reviews. See Pet. Ex. MTK-14. The compensation to CH2M Hill to complete these reviews was \$119,544. This cost was reasonably incurred and a direct result of the directive of the June 30 Order. Also, in accordance with Ind. Code § 8-1-2-70, Petitioner is required to pay for the agency charges from the OUCC and this Commission for the review and processing of Petitioner’s case. The Commission finds that these costs are reasonable and should be included in Petitioner’s rates. Therefore, the Commission directs that a regulatory asset of \$255,491, be recorded on Petitioner’s balance sheet. This asset should be amortized over the expected life of Petitioner’s rates, three years, which results in an \$85,164 increase to test year O&M expense, which yields a pro forma regulatory expense of \$210,164.

Based on the findings above, the Commission finds Petitioner’s operating and maintenance expense to be \$59.994 million as shown below in thousands:

<u>Operating and Maintenance Expenses</u>	<u>(in thousands)</u>
Contract Operations	\$50,534
Postretirement Benefits	3,500
Salaries and Wages	497
Other Employee Benefits	77
Contractual Services	2,512
Purchased Water	1,076
Insurance Expense	361
Other Expenses	1,227
Amortization of Rate Case Expense	210
Total Operating and Maintenance Expense	<u>\$59,994</u>

C. Debt Service Expense.

1. Petitioner’s Direct Evidence. Mr. Skomp testified the Department currently has approximately \$918.87 million of long-term debt outstanding and that the current debt service is approximately \$64 million per year. Mr. Skomp testified that the Department is proposing a capital improvement plan of approximately \$111.379 million over the next two years. The Department has proposed funding this capital improvement plan by a mix of 50% revenue funding and 50% bond funding. Mr. Skomp also provided exhibits demonstrating the estimated sources and uses of funds and the estimated amortization schedule for the proposed waterworks district revenue bonds of 2010, and an estimated combined amortization schedule for

the Department's current bonds and the proposed bonds. *See*, Pet. Ex. JRS-6 and JRS-7. Mr. Skomp testified that a three-year average of \$67.925 million should be required by the Department for its long-term debt requirements. The three-year average was determined by using 33% of year 2010, all of 2011, all of 2012, and 67% of year 2013.

Mr. Skomp further opined concerning the reasonableness of the 2009A bond issue that refunded the Department's variable rate debt to fixed rate debt payable over 28 years. Mr. Skomp testified the Department's prior debt structure was highly sensitive to short-term interest rate fluctuations, paid down little or no principal and included very large balloon payments at the end of 20- to 30-year terms. He stated that the issuance of the 2009A bonds allowed the debt to be restructured to pay down principal during the term of the bonds and to gain stability in debt service payments. Mr. Skomp testified restructuring of the debt was essential to the Department's long term financial operation.

Mr. Skomp also testified concerning the credit rating Petitioner received during the issuance of the 2009A bonds. Mr. Skomp testified the Department's credit rating was downgraded by all three credit rating agencies (Fitch, Moody's and Standard and Poor) and that all the ratings reports address the Department's need to replenish its operating fund to maintain its current ratings. Mr. Skomp testified that if further downgrades resulted, Petitioner would expect to see higher interest rates on any newly issued debt. Mr. Skomp testified the estimated amortization schedule for the proposed 2010 bonds is based on the market conditions considering the financial position of Petitioner.

2. OUC's Evidence. Mr. Kaufman expressed concern regarding the timing of Petitioner's proposed 2010 debt issuance. He testified ratepayers should be protected against the possibility of significant changes in the Department's anticipated debt. Mr. Kaufman proposed rates be increased in two phases. For the first phase, Petitioner's annual debt service would be the 2010 debt expense of \$60,599,230 and for the second phase, Petitioner's annual debt service would "temporarily" be the 2011-2013 average of \$68,830,483. Mr. Kaufman stated he used the term "temporarily" because the actual terms of the loan will not be known until the loan closes. Mr. Kaufman testified the second phase would go into effect one year before the first principal payment is due on the 2010 debt and could take place concurrently with a true-up to the loan. Mr. Kaufman recognized three months is a short time period for a phased increase, but noted if the proposed debt issuance were delayed and principal payments delayed, then the proposal to phase in rates would protect ratepayers against taking longer than the Department had indicated in its direct testimony.

Mr. Kaufman also proposed that if Petitioner delays in issuing its proposed 2010 bonds, any debt attributed to the 2010 bonds be considered a source of funds and used to reduce the amount borrowed. Mr. Kaufman recommended if the debt is not issued within one year after an order is issued in this Cause, then Petitioner be required to reduce its rates and refund any money collected in rates related to the 2010 debt.

Mr. Kaufman also testified that if the Commission required the Department's capital improvement funds be placed into a dedicated account, he recommended the Department be allowed to use money in the capital improvement fund to make debt service payments in the

future if necessary. However, Mr. Kaufman asserted that prior to making such payments, the Department should be required to inform both the Commission and the OUCC that it is experiencing financial distress and needs to use capital improvement funds. He stated such notice should include the reason for the financial distress, any corrective steps being taken, and the amount of funds the Department intends to withdraw from its capital improvement fund.

Finally, Mr. Kaufman also recommended the Department and the OUCC work together to develop a process to review future debt issuances.

3. Industrial Group's Evidence. Mr. Gorman testified that the Department's proposed debt service amount of \$67.925 million was overstated and developed in a way that was inconsistent with other parts of the Department's revenue requirements. He explained the Department's use of projected data in 2012 and 2013 to derive the debt service amount included in its revenue requirement is inconsistent with other aspects of the utility's development of its revenue requirement and outside of the test year adjustment period. As an example, he said the Department did not forecast growth in customers, sales and revenue at current rates past the 2008 historical year. He stated using sales and revenues at current rates at 2008 levels is a significant departure from the way in which the Department proposed to develop the revenue requirement.

Mr. Gorman testified that although the Department made no adjustment to test year revenues for future growth or normalized sales, it projected debt service expenses five years beyond the test year. Mr. Gorman also noted that while the Department developed a budgeted amount of E&R cost for calendar years 2010 and 2011 and certain O&M expenses in 2010, its proposed debt service amount goes beyond the 2008 historical test year to 2013. He asserted the Department's debt service proposal is inappropriate and does not allow for the development of just and reasonable rates.

Relying on Mr. Skomp's testimony regarding the expected life of the rates, Mr. Gorman testified that developing rates for a two-year period, with a plan to review rates every two years, will help better ensure that rates are no higher or lower than necessary to recover the Department's actual cost of providing utility service. He added that the proposal to go outside the two-year time window to pull in higher estimated debt service cost simply inflates the revenue requirement, and does not properly match the timing of revenue receipts with operating expenses, E&R costs, and debt service requirements. In Mr. Gorman's opinion, the Department did not use a balanced methodology for establishing its revenue requirement to ensure rates are just and reasonable.

Mr. Gorman recommended that to be consistent with the Department's entire revenue requirement methodology, the Commission use a two-year debt service average of 2010 and 2011, which results in a debt service of \$64.713 million and reduces the claimed revenue deficiency by \$3.2 million.

4. Petitioner's Rebuttal Evidence. Mr. Klein testified that the Department is opposed to bond-funding more than 50% of its capital program. He stated the Department is out of cash and is, in effect, borrowing from the City. He added the Department's financial situation forecloses additional issuance of debt or borrowing absent the relief requested. He said the

positions taken by the OUCC and the Industrial Group will likely result in the Department being forced to revenue-fund all of its capital projects for the next two years, and possibly longer. Mr. Klein testified the Department would like to meet with the OUCC to develop a process for review of the Department's future debt issuances.

The Department opposed the phased rate relief recommended by the OUCC. Mr. Skomp testified that phased rates are not practical given the capital needs of the Department. He explained that increased revenues from any new rates would likely first be collected sometime in the third quarter of 2010. Therefore, Mr. Skomp testified, a single-phase rate increase would provide the Department with more revenue to fund necessary capital projects in 2010. Mr. Skomp stated that a single-phase rate increase would also send a positive signal to the bond markets that the Commission recognizes Petitioner needs rate relief and could help improve the Department's bond rating, resulting in possibly a lower interest rate. Mr. Skomp testified that the Department is agreeable, however, to a true-up filing after the proposed bonds are issued.

Mr. Skomp agreed with Mr. Klein that a 50% bond-funded/50% revenue-funded approach to the capital improvement program would allow the Department to move toward its long-term goal of funding more capital projects with operating revenue rather than credit.

Mr. Skomp also provided an estimated combined amortization schedule for the Department's current bonds and the proposed bonds. Pet. Ex. JRS-R1. Using the estimated combined amortization schedule and a five-year average (2011 – 2015), \$68.845 million should be required by the Department for its long-term debt requirements.

5. Commission Discussion and Findings. There are three issues associated with the level of Petitioner's debt service to be included in rates. First, the Industrial Group challenged the number of years employed to determine the average of debt service payments. Second, the Industrial Group proposed to increase debt service by funding Petitioner's capital program 70% through bond-funded capital and 30% through E&R. Third, the OUCC proposed a phased rate increase in contrast to the single-phase rate increase proposed by Petitioner.

a. Average Annual Debt Service. The Industrial Group contends that a proposed two-year average annual debt service better matches other elements of Petitioner's revenue requirement, such as the capital program. In its case-in-chief, the Department used a three year average, while on rebuttal the Department based its requested debt service on an estimated five year average, using its projected debt service expense in 2011 through 2015 to arrive at the amount to be included in its revenue requirement. Debt service, while related to the capital program concerning bond funding of capital improvements, is independent of the capital program. Furthermore, debt service is not an operating expense adjustment subject to the accounting adjustment period. Consequently, the Commission finds the Department's debt service should be based on a three-year average using all of 2011, 2012, and 2013 from Pet. Ex. JRS-R1, which yields \$68.846 million.

b. Bond-Funding of Capital Program. The Industrial Group proposed the Department issue bonds for 70% of Petitioner's capital program. The Industrial Group's proposal ignores the highly-leveraged nature of Petitioner's present capital structure. *See, e.g.,*

Pet. Ex. JRS-12. Petitioner presented testimony that it needs to “get off the credit cards” by revenue-funding its capital program to the greatest extent possible. Pet. Ex. MTK-R at 18. Mr. Klein testified that a 50% bond-funded/50% E&R-funded ratio was a step in the right direction from Petitioner’s historic capital funding ratio of approximately 62% bond-funding improvements. Mr. Klein testified that leveraging the Petitioner even further would require ratepayers to pay more in the long run. *Id.* at 19. Mr. Skomp also testified that Petitioner’s debt service coverage ratio needs to be improved. By issuing more debt, the debt service coverage ratio will decrease. Consequently, we do not find it to be in the best interest of Petitioner or its ratepayers that the Department fund its capital program as proposed by the Industrial Group. Petitioner’s funding of the capital program using approximately 50% bonds and 50% E&R is approved.

c. Phased Rate Increase. The OUCC argued for a phased rate increase to take effect when the 2010 bonds are actually issued. OUCC witness Mr. Kaufman testified that the rates should be phased to protect the ratepayers “against the possibility of significant changes in the Department’s anticipated debt.” Pub. Ex. 7 at 11. Mr. Skomp testified that timing and capital needs factors weigh against phasing the rates in this Cause. Pet. Ex. JRS-R at 6. We agree with Petitioner. While there is no evidence in the record that the 2010 bonds have been issued, the Commission agrees with Mr. Skomp that there is a need for funding to be available for capital improvements at the earliest possible date. Pet. Ex. JRS-R at 6. Accordingly, we find it reasonable and necessary to approve a single-phase rate increase.

Notwithstanding the single-phase rate increase approved herein, Petitioner shall prepare and file a true-up report in this Cause within 20 days after closing on the 2010 bonds. If the true-up will have a material impact on the rates approved herein, Petitioner shall also file a revised tariff reflecting the revised rates. The Parties shall have 10 business days to file comments on Petitioner’s true-up report and the materiality of the impact on rates. Petitioner shall have five business days to file its reply to any comments. However, if Petitioner has not closed on its proposed bond issue within 120 days from the date of this Order, Petitioner shall file a tariff reflecting a 3.7% decrease in rates and charges approved herein.

d. Future Debt Issuance. The evidence demonstrates that Petitioner is willing to meet with the OUCC to develop a process concerning future issuances of debt by the Department. Pet. Ex. MTK-R at 21. Therefore, we find that Petitioner and the OUCC should meet to develop a process for review of future debt issuances by the Department. Within six months from the date of this Order, Petitioner shall file a report in this Cause setting forth the process for review of future debt issuances developed with the OUCC.

D. Extensions and Replacements.

1. Petitioner’s Direct Evidence. Mr. Klein testified that the Department engaged the engineering firm Camp, Dresser & McKee, Inc. (“CDM”) to assist the Department in reviewing the 2010 Five Year Capital Works Program Budget (“Capital Plan”) prepared by Veolia. Mr. Klein testified that the Department’s proposed capital projects are required to be completed by law and/or are projects that are critical to the mission of providing quality water to the Department’s customers. Mr. Klein testified that the Department needs to “get off the credit

cards” and fund capital projects with revenues. Mr. Klein opined that the proposed capital projects are reasonable, necessary and in the public interest.

Ed Malone, Vice President of Operations of Veolia, provided background on the development of the capital projects, presented the Capital Plan and the Indianapolis Water Short- and Long-Term Plan prepared by Veolia last year. Mr. Malone explained that pursuant to the Management Agreement, Veolia is required to submit a rolling five-year Capital Plan to the Department by May 31 of each year. He testified that a Capital Project is defined in Section 2 of the Management Agreement, and once projects are identified as potential capital projects, Veolia provides detailed backup information that identifies how the project was priced, costs of similar projects and cost estimates developed from the scope of work. During cross-examination Mr. Malone testified that there are other agreements that define capital project.¹²

Mr. Malone explained that the Capital Plan addresses, from Veolia’s perspective, the current and future capital needs of the Waterworks. He explained that some projects were identified due to rules and requirements of regulatory agencies, while others were developed due to evaluation of existing infrastructure reliability. He stated that Veolia develops cost estimates and analyzes the projects based on various criteria. He explained that projects mandated by law receive the highest priority. Projects that are not legally mandated, but are nonetheless required to maintain the System’s infrastructure receive secondary priority.

Mr. Malone stated that upon Veolia’s submission of the Capital Plan, the Department then generally has its engineering consultant review the plan and develops a project priority list based on available funds. He testified that failing to provide for adequate capital investments can adversely affect the reliable provision of water. Mr. Malone identified certain capital projects that Veolia believes should be implemented without delay.

Mr. Malone also explained several environmental regulatory changes that have an impact on capital planning, including projects necessary for compliance with EPA Stage 2 Disinfection/Disinfection By-Product Rule and Long Term 2 Enhanced Service Water Treatment Rule; the IDEM Ground Water Rule; IDEM’s Lead and Copper Rule; and the Department of Natural Resources Well Head Protection Rule. Mr. Malone concluded by stating the deferral or rejection of capital projects could increase the O&M costs of the Waterworks and impair the reliability and timely provision of service.

Karl E. Tanner, a Board Certified Environmental Engineer employed by CDM, testified that the Department retained CDM to conduct a thorough review and evaluation of the Capital Plan. Mr. Tanner testified that using the Capital Plan and the Department’s input, CDM was to identify necessary projects for presentation in the rate case. Mr. Tanner testified that CDM’s review and evaluation included field investigations, review and analysis of regulations affecting operations, development of a decision making model to prioritize projects, and analysis of project costs. Mr. Tanner testified that CDM determined from the projects outlined in the Capital Plan, 70 separate projects totaling \$111,378,760, as set forth on Petitioner’s Exhibit KET-1, should be implemented by the Department over the next two years (“Capital Improvement Program”).

¹² Petitioner has not presented these other agreements to the Commission.

Mr. Tanner testified concerning the basis for CDM's recommendations, the need and drivers of the projects and described the approach to validating cost estimates. Mr. Tanner testified the four primary criteria used to determine what should be included in the Capital Improvement Program were regulatory, infrastructure renewal, reliability, and financial benefit. He stated these criteria were established following the AWWA guidance document, "Benchmarking Performance Indicators for Water and Wastewater Utilities," which is the industry standard used for benchmarking water utilities.

Mr. Tanner testified that he and the CDM evaluation team met with Department and Veolia representatives on several occasions for purposes of discussing the evaluation approach, project needs, project information, and the timing and sequence of project implementation. Mr. Tanner also described how CDM evaluated Veolia's estimated costs for the proposed projects and concluded that the majority of the estimated construction costs provided were within an acceptable range of industry standards for the projects reviewed.

Mr. Gurkin explained "bucket" jobs are categories of projects that may be planned or unplanned, but for which a certain funding level for projects is anticipated during the year. He said the "buckets" that require the largest amount of funding are: (1) reinforcement mains; (2) replacement mains; (3) relocates for infrastructure improvements by the Indiana Department of Transportation or other units of government; and (4) building, pump station, tank, and plant refurbishments. Mr. Gurkin testified that the Board does not approve the individual projects in the buckets, but the Board does approve the overall bucket funding. He stated that at the time bucket funding is approved, particular relocation or replacement projects cannot be identified with any certainty by the Department. These capital projects typically are unplanned and necessary for continued operation of the System or to avoid conflicts with other infrastructure. During the years 2005 to 2008, the Department spent a total of \$11,409,592 relocating water mains as requested by other governmental entities. The Department also utilizes funding from buckets for emergency projects related to treatment plants, booster stations and other necessary infrastructure repairs.

Mr. Tanner testified that the bucket jobs are budgeted at minimum amounts. Since the distribution system continues to age, Mr. Tanner recommended increasing all "bucket" jobs budgets in future rate cases so that the Department does not find itself in an unmanageable, reactive situation of performing extensive repairs on an ongoing basis.

Mr. Tanner explained the Capital Plan was distilled to a list of recommended projects totaling approximately \$214 million to be implemented over a three-year period. He said the projects were recommended to meet immediate needs for the short-term regulatory, infrastructure, reliability, and financial well-being of the System. Mr. Tanner testified the recommended projects were further refined down to the Capital Improvement Program to be implemented over a two-year period. He said these projects include those that are in immediate need of completion to satisfy regulatory requirements, needed to adequately respond to emergency situations as they arise, and replace System components that are at risk of failure or that severely limit the capabilities of the System to reliably deliver quality drinking water. Mr. Tanner discussed each individual project in his testimony and included a project summary sheet

that detailed the project driver, estimated cost and other relevant information for each proposed project in the Capital Improvement Program.

At the hearing, the Department highlighted several projects. Project CP11-071 is the secondary intake to provide reliability and redundancy to the White River Treatment Plant, and includes the installation of a pump station and pipeline from the White River to the White River Treatment plant. Mr. Klein explained that the White River Treatment plant, which receives its raw water supply from the Central Canal, provides 60% of the water for the System, and all of the water for the City's downtown. According to Mr. Tanner, the points of vulnerability along the Central Canal include: the Broad Ripple Dam, the aqueduct that spans Fall Creek, and the Central Canal itself. Mr. Klein testified that if any of these elements should fail, downtown Indianapolis would not have sufficient water service. Mr. Tanner also stated that past failures of both the Central Canal and the aqueduct demonstrate a need for the alternative intake because without this redundancy, a failure could severely limit the Department's ability to provide water service. Additionally, Mr. Gurkin also testified at the hearing concerning the importance of this project. Tr. at R-17 to R-18.

Several Department witnesses also testified concerning the Department's Automatic Meter Reading Pilot Program. This proposed program will allow the Department to test the effectiveness of an automatic meter reading ("AMR") system. Mr. Tanner testified that many gas and electric utilities already use this type of system, and that these meters can enhance system efficiency and help improve demand management, leak detection, and demand tracking. Petitioner's witness Kerry A. Heid, an independent rate consultant, testified that AMRs are available in numerous formats and that the information from an AMR system would be very useful to the Petitioner. Tr. at T-90. Mr. Tanner and Mr. Heid each testified that with an AMR system, meter data can be provided on a continuous basis throughout the day. Mr. Tanner testified the proposal is for 3,000 meters that will be automatically read via a fixed network system. He said there will be no need to walk or drive the streets collecting data; rather, the data from the meters will be transmitted by radio signal to receivers that will be mounted on storage tanks.

Mr. Tanner also offered two secondary recommendations outside CDM's capital plan review. Mr. Tanner recommended a Filter Optimization Study (Pet. Ex. KET-73) be conducted to evaluate the operation of the filters at existing surface water plants. He testified that the study is needed to review filter operation, enhance water quality, make sure the filters comply with regulations and standards, and determine if additional capacity can be produced and/or the filters can be optimized to provide additional needed capacity. Mr. Klein also testified regarding the need for and benefits of the Filter Optimization Study. Tr. at K-5 to K-7, K-36, and K-77 to K-78. He stated a filter optimization study could increase the Petitioner's rated capacity and help alleviate the Department's capacity issues. *Id.* Second, Mr. Tanner recommended a Residuals Management Study (Pet. Ex. KET-72) be conducted to evaluate alternatives to enhance the residuals management at the White River Treatment Plant. He testified this will enable efficient and reliable residuals processing that will keep operational costs down and avoid disruption at the Petitioner's treatment plants.

2. OUCC's Evidence. Mr. Harold L. Rees, a Senior Utility Analyst with the OUCC, described his review of the Department's proposed \$111,378,760 Capital Improvement Program. Mr. Rees testified that he examined a sample of projects and participated in an inspection tour on February 3, 2010. Mr. Rees testified that he did not find any of these projects to be unnecessary.

Mr. Rees testified that about 30% of the utility's mains are cast iron pipe, which has had a failure rate several times greater than for either ductile iron or PVC, and that the cast iron mains manufactured in the years immediately after World War II are exceptionally prone to failure. Mr. Rees recommended that the Department establish a scheduled program to replace these mains and include additional funding in future capital programs.

Mr. Roger A. Pettijohn, a Senior Utility Analyst, also testified regarding his analysis of the Capital Improvement Program. Mr. Pettijohn stated he found evidence of inadequate investment in capital improvements for extended periods, including outdated pumps, equipment operating without SCADA control and 40-year old switch gears and motor control centers. While building structures seemed fundamentally sound, Mr. Pettijohn said his inspections uncovered some cases of poor housekeeping, a general lack of cleanliness, spalled concrete and discolored piping with areas of paint failure. Mr. Pettijohn acknowledged that some of the Department's plant was undergoing significant construction and that additional improvements would continue. Mr. Pettijohn noted that with \$65.5 million earmarked for system reliability and \$25.4 million addressing regulatory issues, approximately 82% of the capital budget was directed toward keeping the system viable. He testified that the annual revenue-funded portion of \$27.8 million in this Cause is somewhat higher than the \$21.8 million annually approved in Petitioner's last rate case. Mr. Pettijohn opined that Petitioner's proposed capital plan was responsive, reasonable and in the public interest. However, Mr. Pettijohn recommended that the capital improvement funds be placed in a dedicated account to insure the funds would actually be spent on system improvements, given the Department's recent financial issues and the need for capital improvements.¹³

Mr. Pettijohn also addressed the Department's issues with frozen fire hydrants during the winter of 2009 – 2010, which he described as “a combination of an imperfect hydrant maintenance program, bad weather and bad luck.” Mr. Pettijohn said the Coordination Committee, consisting of Veolia, the Department and the Board, undertook a hydrant maintenance investigation and review. He noted Petitioner's discovery responses indicated Veolia believes nearly all frozen hydrants were the result of unauthorized use or failure to report malfunctioning hydrants. Mr. Pettijohn concurred with the investigation's recommendations that hydrant enforcement procedures, including a hydrant permitting program with specific fill stations, would be logical and appropriate, and that it may also be appropriate for such a program to be endorsed by way of a City Ordinance with fining capacity.

Mr. Pettijohn discussed residential meters, meter testing and Petitioner's program of changing out residential-sized (both 5/8 and 1 inch) meters every ten years. He testified that

¹³ As noted above, Mr. Kaufman clarified Mr. Pettijohn's dedicated account proposal by recommending the Department also be allowed to use money in the capital improvement dedicated account, under certain conditions, for the limited purpose of making debt service payments.

Petitioner's testing and replacement schedule complies with or exceeds 170 IAC 6-1-10. He also noted that while it is common for utilities to routinely replace residential meters at 10 years of service (rather than bear the labor and repair expense of testing them), Indiana American Water Company recently submitted a 30-day filing requesting a 15-year testing and replacement schedule for residential-sized meters. He stated the Commission approved Indiana American's request on January 20, 2010 and noted the Commission examined an Illinois American meter testing study originally submitted to the Illinois Commerce Commission which found no appreciable degradation in function attributable to replacing these meters over a 15-year cycle. Mr. Pettijohn testified discarding a meter with one-third of its useful life remaining is imprudent and based on the Department's 2009 tests of more than 6,000 small meters, it should have sufficient data to initiate a similar study and request a similar 15-year program. Mr. Pettijohn concluded that this type of meter extension program would directly reduce costs.

3. Industrial Group's Evidence. Mr. Gorman testified the Department's proposed level of rate revenue funding for annual E&R should be decreased to \$33.6 million and the amount financed through bond funding should be increased to \$77.77 million because, based on a review of the Department's planned E&R two-year budget, there are significant components which reflect extraordinarily large capital expenditures that do not recur annually. He recommended these large capital expenditures, which are not annual recurring projects, be funded by bond revenue. He explained funding \$77.77 million of the Department's two-year capital projects with bond revenues would minimize the cost to customers and spread the cost of these large capital improvement programs over a period that reasonably coincides with the life of the assets in these capital projects.

Mr. Gorman also discussed the Department's contention that the 50/50 funding was to address the credit rating agencies' concerns with the Department's debt level. Mr. Gorman said his proposed revenue adjustments and level of debt funding will help maintain the Department's current bond rating. He noted that in the Moody's report referenced by Mr. Skomp, the debt service coverages range from about 1.61x to 1.25x in the last several years. The report also notes concern about the reduction in debt service coverage caused by increases in debt service coverage requirements caused by the variable rate debt instruments in past years.

Mr. Gorman calculated that after adjustments to the Department's normalized revenue and operating expenses, the Department will be able to produce net revenue available for debt service coverage of \$83.4 million. He said this amount of net revenues in relationship to 2010 and 2011 debt service coverage is 1.4x and 1.2x, respectively. The average debt service is 1.3x, which he stated is consistent with historic debt service coverages and well above the minimum required debt service ratio of 1.1x. He added a rate increase in 2011 may be needed to increase the 2011 coverage, if sales growth or cost reductions do not increase this coverage without a rate increase.

Under Mr. Gorman's recommendation, approximately \$77.77 million of the Department's \$111.38 million Capital Improvement Program would be funded by issuing new revenue bonds, and \$33.6 million would be funded from rate revenue. The \$33.6 million would be funded over a two-year period, creating a need for an annual E&R rate revenue funding level of \$16.8 million.

Mr. Gorman explained that the Department's annual revenue funding for E&R would be reduced by \$11.04 million, but because he recommended the amount of bond funding be increased to \$77.7 million, from the Department's proposed \$55.7 million, he also recommended that the amount of debt service related to this \$22 million of additional bonds be included in the Department's revenue requirement. Consequently, instead of a 2010 issuance of \$59.7 million proposed by the Department, he recommended that the 2010 issue be increased to \$70.8 million to accommodate the higher bond funding of the Capital Improvement Program, which would result in increased debt service cost for the 2010 issue in calendar years 2010 and 2011 of \$1 million. He noted the \$11 million reduction in the annual rate revenue funding would need to be offset by a million dollar increase in debt service cost during a two-year average period, resulting in a net reduction in Petitioner's claimed revenue deficiency by \$10 million.

4. Petitioner's Rebuttal Evidence. Mr. Tanner addressed the reasonableness of the Petitioner's proposed Capital Improvement Program and also testified concerning the reasonableness of the projects proposed in Notices of Intent that have been filed by the Department since the June 30 Order.

Mr. Tanner also provided some additional information about the capital project approval process. He testified that information provided to the Department regarding bucket projects can often be lacking, thus making it difficult to determine whether a proposed project should be implemented or whether it should be deferred. Mr. Tanner testified he is working with the Department to develop a revised process to handle the Department's capital project approval process, which will include the development of a new capital project authorization form that will provide much more information than currently required. He said the new process will be thorough and will clearly outline steps needed for approval of a proposed capital project. The process will also include requiring supporting documentation.

Mr. Malone also addressed maintenance and capital improvements to Petitioner's System. In response to Mr. Pettijohn's comment regarding poor housekeeping and maintenance noted during an OUCC site visit, Mr. Malone explained that the T. W. Moses plant was undergoing extensive upgrades at the time of the OUCC's visit, and the Fall Creek plant was undergoing renovation, including refurbishment of the operations control room, maintenance work on basins and an ongoing filter table project. He asserted that Veolia is confident of its ongoing housekeeping and maintenance practices and procedures, which includes automatically generated preventive maintenance work orders.

Mr. Malone also addressed the recommendation of OUCC witness, Mr. Rees, that the Department establish a scheduled program to replace its cast iron mains. Mr. Malone testified that Veolia's five-year Capital Plan and its Short and Long-Term Plan include replacement of cast iron mains. He also responded to Mr. Rees' request for additional information regarding the Department's tank painting policy by explaining Veolia conducts cleaning and evaluations on the network storage tanks on a two year cycle and advises the Department of the conditions identified during the inspection. He provided a list of the tanks in the System that are in need of refurbishment and that have been identified in the Capital Plan. Mr. Malone identified the Martinsville tank as currently in the poorest condition of those in the System, and identified the

need for this project to be included in the Capital Plan in November 2006. Veolia advised the Department in the summer of 2009 that due to the accelerated deterioration of the exterior coatings, it was recommended that the tank be restored immediately, but noted that the request for authorization to proceed with the capital project is still pending with the Department.

Finally, Mr. Malone also responded to Mr. Pettijohn's recommendation that Veolia consider changing the replacement schedule for residential meters from 10 to 15 years. He noted that the Department's rules provide that the Waterworks will comply with Rule 6(B) in testing and replacing meters. He explained that Veolia plans to continue the statistical analysis on the Meter Replacement Program to ensure its effectiveness.

5. Commission Discussion and Findings. The record in this Cause demonstrates that sizeable portions of the Department's System are old and in need of significant capital investment. No party to this proceeding contested Petitioner's distilled Capital Improvement Program. We find it important to note the fact that there were no disputes about the proposed capital expenditures, which testifies to the validity of the proposed expenditures and to the current status of the existing infrastructure. Notwithstanding our concern that Petitioner has sought enough for capital expenditures, the Commission finds the Capital Improvement Program presented by Petitioner to be reasonable and should be approved. We also note that no party opposed Petitioner's Filter Optimization Study to alleviate the Department's capacity issues or the Residuals Management Study to enhance the residuals management at the White River Treatment Plant. Based on Petitioner's Exhibits KET-72 and KET-73, these studies are estimated to cost \$142,957.

Based on the evidence presented, we find the Capital Improvement Program to be a conservative plan for maintaining Petitioner's System. We further find that funding the capital program 50% through E&R and 50% through bonds is a reasonable approach to undertaking the required capital investment in Petitioner's System, and is consistent with the Commission's findings on Debt Service Expense set forth in this Order. Accordingly, we approve Petitioner's Capital Improvement Program as set forth in Pet. Ex. KET-1 in the aggregate amount of \$111,378,760. In addition, we approve the costs associated with the Filter Optimization and Residual Management Studies amortized over two years. We therefore find Petitioner's E&R revenue requirement to be \$27,916,000.

Based on the evidence presented during this proceeding, the Commission is concerned about the potential for E&R funds collected through rates to be diverted from capital projects should operating costs increase at levels greater than the growth in revenues. Such a scenario would result in the compromising of Petitioner's Capital Improvement Program, which is a necessary element to the successful operation of the utility. Therefore, E&R funds shall be placed into and maintained in a restricted account whereby use of the funds is limited to capital projects or under certain circumstances, for debt service payments only. Prior to making a debt service payment from this account, Petitioner shall first notify the Commission of the reason for the financial distress, any corrective steps taken and the amount of funds it intends to withdraw from the capital improvement fund. In addition, Petitioner shall file semi-annual compliance filings with respect to the E&R budget and an update on the fulfillment of Petitioner's Capital Improvement Program.

E. Working Capital.

1. Petitioner's Direct Evidence. The Department requested an annual working capital allowance of \$13,268,000 to help restore the Department's negative operating fund balance incurred during the adjustment period. *See* Pet. Ex. JRS-2. Mr. Skomp described the various funds that the Department has, some of which have specific purposes and are restricted as to use. He cited as an example, the Renewal and Replacement Fund, which is used to account for the collection of System Development Charges. He also noted that in the June 30 Order, the Commission found that the funds in the Renewal and Replacement Fund should remain restricted for capital improvements designed to increase system capacity. Mr. Skomp indicated another example is the Construction Fund, which funds are restricted by the 2007L Supplemental Waterworks District Net Revenue Bond Resolution. Additionally, Mr. Skomp testified that the Department is required to have a Debt Service Reserve Account, which is intended to protect bondholders in case the utility would not have adequate funds to make required debt service payments in a timely manner.

Mr. Skomp testified regarding the pooling of the Department funds with the City's cash investment program. He said to achieve the best investment rates for all City funds, the City pools any available funds from its departments in order to expand the number of available investment options. This practice allows the Department to actually borrow from other departments since all funds are pooled into one investment. However, he stated, the Petitioner's Bond Fund, Construction Fund and Grantor Trust are held by separate trustees and are not a part of the City's pooled cash investment program. Mr. Skomp said the Department is proposing approximately \$13.3 million per year be allowed in the calculation of revenue requirements to restore the Department's operating fund balance. He opined that this is important because the Department is expected to maintain monies sufficient to pay O&M expenses to the next calendar month under its original bond resolution. Mr. Skomp testified this would be less than what is normally allowed by the Commission's usual 45-day method of determining an appropriate working capital allowance.

Mr. Skomp testified that all three rating agencies expect to see two things out of the current rate request to avoid further downgrades. He said first, they want to see rates sufficient to allow the Petitioner to maintain the coverage ratios that have been committed to; and second, they want to see Petitioner be able to cover recurring expenses. Mr. Skomp testified that if the Department's rating is further downgraded, the Department can expect to see higher interest rates on any newly issued debt. Based on current market conditions, Mr. Skomp testified that interest rates would range from .06% to 1.4% higher for any newly issued debt if another downgrade was forthcoming. He added any downgrades would also affect the ability of current investors to trade the Department's current debt on the secondary markets. Mr. Skomp testified he believes it is in the best interest of the Department and its ratepayers to provide for the annual amount of revenue that is needed to replenish the operating fund to the appropriate level.

2. Oucc's Evidence. Mr. Patrick testified that Petitioner's working capital calculation began with adjusted O&M expenses and added taxes other than income taxes. He stated this sum was divided by 12 months to arrive at a minimum required balance of

\$6,238,000. He stated Petitioner then added the \$20,297,000 projected cash flow deficit for the calendar year ending December 31, 2009 to the minimum required balance calculation. The total of these two numbers is \$26,535,000, which Petitioner seeks to recover over two years.

Mr. Patrick disagreed with this calculation in several respects. First, Mr. Patrick stated taxes other than income taxes, as well as purchased water costs, should be excluded from the calculation of working capital because these expenses are paid "in arrears." He defined cash working capital as the amount of revenue needed to bridge the monthly gap between when expenditures are required to provide service, and the time collections are received for that service. He stated there are two methods used to calculate the amount of working capital needed to bridge that financial gap. One method for calculating working capital is the preparation of a lead/lag study. The second more popular method for calculating working capital is the use of a 45-day formula. He stated the 45-day method assumes the difference between the lead/lag periods is 45 days and calculates 12.5% (45 days / 360 days) of adjusted annual operating expenses as cash working capital. This methodology typically adjusts operating expenses for those items known to be paid after the receipt of revenues or paid "in arrears."

Mr. Patrick further argued Petitioner, by adding its projected cash flow deficit for calendar year 2009, is seeking to recover working capital from ratepayers through retroactive ratemaking. He cited the testimony of Petitioner's witness, Mr. Skomp, concerning the City's pooled cash investment program. Mr. Patrick stated Petitioner's effort to recover its various historical deficits is a request for retroactive ratemaking, which should not be granted by the Commission. Mr. Patrick testified that notwithstanding the prohibition against retroactive ratemaking, there are other sound regulatory reasons why recovery of past operating fund deficits through the provision of future cash working capital should be denied. He asserted the evidence in this Cause indicates Petitioner's cash deficits occurred because of a cash flow shortage, which was recognized by Petitioner's management, and rather than seeking appropriate rate relief, Petitioner transferred funds from other municipal departments and allowed these deficits to build. Mr. Patrick opined the recovery of these deficits through future working capital is an inappropriate use of the statutory provision for working capital.

In support of the OUCC's position that the Department is seeking to obtain working capital through retroactive ratemaking, Mr. Patrick cited to the Commission's Orders in *Walkerton Municipal Water Utility*, Cause No. 37194, (Sept. 14, 1983), r'hg (Feb. 1, 1984); *Town of Geneva*, Cause No. 38023, (Aug. 27, 1986); and *Town of Kingsford Heights*, Cause No. 37999, (March 18, 1987).

Mr. Patrick testified that Petitioner's projected cash shortfall decreased from the \$20,297,000 requested in the permanent portion of its case to \$15,392,000 at the end of November 2009. He testified although the OUCC could not predict whether cash flow would continue to improve, it is clear the requested cash deficit portion of the working capital revenue requirement has decreased. He also noted that Petitioner was authorized by Commission order in the emergency portion of this case to increase rates by 10.80%, and that an improved cash flow has resulted.

Mr. Patrick proposed a working capital revenue requirement of \$2,392,000, which he calculated by taking adjusted O&M expense and deducting purchased water (paid in arrears) and

amortization of rate case expense (non-cash). He then multiplied the total by 12.5% (45 day factor) to arrive at the working capital revenue requirement of (\$7,176,000), which is divided by three years to arrive at the annual working capital revenue requirement.

3. Industrial Group's Evidence. Mr. Gorman disagreed with the Department's proposed working capital amount. According to Mr. Gorman, the Department did not accurately match all cash revenue against the expenses reflected in the cash flow study. He explained that the study included cash operating costs that will be incurred after 2009 but included only 2009 cash revenues. He identified the following as errors: (1) the cash flow study included far more debt service in 2009 (\$70.76 million) than the Department will actually incur (\$41.76 million); (2) the Department included debt service cost in December 2009 for several bond series where the debt service payment became due on January 1, 2010; and (3) the study included \$13.1 million of payment in lieu of tax ("PILT") payments in 2009, which included costs associated with calendar year 2008 that were not made because of the Department's weak cash position.

Mr. Gorman testified excluding the \$29 million of debt service cost in December 2009 that is not scheduled to actually be paid until January 1, 2010 would change the projected negative \$20.0 million end-of-year position to a positive \$9 million end-of-year cash position. He added that if all of this debt service were paid at year-end 2009, then the Department would produce significant positive cash during the first six months of 2010, until the second debt service payments in July 2010 are made, and significantly improve its cash position. He concluded that modeling the upfront payment of cash at year-end 2009 substantially distorts the amount of cash the Department will generate from current rates in order to meet its cash working capital obligations.

Mr. Gorman opined that because the Department included about 18 months of debt service payments in the cash flow study, it would be appropriate to look at the cash flow produced from rates over at least an 18-month period. He said in doing this, an analysis can be more properly made for developing a cash working capital requirement for the utility by balancing 18 months of revenue with 18 months of debt service.

Mr. Gorman testified that including only normal annual recurring PILT payments of approximately \$10.8 million per year, and assuming that the debt service payments scheduled to be made on January 1, 2010 are made in January, and not in December 2009, the Department's cash working capital at the end of the 18-month period would be a positive balance of \$7.99 million. He stated this balance exceeds the Department's targeted balance of \$6.24 million. He added this modified study clearly shows that a cash working capital revenue requirement is not necessary to ensure the Department has adequate cash to meet all of its cash obligations, including restricted cash reserves.

Mr. Gorman noted the Department's monthly cash position would vary over the 18-month period and would average \$1.2 million of cash working capital. He said that while this average balance of cash working capital is less than the Department's targeted \$6.2 million, the actual amount of cash it collects in rates from retail customers will increase by the level of the rate increase permitted in this case. He stated all other things being equal, if rates are increased

to produce \$5 million more cash revenue on an annual basis, then the average monthly cash position of the Department would be \$6.2 million, which is in line with its targeted cash working capital requirement.

4. Petitioner's Rebuttal Evidence. Mr. Klein disagreed that the Department's request for rate relief constitutes retroactive ratemaking. Mr. Klein noted that the Department sought relief from the Commission before borrowing funds to operate the utility from pooled City funds. Mr. Klein also testified that a number of capital projects that were unforeseeable in the emergency phase needed to be performed, citing as an example the main repair on 86th Street near St. Vincent's Hospital. Mr. Klein testified that the Department has continued to look for ways to reduce expenses and declined, or denied, approximately \$2.4 million in capital projects in 2010. Mr. Klein testified that the Department informed the Commission that without full rate relief the Department would run out of cash. Mr. Klein noted that without recovery of the borrowed funds from the City pooled cash, the Department likely could not issue new debt. He also noted that the Commission imposed several unfunded compliance mandates in the June 30 Order, including a Management Agreement Review, Management Structure Review and other items.

Mr. Tanner further responded to the testimony of the OUCC and described the projects that he stated contributed to the Department's request for working capital in this Cause, and were included in the Notice of Intent ("NOI") filings, which the Department filed with the Commission pursuant to the June 30 Order. Mr. Tanner opined that the NOI projects were reasonable and necessary to maintain the delivery of potable water to the Department's customers, comply with regulations, improve reliability, achieve and approve redundancy and benefit long-term financing. He stated the NOI projects represented approximately \$4,722,341. Mr. Tanner testified that effectively managing a utility requires expenditures on unplanned projects that cannot be predicted, but are certain to occur. Mr. Tanner testified that these NOI projects were not foreseeable at the time of the emergency rate case and, therefore, were not approved for inclusion.

Mr. Skomp also disagreed with the OUCC's argument regarding retroactive ratemaking. Mr. Skomp testified that all of the cases cited by OUCC's witness, Mr. Patrick, involve situations where the utility sought relief after incurring a negative operating fund balance. Mr. Skomp testified the Department had a \$15.658 million deficit on December 31, 2009, but that cash balances were positive at the end of the test year (*i.e.*, December 31, 2008). Mr. Skomp testified that a deficit situation occurred during the pendency of this Cause and during the allowable financial adjustment period.

Mr. Skomp asserted that the Department is not attempting to recover past deficits because the Department petitioned for a rate increase before incurring the negative operating fund balance, but its requested relief was not fully granted. Mr. Skomp also testified that the Department does not have stockholders and therefore is not requesting a guarantee or any sort of return on investment for stockholders.

Mr. Skomp also testified that the working capital allowance is needed to improve the Department's bond coverage ratio. He stated improving Petitioner's bond coverage ratio would

have many positive effects, including bringing Petitioner into compliance with its bond resolution, improving its credit rating and lowering its overall borrowing costs. Mr. Skomp also asserted that an inability to rebuild an adequate unrestricted cash position would negatively affect the Department's credit rating and its ability to issue the proposed 2010 bonds. Mr. Skomp further testified the inability to issue the proposed 2010 bonds would result in the Capital Improvement Program being funded entirely through E&R, which would lead to a higher rate increase.

At the hearing, Mr. Skomp further testified that other alternatives to alleviate the deficit were explored and found to be impractical. Specifically, Mr. Skomp testified that there are significant barriers to monetizing the Department's note with the City of Carmel. Tr. at W-48 to W-61. Mr. Skomp noted that consents would be needed; that Internal Revenue Service regulations would make the monetization difficult, if not impossible; that the present value of the note would be depressed due to limited default provisions found in the note; and a high discount rate would likely be applied in determining the present value of the note. *Id.*

Mr. Skomp also defended his methodology for calculating working capital. He disagreed with the OUCC's witness, Mr. Patrick, that there are only two methods to calculate working capital. Mr. Skomp testified that he based his working capital calculation on the requirements of Petitioner's bond resolution and asserted that the Commission has considered such working capital calculations in other cases. Mr. Skomp further noted that the 45-day method for calculating working capital excludes taxes, while Petitioner's bond resolution defines O&M expense to include taxes and PILT. Mr. Skomp testified that under Petitioner's bond resolution, Petitioner is required to maintain at least one month's O&M expense. Accordingly, Mr. Skomp recommended the working capital calculation that he calculated for Petitioner.

5. Commission Discussion and Findings. The arguments concerning Petitioner's working capital focus on the need for working capital by Petitioner, retroactive ratemaking, and the proper methodology.

a. Retroactive Ratemaking. Petitioner includes in its working capital requirements a deficit incurred during the adjustment period. The evidence demonstrates that Petitioner had a positive fund balance at the end of the test year and a positive fund balance when it filed its Petition initiating this Cause. Petitioner incurred the deficit during the latter half of the adjustment period, after its emergency rates were approved, and during the pendency of the "permanent" rate proceeding.

Petitioner also presented evidence that it incurred numerous unforeseen capital expenditures resulting from "bucket" jobs such as relocations and other infrastructure projects that were unknown at the time of the emergency case. Petitioner presented evidence that if it was in a right-of-way and was ordered to move its facilities, it had no choice but to comply. Petitioner testified it could not foresee these types of projects and incurred approximately \$4.7 million in capital expenditures as a result of these projects. Petitioner also offered testimony that the costs of compliance with the June 30 Order, which included multiple reporting and comprehensive review requirements, have been substantial.

The case law on the subject of retroactive ratemaking makes clear that when a utility fails to timely request rate relief before its financial condition deteriorates into deficit spending, recovery would be retroactive ratemaking. *See e.g., Town of Walkerton*, Cause No. 37194, 1993 Ind. PUC LEXIS 226 (Sept. 14, 1983) (recovery of end of test year fund balance deficit if allowed would be retroactive ratemaking). Other cases cite to “historical cash flow shortage.” *See e.g., Town of Geneva*, Cause No. 38023, 1986 Ind. PUC LEXIS 176 (Aug. 27, 1986) (utility operating at a deficit for a number of years failed to timely seek rate relief).

As noted earlier, the two primary purposes for the rule against retroactive ratemaking are to ensure that utilities petition for rate relief before encountering a deficit spending situation and to avoid guaranteeing recovery of stockholder investments. *Narragansett Electric Co. v. Burke*, 415 A.2d 177, 178-79, 37 P.U.R.4th 569 (R.I. 1980). While Petitioner does not have stockholders, the Commission has previously indicated the concern underlying the second purpose noted above (*i.e.*, if a utility’s income were guaranteed, it would lose all incentive to operate in an efficient cost-effective manner), is equally applicable to municipal utilities. *See Town of Kingsford Heights*, Cause No. 37999, 1987 Ind. PUC LEXIS 335, at *40-41 (March 18, 1987). However, we note that unlike an investor owned utility, a municipal utility does not lose all incentive to operate efficiently and cost-effectively because municipal officials are elected and subject to re-election by ratepayers. Nor do municipal utilities have stockholders with whom the risk for operation of the utility may be shared.

The facts presented in this Cause are distinguishable for at least two reasons from those cited by the OUCC where the utility had incurred historical deficits and delayed in its filing for rate relief.¹⁴ First, the evidence in this Cause is clear that Petitioner filed its request for emergency rate relief *before* it incurred its deficit. Petitioner’s cash deficit occurred in the adjustment period subsequent to the test year, and after Petitioner’s request for emergency relief. Second, unlike the other utilities which made no effort to avoid deficit spending, Petitioner attempted to secure a line of credit, but the lender rescinded its line of credit offer.

Therefore, based upon the evidence presented, we do not find Petitioner’s proposed adjustment to working capital to constitute retroactive ratemaking. In this instance, Petitioner appropriately and timely filed for emergency and permanent rate relief to address its increasing debt service expense. In doing so, Petitioner seeks not to recover past losses, but to obtain adequate working capital on a prospective, or going forward, basis.¹⁵

Even if, as the OUCC argues, the authorization to increase the amount of working capital could be viewed as retroactive ratemaking, making such a finding in this case would serve neither of the purposes for which the general prohibition was intended and would require its application in contravention of common sense and equity. Upon becoming aware of its increasing debt service, Petitioner filed a request for emergency and permanent rate relief.

¹⁴ They are also distinguishable, for the same reason, from the operating losses Veolia allegedly experienced during the first five years of operation and that Petitioner now seeks to recover as part of the First Amendment expense as discussed earlier herein.

¹⁵ We note this is also consistent with the statutory requirement that rates and charges for municipal utilities produce on a prospective basis sufficient revenue to “provide adequate money for working capital.” Ind. Code § 8-1.5-3-8(c)(4).

Petitioner did not wait until it had incurred a cash fund deficit to file its request for rate relief. The revenue requirements established in the June 30 Order provided sufficient funds to meet Petitioner's ongoing needs. However, what was not considered was the deficit between Petitioner's cash shortfall needed to make its July 1, 2009 debt service payment and the additional PILT payment that was deferred from 2008. Just one day after the June 30 Order was issued, Petitioner incurred debt service payments of \$12.7 million, but only had \$1.9 million cash on hand. Petitioner was also required to make a 2008 PILT payment of \$7.7 million in August of 2009. Ultimately, Petitioner's eroded cash position at June 30, 2009 and December 31, 2009 was a result of debt service payments related to its variable rate debt.

As noted in Petitioner's emergency case, the primary factors causing Petitioner's working capital deficiency were Petitioner's debt status, compounded by the exceptional chaos in the financial market. Too much variable rate debt on Petitioner's books and the failure of the swaps (*i.e.*, the financial agreements designed to be a hedge against potential future increases in interest rates) to work as anticipated caused significant increases in Petitioner's debt service payments, while customer rates remained static. Although less reliance on variable rate debt could have materially lessened the impact of the Department's financial predicament, the economic situation that occurred in 2008 was unanticipated, extraordinary and virtually unprecedented. Consequently, even if recovery of Petitioner's cash shortfall could be considered retroactive ratemaking, we find the unique facts presented in this Cause, along with the significant, involuntary and unexpected costs Petitioner has incurred since the filing of its emergency case, to create an extraordinary circumstance to which the prohibition should not apply.

Therefore, based on the foregoing, the Commission finds that Petitioner's request for rates that will increase the amount of Petitioner's working capital necessary for utility operations on a prospective basis should be granted.

b. Working Capital Calculation. Each party presented different methods to calculate working capital. The Petitioner presented a method of calculating working capital based on a 30-day cycle that mirrored the requirements in its bond resolution. The OUCC proposed a working capital allowance based on the 45-day method. The Industrial Group did not specifically present a working capital allowance, but instead argued that its proposed rate increase would fall right to the bottom line and would alleviate the need for working capital. While this Commission has considered other working capital calculations, we have only accepted two: either the standard 45-day method; or a lead/lag study for calculating working capital.

Given that a lead/lag study was not presented in this case, we find that the Petitioner should be allowed a working capital allowance based on the standard 45-day method to represent the time between the need to pay operating expenses and the revenue recovered from ratepayers to cover those costs. We find that the 45-day method is a reasonable method of calculating working capital. Accordingly, we find Petitioner's working capital allowance should be \$7,674,000.

<u>Working Capital Calculation</u>	<u>(in thousands)</u>
Operation and Maintenance Expense (O&M)	\$59,994
Less: Purchased Power	0
Purchased Water	1,076
Adjusted O&M Expense	58,918
Divided By: 45 Day Factor	8
Sub-total	7,365
Less: Cash on Hand @ 12/31/09	(15,658)
Working Capital Requirement	23,023
Divided By: 3 Year Amortization Period	3
Annual Working Capital Requirement	<u>\$7,674</u>

F. Taxes Other Than Income Taxes.

1. Petitioner's Direct Evidence. Petitioner included \$10.769 million of taxes other than income tax expense. Petitioner made two adjustments to taxes other than income tax expense. First, Petitioner adjusted for the Utility Receipts Tax ("URT") by reducing adjusted operating revenues for adjusted sales for resale. Mr. Klein testified that Petitioner had obtained a revenue ruling from the Indiana Department of Revenue finding that no URT was due on sales for resale. Petitioner then multiplied operating revenue subject to the URT by the URT rate of 1.40% to obtain the adjusted tax liability of \$1,846,000. Petitioner then subtracted test year URT expense of \$1,764,000 to arrive at an adjustment of an increase in \$82,000 in URT liability. *See* Pet. Ex. JRS-5 at 5.

Petitioner's second tax other than income tax expense adjustment concerned its PILT expense. Petitioner adjusted its test year PILT expense downward \$1,083,000 from the test year amount of \$10,006,000 to a *pro forma* proposed level of \$8,923,000. *Id* at 6.

2. OUC's Evidence. The OUC accepted Petitioner's PILT adjustment. Pub. Ex. 2 at 11. However, whereas Petitioner proposed an increase of \$82,000 for URT related to present rate revenues, the OUC proposed an increase of \$106,000. Mr. Patrick testified this difference was a result of the OUC's different proposed revenue adjustments. The OUC also proposed a test year payroll tax increase of \$24,000 based on proposed salaries and wages of \$497,000.

3. Petitioner's Rebuttal Evidence. Petitioner's rebuttal evidence agreed with the OUC's adjustments to URT expense and payroll taxes.

4. Commission Discussion and Findings. The Commission finds that Petitioner's *pro forma* taxes other than income tax expense are \$1,935,000 and that such amount should be included in Petitioner's revenue requirement. Included in this amount is URT tax of \$1,870,000 based upon *pro forma* operating revenues of \$133,894,000 less sales for resale of \$293,000. We also find *pro forma* PILT to be \$8,923,000.

8. Total Revenue Requirement. The Commission finds that Petitioner's current rates and charges are insufficient to meet the Department's annual revenue requirement and are,

therefore, illegal and unreasonable. Based on the evidence of record, the Commission finds that Petitioner’s *pro forma* annual revenue requirement is \$168,188,000. Petitioner’s rates should be increased in the aggregate by 25.99% to produce additional operating revenue of \$34,781,000, in order to meet its annual revenue requirements as follows:

<u>Revenue Requirements</u>	<u>(in thousands)</u>
Operation and Maintenance Expense	\$59,994
Taxes Other Than Income	1,935
Payment in Lieu of Taxes	8,923
Outstanding Veolia Payable	0
Debt Service	68,846
Extensions and Replacements	27,916
Working Capital	<u>7,674</u>
Total Revenue Requirement	175,289
Less: System Development Charge	2,513
Carmel Water Payment	1,577
Jobbing and Contract Work	796
Interest Income	<u>2,215</u>
Net Revenue Requirement	168,188
Less: Pro forma Present Rate Revenue	133,845
Other Revenues at Current Rates	<u>49</u>
Net Increase Required	34,294
Divided By: Gross Revenue Conversion Factor	<u>0.986</u>
Required Revenue Increase	<u>\$34,781</u>
Percentage Increase	<u>25.99%</u>

9. Cost of Service Increase in Rates.

A. Petitioner’s Direct Evidence. Mr. Heid prepared a cost of service study and recommended the rate design for the Department. Mr. Heid testified that the purpose of the cost of service study is to allocate the total cost of service to each customer class. The cost of service includes debt service, E&R, O&M expenses, and taxes. The cost of service study is allocated to the following classes: residential, commercial, industrial, sale for resale, private fire protection and public fire protection. Mr. Heid testified he used the AWWA “base extra capacity” method to allocate costs to customer classes, which has been widely used and accepted in Indiana and elsewhere. Mr. Heid summarized the results of his study explaining that in the Department’s previous rate case, Cause No. 43056, it was found the industrial and sale for resale customer classes were being subsidized by other customer classes, which still exist in this proceeding. Therefore, the industrial and sale for resale customer classes experience overall percentage increases above the system average to eliminate the current subsidies, the residential and commercial customer classes receive approximately the overall system average percentage increase and the private fire protection customer class receives a significant percentage reduction. Mr. Heid explained that a review of past cases found that the private fire service rates, including the fire meter rates, had been unchanged since at least Cause No. 39128 in 1992 and that the Department has no knowledge of the reason for this treatment, but the decrease to the

private fire service customers in the current proceeding appears to be attributable to the level of the present private fire service rates. Mr. Heid concluded that he had no information that would enable him to conclude the existing factors are not appropriate.

Mr. Heid testified the Department undertook an analysis of its capacity factors as required in the Commission's Order in Cause No. 43056. However, Mr. Heid testified that because the Department reads meters every other month, less than desirable detail exists to conduct the peak day and peak hour capacity factor analysis. He said monthly and estimated meter readings are a common problem when performing a capacity factor analysis. Mr. Heid testified that the Department's proposal to undertake the AMR pilot program is a good first step toward obtaining better information that could facilitate a capacity factoring analysis in the future. Mr. Heid recommended that the Department continue to utilize its existing capacity factors given the lack of information available to support a recommendation to revise the capacity factors.

Mr. Heid added that consistency from case to case, as well as engineering judgment and experience from other studies, also bolsters the reasonableness of the proposed capacity factors. Mr. Heid testified the capacity factors the Department uses have been in place since 1990, utilizing the same cost of service methodology since the 1970s. He added the AWWA Water Rates Manual, 5th Edition, recommends that the system diversity ratio should be in the range of 1.1 to 1.4 for many systems. Mr. Heid calculated the maximum day diversity ratio to be 1.4, and a maximum hour diversity ratio to be 1.41, both of which he believed were reasonable results.

Mr. Heid concluded that the ratio of system maximum hour demand to average day demand is 2.21. Mr. Heid's analysis indicated the maximum day demand is 1.6 times the average day demand. Mr. Heid testified that the maximum day demand to average day demand ratio of 1.6 indicates that 62.5% of the capacity of maximum day facilities is required for average or base use and the remaining 37.5% is required for maximum day extra capacity. The maximum day to average day demand ratio of 1.6 combined with a maximum hour to average day demand ratio of 2.21 indicates that 45.25% of the capacity of maximum hour facilities is required for base use, 27.15% is required for maximum day demand in excess of base or average use, and the remaining 27.6% is required for maximum hour extra capacity in excess of maximum day.

B. OUC's Evidence. Mr. Dahlstrom testified there is a need to update the 20-year-old capacity factors, at least in part because Mr. Heid's diversity ratio calculations were at the outermost limit of the AWWA's range of acceptability. He testified that it was not uncommon for a utility's customer count, customer mix, customer usage and demand to change over two decades, which would not be reflected in the existing capacity factors. However, Mr. Dahlstrom concluded that because of the Department's failure to acquire the proper information and accurate data, there was little choice other than to continue using the existing capacity factors to allocate costs. He recommended the Commission order the Department to prepare the data necessary to develop updated capacity factors and equivalent meter analysis and provide the data and results to the OUC and the Commission.

Mr. Dahlstrom also took issue with Mr. Heid's proposed equivalent meter analysis performed using current meter costs. Mr. Dahlstrom pointed out various data inconsistencies within the analysis, such as smaller three inch meter costs exceeding those for larger four inch meters and a substantial cost increase for three inch meters over two inch meters. Mr. Dahlstrom prepared a meter cost/meter size regression analysis and developed equivalent meter cost allocators, which he believed to be a more representative comparison.

Mr. Dahlstrom disagreed with Petitioner's proposal to decrease fire protection rates by 29% while increasing all other classes, including an almost 34% increase for residential customers. Based on the Department's failure to complete the capacity factor analysis required by the Commission in its Cause No. 43056 Order and the Department's admission that it had no knowledge as to why fire protection rates had remained unchanged since at least 1992, Mr. Dahlstrom recommended an increase for fire protection rates at the average increase for all customers.

Mr. Dahlstrom agreed with Mr. Heid that, absent special circumstances, a cost-based rate design will create rates developed to recover, as closely as possible, revenues allocated to each customer class in the cost of service model. Mr. Dahlstrom concurred with Mr. Heid's opinion that the Department's current rates are not cost-based, as they include subsidies paid by other classes that benefit both the Industrial and Sale For Resale classes. Mr. Dahlstrom agreed with Mr. Heid's assertion that Petitioner's proposed rates, based on Petitioner's cost of service model, are designed to remove these subsidies. Mr. Dahlstrom also agreed with Mr. Heid that rates should be cost-based in this case.

Finally, Mr. Dahlstrom recommended that if any recalculation of the rate design is required, then any new rates developed should also be cost based, without any subsidies.

C. Industrial Group's Evidence.

1. Cost Allocation. Mr. Gorman raised two issues with the Department's cost of service study. First, he testified that Mr. Heid did not properly allocate the cost of purchased power between demand and base volume components. Second, he said that in allocating costs between large and small customers, Mr. Heid did not include all customer billing factors for private fire protection service, which resulted in substantially under-allocating costs to this classification and resulted in an over-allocation of costs to other customer classes.

Mr. Gorman reviewed the Department's actual purchased power expense, which showed that the Department pays for power based on demand and energy billing factors. Mr. Gorman explained that demand factors are tied to the highest electric consumption in the month, whereas energy factors reflect the average hourly electric use. Mr. Gorman said that a breakout of the Department's bills varies depending on the pumping stations and other uses, but generally, the bills demonstrate that the Department's power costs relate to approximately 50% demand cost and 50% energy cost. He added the actual bills themselves show much higher demand for many accounts, and lower demand components for others.

Mr. Gorman said the Department's purchased power demand cost is based on the Department's monthly peak demands, due to peak water demands, while the energy cost is based on the Department's monthly average use of water volume. He said peak water demand is based on the highest daily and hourly demand for the month, which increases the pumping demand. Average flow reflects normal average use of the pumping and other electrical equipment. Mr. Gorman explained that allocating 50% of the Department's purchased power on demand, based on peak day/peak hour requirements, and the remaining 50% on base volume or normal use of water would be consistent with how the Department incurs purchased power expense. He added the Department's electric demand and energy breakdown is generally consistent with water pumping stations for other utilities that he has seen in other rate proceedings.

Mr. Gorman noted that the Department's cost of service study did not allocate purchased power in relationship to the peak demands and hourly flow. He said the Department's allocation of 90% of total power costs on flow, which would correspond to the kWh it buys from its electric utility, and only 10% of total power costs on demand is inappropriate in relationship to how the Department actually buys power.

Mr. Gorman recommended using Factor 4 to allocate purchased power costs because that factor assigns approximately 45% of the total purchased power costs on base volume, and 55% of purchased power costs to peak day/peak hour water demands to reflect what is causing the cost. He said allocation Factor 4 seems to be the closest breakout of demand and energy that coincides with the Department's actual power bills, which reflect power cost based on peak monthly water demands and hourly flows. He concluded this allocation factor is a more reasonable approximation of the factors that drive the Department's costs of purchased power. Mr. Gorman said the Department's proposed allocation is primarily based on volume, which ignores cost associated with peak monthly demand.

Mr. Gorman added that using allocation Factor 4 is consistent with the allocation factor the Department used for its pumping equipment for transmission and distribution. He noted that pumps use large amounts of electrical power and are a major contributor, if not the primary contributor, to the Department's total power expense because the pumps' electric usage increases as water demand increases. Increased pumping increases the Department's electrical demand and power expense. He said pumping equipment costs, and the power needed to operate that equipment, are similar cost components and should be allocated to customers in a similar manner.

Mr. Gorman also took issue with how Mr. Heid determined base demand and customer billing units. He explained Mr. Heid did not include several customer cost factors for private fire protection in his cost study. Mr. Gorman said these factors include number of bills, equivalent metering, and meter reading data for private fire protection service. Mr. Gorman explained that by understating the units of service in the determination of base, max day/max hour, and customer cost components, the Department substantially underestimated the cost of providing private fire protection service. He said this flaw was evident by comparing Mr. Heid's estimated cost of service to the current rate revenue for this service, which showed that private fire protection current rates significantly over-recover the Department's cost of providing this service. Mr. Gorman said excluding the customer components for private fire protection service

has resulted in significant under-allocation of customer-related cost to this customer classification, understating the cost to provide private fire protection service.

Mr. Gorman corrected the Department's cost of service study for the customer billing factors associated with private fire protection service by including the customer units of service Mr. Heid reflected on his Exhibit KAH-3 on the units of service sheet. Mr. Gorman explained that Mr. Heid overstated the equivalent meters for the Commercial class and understated meters belonging to the Private Fire Protection class. Mr. Gorman moved the meters back to the appropriate class, which decreased the cost associated with residential, commercial and industrial customers in Mr. Heid's cost of service study.

Mr. Gorman recommended the Commission approve his change in the allocated cost of service study to reflect a more appropriate allocation of purchased power expense and his treatment of customer components for private fire protection service.

2. Rate Design. Mr. Gorman also addressed the Department's proposed rate design. He recommended the Commission consider gradualism in adjusting rates in this proceeding. He said customers have already experienced a 10.8% interim rate increase, and the Department proposed almost a 35% additional increase. He noted the Department's proposal for industrial customers would result in an almost 56% increase on top of the 10.8% emergency increase, if the Department's claimed revenue deficiency, cost of service study and rate design are approved in this proceeding. Mr. Gorman said this increase will be borne by industrial customers that are already in a very difficult economic environment, and may very well cause serious financial harm for many of those industrial customers.

Mr. Gorman said that because of the significant rate increase the Department was requesting and the recognition that even with his recommended adjustments industrial customers would still be facing over a 50% increase on top of the 10.8% increase, he recommended the Commission adjust rates by an equal percent change across-the-board for all classes to cure any revenue deficiency found by the Commission. He said an across-the-board revenue allocation is supported by the concept of gradualism to ensure no rate class experiences rate shock.

D. Industrial Group's Cross-Answering Evidence. In cross answering testimony, Mr. Gorman addressed the OUCC's recommendations regarding the Department's equivalent meter analysis and the OUCC's testimony that the Department should move to full cost of service rates in this rate case.

1. Equivalent Meter Factor. Mr. Gorman agreed with the OUCC's observation that the Department's proposal to use current meter cost as a proxy for actual meter cost in the cost allocation does not properly allocate the Department's actual cost of meters across classes. However, he noted the OUCC proposed a similar inexact methodology for allocating customer meter cost. He said instead of using current meter cost as proposed by the Department, the OUCC proposed a regression analysis to approximate the change in cost of meter based on the size of the meter as a proxy for actual meter cost. Mr. Gorman stated that the OUCC's equivalent meter factor estimates were not any more reasonable than the Department's

estimates because the OUCC was approximating the cost of meters across classes, and not accurately measuring the Department's actual cost of meters.

Mr. Gorman presented a table reflecting the Department's and OUCC's equivalent meter factor estimates, along with those published by the AWWA. Mr. Gorman noted that the Department's estimates were closer to the estimates published by the AWWA than the OUCC's, although even the Department's meter cost estimates for customers appeared high. Mr. Gorman said that while actual data is not available, and more exact equivalent meter factor estimates cannot be calculated, the OUCC's factors appeared substantially overstated and recommended that they not be relied upon.

2. Gradualism. Mr. Gorman, citing to the Commission's decisions in Cause No. 39066 and consolidated Cause Nos. 40049/40050, stated that the Commission has previously acknowledged the need to gradually move to full cost of service rates in order to avoid rate shock. Mr. Gorman compared the rate impact in this case to these prior cases. He said in this case, the Industrial class is facing a minimum rate increase of 51.45% under the Industrial Group's adjusted cost of service study, and under the Department's proposal, the Industrial class is facing an almost 56% increase. He noted the Sale for Resale class is facing similar increases. He said these potential increases are over 50%, which the Commission found to constitute rate shock in Cause Nos. 40049/40050. He added that the situation is actually more extreme in this case because these increases are in addition to the 10.8% emergency increase that has already gone into effect. Mr. Gorman opined that because of the size of these extraordinary increases, special circumstances exist that justify application of gradualism in this case to avoid rate shock under a movement to full cost of service study.

Mr. Gorman noted that in his direct testimony, he recommended the Commission authorize any rate increase on an across-the-board basis. He added, however, to the extent the Commission wished to move the customer classes closer to cost of service more quickly, he would recommend that a 25% to 50% subsidy reduction be applied in this case. Mr. Gorman calculated the impact on the various classes under both a 25% and 50% subsidy reduction, utilizing the Industrial Group's adjusted cost of service study and the Department's requested overall rate increase. He noted that, in comparison to increases under the Industrial Group's adjusted cost of service, a subsidy reduction in this range would have limited impact on the residential and commercial classes while significantly reducing rate shock for the industrial class.

Mr. Gorman added that the smaller the rate increase, the faster rates could move toward 100% cost of service. He said if the Commission were to accept the Industrial Group's revenue recommendation, gradualism may not be necessary; however, if the Commission authorized an increase closer to what the OUCC recommended or the Department has requested, then he recommends that the Industrial and Sale for Resale Class increase be limited to eliminating no more than 50% of the current subsidy to gradually move class rates to cost of service.

E. Petitioner's Rebuttal Evidence. Mr. Heid testified he believed the Department's equivalent meter factor analysis is correct. He testified that the purpose of an equivalent meter factor analysis is to differentiate and assign meters and services related costs to

ensure that customers pay their proportion share of these costs. Mr. Heid recognized Mr. Dahlstrom's concern that the equivalent meter factor analysis should reflect actual costs, but stated it is common practice in such analyses to use current day costs if actual embedded cost detail does not exist. Additionally, Mr. Heid testified that current day costs have an advantage over actual embedded costs by eliminating the price level effect of different vintage investments that exist with actual embedded costs.

Mr. Heid testified that although Mr. Dahlstrom highlighted differences between the costs of certain meters, the costs are accurate. As an example, Mr. Heid testified that few three inch meters are installed, resulting in a higher unit cost than for larger four inch meters that are installed in greater quantities. Additionally, larger meters are designed differently and do not require the individual parts smaller meters require. Larger meters also have different installation requirements than smaller meters. For these reasons, Mr. Heid testified, the difference between the costs of the various meter sizes is reasonable.

Ms. Baumes also responded to Mr. Dahlstrom's conclusion that "[u]sing current costs for metering equipment as a proxy [for preferred historical costs] does not accurately reflect the actual costs of the equipment throughout the utility's system." She stated Mr. Dahlstrom has not shown how his proposed linear regression of a limited data set would present more accurate guidance than use of the current, actual costs. She stated that in her view, Mr. Dahlstrom's criticism of the use of current costs is ill-founded and that the use of current pricing is superior to Mr. Dahlstrom's proposal to use a calculated model. Ms. Baumes explained that in the original data submitted to the Department's witness, Mr. Heid, the three inch meter cost was excluded because of the very small number of three inch meters used. Out of 48,958 meters from 2007 through October 2009, only 20, or 0.04% were three inch meters. Only 44, or 0.09%, were four inch meters. She stated that these costs were thus deemed not material and were not updated for the study. She testified that the costs are higher on the three inch meter because of its low volume.

Mr. Heid also disagreed with Mr. Gorman's analysis concerning purchased power costs. Mr. Heid asserted his belief that the 90% base and 10% maximum day maximum day extra capacity cost has been used consistently by the Department and its predecessors. Mr. Heid testified there is no correlation between purchased power demand costs and water system peak demand. Mr. Heid testified that the Department will incur purchased power demand costs even if it has uniform demand. He also testified that Mr. Gorman's premise assumes that all billed electric demand costs should be classified to the extra capacity cost functions and all energy costs should be allocated to the base cost function. Mr. Heid testified that this fails to recognize that the base cost function includes not only variable costs, but also a portion of demand or capacity costs. In other words, Mr. Heid stated, base costs include a portion of capacity costs and it is only the extra capacity costs that are assigned to the extra capacity cost functions. Mr. Heid stated therefore, a significant portion of the electric power demand costs would still appropriately be classified as base costs, which includes the capacity costs associated with serving customers under average load conditions. Additionally, Mr. Heid testified, this functionalization of purchase power costs is directly in conflict with Mr. Collins' proposed water sales normalization adjustment, which assumes that purchase power costs are 100% energy related with no demand or capacity component.

Mr. Heid also disagreed with Mr. Gorman's allegation that private fire protection service is under-allocated. Mr. Heid stated that Mr. Gorman failed to explain the basis for his belief. Mr. Heid testified that private fire meters serve both the normal every day metered water supply function, while simultaneously serving as an unmetered fire connection. The customer or bill account for private fire meters is included within the Commercial rate class while still being separately identified for inclusion with the private fire lines. Therefore, Mr. Heid stated, his cost of service study does not under allocate costs to private fire protection service.

Finally, Mr. Heid rejected Mr. Gorman's testimony about an across-the-board rate increase and disagreed with Mr. Gorman's analysis concerning gradualism. Mr. Heid testified that Mr. Gorman's discussion of gradualism was perplexing, as Mr. Gorman proposed no movement towards cost-based rates. Mr. Heid testified that gradualism is the gradual movement toward cost-based rates while mitigating rate shock. Because Mr. Gorman recommended an across-the-board increase, Mr. Heid testified that Mr. Gorman's recommendation is at odds with gradualism and moving toward cost-based rates.

F. Commission Discussion and Findings.

1. Equivalent Meter Factor Analysis. The evidence of record weighs in favor of finding the equivalent meter factor analysis performed by Mr. Heid is as accurate as the available data will allow. Mr. Heid testified that many utilities do not keep records of historical meter costs, and so current meter costs are often used for equivalent meter factor analyses. Mr. Heid's testimony that current day costs for meters provide a sufficient data set when historical costs are unavailable is reasonable. Further, Mr. Heid's explanation for seeming irregularities in meter costs makes sense and is reasonable given the lack of data to conduct a thorough analysis. We find that although Petitioner has performed an equivalent meter factor analysis based on the best available data, such analysis failed to meet the level of analysis contemplated in our Order in Cause No. 43056. Consequently, within 60 days of this Order, Petitioner shall begin collecting the data necessary, including historical meter costs, to provide a current Equivalent Meter Factor analysis in its next base rate case.

2. Capacity Factor Analysis. The Commission's Order in Cause No. 43056 directed Petitioner to perform a capacity factor analysis for the cost of service study to be filed in this Cause. Again, Petitioner conducted the analysis, but failed to collect the data necessary to bring the study current, leaving its witness, Mr. Heid, in the unenviable position of working with data from two decades ago. This data does not capture any changes in customer count or customer mix since 1990. It does not reflect the impact of changes in customer demand or usage, including the effects of high efficiency washers, low-flow showerheads, and other such conservation means employed during that time. Despite these infirmities, Petitioner's existing capacity factors are what is available at this time. We note that Mr. Heid testified that AMR systems can provide a wealth of information needed to perform a reliable capacity factor analysis and further discussed the limitations of bi-monthly meter readings. Therefore, within six months of the date of this Order, Petitioner shall determine how it will collect the necessary data to perform a current capacity factor analysis for submission in its next base rate case and notify the Commission of its determination.

3. Private Fire Protection. Mr. Gorman testifies that Mr. Heid's conclusion results in a significant under-allocation of costs to provide private fire service but fails to adequately support his belief. The Commission finds Mr. Heid's allocations to be reasonable under the circumstances. Given the absence of reliable argument supporting a rate increase or to hold rates at their present levels, we find the private fire protection class should receive the rate decrease according to the cost of service study.

4. Purchased Power Allocation. The Commission declines to accept the Industrial Group's proposal to allocate purchased power costs on a factor for base, max day and max hour. Mr. Heid allocated purchased power primarily to base, and we agree that the evidence of record supports Mr. Heid's allocation. The Commission disagrees that it is appropriate to allocate all power demand charges to peak day and peak demand charges. The base cost function includes not only variable costs but also a portion of the demand or capacity costs. Demand costs are associated with providing facilities to meet the demands placed on the systems by customers. Accordingly, the Petitioner is assessed a demand charge even during months where there is no max day or max hour because the demand charge is intended to compensate the electric utility for the cost of constructing the infrastructure to provide the electricity needed every day and during peak usage. While some portion of this charge results from the need to have facilities in place to serve periods of peak usage, the bulk of the charge is related to meeting base demands. Consistent with our recent decision on this issue in *Indiana American Water Company, Inc.*, Cause No. 43680 at 108 (April 30, 2010), the Commission accepts the allocation of purchased power costs put forth by Mr. Heid.

5. Rate Design. Mr. Heid explained that Mr. Gorman's proposed across-the-board increase would perpetuate known, existing subsidies in Petitioner's rate structure and we agree. However, we also believe the subsidies being provided to the industrial and resale customer classes should not be eliminated entirely through the pendency of this case. The Commission agrees with Mr. Gorman that to impose a rate increase in excess of 50% on both the industrial and resale customer classes on top of the recent 10.8% rate increase approved in the emergency proceeding is excessive and should therefore be mitigated.

As we have previously noted, the Commission has often been faced with the competing goals of cost-based rates and the minimization of excessive rate impact or "rate shock." *See Ohio Valley Gas Corp.*, Cause No. 40049, 1995 Ind. PUC LEXIS 405, *22 (Nov. 9, 1995). While we agree that utility rates should accurately reflect the cost of providing service to each customer class, we have frequently required a gradual movement toward such cost-based rates in order to strike a balance between the long-term benefit of cost-based rates and the short-term detriment of rate shock. *Id.*, citing *Southern Ind. Gas & Elec. Co.*, Cause No. 39871, at 58-61 (June 21, 1995). What movement toward cost based rates using gradualism is a matter of the Commission's judgment and discretion based upon the circumstances presented. *Ind. Gas Co., Inc.*, Cause No. 38080, 1987 Ind. PUC LEXIS 115, *141 (Sept. 18, 1987). Mr. Gorman explained that if the Commission wished to move the customer classes closer to cost of service rates, he proposed a 25% to 50% subsidy reduction be applied in this case. Based upon the evidence presented, we find that a 50% subsidy reduction should apply to both the resale and industrial customers with the goal to reach cost-based rates for all customer classes in

Petitioner's next rate proceeding. We believe a 50% subsidy reduction is reasonable and mitigates rate shock by limiting all customer class rates to an increase of less than 50%.

10. Other Tariff Issues. On February 23, 2010, the Commission issued a docket entry requesting support for the \$5.50 per foot "Review and Inspection Fee" shown on certain "Water Main Extension Agreement" contracts. On February 26, 2010, Petitioner responded with a worksheet purporting to support a \$13.58 per foot Inspection Fee and an explanation that the Department intends to seek Commission approval of the Review and Inspection Fee in order to place it on its tariff. The Department explained that the worksheet attached as Exhibit E demonstrates the methodology used to calculate the typical cost per linear foot to ensure that the performance of the developer-installed water main is in accordance with the Department's Standard Practice and Engineering Requirements for the Installation of Water Mains, Service Lines, Meters and Appurtenances. The Department further explained that the \$5.50 per linear foot Inspection and Review Fee has remained unchanged since 1995 and was originally utilized by the Department's predecessor, Indianapolis Water Company, Inc. In his rebuttal testimony, Mr. Klein explained that the Department provided an explanation and cost support and requested the Commission approve the current inspection fee to be included in the Department's tariff. Pet. Ex. MTK-R1 at 20.

The Commission finds that the Department's proposed cost justification is inadequate to support the \$5.50 per foot Inspection Fee. While the Department provided a description of costs that the Inspection Fee was intended to cover along with a list of positions at current rates and hours worked, nothing was provided to explain the relationship between the duties of the positions to the proposed Inspection Fee nor the reasonableness of the cost rates and hours justification. Moreover, this issue was raised subsequent to the OUCC's filing of its case-in-chief. Therefore, the Commission finds that sufficient evidence was not presented to support Petitioner's proposed inspection fee and Petitioner is directed to file within 60 days of this Order a Thirty-Day filing, in accordance with 170 IAC 1-6 *et seq.*, that contains adequate cost support for the proposed fee.

On February 12, 2010, the Department responded to a February 8, 2010 docket entry from the Commission inquiring about language contained in the Department's main extension agreement that required a residual pressure of 30psi which was inconsistent with the Department's rules approved and on file with the Commission. In rebuttal testimony, Mr. Klein indicated the need to update the Department's rules to accurately reflect the current practice. Pet. Ex. MTK-R1 at 21. Therefore, within 60 days of this Order, Petitioner shall make a Thirty-Day filing that supports the Department's current practice regarding required residual pressure for the delivery of fire protection services.

Finally, the Department proposes to amend its rules to more accurately describe the estimating logic currently being used. While the Commission is concerned that no studies of alternative estimating methods, such as the use of algorithms, were discussed or provided to support or explain that Petitioner's current bill estimation method is reasonable, the Commission finds Petitioner's proposed revision to its rules better clarifies Petitioner's current practice and should be approved. In Petitioner's next rate case, Petitioner shall complete a study that reviews various estimating methods and provide a recommendation regarding the best estimating

practice. However, if Petitioner converts to monthly meter reading, this study need not be undertaken.

11. Reporting Requirements. Subsequent to Petitioner's last rate case in Cause No. 43056, the Commission directed Petitioner to file meter reading and taste and odor reporting to the Commission due to significant consumer complaints. The Commission believes that Petitioner has addressed, or is in the process of addressing, these issues and thus, no longer needs to continue reporting at this time. Petitioner shall also cease the filing of "any contracts, agreements, joint ventures, or other type of transaction relating to the operation, management, sale or transfer of the water utility . . ." as required by the Commission's June 30 Order.

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

1. Petitioner shall be and is hereby authorized to increase its existing rates and charges as provided in Finding Paragraph No. 8. Petitioner shall update its Cost of Service Study to reflect the adjustments in Finding Paragraph No. 9.

2. Petitioner shall file with the Water/Sewer Division of the Commission a tariff schedule in accordance with the Commission's rules and consistent with this Order. Said tariff, when approved by the Water/Sewer Division, shall cancel all previously approved rates and charges and Petitioner's new charges shall be in full force and effect.

3. Petitioner shall file with the Commission and serve all parties of record, within 20 days of closing on the proposed 2010 bonds, a true-up report containing the following: the actual principal amount borrowed; the interest rate; the sources and uses of funds; and an amortization schedule. Petitioner shall also file an amended tariff with the Water/Sewer Division upon filing its true-up report if a material change results from the rates approved herein. Such tariff shall be effective upon approval by the Water/Sewer Division and shall apply to water usage from and after the date of approval. If Petitioner does not issue the proposed 2010 bonds within 120 days from the date of this order, a filing shall be made to remove the debt service and lower the utility's rates by 3.7%.

4. Petitioner is authorized to amend its Rules and Regulations as depicted on Pet. Ex. MTK-27. Petitioner shall file with the Water/Sewer Division of the Commission the First Revised Page 11 to its Rules and Regulations and have it approved before the rule change shall become effective.

5. Within 60 days of this Order and pursuant to Finding Paragraph No. 10, Petitioner shall make a Thirty-Day filing, in accordance with 170 IAC 1-6 *et. seq.*, that provides adequate cost support for its proposed inspection fee.

6. Within 60 days of this Order and pursuant to Finding Paragraph No. 10, Petitioner shall make a Thirty-Day filing, in accordance with 170 IAC 1-6 *et. seq.*, to update its rules to accurately reflect Petitioner's required residual pressure for the delivery of fire protection services.

7. Petitioner shall comply with the reporting and compliance filing requirements set forth in this Order.

8. In the filing of its next rate case, Petitioner shall comply with the requirements set forth in Finding Paragraph Nos. 6.D.4, 9.F.1., 9.F.2, and 10.

9. In accordance with Ind. Code § 8-1-2-70, Petitioner shall pay the following itemized charges within 20 days from the date of this Order, into the Treasury of the State of Indiana, through the Secretary of the Commission.

Commission Charges	\$ 79,603.24
OUCG Charges	\$ 56,258.44
Legal Advertising Charges	\$ 84.86
Total	\$135,946.54

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

LANDIS, MAYS AND ZIEGNER CONCUR; ATTERHOLT NOT PARTICIPATING:

APPROVED: FEB 02 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