

STATE OF IOWA  
DEPARTMENT OF COMMERCE  
UTILITIES BOARD

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IN RE:  IOWA-AMERICAN WATER COMPANY	DOCKET NO. RPU-2013-0002
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**FINAL DECISION AND ORDER**

(Issued February 28, 2014)

**I. PROCEDURAL HISTORY AND INTRODUCTION**

On April 30, 2013, Iowa-American Water Company (Iowa-American) filed with the Utilities Board (Board) proposed water tariffs, identified as TF-2013-0069 and TF-2013-0070. In TF-2013-0069, Iowa-American proposed a temporary annual increase in its Iowa retail water revenue of approximately \$2.68 million, or about 7.5 percent over current Iowa retail water revenue. Pursuant to Iowa Code § 476.6(10), Iowa-American implemented its proposed temporary rates ten days after its April 30, 2013, filing; the rates are subject to refund. In TF-2013-0070, Iowa-American proposed a permanent annual increase in its Iowa retail water revenue of approximately \$6.4 million, or about 18 percent over its current revenues.

Iowa-American's filing indicates that the primary drivers for the requested increase are new utility plant investments of about \$16.1 million, increased capital costs of about \$2.2 million, and increased operations and maintenance expenses of about \$0.8 million. Iowa-American is also asking that the Board approve a surcharge that would allow Iowa-American to earn a return of and return on its investments in

future infrastructure replacement without a rate proceeding, an automatic adjustment clause that would allow purchased power and chemical costs to be flowed through to customers on an automatic basis, and a declining usage adjustment to address declining water usage.

The Board issued an order on May 29, 2013, docketing the proposed filing and setting a procedural schedule. Two consumer comment hearings were held, one in Bettendorf on June 3, 2013, and the other in Clinton on June 4, 2013. The Consumer Advocate Division of the Department of Justice (Consumer Advocate) is the only other party to the proceeding.

On July 19, 2013, the Board issued an order denying a motion for issue preclusion filed by Consumer Advocate. Consumer Advocate said that in this proceeding Iowa-American said it qualifies for an exception to the application of double leverage, an issue that was litigated in Iowa-American's last rate proceeding (Docket No. RPU-2011-0001, "Final Order" issued February 23, 2012) and decided adversely to Iowa-American. Because the Board's decision was issued only 14 months prior to the filing of the current rate case, Consumer Advocate said issue preclusion applied.

The Board denied the motion for issue preclusion because in a rate proceeding, the Iowa Supreme Court has said the Board functions in a legislative capacity, where application of issue preclusion is not appropriate. However, the Board did share Consumer Advocate's concern about the costs of re-litigating the

same issues in multiple dockets and noted that Consumer Advocate could raise arguments that any rate case expense associated with the double leverage issue should not be recovered from ratepayers.

The Board held a hearing in this case on October 30-31, 2013. Iowa-American and Consumer Advocate filed post-hearing initial and reply briefs.

Iowa-American filed several exhibits after the hearing in response to requests for information by the Board. Consumer Advocate filed an objection to four of these (Exhibits 3, 4, 8, and 9) on November 14, 2013. In an order issued December 16, 2013, the Board sustained the objection, stating that the narrative, explanation, or testimony provided by Iowa-American in the four exhibits at issue went beyond the Board's requests for additional information and Iowa-American used these exhibits as an additional opportunity to submit explanatory testimony or argument. The Board noted that if the exhibits were admitted, Consumer Advocate would need time for discovery, filing rebuttal testimony, and perhaps cross-examination, which would necessitate extending the 10-month deadline. Neither party requested an extension to accommodate the four exhibits.

Consumer Advocate filed an objection to Iowa-American's report of actual rate case expense on January 2, 2014, alleging that it lacked the detail required by 199 IAC 26.4(6). Iowa-American filed additional expense support on January 10, 2014.

On January 16, 2014, Consumer Advocate filed a motion for reduction of recoverable rate case expense. Iowa-American filed a resistance to Consumer

Advocate's motion on January 24, 2014, and Consumer Advocate filed a reply to the resistance on January 29, 2014. The Board will address the motion and resistance after it has addressed issues raised in the rate case.

## **II. RATE BASE ISSUES**

### **A. Business Transformation**

Iowa-American and Consumer Advocate agreed that \$4,939,942 associated with Iowa-American's business transformation program should remain in plant in-service. The corresponding amounts in accumulated depreciation and depreciation expense are to be as reflected in Iowa-American's filing. (Tr. 6-7; 700-701) Iowa-American's business transformation program includes computer hardware and software upgrades.

### **B. Cash Working Capital**

Cash working capital is a reflection of the amount of investor-supplied capital used to cover the day-to-day cash needs of a utility. Calculation of the cash working capital is necessary because the utility provides a service but does not receive payment for the service for a certain number of days, which is called the revenue lag. Cash working capital also accounts for the fact that the utility receives a service from a vendor or employee but does not pay for the service for a certain number of days after it is provided, which is the payment lag. Iowa-American performed a lead/lag study to analyze Iowa-American's receipts and payments based on data for the

twelve months ended December 31, 2012, in order to determine Iowa-American's cash working capital requirement. (Tr. 544)

Consumer Advocate disagreed with several adjustments made by Iowa-American for such things as revenue lag days, federal income tax expense lead days, property tax expense lead days, state income tax expense lead days, and miscellaneous expense lead days. Consumer Advocate said that the adjustments made by Iowa-American reduce test year revenue, creating the potential for windfall profits for Iowa-American at the expense of Iowa-American's ratepayers.

**1. Bill Collection Days**

Iowa-American's lead/lag study was based on daily accounts receivable balances and resulted in a calculation showing 26.58 bill collection days. Consumer Advocate argued it was appropriate to cut off bill collections days after 24 days, because after 23 days Iowa-American charges a late fee.

The Board will adopt Iowa-American's 26.58 bill collection days. Regardless of whether Iowa-American charges a late fee, cash is not available to Iowa-American for working capital from revenue that is uncollected and a late payment fee does not make up for uncollected revenue in the cash working capital calculation. This results in total revenue lag days of 72.05 days, which is composed of the 26.58 bill collection days and three uncontested figures: service lag days of 39.72 days, billing lag days of 4.97 days, and lockbox collection lag of 0.78 days.

## **2. Federal and State Income Tax Expense Lead Days**

In calculating federal income tax expense lead days, Consumer Advocate used a method based on monthly accruals while Iowa-American's method was based on actual payment dates. (Tr. 557) Iowa-American pays its income taxes quarterly.

Iowa-American counts the days until the tax payment and does not use monthly accruals. Because over 94 percent of Iowa-American's customers are billed on a quarterly basis (Thakadiyil Ex. 2), the average service period for Iowa-American's customers is 39.72 days. Consumer Advocate uses 15.2 days, a number that might be appropriate if Iowa-American's customers were billed monthly like most customers of Iowa's rate-regulated electric and gas utilities, but Consumer Advocate has not provided evidence to convince the Board that its monthly accrual method is more appropriate when most customers are billed quarterly. The Board will use Iowa-American's 37.0 tax expense lead days for federal income tax.

Consumer Advocate argued that its federal method should also be used to compute state income tax expense lead days. However, because the Board has determined it will use Iowa-American's computations for federal income tax expense lead days, it will also use Iowa-American's method for the state computation, which results in 52.25 lead days for state income taxes.

### **3. Property Tax Expense Lead Days**

Similar to the tax calculations, Consumer Advocate uses a method based on monthly accruals for each of the 12 months of the test year to calculate property tax expense lead days; Iowa-American does not use a monthly accrual and counts the days until tax payment. As discussed above, Iowa-American's method of calculating cash working capital is most appropriate, and it results in lead days of 332.86 days for property tax expense.

### **4. Miscellaneous Expense Lead Days**

Consumer Advocate used Iowa-American's 38.4 miscellaneous expense lead days for all expenses other than labor and fuel. Iowa-American prepared an analysis for each expense category. Iowa-American's method provides a more accurate result by analyzing each expense category and will be used to calculate cash working capital for other operations and maintenance expenses.

## **III. INCOME STATEMENT ISSUES**

### **A. Unbilled Revenue**

Iowa-American said that unbilled revenue should be removed from the calculation of test year revenue, stating that unbilled revenue is an accounting entry recorded for financial statement purposes to account for services provided but not yet billed at the end of an accounting period. (Tr. 516) Iowa-American noted that all customer meters are not read and billed on the last day of each month and,

therefore, there is always a certain amount of revenue left unbilled that is related to services provided prior to the end of the month.

Consumer Advocate argued that Iowa-American's proposed unbilled revenue adjustment creates a mismatch between test year revenue and test year expenses, violating the matching principle. (Tr. 987) Consumer Advocate said a similar adjustment was rejected by the Board in a prior Iowa-American case. Iowa-American Water Company, "Final Decision and Order," Docket No. RPU-90-10 (10/21/1991), p. 27.

The proposed adjustment for unbilled revenue would result in a mismatch of revenues and expenses, violating the matching principle. Iowa-American proposed an adjustment for revenues because under the accrual method of accounting unbilled revenue is included as revenue in the test year. However, Iowa-American failed to make any corresponding adjustment for expenses. The proposed unbilled revenue adjustment will be rejected.

**B. Uncollectible Expense**

There are two issues related to uncollectible expense. The first is the amount of the test year adjustment to create a normalized amount of uncollectible expense to include in rates determined in this proceeding. Iowa-American and Consumer Advocate both agree an adjustment should be made, but disagree on the amount.

The second issue is whether there should be an additional adjustment to uncollectible expense, as proposed by Iowa-American, to account for uncollectible

expense associated with the rate increase in this proceeding. Consumer Advocate opposed this adjustment.

**1. Adjustment to Test Year**

Iowa-American used an average of 2010, 2011, and 2012 data to calculate its uncollectible adjustment to the test year, which is the first issue. Iowa-American calculated the adjustment by first taking the ratio of the three-year average of net charge-offs to billed revenue and then applying the ratio to the pro forma present and proposed revenues. (Tr. 465, 472)

Consumer Advocate averaged three years of uncollectible expense (2009, 2010, and 2011) to determine its proposed adjustment to test year uncollectible expenses. Consumer Advocate said the use of the test year in the average carries any abnormal amounts forward.

Iowa-American's method produces an adjustment of (\$60,512) and Consumer Advocate's method produces an adjustment of (\$102,084) to uncollectible expenses. There are problems with both methods.

Iowa-American did not use the general ledger account expense for its calculation for uncollectible accounts expense, but instead used net charge-offs that include accruals, or a reserve, in its calculation for uncollectible accounts expense. The reserve includes an amount that Iowa-American is not certain of at the time Iowa-American books the expense. (Tr. 478-479) Consumer Advocate used the general ledger account balance, which is the appropriate starting point because this

balance does not include a reserve and more accurately reflects the uncollectible expense.

However, in calculating the adjustment using a three-year average, the test year should normally be included to reflect the most recent uncollectible levels. No persuasive evidence was presented to exclude the test year from the average. Using a three-year simple average for the years 2010, 2011, and 2012, the adjustment to unbilled revenue reflected in Iowa-American's new rates will be (\$72,696).<sup>1</sup> A simple average more accurately measures the account experience than a ratio method.

## **2. Adjustment Based on Proposed Rates**

Iowa-American argued that to the extent revenues are increased as a result of this proceeding, an adjustment should be made to reflect the fact that a portion of these revenues will also be uncollectible. Iowa-American said that there was a direct correlation between uncollectible expenses and revenues and that when revenues increase, uncollectible expenses also increase, with the ratio of uncollectible expense to revenue being about one percent over the past five years. (Tr. 481, 484) Iowa-American's method would result in a test year increase of \$63,530 to uncollectible expense to account for additional amounts that will not be collected under the new rates.

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<sup>1</sup> The three year-average is \$333,075, which requires a decrease of test year expense of \$72,696 (\$333,075-\$405,771).

Consumer Advocate opposed any adjustment to uncollectible expense to reflect new revenues that will not be collected. Consumer Advocate argued that the adjustment is speculative and not known and measureable, citing Iowa Code § 476.33(4).

The Board will not make an additional adjustment to account for any increase in uncollectible revenue based on the rates approved in this proceeding. Any adjustment based on other than present rates is speculative and not known and measureable; it is also an adjustment for something that will occur more than nine months after the end of the test year. A similar adjustment was rejected in another Iowa-American proceeding, Docket No. RPU-90-10.

The Board notes that Iowa-American included an increase in uncollectible expense based on new rates in the number that it grossed-up for taxes. Because that proposed adjustment will be rejected by the Board, the amount of this proposed adjustment will be removed before the gross-up for taxes.

**C. Interest Synchronization**

Interest synchronization is an adjustment to recognize the income tax effect of differences between the test period interest expense reported by Iowa-American and the interest expense included in the overall return on rate base. (Tr. 990) Iowa-American and Consumer Advocate agree that such an adjustment needs to be made and they also agree on the method used for the adjustment. Their differences are based on the size of rate base, weighted cost of debt, and the double leverage

adjustment. The interest synchronization adjustment will be recalculated to reflect the Board's decisions on these three issues and reflected in the schedules attached to this order.

**D. Weather Normalization and Declining Usage**

Iowa-American proposed to decrease test year revenues for declining usage and weather normalization. Consumer Advocate did not make either of these adjustments to test year revenues. These issues will be discussed in detail later under Rate Design—Billing Units.

**E. Fuel and Power, Chemicals, and Waste Disposal Expense**

Iowa-American proposed an adjustment to certain test year expense levels to reflect a decrease in power consumption, chemical usage, and waste disposal; these adjustments are tied to Iowa-American's proposal to adjust test year sales for declining usage and weather normalization. Whether such adjustments to power consumption, chemical usage, and waste disposal are appropriate depends on the Board's decisions regarding declining usage and weather normalization. These issues will be discussed in detail later under Rate Design—Billing Units.

**F. Property Tax**

Iowa-American and Consumer Advocate agreed that the appropriate adjustment to test year property tax expense is \$263,006. The Board will reflect this adjustment to test year property tax expense.

**G. Rate Case Expense**

Historically, the Board has typically amortized rate case expense over a three-year period. In this proceeding, Iowa-American has asked for a two-year amortization of current rate case expense and the unamortized balance from its prior rate case proceeding, Docket No. RPU-2011-0001. Iowa-American said a two-year amortization is consistent with its historic rate case pattern; Iowa-American filed rate proceedings in 2007, 2009, 2011, and 2013. Iowa-American said using a two-year amortization period would prevent rate case expense obligations being shifted to future customers.

Consumer Advocate recommended the Board use a three-year amortization, consistent with past practice in Iowa-American rate filings. Consumer Advocate pointed out that in 2011, Iowa-American's rate case expense totaled nearly 40 percent of the allowed revenue increase. Arguing that Iowa-American is relitigating in this proceeding issues lost in past decisions, Consumer Advocate also filed a motion to disallow some rate case expense.

Consumer Advocate's motion to disallow some of the rate case expense will be addressed in a separate section of this order after all regular rate case issues are decided. The Board here will only address the appropriate amortization period for current rate case expense and any unamortized balance.

The Board has expressed concern about the frequency of Iowa-American's rate cases and, like the Consumer Advocate, the Board is also concerned about the

amount of rate case expense, particularly as a percentage of the overall revenue increase. While the Board does not want to encourage Iowa-American to file rate cases every two years, the Board acknowledges that a three-year amortization period for rate case expense, given Iowa-American's historic rate case pattern, shifts more of the rate case expense obligation to future customers. The Board will adopt in this proceeding a two-year amortization period for current and unamortized rate case expense, but this decision should not be taken as an indication that the Board is supportive of Iowa-American's current rate case cycle or that future rate case expense will be amortized over a similar period.

#### **IV. COST OF CAPITAL ISSUES**

##### **A. Overall Cost of Capital**

##### **1. Return on Equity**

In setting an allowed rate of return on equity investment, the Board is to balance investor and consumer interests. For example, if rates produce earnings that are below a fair and reasonable level, they are unjust or confiscatory to the owners of the utility property; if rates produce earnings that are above a fair and reasonable level, the rates are oppressive to the utility's ratepayers. Davenport Water Co., v. Iowa State Commerce Comm'n, 190 N.W.2d 583, 604-05 (Iowa 1971). In addition, the U.S. Supreme Court in Federal Power Commission v. Hope Natural Gas Company, 320 US 591 (1944) held that "the return to the equity owner [the utility] should be commensurate with returns on investments in other enterprises

having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital ....”

In determining the allowed return, the various models generally produce a range for the Board to consider. There is no precise return on equity that is accurate or the only one that is appropriate, but a range of reasonable returns. Within that range, the Board determines the most appropriate return, balancing the interests of shareholders and ratepayers.

Iowa-American and Consumer Advocate each presented return on equity (ROE) testimony. Both of the ROE witnesses used the discounted cash flow (DCF) model. Iowa-American also used the risk premium method and capital asset pricing model (CAPM) to develop its recommendation; Consumer Advocate used the capital asset pricing model (CAPM) only as a check on its DCF result, but did not rely on CAPM in its analysis.

Iowa-American’s witness recommended a 10.8 percent ROE, which included a 40 basis point adjustment for the small size of the company and a 30 basis point adjustment for flotation costs. The two adjustments will be addressed later. Without these adjustments, Iowa-American’s ROE recommendation is 10.1 percent. (Tr. 200) Consumer Advocate recommended a 9.3 percent ROE with no adjustments.

In presenting the various ROE models, there were arguments presented not only with respect to the final recommendation but also with respect to some of the

inputs and the validity of some of the models. One of the disagreements between Iowa-American and Consumer Advocate was with respect to the DCF models used. Consumer Advocate used the compounding form of the DCF model where the dividend yield does not reflect additional growth, while Iowa-American used the constant growth DCF model where the dividend yield is increased  $(1 + g)$  (expected rate of growth in dividends per share)). Under the Board's preferred DCF method, the Federal Energy Regulatory Commission (FERC) model, the dividend yield is increased by  $1 + .5g$ , or half of what was used by Iowa-American. Iowa-American and Consumer Advocate agreed on the proxy group used in their respective DCF analyses, and the Board will consider the ROE results produced by the proxy group.

In the past, the Board has placed more reliance on the FERC DCF version because it represents a compromise between the continuous compounding and constant growth models, with some of the strengths and weaknesses of each approach. There is, however, no perfect DCF model, and the Board looks at the results of all the DCF models as one tool in determining Iowa-American's ROE.

Iowa-American also used the risk premium model. In its simplest form, the risk premium model takes a specific long-term debt interest rate and adds an associated risk premium to estimate the ROE.

Both parties used the CAPM, either as part of the analysis or as a check on the DCF results. Historically, the Board has not given much weight to any CAPM analysis, because there were concerns about its reliability. However, the Board has

considered the results from the CAPM method as another tool in its ROE determination, al beit not the most important one, and will do so here, as well.

All the models used by the various parties produced results worth considering, although the Board has traditionally given more weight to some models than others. In this proceeding, none of the models appeared to produce results that were contrived or so unreasonable as to be not worthy of consideration.

The final ROE recommendations (without adjustments) are Iowa-American at 10.1 percent and Consumer Advocate at 9.3 percent. In this proceeding, the various DCF results range from about 8.5 to 10.53 percent (Tr. 881, 887), the various CAPM ranges are from about 8.2 to 10.1 percent (Tr. 107, 886), and the various risk premium ranges are from about 10.1 to 10.7 percent. (Tr. 108, 112)

The Board in recent years has used the risk premium method as a check on reasonableness when determining ROE. The risk premium model often used by the Board adds 250 to 450 basis points to either the most current A-rated utility bond yield, or the 12-month average of that yield. The most recent bond yield available (October 2013) is 4.7 percent, which produces a ROE range of 7.2 to 9.2 percent, below the ROE recommendation of either party. This reflects the fact that bond yields are historically low and therefore should not be relied upon as predictors of the future with as much confidence as in prior cases, when bond yields were significantly higher and there appeared to be a more normal relationship between bond yields and ROE.

In reviewing current market data and the ranges produced by the various models, the Board concludes an ROE between 9.5 and 10.1 percent is reasonable, particularly given the relative closeness of the DCF and CAPM ranges. The Board will set the ROE at 9.9 percent, which appropriately balances the interests of the shareholders and ratepayers and is consistent with recent ROE decisions.

## **2. Size Adjustment**

Iowa-American argued that because it is small in size compared to the size of other water companies used by its ROE witness in his proxy group, there should be a 40 basis point upward adjustment to the ROE to reflect this risk. (Tr. 122-124) In addition, Iowa-American said it was facing increasing amounts of business risks compared to its peer companies due to the approximately \$50 million of capital investment that Iowa-American plans in the next five years. (Tr. 125)

Consumer Advocate opposed Iowa-American's size adjustment, noting that Iowa-American is a subsidiary of a large national company. Consumer Advocate pointed out that throughout the record, there are references to the synergies that exist with American Water as the parent such as control of Iowa-American's board of directors, amounts spent for services from related companies, and American Water acquiring debt on behalf of Iowa-American. (Tr. 199-202)

The Board will reject Iowa-American's proposed size adjustment. As the Board has noted in the past, because the various ROE models consider so many factors, it is difficult to isolate any one item, such as size, and make that the basis for

an additional adjustment to the allowed return on equity. Interstate Power and Light Company, “Final Decision and Order,” Docket Nos. RPU-02-3, RPU-02-8, ARU-02-1 (4/15/2003), p. 63.

Proxy groups generally contain both large and small companies and should capture any risk associated with size, if it is significant. There is no persuasive evidence to persuade the Board to isolate individual factors to adjust ROE because the models take into account such factors as business and financial risk. See, Interstate Power and Light Company, “Final Decision and Order,” Docket No. RPU-08-1 (2/13/2009), p. 62. Also, the proxy group used in this case was selected because the companies have risk criteria similar to Iowa-American’s, making separate adjustments for isolated factors unnecessary.

### **3. Flotation Costs**

Iowa-American argued that a flotation cost adjustment was necessary because issuing common equity is not cost-free. Iowa-American said that direct costs associated with common equity include compensation for marketing and consulting services and that indirect costs associated with common equity deal with what is called market pressure where there is downward pressure on the stock price due to the new issuance increasing the supply of stock. (Tr. 113-114) Iowa-American noted that because flotation costs are not expensed when common stock is issued, they need to be recovered another way, such as through an upward

adjustment to the ROE. Iowa-American asked for a 30-basis point adjustment. (Tr. 115)

Consumer Advocate opposed the adjustment, stating that Iowa-American does not have flotation costs because no common stock was issued in the test year and no issuance is planned in the near term, no Iowa-specific data were provided by Iowa-American (so any adjustment would be speculative), and no market pressure adjustment is needed because utility stocks trade far above book value in the market, meaning that market pressure is already accounted for. (Tr. 895) Consumer Advocate pointed out that Iowa-American's witness agreed that Iowa-American does not have flotation costs and that American Water's flotation costs were reflected in its market stock price. (Tr. 195-199)

The Board will deny the proposed flotation adjustment. No common equity has been issued recently and Iowa-American expects to issue none in the near future. See, Iowa Southern Utilities Company, "Final Decision and Order," Docket No. RPU-85-11 (02/25/1986), p. 58.

**B. Capital Structure**

The primary difference between Iowa-American's and Consumer Advocate's proposed capital structure is whether to include Iowa-American's November 2013 debt that was issued outside the test year and more than nine months after the conclusion of the 2012 test year. Iowa Code § 476.33(4). Iowa-American said the expected interest rate for the 30-year issuance is 4.95 percent and the estimate

issuance expense is \$40,800. (Tr. 290, 302) Iowa-American argued that the issuance should be included in the capital structure because it was sufficiently known and measureable and reflects the actual capital invested in its assets to provide service to Iowa-American's customers.

Consumer Advocate excluded the November 2013 debt issuance because it was outside the test year and occurred more than nine months after the test year. Consumer Advocate said that such adjustments are not known and measureable.

The Board will exclude the November 2013 debt issuance from Iowa-American's capital structure and use the capital structure proposed by Consumer Advocate. The issuance occurred more than nine months after the conclusion of the test year and § 476.33(4) only requires the Board to consider verifiable data within this nine-month period. The Board has consistently denied such adjustments to capital structure outside that nine-month period, which in this case ended on September 30, 2013. (Tr. 867)

**C. Double Leverage**

In looking at a rate-regulated utility's capital structure, the Board traditionally considers the capital structure of the utility company, which includes debt, as the first layer of leverage. The Board also considers any debt at the parent holding company level that could be used for a capital infusion into the utility, which is the second layer of leverage. Without the double leverage adjustment, there is concern that a parent company could manipulate its debt and equity at the parent and subsidiary levels to

earn an equity return on long-term debt that is actually invested in its utility subsidiary.

The Board has rejected utility efforts to avoid double leverage adjustments in several cases, including Docket Nos. RPU-02-3, RPU-02-8, and ARU-02-1 and Iowa-American's prior rate case, Docket No. RPU-2011-0001. However, the Board in those cases said it would not apply double leverage mechanically in each case, but rather would examine the particular facts and circumstances in each case where the adjustment is proposed.

The Iowa Supreme Court has affirmed the Board's use of double leverage on two occasions, in General Telephone Co. of the Midwest v. Iowa State Commerce Comm'n, 275 N.W.2d 364, 369 (Iowa 1979), and United Telephone Co. v Iowa State Commerce Comm'n 257 N.W.2d 466, 479-480, 482 (Iowa 1977). It is important to note that the Court did not mandate that double leverage be applied in all (or any) situations. Examples of application of the double leverage adjustment, and an exception to when the adjustment is made, are detailed in Iowa-American's last rate case decision. Iowa-American Water Company, "Final Order and Order Approving Settlement," Docket No. RPU-2011-0001 (2/23/2012), pp. 15-19.

Since 1977, double leverage has been applied to Iowa-American. Iowa-American in this case argues that it qualifies for an exception because there were no cash proceeds from debt issues available to invest in Iowa-American's common equity. Iowa-American's arguments regarding an exception to the application of

double leverage in this case are substantially the same as those posed by Iowa-American in its last rate case, and for the same reasons the Board will not apply an exception to the application of double leverage in this case. Id., pp. 14-20.

Iowa-American also argued in this proceeding that double leverage should not be applied under any circumstances. Iowa-American said that there were various conceptual and practical limitations to double leverage.

First, Iowa-American said that double leverage violates the cost of capital concept and principles of finance, economics, and fairness. Iowa-American argued that how the capital is used is what determines the true cost of capital, not the source of the funding for the investment. (Tr. 71, 77)

Second, Iowa-American maintained that double leverage is illogical because the equity contributed by the parent has one cost rate while the equity contributed by individual investors has a different cost rate and double leverage implies that an investor would earn zero percent return if the investor inherited the stock or received it as a gift. (Tr. 175-176) Also, Iowa-American said that under double leverage, the subsidiary's cost of equity could be higher simply because it was sold to a different owner. (Tr. 176)

Third, Iowa-American argued that double leverage is discriminatory to a corporate investor because if a utility is a standalone company it would earn one equity return while a utility that is part of a holding company would likely earn a lower return even though they are identical in all other respects. (Tr. 177-178) Based on

Consumer Advocate's position, Iowa-American said that the standalone utility's individual investor would earn a 9.3 percent return while the corporate investor would earn 8.885 percent. (Tr. 937-938; Munoz Reply Exh. MM-2, Sch. A, p. 1)

Iowa-American noted that it found double leverage was used only by one other state regulatory body, Tennessee. (Tr. 171) Iowa-American also said that FERC rejected the application of double leverage within the past year.

Iowa-American pointed out that an argument that has always been used to support double leverage is that capital is fungible as funds pass between the parent and subsidiary. However, Iowa-American argued that the fungibility argument fails with respect to the subsidiary's retained earnings because those are never passed through to the parent company; therefore, Iowa-American said it was not possible to mix its retained earnings with funds held by American Water, Iowa-American's parent. (Tr. 255-256)

Consumer Advocate urged the Board to apply the double leverage adjustment. Consumer Advocate said that determining the capital structure for an independent utility is straightforward; however, this task is more difficult when a utility is part of a holding company. Consumer Advocate argued that it is important to incorporate the parent/subsidiary relationship when determining the subsidiary's capital structure to prevent the earnings from being above a fair and reasonable level because the parent's investment is leveraged twice, once at the parent level and once at the subsidiary level. (Tr. 887)

Consumer Advocate noted that a well-run company uses debt in combination with equity to produce the lowest overall cost of capital. The combination of the parent's capital is used to invest in the equity of a subsidiary, and Consumer Advocate maintained that the parent should not earn an equity return on capital funds that are cheaper because the parent then would earn a return above a fair and reasonable level. Consumer Advocate concluded that considering the parent's cost of capital reflects the true capital costs of a wholly-owned subsidiary of a holding company. (Tr. 887-888)

Historically, double leverage was used to prevent financing abuse by the parent corporation. Application of the double leverage adjustment discourages a parent from artificially inflating the common equity return by increasing the amount of debt at the parent level and decreasing the amount of debt at the subsidiary level. (Tr. 889)

One Board member believes that the evidence presented by Iowa-American in this docket was basically the same as the company presented in Docket No. RPU-2011-0001 and found that Iowa-American had not presented persuasive evidence for the Board to depart from its long-standing precedent applying double leverage. This Board member is not persuaded that an exception for retained earnings is warranted because those earnings could also be manipulated at the subsidiary level so that the utility could earn a higher return. For these reasons, and the reasons set forth in the

final order in Docket No. RPU-2011-0001 cited previously, this Board member would apply the double leverage adjustment.

Another Board member finds the arguments against the application of double leverage persuasive and would no longer apply the adjustment to Iowa-American. Iowa is one of perhaps only two states that still apply the adjustment and application of the adjustment could place Iowa-American at a competitive disadvantage with respect to capital investment by its parent, American Water Works, when higher earnings may be earned by utility subsidiaries in states where there is no double leverage adjustment. This would also be true for other Iowa rate-regulated utilities with a parent company that has more than one subsidiary. In particular, this Board member believes the evidence and argument regarding retained earnings demonstrates the conceptual problems with the double leverage adjustment cited by Iowa-American.

This does not mean this Board member is not concerned with the abuses that double leverage was designed to prevent, such as artificially inflating the common equity return by increasing the amount of debt at the parent and by decreasing the amount of debt at the subsidiary. However, this Board member would have the Board deal with these issues as other jurisdictions have, by imposing a hypothetical capital structure on the utility, if necessary. Consumer Advocate acknowledged that other states use this instead of double leverage. (Tr. 959-960) Continuing to use a regulatory tool that has fallen out of fashion puts Iowa at a disadvantage because of

the decreased return that results from application of double leverage; by using a different tool to prevent the same ills, parent companies with subsidiaries in more than one state may look more favorable than the Iowa utility as an appropriate place to invest additional capital.

Two Board members heard the evidence at hearing and are participating in this decision; the other Board member recused herself from this proceeding. Because the two Board members do not agree on the application of double leverage, Iowa-American has not met its burden of persuasion to change the Board's previously-established regulatory principle and double leverage will therefore be applied to Iowa-American, consistent with past Board precedent.

## **V. PROPOSED ADJUSTMENT CLAUSES**

### **A. Qualified Infrastructure Plant Adjustment Surcharge**

Iowa-American proposed a Qualified Infrastructure Plant Automatic Adjustment Clause (QIP), a cost recovery mechanism for use between rate cases that it said would provide Iowa-American an incentive to accelerate investment in its infrastructure replacement program. Iowa-American said its QIP proposal is designed to recover a return on and return of capital investments to replace or rehabilitate qualified non-revenue producing plant. Iowa-American stated that the QIP is necessary because of Iowa-American's aging infrastructure, a substantial portion of which is between 50 and 100 years old and a significant portion of which is nearing the end of its expected life. Iowa-American argued that an accelerated

infrastructure improvement program will improve water quality, increase water pressure, have fewer main breaks and service interruptions, and lower levels of lost water. Currently, Iowa-American replaces about 0.3 percent of its buried system each year (a 300-year replacement cycle); Iowa-American contends a QIP would allow it at some point to increase the replacement rate to 1.0 percent (100-year replacement cycle) for distribution system pipe and 2.0 percent (50-year replacement cycle) for valves and hydrants.

The QIP proposed by Iowa-American would only apply to qualified non-revenue producing plant investment that had not been included in rate base in a prior rate proceeding. Iowa-American said that the QIP rate would be established semi-annually using actual historical plant replacement that has been placed in service and is used and useful. Iowa-American said it would file for recovery and the Board and Consumer Advocate would have 90 days to request additional information, review, and verify the information. Iowa-American noted that the proposed QIP also includes an annual reconciliation between authorized collections and actual collections; the reconciliation would be filed within 60 days of the end of the QIP rate adjustment year. Iowa-American said that any over or under collection would then be included in the calculation of the QIP rate adjustment. Iowa-American proposed to cap the recovery through the QIP at 15 percent of the total authorized revenue level as established by the Board in the most recent general rate proceeding.

Consumer Advocate opposed the proposed QIP, noting that it is virtually identical to the QIP rejected by the Board in Iowa-American's last rate case.

Consumer Advocate said that the QIP does not meet the traditional criteria used by the Board for approving automatic adjustment mechanisms, which are: (1) whether the costs proposed to be recovered are beyond the control of management; (2) whether the costs are subject to significant variations; and (3) whether the costs are a significant part of the utility's cost of providing service. Consumer Advocate pointed out that Iowa-American acknowledges that the QIP fails to satisfy any of the traditional factors.

Consumer Advocate also argued that Iowa-American does not need the clause to make necessary infrastructure investments, noting that fewer than half of American Water Works' water utility subsidiaries have such a clause and that Iowa-American witness Kaiser testified that approval of the QIP would not change how Iowa-American approached its infrastructure investment and that Iowa-American had not had any problems obtaining the necessary capital from its parent corporation, American Water Works. Consumer Advocate noted regulatory lag was not a factor because of Iowa's temporary rate statutes and the statute allowing consideration of investment that is in place within nine months after the end of the test year.

Consumer Advocate pointed out that Iowa-American has no actual, specific plan to increase infrastructure investment from the current 0.3 percent level. While Iowa-American indicated such a clause could extend the time between rate cases,

Consumer Advocate said that there was no specific commitment and Iowa-American refused to give a date for its next rate filing, if QIP were approved. Consumer Advocate noted that Iowa-American did not want to share any of the benefits of QIP with its ratepayers, either in the form of a lower rate of return for QIP-eligible costs to reflect reduced risk or a commitment to file rate cases less frequently.

Use of adjustment mechanisms to address certain costs is authorized by Iowa Code § 476.8 and the Board has approved such mechanisms when they meet certain criteria. Traditionally, an adjustment mechanism permits utility rates to be adjusted up or down automatically in relation to fluctuations in certain defined operating expenses, allowing increases or decreases in costs to be passed on to customers with no profit or loss to the utility. Adjustment clauses are common for electric utilities for fuel costs and gas utilities for gas costs; clauses have also been approved by various states for other expenses.

The Board has recognized, however, the occasional need for adjustment mechanisms that do not necessarily meet the traditional standards. The Board adopted for natural gas utilities an automatic adjustment mechanism that allowed for a recovery of and return on investments that were required because of government action or federal and state pipeline safety regulations. Rule 199 IAC 19.18 provides for such a clause, provided that certain conditions are met.

Iowa-American is proposing that the Board approve an automatic adjustment mechanism that allows the company to recover from ratepayers a return on and a

return of certain capital investments between general rate case filings. The eligible capital investment would be for replacement of utility plant in the following accounts: (1) Account 331 (343), Transmission and Distribution Mains, including main rehabilitation and valves; (2) Account 333 (345), Services; (3) Account 334 (346 & 347), Meters and Meter Installations; and (4) Account 335 (348), Hydrants. The eligible plant would be non-revenue producing plant that was not included in Iowa-American's rate base in this rate case. Iowa-American said that the QIP proposed in this case is essentially the same as the QIP proposed in Iowa-American's prior general rate case, with one exception. The cap for the QIP has been raised in this proposal from 5 percent to 15 percent. (Tr. 611)

In Docket No. RPU-2011-0001, the Board found that the proposed QIP did not satisfy the three traditional factors that the Board normally considers when deciding whether to approve a proposed automatic adjustment mechanism. Iowa-American Water Company, "Final Order and Order Approving Settlement (Final Order)", Docket No. RPU-2011-0001 (2/23/2012), p. 11. The three primary traditional factors considered by the Board when considering whether to approve an automatic adjustment mechanism are: (1) whether the costs are beyond the direct control of the management; (2) whether the costs are subject to significant variations; and (3) whether the proposed costs are a significant part of the costs of providing service. (see 199 IAC 19.18(1)"a" and 20.9(1)). As in the prior case, Iowa-American has not argued that the capital investments are beyond the control of management.

The proposed QIP does not meet the traditional adjustment clause three-part test. The investment projected by Iowa-American shows that Iowa-American management has control over the rate of replacement and that Iowa-American can, if management chooses, increase the replacement rate without a QIP. Iowa-American management has budgeted a fairly even investment in QIP-type plant over the period 2008-2012 and is projecting fairly even investment in QIP-type plant over the period from 2013-2017. Based upon the projections, there does not appear to be significant fluctuations in those investments. In addition, Iowa-American's overall rate base is approximately \$101 million and Iowa-American's investment in QIP-eligible plant in 2013 as shown on Exhibit 9 is approximately \$5,127,000. QIP-type plant, if all plant is included, is approximately 6 percent of the total rate base and this is not a significant part of the cost of providing service.

As evidenced by the natural gas rule, there can be circumstances where adjustment clauses can be justified that do not meet the traditional regulatory scheme for adjustment clauses. However, the justifications put forth by Iowa-American do not justify establishment of the proposed QIP in this case.

Regulatory lag is not a sufficient justification for the proposed QIP. In Docket No. RPU-2011-0001, the Board stated that regulatory lag was not a sufficient justification for implementing the QIP proposed in that case. (Final Order, p. 11) The Board pointed out under current law Iowa-American can recover capital infrastructure investment placed in service within nine months after the close of the

test year in a general rate case and can implement temporary rates within ten days of filing an application for a general rate increase. These two provisions limit regulatory lag and, coupled with Iowa-American's continued filing of general rate increase cases every two years maximum, regulatory lag is reduced to 12-18 months. Id. This short period of regulatory lag does not justify a QIP, and Iowa-American made no firm commitments in this proceeding to increase the time between its general rate cases.

As noted by Consumer Advocate, any mechanism designed to reduce regulatory lag should provide some benefit to ratepayers. In this case, Iowa-American presented a proposal that would not benefit ratepayers. Under the QIP proposal, customers could be charged up to an additional 15 percent of the customer's normal bill every six months. Iowa-American has not offered to extend the time between rate cases or reduce the carrying charge for QIP investment, either of which would provide a benefit to ratepayers and partially offset the significant rate increases that could result from the QIP.

The Board offered similar criticisms in Docket No. RPU-2011-0001, yet Iowa-American presented an almost identical proposal in this case that did not respond to the Board's criticisms that Iowa-American's plans are indefinite and there are no tangible benefits to ratepayers. There is still no concrete, plan to replace aging infrastructure and no tangible benefits to ratepayers from the proposed clause. Iowa-American appeared to simply ignore the Board's order in Docket No. RPU-

2011-0001 in fashioning its current proposal. As acknowledged by Iowa-American, nothing really changed with the current proposal, other than to increase the QIP cap from 5 to 15 percent of the total authorized revenue.

While Iowa-American's planned expenditures for 2013 through 2017 are an increase over the expenditures for the previous five years, the evidence in this case is similar to the evidence in Docket No. RPU-2011-0001 in that Iowa-American's replacement program consists of replacing plant where leaks and breaks occur and when facilities are required to be relocated due to state or local government action. Since leaks and breaks are projected to increase, Iowa-American responded by increasing the amount budgeted for replacement. Iowa-American states that it wants to increase its replacement rates to 1 and 2 percent (as it said in the last rate case, also), but presented no specific plan to do so. A statement by Iowa-American that replacing small mains in Clinton is a priority without additional information about a program to replace the mains is insufficient to justify QIP rate increases between rate cases.

It appears from responses to Board questions that Iowa-American made a management decision to maintain the current replacement rate of 0.3 percent in the past and has made a management decision to increase investment for QIP-type plant for the next five years, but the evidence shows that this amount will be spent whether or not QIP is approved. There is no proactive, specific, concrete plan to increase the level of replacement to the levels that Iowa-American claimed were

necessary. General assertions about the need for replacement have now been made in two cases, with no apparent plan to tackle the problem. Iowa-American did not address the concerns raised by the Board in the last rate proceeding.

The testimony at the hearing demonstrates that Iowa-American has chosen to maintain the current 0.3 percent replacement rate over the past years even as Iowa-American has argued in rate cases that the rate is not sufficient to replace aging water mains. According to Mr. Verdouw, Iowa-American will receive enough investment from its parent company for projects that "absolutely" have to be done, but if Iowa-American is going to move its replacement program from 0.3 percent to 1 percent Iowa-American will have to spend more. (Tr. 740) Mr. Verdouw testified if the Board approved the Iowa-American proposals for a QIP, declining usage, weather normalization, and the adjustment clause for purchase power and chemical costs, Iowa-American might be willing to commit to extending the period between rate cases, but no firm commitment was given and it appeared the extension would be at most for only 6 to 9 months.

Mr. Kaiser testified that Iowa-American has no plans to replace water mains beyond normal leak and break and relocation replacements and approval of the QIP would not change the replacement program. (Tr. 412, 413) According to Mr. Kaiser, a QIP would make more funds available but would not change replacement plans. (Tr. 414) Capital investment for main replacement must be put into the investment budget that is approved by the parent corporation and priorities on replacing pipe

would not change if a QIP is approved. (Tr. 416) Mr. Kaiser testified that approval of a QIP-like mechanism in other states had extended the time between rate cases from two to two and one half years on average.

In this case, Iowa-American has provided similar justification for an automatic adjustment mechanism as it did in its last rate proceeding. There are Iowa-American facilities that are required to be relocated because of state and local government action; however, Iowa-American has not proposed to limit the QIP to just those investments. While increasing the rate of replacement of aging infrastructure might justify an adjustment clause, no specific plan to do this was presented and no ratepayer benefits from the proposed clause were presented. The QIP as proposed by Iowa-American would recover investment for facilities that will be replaced under current replacement programs and has been accounted for in future budgets, with no apparent acceleration to tackle the aging infrastructure problem and to increase replacement levels to 1 percent for distribution system pipe and 2 percent for valves and hydrants.

It is particularly important that Iowa-American has not shown that ratepayers will benefit from the surcharge. If approved, the QIP would mean rate increases for Iowa-American customers between general rate cases (which are currently filed every two years), resulting in a continuous increase in customer rates with no offsetting benefit. Iowa-American has also proposed to recover the rate of return approved by the Board in this case on the QIP investment even though QIP recovery

reduces the risk to Iow-American for recovery of these investments. In the natural gas utility infrastructure automatic adjustment rule, the Board set the return on eligible investment at the utility's cost of debt to recognize this reduced risk. Iow-American does not agree with a reduced return for determining QIP recovery.

Without a commitment to extend the time between rate cases and some recognition that a QIP reduces the recovery risk of QIP eligible investments (and without a proactive QIP plan), there appears to be little or no benefit to ratepayers of the QIP. Under the QIP, customers would face rate increases of up to 15 percent every six months and then general rate increases every two years, at least under Iow-American's current rate case timing. However, each case costs about \$1 million in rate case expenses; these costs are generally recovered from ratepayers. If the QIP is adopted, ratepayers would not only be subject to the approximately \$1 million rate case expense every two years, but would have to pay the additional QIP surcharges between rate cases.

Finally, the Board has concerns about the mechanics of the QIP proposal. The QIP proposal submitted by Iow-American is too broad and should cover distribution infrastructure only, not those items for which Iow-American has a current replacement plan. In addition, potential increases every 6 months, and the process to implement those increases, appears unworkable and untenable for ratepayers, the Board, and Consumer Advocate. For all of these reasons, Iow-American's QIP proposal will be rejected.

**B. Purchased Power and Chemical Charge**

Iowa-American proposed an automatic adjustment mechanism for the pass-through of incremental changes in purchased power and purchased chemical costs that differ from the level of costs authorized by the Board in base rates. Iowa-American said that its chemical costs are beyond the utility's control and subject to market forces. Iowa-American noted that its purchased power costs are subject to automatic adjustment mechanisms, such as an energy adjustment clause, that are utilized by Iowa-American's electric service providers.

Consumer Advocate opposed the clause, noting that the proposed mechanism would severely reduce or eliminate Iowa-American's economic incentive to control relevant expenditures. Consumer Advocate argued that the proposed clause did not meet the three traditional criteria for an adjustment mechanism, primarily because the costs are not significant or volatile enough. Consumer Advocate also argued an adjustment mechanism was inappropriate since the proposed clause seeks to recover two unrelated costs.

While these costs together may be Iowa-American's largest non-labor operations and maintenance expense, together they represent only 7.9 percent of Iowa-American's total expense and only 20 percent of Iowa-American's total operation and maintenance expenses, excluding labor and benefits. More importantly, the adjustment mechanism proposed by Iowa-American seeks to

combine two unrelated costs in an attempt to meet the traditional adjustment clause criteria.

Examined separately, neither purchased power nor chemical costs is a significant portion of Iowa-American's overall cost of providing service to customers. These costs are part of the normal operating expenses of doing business as a water utility and are not the type of costs traditionally eligible for an automatic adjustment mechanism.

A pass-through mechanism for these costs would reduce Iowa-American's incentive to take steps to use electricity more efficiently. It would also reduce Iowa-American's incentive to monitor the contracting practices of its affiliate that negotiates chemical purchases. Chemical costs in particular are not entirely beyond the direct control of management. These types of operating costs are appropriate to examine in a general rate proceeding where all of the utility's expenses and revenues can be matched in determining just and reasonable rates.

Attempting to combine two disparate costs in an adjustment clause is not reasonable and the Board will not approve the proposed adjustment. Examined separately, Iowa-American has not shown that the three traditional criteria have been satisfied. These costs, particularly chemical costs, are normal operations and maintenance expenses that are appropriate to consider in rate proceedings and are not so extraordinary or significant as to warrant an adjustment mechanism.

## **VI. COST-OF-SERVICE ISSUES**

### **A. Introduction**

Prior to 2009, Iowa-American had two separate rate structures for General Metered Service and Private Fire Service, one for the Quad Cities district and one for the Clinton District. General Metered Service rates (customer charges and volumetric consumption charges) were equalized between the two districts with the Board's final decision in Docket No. RPU-2009-0004. Private Fire rates were equalized with the final decision in Docket No. RPU-2011-0001 so that now both districts pay the same rates for all services.

In Docket No. RPU-2011-0001, the Board ordered Iowa-American to file a new class cost-of-service study in its next rate proceeding. Iowa-American provided such a study in this docket, which uses the Base-Extra Capacity method described in the 2012, 6<sup>th</sup> edition, Principles of Water Rates, Fees and Charges (as well as prior manuals) published by the American Water Works Association. Iowa-American said that the four basic cost functions allocated to each customer class are base costs (average daily class usage), extra capacity costs (class usage in excess of average usage), customer costs (facilities costs and accounting costs), and fire protection costs.

Consumer Advocate did not perform a separate cost-of-service study but disagreed with two aspects of the study, the peak day ratio and allocation of customer costs. Each will be discussed separately.

**B. Peak Day Ratio**

Iowa-American proposed a peak day ratio of 1.65, which is rounded up from the actual number Iowa-American determined, 1.632. Consumer Advocate used a peak day ratio of 1.45.

Iowa-American said its peak day ratio means that peak day usage on its system is 65 percent higher than average day usage and is calculated based on actual data in its cost-of-service study. Consumer Advocate's proposed peak day ratio of 1.45 (peak day usage is 45 percent higher than average day usage) is based on a 15-year average of annual peak day ratios from 1998 through 2012.

Iowa-American argued that Consumer Advocate's peak day ratio underestimates the costs associated with the extra capacity on its system and therefore does not properly allocate costs associated with peak demand. In examining peak day ratios from 1998 through 2012, the Board agrees. The ratios for 2011 and 2012 were both 1.63 and were higher than past ratios, indicating that use of such a long-term average is not representative of Iowa-American's current level of excess capacity. (Herbert Exh. 1, Sch. 4)

However, the Board does not believe it is appropriate to round up the actual peak day ratio calculated by Iowa-American, 1.632, to 1.65. The Board will adopt 1.63 as the peak day ratio.

**C. Customer Costs**

Customer costs are those costs associated with serving customers regardless of their usage or demand characteristics. There are direct customer costs related to customer facilities (meters and service lines) and customer accounting (billing and meter reading). There are also indirect or common costs; Iowa-American allocates some of these costs to the customer charge while Consumer Advocate does not.

Iowa-American said that the AWWA Water Rates Manual supports the use of fully allocated customer costs, including indirect or common costs, to develop customer charges. Iowa-American argued that administrative and general costs are fixed and support the entire operation of the company, not just the water-related costs. Iowa-American maintained that if none of the administrative and general costs are allocated to customer related functions, then 100 percent of these costs would be allocated to consumption charges, resulting in understated customer charges and overstated consumption charges. Because these common costs are fixed, Iowa-American said that a portion should be allocated to the fixed customer charge.

Consumer Advocate said that Iowa-American's current customer charge is too high and any rate increase should only be applied to the volumetric or consumption charges. Consumer Advocate excluded from the customer charge several costs, including employee pensions, health care, payroll taxes and other benefits that it argued were not costs associated with the delivery of water service to the individual customer. (Tr. 792-796)

Iowa-American's cost allocation method is consistent with the AWWA Water Rates Manual. Consumer Advocate did not identify any recognized authority which would exclude all customer costs from the customer cost allocation. Because the common costs do not change and some of those costs are related directly to the salaries and wages of meter and service line repairmen and others that perform functions directly related to providing service to the customer, it is appropriate to allocate some common costs to the customer charge and Iowa-American's allocation will be used in this proceeding.

## **VII. RATE DESIGN ISSUES**

### **A. Billing Units—Declining Usage and Weather Normalization**

Iowa-American proposed three adjustments to test year billing units and revenues by customer class. One was a proposed customer growth adjustment, which increased billing units and revenues. This adjustment was accepted by Consumer Advocate and is not contested.

The other two proposed adjustments are contested. The adjustments are for declining usage and weather normalization; both proposed adjustments reduce billing units and projected revenue, requiring an offsetting increase to the revenue requirements.

Iowa-American said that because Iowa-American's customers continue to use less water due to conservation and installation of efficient appliances, there should be an adjustment for declining usage. Iowa-American calculated base usage by

using consumption during the winter months of January through March over a ten-year period (2003 through 2012); usage during these months is generally not influenced by outdoor use such as lawn watering. Iowa-American's linear regression analysis showed that residential usage is declining at an annual rate of 1,224 gallons per customer.

Consumer Advocate opposed the adjustment, noting that declining usage and declining sales are not the same. Consumer Advocate pointed out that Iowa-American's sales have increased in the years 2010, 2011, and 2012, so it would be inappropriate to project reduced revenue when revenue is increasing. Also, Consumer Advocate said that the number of customers has steadily increased since 2003, resulting in increased water sales.

Iowa-American also proposed a weather normalization adjustment because the test year was one of the warmest on record, resulting in an increase in non-base usage such as lawn watering. Iowa-American said its adjustment normalizes test year revenues to reflect normal weather.

Consumer Advocate said that Iowa-American's test year sales and revenues were reasonable and representative of normal operation conditions such that no adjustment was necessary. Consumer Advocate said the methodology to support Iowa-American's adjustment is based on usage from three winter months and assumes weather in the summer months is the only variation, ignoring the other six

months of the year. Consumer Advocate said a similar adjustment proposed by another American Water Works subsidiary in Kentucky was rejected.

In recent years (beginning in 2006), Iowa-American has filed a rate proceeding every two years. Iowa-American's annual report filings with the Board show the following data for the residential class: <sup>2</sup>

**Gallons Per Residential Customer  
2006 through 2012 and Compared to 7-Year Average**

	<b>Gallons Sold (000)</b>	<b>Number of Customers</b>	<b>Gallons (000) Per Customer</b>	<b>Compared to 7-Yr Avg.</b>
2006	3,442,444	53,406	64.46	15.92%
2007	3,102,494	53,842	57.62	3.63%
2008	2,944,154	54,196	54.32	(2.30%)
2009	2,847,755	54,410	52.34	(5.87%)
2010	2,849,789	54,599	52.19	(6.13%)
2011	2,908,482	54,847	53.03	(4.63%)
2012	3,061,810	55,395	55.27	(0.60%)
<b>7-Year Average</b>			<b>55.61</b>	

The last column of the table compares annual gallons per customer to the seven-year average of 55.61. Although 2012 residential gallons per customer are slightly lower than the average, it is the smallest deviation in the seven-year period. Iowa-American's sales, as pointed out by Consumer Advocate, have generally increased in recent years and, in fact, both sales and per customer usage increased in 2010, 2011, and 2012. There is no substantial evidence in the record supporting

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<sup>2</sup> Rate case billing units are in hundred cubic feet (CCF) and annual report usage is based on gallons. Beginning in 2013, the annual report form for water utilities requires usage to be provided in both CCF and gallons.

either proposed adjustment and both the declining usage and weather normalization adjustments will be rejected.

**B. Proposed Rates and Public Fire**

Iowa-American urged that any increase in rates resulting from this case should be based on Iowa-American's rate design recommendations, that customer charges should be increased to recover their associated costs, and commodity rates should be increased for each rate block in order to generate revenues from those rates that match their indicated costs. Iowa-American said its proposed customer charge would recover both the direct costs associated with providing service to customers, plus a portion of the indirect or common costs associated with providing service to customers.

Consumer Advocate argued that Iowa-American's customer costs were currently too high and not supported by the class cost-of-service study. Consumer Advocate said that there should be no change to Iowa-American's customer costs and that Iowa-American should not be allowed to move towards a straight fixed-variable rate design.

As noted in the earlier discussion regarding customer costs under the class cost-of-service study, Iowa-American's class cost-of-service study was performed in a manner consistent with the AWWA Rate Manual, the only reference material provided in this proceeding to support a study. Consistent with the manual, some

indirect or common costs are appropriately included in the customer charge, and the Board will generally adopt Iowa-American's approach, with some exceptions.

Herbert Exhibits 2 and 7 show how costs are used to calculate the customer charge for the 5/8 inch meter. These exhibits show that all costs associated with public fire protection, such as fire hydrants, are currently recovered by Iowa-American solely through the customer charge.

Recovery of public fire costs in Iowa-American's service territory has changed since 1990. Prior to 1990, Iowa-American recovered public fire costs directly from the cities it served. In 1989, the legislature adopted Iowa Code § 476.6(15) which allowed cities that were furnished water by a public utility subject to rate regulation (like Iowa-American) to request that the Board allow recovery of public fire costs through the rates assessed to customers covered by the applicant's fire protection service. The cities served by Iowa-American filed these requests, and since 1990 public fire service costs have been recovered through Iowa-American's General Metered Service rates. In Docket No. RPU-90-10, the Board addressed the recovery of public fire costs. The final order in that docket states Iowa-American proposed recovering public fire costs through a uniform adjustment to all volumetric block rates, which the Board accepted. Subsequent Iowa-American rate cases, until this proceeding, resulted in a settlement of the issue.

It is appropriate for the Board to determine in this proceeding how public fire costs are to be recovered. Any public fire costs not recovered through the monthly

customer charge would be recovered through the volumetric charge. The manner of recovery is revenue-neutral for Iowa-American. Options include recovery of all public fire costs through the customer charge (as proposed by Iowa-American), recovery of all public fire costs through volumetric rates, maintaining the existing customer charge and recovering the remaining public fire costs through volumetric rates (as implicitly proposed by Consumer Advocate), or allocation of public fire costs on another basis, such as 50 percent recovery through the customer charge and 50 percent through the volumetric charge.

Iowa-American's class cost-of-service study presents no clear rationale for allocating all public fire costs to the customer charge. Apparently, Iowa-American preferred volumetric recovery in 1990, but prefers to recover public fire costs in the customer charge today, without any explanation for the change of approach. Because of the lack of rationale in the cost-of-service study and the different methods of recovery used in the past, it appears any of the options described above would be reasonable. The Board will allocate 50 percent of the public fire charges to the customer charge and 50 percent to the volumetric charge in order to obtain some of the benefits of each approach. However, taking into consideration other revenue and allocation decisions contained in this order, Iowa-American will be required to set the customer charge for the 5/8 inch meter at a rate that is no higher than the rate calculated based on the allocated costs determined by the class cost-of-service study; the \$16.37 charge calculated by Iowa-American was based on acceptance of

its proposals and will change with the revised class cost-of-service study the Board will require. However, Iowa-American will not be permitted to round this charge up, like it rounded the \$16.37 up to \$16.40 in its proposal. The customer charge can be no higher than what the revised class cost-of-service study shows.

### **VIII. PRIVATE FIRE**

Iowa-American provides three separate and distinct services to its customers. Iowa-American's primary business is supplying general metered service, or potable water, to its customers. The costs of providing general service are recovered from all customers. Iowa-American also provides public fire service, which consists of the delivery of water to public fire hydrants for the purpose of fighting fires. The costs of that service are spread among all of Iowa-American's customers because all customers benefit. Going forward, half of the cost of public fire service will be paid by ratepayers through their customer charge and half of the cost through the volumetric charge, but all customers will still contribute to the cost of public fire service.

The third type of service, private fire service, is provided to customers with fire protection facilities specifically dedicated to their property (i.e., sprinkler systems) to protect the property from fires. Iowa-American's costs associated with private fire service are largely capacity costs, which means there is additional standby system capacity to deliver water in sufficient quantities during fire emergencies, while

maintaining general metered service for all other customers. Currently, private fire service is paid for by the customer requesting the service.

In Iowa-American's last rate proceeding, Docket No. RPU-2011-0001, there was substantial public interest in the level of Iowa-American's private fire service rates so the Board directed Iowa-American to include in its next rate filing a new class cost-of-service study that includes private fire service and also information on how other water companies recover the costs of private fire service. In this proceeding, Iowa-American recommended that private fire rates be increased to recover the costs of the service as shown by the class cost-of-service study and that those costs be paid by those requesting the service.

Some Iowa cities with populations over 25,000 have separate private fire service rates while others recover the costs from all water customers. With most costs incurred by a utility, the Board believes the cost causers should be the cost payers. This is a difficult principle to apply with private fire costs because those that install a sprinkler system not only benefit directly but there is also a broader public benefit because sprinkler systems help contain fires and often prevent them from spreading to other properties. Iowa-American's witness also noted that private fire service likely reduces the demand for public fire protection in those buildings protected by private fire service and also reduces the demand for public fire service in the immediate vicinity of protected buildings, another public benefit. (Tr. 340) Finally, even if private fire costs were spread to all customers, those private fire

customers make a significant investment to obtain the service by paying for the sprinkler system and distribution main tap.

Because of the public benefits that result from private fire service, it is appropriate to spread some of the associated costs to all of Iowa-American's customers. In this proceeding, the Board will allocate 75 percent of the costs of private fire service to those that would traditionally be deemed the cost causers (private fire customers) and 25 percent to all of Iowa-American's customers, who share in the public benefit. The 25 percent allocated to all customers will be divided evenly (50/50) between the customer charge and volumetric charge. This allocation could change in the next rate proceeding as the Board continues examining and considering the policy issues surrounding private fire service and who should pay for the benefits that such service provides.

#### **IX. COMPLIANCE FILING**

Because the Board has made changes to the revenue requirement and rate design initially proposed by Iowa-American, Iowa-American will be directed to file an updated class cost-of-service study (including the functionalized costs by cost category) that reflects the Board's decisions on the issues in this proceeding and corresponds with Iowa-American's approved revenue requirement. Iowa-American will also be required to file schedules showing how its proposed compliance rates are calculated and an updated bill analysis (proof of revenue) demonstrating that its

proposed compliance rates will produce no more than the approved revenue requirement.

All documentation supporting Iowa-American's post-decision filing is to be provided in Excel format, including formulas for each calculation. In addition, for future rate cases in which Iowa-American files a class cost-of-service study, Iowa-American will be required to file schedules showing the functionalized costs by cost category and schedules showing how all rates are calculated. These schedules are to be provided in Excel format, including formulas for each calculation.

#### **X. OBJECTION TO RATE CASE EXPENSE**

On December 27, 2013, Iowa-American filed a report of actual rate case expense in Docket No RPU-2013-0002. On January 2, 2014, Consumer Advocate filed an objection to the rate case expense report. In the objection, Consumer Advocate said that the rate case report filed December 27, 2013, by Iowa-American does not provide the detail required by Board rules.

On January 10, 2014, Iowa-American filed an amended rate case expense report that included additional details of the expenses incurred by Iowa-American in this rate case proceeding. The summary shows actual rate case expenses for outside counsel, outside expert witnesses, and utility personnel. Under utility personnel, the amended report shows "Service Company" with total hours of 1,314 and a rate-per-hour of \$85. The total expense shown is \$111,662.30. (The

amended report refers to "Filing Requirements Rule 7.3," but the rate case expense filing requirements are now found in 199 IAC 26.4.)

On January 16, 2014, Consumer Advocate filed a "Motion for Reduction of Recoverable Rate Case Expense" requesting the Board (a) reduce Iowa-American's rate case recovery in two categories and (b) order Iowa-American to file details of rate case expenses related to service performed by American Water Works or Iowa-American affiliates sufficient to allow the Board and Consumer Advocate to assess the propriety of those expenses. Consumer Advocate said that it would be unjust and unreasonable to allow Iowa-American to charge ratepayers for the costs of re-litigating the double leverage issue and requests the Board disallow those costs as part of rate case expense. Consumer Advocate also objected to Iowa-American's Amended Rate Case Report, arguing the report fails to include information necessary for the Board and Consumer Advocate to assess the reasonableness of the fees paid to an expert witness hired by Iowa-American, Roger A. Morin.

On January 24, 2014, Iowa-American filed a resistance to the Consumer Advocate's motion. On January 29, 2014, Consumer Advocate filed a reply to Iowa-American's resistance.

**A. Consumer Advocate's Motion**

Consumer Advocate stated that Iowa Code § 476.6(5) provides that as part of the findings of the Board regarding a requested increase in rates, the Board "shall allow recovery of costs of the litigation expenses over a reasonable period of time to

the extent the board deems the expenses reasonable and just." Consumer Advocate noted that this section also requires that at the conclusion of the proceeding the utility "shall submit to the board a listing of the utility's actual litigation expenses in the proceeding."

Consumer Advocate pointed out that the Board, in an order issued July 19, 2013, in this docket, expressed concern about the level of Iowa-American's rate case expense. Consumer Advocate also pointed out that the Board, in the July 19, 2013, order, stated "[r]elitigating issues every two years when the facts being litigated have not changed significantly and the testimony is substantially the same may at some point be unreasonable, at least with respect to recovery from ratepayers of litigation expense associated with repetitive issues." In re: Iowa-American Water Company, "Order Denying Motion for Issue Preclusion," Docket No. RPU-2013-0002, (5/19/13), pp. 5-6.

Consumer Advocate argued that Iowa-American has chosen to relitigate the double leverage issue even though the issue was fully litigated less than two years ago in Docket No. RPU-2011-0001. Consumer Advocate maintained that the evidence and arguments presented by Iowa-American in this case are virtually identical to the evidence and arguments addressed by the Board in the previous docket. Consumer Advocate then listed the similarities between the evidence and arguments in the two dockets and pointed out that the Board has expressed

concerns about the relitigation of issues where the evidence is without significant difference from a recent case.

Consumer Advocate also argued that Iowa-American failed to provide the hours worked and the hourly rate for outside expert witness Dr. Morin, who testified on cost of capital issues, including double leverage. Consumer Advocate maintained that Board rules require this information so the Board can assess the reasonableness of the fees paid to Dr. Morin.

Consumer Advocate noted that some of the rate case expenses objected to in its motion filed on January 16, 2014, are expenses associated with American Water Works Service Company (Service Company) and employees of American Water Works. Consumer Advocate said that Iowa-American failed to disclose the hours worked by each employee of the Service Company and American Water Works and this failure prevents the Board and Consumer Advocate from determining the reasonableness of those expenses and whether the services in the rate case were already paid for under Iowa-American's service agreement with the Service Company.

Consumer Advocate argued that Iowa-American has not complied with the filing requirements of 199 IAC 26.4 because it has not provided the hours worked by each Service Company employee and each employee's hourly rate. Instead, Consumer Advocate noted that Iowa-American has filed total hours worked and total

cost. Consumer Advocate argued that the language in the rule is clear that Iowa-American is to file the hours and hourly rate of each outside consultant or witness.

**B. Iowa-American Resistance**

Iowa-American said that the fact that rate case expenses must be filed for Board approval and the estimated expenses are often subject to cross-examination at the hearing provides the utility with the incentive to ensure that these costs are reasonable. Iowa-American stated that the Board has approved rate case expenses in earlier dockets and that the rate case expenses sought to be recovered in this docket should be reviewed based upon the facts, circumstances, and conduct of the parties in this docket.

Iowa-American argued that double leverage is a viable and reasonable issue for the Board to consider in this rate case. Iowa-American pointed out that although the double leverage issue was argued in Docket No. RPU-2011-0001, the issue had not been fully litigated for more than 20 years in an Iowa-American rate case. In addition, Iowa-American noted that the Board signaled a continuing interest in the issue by conducting an information gathering meeting addressing double leverage on November 27, 2013. Finally, Iowa-American argued that the evidence in this case is not the same evidence presented in Docket No. RPU-2011-0001 since the evidence in this docket specifically addresses previous Board questions and more fully develops the impact of double leverage on Iowa-American.

Iowa-American maintained that there is sufficient information in this case to assess the reasonableness of the fees paid Iowa-American witness Dr. Morin. The fee arrangement with Dr. Morin is clearly set out in the engagement letter, Attachment A to Iowa-American's resistance, and received into the record at hearing as Consumer Advocate Exhibit 103. Iowa-American explained that the letter of engagement sets out the flat-fee arrangement with Dr. Morin, which is a common practice for utility consultants.

Iowa-American pointed out that Dr. Morin presented testimony and underwent significant cross-examination on two major issues in this case, double leverage and rate of return. The length of Dr. Morin's prefiled testimony, the necessity of Dr. Morin reviewing the testimony of the Consumer Advocate's witness, Dr. Morin's response to discovery, and Dr. Morin's preparation and appearance at the hearing show that the flat-fee arrangement was reasonable. Iowa-American argued that reference to hours worked and hourly rate are not the only way to consider the reasonableness of rate case expense items such as outside consultant fees.

With respect to work performed by Service Company employees, Iowa-American said that the practice of engaging Service Company personnel for the Iowa rate case provides Iowa-American with access to individuals with significant industry expertise at a cost that is much less than if Iowa-American were to engage them individually. Iowa-American stated that the detail presented in the initial rate case report is consistent with the detail provided by Iowa-American in the previous rate

case, Docket No. RPU-2011-0001, and that the rate case expense was approved as filed in that docket. Iowa-American stated that there is significant information in the record that explains the value of the services provided by the Service Company, including the services for this rate case. Iowa-American cited to transcript pages 54-56 and 765-766, and Verdouw prefiled direct testimony on pages 4-13. Iowa-American filed Attachment B to the resistance with specific hourly information for Service Company personnel associated with the rate case.

Attachment B submitted by Iowa-American shows the travel, hotel, and meals for each individual associated with this rate case, including outside counsel, outside witnesses, and internal employees: Rogers, Moore, Verdouw, Riechart, Tinsley, Thakadiyil, Kaiser, Jones, Rungren, and Bates. Iowa-American also provided in Attachment B the hours worked and hourly rate for 19 other Service Company employees associated with this rate case; for the 10 other Service Company employees identified above, the hours worked and hourly rates are shown only for Mr. Riechart and Mr. Thakadiyil.

**C. Consumer Advocate Reply**

Consumer Advocate argued that Iowa-American has not identified any evidence in this case that is significantly different than the evidence presented in Docket No. RPU-2011-0001 on the issue of double leverage. In addition, Consumer Advocate argued that a change in the members of the Board cannot justify the costs of re-litigating the double leverage issue because this would encourage relitigation of

issues in the future, despite the existence of years of agency precedent. Consumer Advocate maintained that shareholders should be required to pay for relitigation of issues previously decided by the Board when there is no significant change in the evidence presented.

Consumer Advocate argued that Iowa-American is required by 199 IAC 26.4 to demonstrate that expenses incurred are just and reasonable and Iowa-American has not fulfilled this obligation with regard to Dr. Morin's expenses. Consumer Advocate pointed out that the engagement letter provides certainty with respect to the fees paid Dr. Morin; however, the requirement is that the fees be just and reasonable and not just certain. Without the number of hours worked and the hourly rate charged by each outside witness, Consumer Advocate said that the Board is unable to determine the reasonableness of these expenses.

Consumer Advocate also asserted that the rate case expense report, as supplemented, still lacks the necessary detail for the Board to properly determine whether the costs of the Service Company employees were reasonable and just and not duplicative as an expense item. Consumer Advocate argued that Iowa-American has not provided the detail as required by 199 IAC 26.4 so the Board can ensure that rate case expense does not include expenses covered by test year expenses and, therefore, are not being double recovered.

Even though Iowa-American has provided the hours worked and hourly rate for Service Company employees, Consumer Advocate argued Iowa-American has

not described the work performed by the Service Company employees or explained why the work was not included in "Test Year Service Expense" of \$4,479,976.

Consumer Advocate pointed out that Iowa-American paid \$4,479,976 during the test year for work performed by Iowa-American affiliates under a service agreement, which represents approximately 15 percent of test year expenses.

Consumer Advocate noted that Attachment B provided by Iowa-American only lists one of six Service Company employees who appeared as a witness in the rate case proceeding and the assumption by Consumer Advocate is that the other five witnesses' expenses were included in test year expense. Consumer Advocate argued that Iowa-American needs to explain how it calculated and accounted for these costs and how it determined which rate case expenses were included in the test year and which rate case expenses were not included in the test year. Consumer Advocate maintained that the Board needs this information to ensure there is no double recovery of these expense items. Consumer Advocate said the Board should disallow the Service Company rate case expense since Iowa-American had the burden of proof on this issue.

**D. Board Discussion**

Rule 199 IAC 26.4 provides, in relevant part, as follows:

**199—26.4(476) Rate case expense.**

**26.4(1)** A utility making an application pursuant to Iowa Code section 476.6 shall file, within one week of docketing of the rate case, the estimated or, if available, actual expenses incurred or to be incurred by the utility in litigating the rate case. Except for expenses incurred in

preparation of the rate filing and notification of customers, the expenses shall be limited to expenses incurred in the time period from the date the initial application is filed through the utility's reply brief. Each expense shall be designated as either estimated or actual.

**26.4(2)** Estimated or, if available, actual expenses shall identify specifically:

- a. Printing costs for the following:
  - (3) Testimony
  - (4) Briefs
- d. Outside expert witness/consultant
  - (1) Number of outside consultants employed
  - (2) Hours per consultant employed
  - (3) Cost/hour per consultant employed
- e. Expenses stated by individual for both outside consultants and utility personnel
  - (1) Travel
  - (2) Hotel
  - (3) Meals
  - (4) Other (specify)
- f. Other (specify)

**26.4(3)** Rate case expense shall not include recovery for expenses that are otherwise included in test year expenses, including salaries for staff preparing filing, staff attorneys, and staff witnesses. Rate case expense shall include only expenses not covered by test year expenses for the period stated in subrule 26.4(1).

**26.4(6)** Actual utility expenses shall be filed in the same format and detail as estimated expenses and shall be filed within two weeks after filing the final brief. All material variances shall be fully supported and justified.

**26.4(7)** The board may schedule any additional hearings to litigate the reasonableness of the final expenses.

Three issues were raised by Consumer Advocate with respect to Iowa-American's rate case expense: double leverage, Dr. Morin's fee, and Service

Company fees. There is a fourth issue the Board will address: rate case expense associated with the proposed QIP clause.

The first issue raised by Consumer Advocate is double leverage. Although the Board agrees that the evidence in this rate case is similar to the evidence concerning double leverage presented in Docket No. RPU-2011-0001, the Board will not disallow any rate case expense associated with this issue. While double leverage has been applied to Iowa-American for at least 20 years, the issue had not been fully litigated during that time period until Docket No. RPU-2011-0001, Iowa-American's most recent rate proceeding. Subsequent to the Board's decision to apply double leverage to Iowa-American, the Board held a meeting to allow interested participants to provide information about double leverage outside the confines of a rate case proceeding. There were numerous participants and the meeting could have been viewed by Iowa-American as an indication of the Board's continued interest in the subject. Further, the Board has now split on this issue, so double leverage will likely be relitigated until there is a definitive Board statement on the issue.

The second issue is Dr. Morin's fee. The Board understands Consumer Advocate's concern about the lack of detail to support the fee paid Morin in this case but there is no question that the issues addressed by Dr. Morin (double leverage and return on equity) are important and large-dollar issues that required significant time in preparing testimony, responding to discovery requests, reviewing Consumer Advocate testimony, preparing for hearing, and appearing at the hearing. There is

no dispute as to Dr. Morin's expert qualifications in these subject areas and there is not sufficient information to disallow any of the fees paid to Dr. Morin in this case, particularly given that many experts in utility proceedings charge a flat fee like Dr. Morin. However, in future rate proceedings Iowa-American will be required to provide justification for any fee where the issues addressed by an outside consultant are settled. This information would consist of an hourly rate or similar amount associated with the time the consultant spent working on issues in the case. Even though the engagement may be by flat fee, the Board expects that in the future the time will be tracked on an hourly basis to help to establish whether the flat fee was reasonable.

The third issue raised by Consumer Advocate is Service Company expenses. Consumer Advocate argues that the Board should disallow rate case expense for Service Company employees because Iowa-American has not provided the detail to support the expenses associated with these employees as required by 199 IAC 26.4. Consumer Advocate maintained that Iowa-American is required to provide a description of the work performed by the Service Company employees and explain why that work was not part of the test year service contract expenses.

Board rule 199 IAC 26.4, in pertinent part, requires a utility to file within one week of the docketing of a general rate increase filing estimated or actual expenses in preparation of the rate filing, notification of customers, and litigation expenses

between the date of filing and the utility's reply brief. Iowa-American estimated the cost of Service Company Labor and Benefits for this rate case as \$153,000.

Iowa-American filed Tinsley Workpaper 5 showing the expenses paid to the Service Company during the test year. Tinsley Workpaper 5 does not include a breakout of hours worked or an hourly rate for specific employees from the Service Company that performed the various functions that Iowa-American includes in the workpaper. In addition to other categories, the workpaper shows expense items for "Regulatory Operations," "Regulatory Services," and "Legal."

Attachment B to Iowa-American's January 24, 2014, resistance includes the hours worked and hourly rate for Service Company employees included in the actual expenses claimed by Iowa-American for this rate case. As noted by Consumer Advocate, Attachment B does not show any hours worked or an hourly rate for Iowa-American witnesses Verdouw and Kaiser. Attachment B does show hours worked and an hourly rate for Iowa-American attorney Reichart and Iowa-American employee Thakadiyil.

Without more detail describing what services are provided in the test year by Service Company employees and more detail describing the work performed by the Service Company employees shown on Attachment B, the Board is unable to determine whether the actual rate case expense submitted by Iowa-American involves double counting of work performed by Service Company employees during the test year. It seems unusual that two Service Company witnesses, Mr. Verdouw

and Mr. Kaiser, have no hours shown on Attachment B while other employees that presumably helped in preparation of the two witnesses' testimony are included for recovery in rate case expense. There is simply inadequate support and documentation for the Service Company expenses.

The total actual rate case expense for Service Company employees as shown on Attachment B is \$111,662. This total includes actual rate case expense for Mr. Reichart and Mr. Thakadiyil. While it is evident that Mr. Reichart as Iowa-American counsel had actual rate case expense incurred outside the test year, there is not sufficient support to identify these expenses because there is a "Legal" category of expenses included in the test year without any detail.

In reviewing the record, Iowa-American has not provided sufficient support to establish the reasonableness of the Service Company expenditures, and those expenses (\$111,662) will be disallowed. In its next rate proceeding, Iowa-American will be required to provide descriptions of work performed by Service Company employees during both the test year and during the rate case proceedings to establish that there is no double-counting, or risk disallowance of Service Company expenses.

Another category of rate case expense needs to be examined, and that is the cost associated with litigating Iowa-American's proposed QIP clause. The Board in its May 19, 2013, order denying Consumer Advocate's motion for issue preclusion raised the issue that Iowa-American was relitigating issues every two years where an

issue and the supporting testimony and exhibits did not change significantly from case to case. The Board stated that at some point the expenses of relitigation could be considered unreasonable from ratepayers' view and it would be more appropriate for the utility to recover the litigation expense associated with these issues from shareholders rather than ratepayers. In this case, the issue of Iowa-American's proposed QIP automatic adjustment mechanism is an issue that was litigated in the last rate case, Docket No. RPU-2011-0001. The proposed QIP mechanism and the testimony and exhibits supporting the QIP in this case are essentially the same as the QIP proposed in the earlier rate case, as acknowledged by Iowa-American's witness. (Verdouw Direct, p. 48) The only significant difference from the last rate case to the current rate case is that the cap on the amount to be recovered from ratepayers through the QIP has been raised from 5 percent to 15 percent.

Two Iowa-American witnesses (Mr. Kaiser and Mr. Verdouw) provide the majority of the testimony and evidence on QIP, although QIP is mentioned by some other Iowa-American witnesses. Mr. Kaiser presents essentially the same testimony he presented in Docket No. RPU-2011-0001, with updates for the passage of time and some additional detail about the age of the water system infrastructure. Mr. Verdouw presents the underlying rationale in support of the QIP in this case and his testimony is similar to the testimony by Iowa-American witness Foran in Docket No. RPU-2011-0001. Mr. Verdouw testified at the hearing that the increase in the cap

and the additional states that had adopted a similar recovery mechanism were the only changes from Docket No. RPU-2011-0001. (Tr. 761)

As discussed earlier in this order in its decision on QIP, the Board noted that In Docket No. RPU-2011-0001, the Board found that the QIP as proposed (1) did not meet the traditional three criteria for approving an automatic adjustment mechanism; (2) that regulatory lag was not sufficient justification for implementing the QIP in that case; (3) there appeared to be no benefit to rate payers from the QIP; and (4) Iowa-American had not presented a specific replacement plan to replace parts of the aging infrastructure. In this docket, the Board previously discussed that (1) Iowa-American admits the QIP does not meet the three traditional criteria; (2) regulatory lag is not a significant issue since Iowa-American files a rate case every two years and Iowa statutes contain provisions minimizing the lag; (3) there appears to be no benefit to ratepayers from the QIP such as extending the time between rate cases or a reduced rate or return; and (4) Iowa-American did not present a specific plan for replacing aging infrastructure. The only plan presented by Mr. Kaiser is to replace leaks and breaks as they occur, which is the same plan Mr. Kaiser presented in Docket No. RPU-2011-0001.

Based upon the repetition of the testimony and the lack of new evidence to support the QIP in this case, the Board will deny rate case expense associated with Mr. Verdouw's and Mr. Kaiser's testimony in support of the QIP. However, as the Board noted when discussing Service Company rate case expenses, there appears

to be no expense associated with Mr. Verdouw's and Mr. Kaiser's testimony in this case. Since there appears to be no expense associated with the Iowa-American witness testimony in support of QIP, there is not a specific amount that can be disallowed.

While there is no specific amount that can be disallowed based on Iowa-American's expenses, there was Board and Consumer Advocate time associated with reviewing the clause, although the Board cannot determine exactly how much Board and Consumer Advocate time was spent on the issue. However, the Board can readily determine the amount of time the Board staff person primarily responsible for the QIP issue spent on the case. This amount is \$5,830, and it will be disallowed. The Board notes that other expenses of the Board and Consumer Advocate associated with relitigating QIP offer further support for the disallowance of the amount of costs associated with the Service Company.

Iowa-American's rate case expense constitutes a large percentage of the overall revenue increase, particularly because Iowa-American has a historic pattern of filing rate cases every two years. While there can be extenuating circumstances where rate cases must be filed close together, here it appears to be a pattern and not the result of extenuating circumstances. This is supported by Iowa-American's evidence as to the time between rate cases in other jurisdictions. The Board encourages Iowa-American to extend the time between rate cases and to put more effort into resolving issues early with Consumer Advocate and any other intervenors,

or risk the burden of rate case expense being placed on the shareholders, not the ratepayers, of Iowa-American. Of particular note is the rate case expense in Docket No. RPU-2011-0001, where rate case expense represented about 40 percent of the rate increase. Management should seek ways to manage the utility such that more money is put into replacing pipe and less spent on rate case expense.

## **XI. FINDINGS OF FACT**

Based on a thorough review of the entire record in these proceedings, the Board makes the following findings of fact:

1. The business transformation adjustment of \$4,939,942 agreed to by Iowa-American and Consumer Advocate is reasonable.
2. It is reasonable to use total revenue lag days of 72.05 days (including 26.58 bill collection days), federal income tax lead days of 37.0 days, state income taxes lead days of 52.25 days, property tax lead days of 332.86 days, and Iowa-American's miscellaneous expense lead days.
3. Based on the evidence in this proceeding, the unbilled revenue adjustment proposed by Iowa-American is unreasonable.
4. It is reasonable to use a three-year simple average to calculate an uncollectible expense adjustment of (72,696).
5. It is unreasonable to make an adjustment to uncollectible expense to account for any increase in uncollectible revenue based on the rates approved in this proceeding.

6. It is reasonable to recalculate interest synchronization to reflect the Board's decisions in this proceeding.
7. It is reasonable to adjust test year property tax expense by \$263,006.
8. Based on the evidence in this proceeding, it is reasonable to adopt a two-year amortization period for current and unamortized rate case expense.
9. It is reasonable to adopt a return on common equity for Iow-American of 9.9 percent.
10. It is unreasonable to adjust Iow-American's return on equity based on the utility's size.
11. It is unreasonable to adopt a flotation cost adjustment to Iow-American's return on equity.
12. Based on the evidence in this proceeding, it is reasonable to use the capital structure for Iow-American proposed by Consumer Advocate.
13. Iow-American did not meet its burden regarding elimination of the double leverage adjustment and, therefore, double leverage will be applied.
14. Based on the evidence in this proceeding, it is unreasonable to adopt a qualified infrastructure plant adjustment surcharge as proposed by Iow-American.
15. It is unreasonable to adopt an automatic adjustment mechanism for purchased power and chemical charges.
16. 1.63 is a reasonable peak day ratio.

17. It is reasonable to allocate some common costs to the customer charge and Iowa-American's allocation is appropriate in this proceeding.

18. It is unreasonable to adopt an adjustment to test year billing units and revenues for either declining usage or weather.

19. It is reasonable to allocate 50 percent of the public fire costs to the customer charge and 50 percent to the volumetric charge, and it is reasonable to set the customer charge for the 5/8 inch meter at a rate no higher than the rate calculated based on the allocated costs determined by Iowa-American's class cost-of-service study.

20. It is reasonable to allocate 75 percent of the costs of private fire service to private fire customers and 25 percent to all of Iowa-American's customers, with that 25 percent allocation divided evenly (50/50) between the customer charge and volumetric charge.

21. It is reasonable to reduce rate case expense recoverable from ratepayers by \$117,492.00.

## **XII. CONCLUSIONS OF LAW**

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to Iowa Code chapter 476 (2013).

### **XIII. ORDERING CLAUSES**

#### **IT IS THEREFORE ORDERED:**

1. The proposed tariffs filed by Iowa-American Water Company on April 30, 2011, identified as TF-2013-0069 and TF-2013-0070, and made subject to investigation as part of this proceeding, are declared to be unjust, unreasonable, and unlawful.

2. Iowa-American Water Company shall file tariffs in compliance with this order within 20 days from the date of this order, reflecting rates that produce additional annual revenues (above test year revenues) of no more than \$40,573,126, consistent with this order and attached schedules A through D. Iowa-American shall file at the time it files proposed compliance tariffs an updated class cost-of-service study (including the functionalized costs by cost category) that reflects the Board's decisions on the issues in this proceeding and corresponds with Iowa-American's approved revenue requirement. Iowa-American shall also file within 20 days of the date of this order schedules showing how its proposed compliance rates are calculated and an updated bill analysis (proof of revenue) demonstrating that its proposed compliance rates will produce the approved revenue requirement. All documentation supporting Iowa-American's post-decision filing (except the tariffs themselves) is to be provided in Excel format, including formulas for each calculation. The compliance tariffs shall become effective upon approval by the Board.

3. In future rate case proceedings, Iowa-American is to provide additional support for rate case expense as identified in the body of this order.

4. For future rate cases in which Iowa-American files a class cost-of-service study, Iowa-American shall file schedules showing the functionalized costs by cost category and schedules showing how all rates are calculated. These schedules shall be provided in Excel format, including formulas for each calculation.

5. This order constitutes the final decision of the Utilities Board in Docket No. RPU-2013-0002.

**UTILITIES BOARD**

ATTEST:

/s/ Elizabeth S. Jacobs

/s/ Joan Conrad  
Executive Secretary

/s/ Nick Wagner

Dated at Des Moines, Iowa, this 28<sup>th</sup> day of February 2014.

Iowa American Water Company  
Revenue Requirement  
Schedule A  
Docket Number RPU-2013-0002  
Final Rates

	<u>Amount</u>
1 Rate Base	\$100,823,968
2 Rate of Return	8.467%
3 Required Net Operating Income	\$8,536,765
4 Adjusted Net Operating Income	\$6,288,884
5 Net Operating Income Deficiency (Excess)	\$2,247,882
6 Revenue Conversion Factor	1.71145
7 Revenue Deficiency (Excess)	\$3,847,137
8 Adjusted Operating Revenue	\$36,725,989
9 Revenue Requirement	\$40,573,126

**Iowa American Water Company**  
**Rate Case**  
**Schedule B**  
**Docket Number RPU-2013-0002**  
**Final Rates**

	<u>Rate Base</u>
1 Plant in Service	\$178,835,713
2 Accumulated Amort. & Deprec.	<u>\$51,940,450</u>
3 Net Utility Plant	\$126,895,263
Additions to Rate Base	
4 Materials and Supplies	\$528,016
5 Fuel Stocks	\$0
6 Prepayments	\$94,175
7 Cash Working Capital	<u>\$416,636</u>
8 Total Additions	\$1,038,827
Deductions to Rate Base	
9 Accum. Deferred Income Tax	\$17,722,644
10 Contributions in Aid of Constr.	\$3,605,683
11 Customer Advances	\$5,608,480
12 Accum. Prov. For Uncollectibles	<u>\$173,315</u>
13 Total Deductions	\$27,110,122
14 Total Rate Base	<u><u>\$100,823,968</u></u>

**Iowa American Water Company**  
**Weighted Average Cost of Capital**  
**Schedule C**  
**Docket Number RPU-2013-0002**  
**Final Rates**

**American Water Works Corporation**

	Amount	Ratio	Cost Rate	Weighted Cost
1 Long-term Debt	\$939,159,337	12.785%	6.055%	0.774%
2 Preferred Stock	\$0	0.000%	0.000%	0.000%
3 Common Equity	<u>\$6,406,399,179</u>	<u>87.215%</u>	9.900%	<u>8.634%</u>
4 Total	<u><u>\$7,345,558,516</u></u>	<u><u>100.00%</u></u>		<u><u>9.408%</u></u>

**Iowa American Water Company**

5 Long-term Debt	\$44,454,114	47.429%	7.424%	3.521%
6 Preferred Stock	\$0	0.000%	0.000%	0.000%
7 Common Equity	<u>\$49,273,491</u>	<u>52.571%</u>	9.408%	<u>4.946%</u>
8 Total	<u><u>\$93,727,605</u></u>	<u><u>100.00%</u></u>		<u><u>8.467%</u></u>

**Iowa American Water Company  
Income Statement  
Schedule D  
Docket Number RPU-2013-0002  
Final Rates**

	<u>Amount</u>
1 Operating Revenues	\$40,573,125
Operating Expenses	
2 Oper. And Maint. Expense	\$17,820,665
3 Depreciation and Amortization	\$6,832,445
4 General Taxes	\$3,720,985
5 Federal Income Tax	\$954,739
6 State Income Tax	\$553,804
7 Federal Deferred Income Tax	\$1,787,061
8 State Deferred Income Tax	\$403,859
9 Investment Tax Credit	<u>(\$37,198)</u>
10 Total Operating Expense	<u>\$32,036,360</u>
11 Operating Income	<u><u>\$8,536,765</u></u>