ORIGINAL

OFFICIAL EXHIBITS

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF THE CITY OF EVANSVILLE, INDIANA, BY ITS WATER AND SEWER UTILITY BOARD FOR AUTHORITY TO ISSUE BONDS, NOTES, OR OTHER OBLIGATIONS, FOR AUTHORITY TO CHANGE ITS RATES AND CHARGES FOR WATER SERVICE, AND FOR APPROVAL OF NEW SCHEDULE OF RATES AND CHARGES APPLICABLE THERETO.	)	**CAUSE NO. 42176**

APPROVED: FEB 18 2004

IURC
PETITIONER'S
EXHIBIT NO. CX-2
4-7-22 LR
DATE REPORTER

BY THE COMMISSION:
David E. Ziegner, Commissioner
Thomas Cobb, Administrative Law Judge

On February 13, 2002, the City of Evansville, Indiana ("Petitioner") filed its Petition with the Indiana Utility Regulatory Commission ("Commission") seeking authority to issue bonds and for approval of a new schedule of rates and charges for water service. Azteca Milling, LP, Bristol-Myers Squibb Company and its wholly owned subsidiary; Mead Johnson & Company; Deaconess Hospital; George Koch & Sons, LLP; German Township Water District, Inc.; Gibson Water, Inc.; PPG Industries, Inc.; St. Mary's Medical Center; and Whirlpool Corporation (collectively, "Intervenors") filed petitions to intervene in the proceeding. Each petition to intervene was granted by the Commission.

Pursuant to notice duly published as prescribed by law, a prehearing conference was held in this matter on April 24, 2002, at 11:00 A.M., in Room E-306, Indiana Government Center South, Indianapolis, Indiana. Petitioner, Intervenors and the Office of Utility Consumer Counselor ("Public") appeared and participated in the prehearing conference.

After receiving an extension of time to file its case-in-chief, Petitioner prefiled the direct testimony and exhibits of John R. Skomp and Joe A. Thais on July 22, 2002. Petitioner subsequently filed numerous corrections, revisions and supplements to its direct case-in-chief without seeking a modification to the Prehearing Conference Order. (On September 17, 2002, Petitioner filed Petitioner's Exhibit JC, the supplemental testimony of witness Cameron. On October 15, 2002, the City filed the bond and rate resolutions as Exhibits JC-S-2 and JC-S-3. On October 17, 2002, new counsel entered appearance for the City, and, on October 21, 2002, original counsel for Evansville withdrew from this proceeding. On November 13, 2002, and November 19, 2002, Petitioner prefiled corrections and revisions to the direct testimony of witnesses Skomp and Thais.

On November 22, 2002, Intervenors prefiled the direct testimony and exhibits of witnesses Richard A. Burch, Kerry A. Heid and John M. Seever. On the same day, Public prefiled the direct testimony and exhibits of Dana Lynn, Judith Gemmecke and Scott Bell. After receiving further extension of time, Petitioner prefiled the rebuttal testimony and exhibits of witnesses Skomp and Thais on February 7, 2003.

On February 27, 2003, Intervenors filed a Motion to Strike Petitioner's Rebuttal Evidence or, in the Alternative, Motion for Continuance or Bifurcation of Evidentiary Hearing ("Motion"). Petitioner filed a Response in Opposition to Intervenors' Motion immediately before the evidentiary hearing on March 3, 2003.

Pursuant to notice duly published as required by law, the evidentiary hearing was convened on March 3 and 4, 2003, at 9:30 A.M. in Room TC-10, Indiana Government Center South, Indianapolis, Indiana. Before commencing the evidentiary hearing, the Presiding Officers heard argument on the Intervenors' Motion. The Presiding Officers denied Intervenors' Motion to strike portions of Petitioner's witness Skomp's prefiled rebuttal testimony and exhibits and denied the request of Intervenors and Public to file surrebuttal testimony. The Commission did, however, grant Intervenors' Motion to Bifurcate that portion of the hearing related to Petitioner's rebuttal testimony and exhibits. (Tr. at A-19-20). The Commission scheduled a separate hearing on Petitioner's rebuttal testimony and exhibits for March 17, 2003, and set a Field Hearing in Evansville, Indiana, for March 31, 2003.

On March 14, 2003, without leave of the Presiding Officers, Petitioner prefiled new, "supplemental rebuttal" evidence that Petitioner designated as Exhibit JAT-RS and Exhibits JRS-6 and JRS-12. While Exhibit JAT-RS consisted of three pages of additional testimony from Petitioner's engineer, Mr. Thais, Exhibits JRS-6 and JRS-12 consisted of numerous pages of new exhibits, analyses and testimony from Petitioner's accountant, Mr. Skomp. When the evidentiary hearing was reconvened on March 17, 2003, Intervenors and Public objected to admission into evidence of Exhibits JRS-6 and JRS-12. The Presiding Officers sustained the objection of Intervenors and Public and Exhibits JRS-6 and JRS-12 were stricken from the record.

On March 31, 2003, at 6:00 P.M., the Commission held a public Field Hearing in the Evansville Civic Center Complex, Room 301, One N.W. Martin Luther King Jr. Boulevard, Evansville, Indiana. At the Field Hearing, the Presiding Officers received oral and written comments from interested parties. Pursuant to a Motion from the Public, the Commission received additional written comments after the Field Hearing. By the close of the Field Hearing there were no pending motions or additional hearings that were scheduled.

Thereafter, on September 17, 2003, and after all proposed orders had been received by the Commission, the City of Evansville then filed its Verified Petition of the City of Evansville to Reopen the Record for the Purpose of Admitting Additional Evidence. This filing necessitated responsive filings by the other parties, and on September 29, 2003, the OUCC filed its Response of the OUCC to the Verified Petition of the City of Evansville to Reopen the Record for the Purpose of Admitting Additional Evidence, and, also on September 29, 2003, Azteca Milling LP filed their Response to Verified Petition of the City of Evansville to Reopen the Record for the Purpose of Admitting Additional Evidence, and, on October 2, 2003, the City

of Evansville filed its Reply in Support of its Verified Petition to Reopen the Record for the Purpose of Admitting Additional Evidence. On December 16, 2003, the Presiding Officers issued their Docket Entry denying the Verified Petition of the City of Evansville to Reopen to Record for Purposes of Admitting Evidence.

All rulings of the Presiding Administrative Law Judge are hereby affirmed by the Commission.

The Commission, having examined and considered all of the evidence of record and now being fully advised, finds as follows:

1. **Notice and Jurisdiction**. Proper legal notice of the filing of this Petition and the hearings held herein were published as required by law. Petitioner is a municipally owned utility within the meaning of the Public Service Commission Act, as amended, and is subject to the jurisdiction of this Commission in the manner and to the extent provided by the laws of the State of Indiana. The Commission has jurisdiction over Petitioner and the subject matter of this Cause.

2. **Petitioner's Characteristics**. Petitioner owns and operates a municipal waterworks facility serving approximately 55,000 customers in the incorporated City of Evansville, as well as unincorporated areas of Vanderburgh County and outside of Vanderburgh County, Indiana. In addition, Petitioner sells water to certain nonprofit, municipal and investor-owned water utilities, including Intervenors German Township Water District, Inc. ("German Township") and Gibson Water, Inc. ("Gibson").

3. **Relief Requested**. Petitioner requests authority to issue $25,450,000 in revenue bonds to finance the construction of various improvements to its municipal water system. In its original filings, Petitioner also sought to change its rates to increase its revenue by approximately $2,886,415 or 26%. In rebuttal, Petitioner accepted some of the adjustments proposed by Public and Intervenors; however, Petitioner sought to offset the proposed adjustments by substituting its previously calculated cost of extensions and replacements with a higher amount for depreciation expense. In its post hearing filing, Petitioner modified its request yet again, and it now seeks an increase of 23.91% or $2,656,238. Under its most recent request, Petitioner calculates its rates based on the specific cost for extensions and replacements.

Petitioner proposes to collect almost the entire proposed increase from Petitioner's out-of-town and large volume users by implementing a 35% surcharge on all out-of-town customers and by reducing the number of rate blocks for its large volume users.

4. **Field Hearing**. At the Field Hearing, several customers voiced opposition and submitted written comments objecting to Petitioner's proposed change to its rate structure. After the Field Hearing, the Commission also received additional written comments objecting to the 35% surcharge on outside city customers. The lone voice of support for Petitioner's proposal came from an individual, Mr. Thomas Kimpel, who represented the Warrick County Redevelopment Commission, Warrick County Economic Development Council and Warrick County Department of Economic Development. According to Mr. Kimpel, an attorney for the

Warrick County group, Petitioner needed the proposed increase so that Petitioner would have sufficient funds to extend a water line to a proposed industrial park in Warrick County. Mr. Kimpel requested that the Commission approve Petitioner's request as expeditiously as possible so Petitioner could extend the water line in time for Warrick County to attract new business to the industrial park. (Tr. of March 31, 2003 field hearing, FH-4, line 1 to FH-7, line 7). Mr. Kimpel's testimony at the Field Hearing was the first time the Commission and parties heard any evidence that Petitioner intended to use bond or ratepayer monies to extend service to a yet-to-be-constructed industrial park in Warrick County. In addition to Mr. Kimpel, several other customers provided written or oral comments, which comments expressed concern about the economic impact of the proposed rates and the fairness of the proposed surcharge.

5. **Test Year**. Pursuant to the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and proforma operating revenues, expenses and operating income under present and proposed rates is the twelve (12) months ended March 31, 2002. The financial data for such test year, when adjusted for changes as provided in the Prehearing Conference Order, fairly represents the annual operation of Petitioner. We conclude, therefore, that such test year is a proper basis for fixing new rates for Petitioner and testing the effects thereof.

6. **Petitioner's Proposed Capital Improvement Projects**. Petitioner requested authority to issue $25,450,000 in bonds to pay for a number of upgrades to Petitioner's water plant infrastructure, which will allow it to continue to provide adequate and reliable service to customers located north of the City of Evansville in an area known as the "Northern Pressure Zone." Petitioner intends to make capital improvements to its distribution system, including the addition of new mains, the replacement of existing mains with more reliable and/or larger mains, and the looping of some mains. Petitioner also plans to add pumping capacity to supply more water from the downtown area to the Northern Pressure Zone, as well as, additional pumping capacity to increase the flow of water within the Northern Pressure Zone. Petitioner further intends to renovate certain storage tanks, make upgrades to its treatment plant and implement a Supervisory Control and Data Acquisition ("SCADA") system.

(a) Applicable Law. Pursuant to I.C. 8-1-2-19, a municipality must seek Commission approval prior to issuing bonds. The Commission applies a two-pronged test in determining whether to approve the issuance of bonds. That test has been described in prior Commission Orders, as follows:

> First, the Commission must consider whether the proposed capital improvement program is reasonably necessary to enable the Petitioner to render adequate and efficient utility service; second, the Commission must determine whether the proposed bond issue is a reasonable method for financing the necessary capital improvements. In re Town of Sellersburg, Cause No. 37921, approved June 4, 1986; In re City of Elkhart, Cause No. 38892, approved May 9, 1990. (emphasis added).

(b) Evidence Relating to the Capital Improvement Program. Petitioner's witness Joe A. Thais, an engineer with HNTB Corporation, testified regarding the necessity for the

proposed projects. Petitioner engaged HNTB Corporation in 1998 to develop a "Master Plan" for the water utility. HNTB performed extensive evaluations of both the water distribution system and treatment plant in preparing the Master Plan and arriving at its original recommendation of projects which were necessary for Petitioner to continue to provide adequate and efficient utility service. HNTB updated portions of the Master Plan in 2002, at which time it revised the recommended project list for inclusion in this rate and financing case.

Mr. Thais testified that the projects Petitioner is requesting Commission authority to finance in this proceeding are necessary in order for the utility to continue to provide adequate and reliable water service to its customers. Mr. Thais explained that population growth to date in the Northern Pressure Zone, together with expected continued growth and increased demand, will limit the ability of the utility to meet the future needs of its customers on a consistent basis unless it implements the proposed capital improvement projects. He testified that during the Summer of 2002, Petitioner's system experienced several days of low pressure in certain areas of the Northern Pressure Zone and Petitioner had difficulty keeping full tanks serving the area. In addition, all of the pumps at booster stations servicing the Northern Pressure Zone had to be in operation in order to maintain the quality of water and adequate pressure in the zone.

Mr. Thais testified that while Petitioner was able to maintain adequate pressure and preserve water quality in the Northern Pressure Zone in the Summer of 2002, it cannot continue to operate its system in such a manner in the future. Mr. Thais stated that "[i]f the utility is not able to complete the proposed projects, it could soon be put in the position of being unable to provide reliable service to its customers." (JAT-R at 6.)

Public's witness, Scott A. Bell, indicated that the Public did not oppose Petitioner's proposed projects, except for one item. Mr. Bell recommended that Petitioner postpone its proposal to purchase an additional lime feeder, which carried an estimated cost of $70,000. (SAB at 7.) On rebuttal, Mr. Thais indicated that Petitioner was willing to postpone the purchase of the lime feeder, unless one of its existing lime feeders experiences a mechanical failure. (JAT-R at 15.)

Intervenors expressed concern about what it termed as the changing and inconsistent reasons for the Capital Improvement Project. A substantial portion of Intervenors' testimony was devoted to arguments that Petitioner's proposed projects were not necessary because German Township and Gibson are not seeking any additional water beyond what they are entitled to receive under their current contracts with Petitioner. (RAB at 12.) Mr. Thais, however, testified that Petitioner is currently having problems supplying water through its existing lines to customers in the Northern Pressure Zone, including German Township and Gibson. According to Mr. Thais' testimony, the only way Petitioner's existing facilities can continue to meet the current needs of German Township and Gibson is to limit the demand of industrial customers during maximum day pumping conditions and limit future growth in the Northern Pressure Zone. (JAT-R at 11.)

Intervenors' witness Richard A. Burch also indicated that a recent decision by Indiana-American to discontinue purchasing water from Petitioner for its Newburgh service has resulted in Petitioner "finding" four million gallons per day, which is "like a new or rehabilitated water

treatment facility that is now newly available to meet . . . 'anticipated growth' without any capital expenditures." (RAB-7). Mr. Burch stated that it was his understanding that Indiana-American has a written contract with Petitioner reserving a capacity of four million gallons per day. (Id.) Mr. Thais testified that there has never been a written contract between Petitioner and Indiana-American and that Petitioner's records indicate Indiana-American's historical usage has been less than 750,000 gallons per day. Mr. Thais stated that even if an additional four million gallons per day became available after Indiana-American has reduced its demand, the potential maximum day still would be at 82% of the plant's firm capacity. Mr. Thais testified that having a maximum day this close to the plant's firm capacity is the reason Petitioner has proposed to install new capacity in these systems. (JAT-R at 10.)

Intervenors also generally challenged Petitioner's assertion that the projects were needed in order for it to continue to provide adequate and reliable service to the Northern Pressure Zone. In his rebuttal testimony, Mr. Thais stated that the growth occurring in the Northern Pressure Zone is the reason the projects are necessary, and that if it were not for the growth in the Northern Pressure Zone, none of the proposed projects would be needed.

On cross-examination by the Public, Mr. Burch pointed to a map showing several proposed projects within the corporate limits of the City of Evansville and indicated that those projects were not needed to improve service to the Northern Pressure Zone. In response, Mr. Thais testified on rebuttal that each of the projects Mr. Burch had identified was driven completely by growth occurring in the Northern Pressure Zone. Two of the projects involved pumps, which are needed to force additional water into the Northern Pressure Zone. Another project involves the installation of a new transmission main to enable the high service pumps at the treatment plant to pump more water across the downtown area towards the Northern Pressure Zone.

Mr. Thais indicated that in his opinion, if the Commission were to accept Intervenors' recommendation and not approve financing for any of Petitioner's proposed projects, the consequences would be disastrous (JAT-R at 14.), and Petitioner likely would be unable to provide adequate and reliable service to customers in the Northern Pressure Zone in the near future. Mr. Thais indicated that if the Commission does not approve the proposed projects, the utility would quickly be in a position of having to require customers in the Northern Pressure Zone to limit their usage of water during high demand periods. Petitioner also would not be able to add any new customers to its system in the Northern Pressure Zone. Mr. Thais stated that even delay in the commencement of construction of the projects is likely to be detrimental to the utility and its customers. If the projects are delayed, the price of the projects may increase. This could result in the Petitioner being unable to complete necessary projects.

(c) Evidence Regarding Reasonableness of Cost Estimates. Petitioner provided cost estimates for the projects it proposed in this Cause. With respect to the infrastructure investments Petitioner needs to extend and improve its mains to provide adequate and reliable service to its growing customer base in the Northern Pressure Zone, Petitioner provided estimates totaling $11,720,000. Petitioner also estimated that it would incur a cost of $2,800,000 associated with miscellaneous small main extensions and replacements necessary to loop its existing mains in order to avoid stagnant water and to increase pressure and reliability in the

Northern Pressure Zone. Petitioner estimated that the cost of the projects needed to increase its pumping capacity to force more water into the Northern Pressure Zone would be $1,710,000. Petitioner estimated that its proposed treatment plant improvements would cost $6,370,000. Petitioner also provided estimates for the rehabilitation of its storage tanks and the installation of the SCADA system. Petitioner estimated that its storage tank repairs would cost $670,000, and the cost associated with implementing a SCADA system would be $1,540,000. The total cost of the improvements Petitioner is proposing was estimated to be approximately $24,810,000. The variance between the estimated cost of the improvements and the amount for which Petitioner seeks financing authority ($25,450,000) consists of bond insurance costs, underwriters discounts, costs of issuance and other miscellaneous expenses.

The evidence showed that Petitioner has not yet received bids for a number of the projects. Petitioner is, however, on the verge of finalizing an agreement with EA2 Systems – American Water Services ("EA2") for the management of certain distribution system and booster station projects, which account for approximately $12,000,000 of the total cost of the projects for which financing approval is sought in this proceeding. (JAT-R at 14-15.) EA2 has offered the utility a Guaranteed Maximum Purchase Price ("GMPP") for those projects, which price was effective so long as construction was to be completed by the end of 2003, which deadline has passed as a result of the procedural delays set out above.

Mr. Thais testified that it is difficult to obtain bids for projects of this type when the utility cannot be certain when construction will begin and without having financing in place for the projects. However, Mr. Thais stated that based on his experience with similar projects being developed for other HNTB clients, in his opinion, Petitioner's cost estimates are accurate. (JAT-R at 16). Mr. Thais testified that HNTB maintains an extensive system, which includes the unit costs for materials and labor. When estimating costs at this planning level, HNTB uses the records from this system to provide a historical basis for its cost estimates.

Both the Public and Intervenors expressed concern about the 20% contingency built into Petitioner's project cost estimates. Mr. Thais testified that the contingency is typical for projects at the pre-design state of planning and will allow the utility to have sufficient funds to be available for changes or unforseen conditions encountered during the design phase.

Public's witness Bell suggested that any potential problem caused by Petitioner's use of a 20% contingency figure in developing its request for financing authority could be mitigated by the Commission's requiring Petitioner to obtain as many bids as possible prior to issuing the proposed bonds. (SAB at 6.) Mr. Bell further suggested that Petitioner should be required to file an annual report with the Commission and the Public outlining the status of each project. Mr. Bell testified that in the event that "all projects are completed and excess bond funds remain, then any excess funds would be spent on additional capital improvement projects outlined in [Petitioner's] Master Plan." (Id.) Mr. Bell further suggested that Petitioner be required to inform the Commission should it have any excess bond funds and identify the Master Plan projects it intends to complete. (Id.) Mr. Thais testified on rebuttal that Petitioner would be willing to agree to Public's conditions. We find Mr. Bell's conditions reasonable, and Petitioner is directed to adopt them.

(d) Evidence Regarding Reasonable Method for Financing the Projects. The second element we consider when determining whether to approve a proposed bond issuance is whether the proposed method of financing is reasonable. Petitioner's witness John R. Skomp testified that in his opinion, "the proposed bonds are a reasonable method of financing the utility's capital improvement projects." (JRS at 8.) No party argued that financing with tax-exempt revenue bonds was an unreasonable method to secure funds. According to Petitioner's evidence, the proposed bond issuance in the amount of $25,450,000 would be amortized over a period not to exceed twenty (20) years, at an interest rate not to exceed 7.5%. Mr. Skomp testified that the projects will benefit customers during the time the proposed bonds are being retired and, therefore, the customers being benefited by the capital improvement projects will bear a portion of the cost of paying debt service associated with financing the projects.

The Public did not raise any issues with respect to Petitioner's methodology for financing the proposed projects, but did indicate that the Commission should require Petitioner to perform an interest rate true-up to take into consideration any material changes between the assumed interest rate and the actual interest rate when the bonds are sold. (SAB at 18.) In his prefiled rebuttal testimony, Mr. Skomp agreed that Petitioner would perform an interest rate true-up, as suggested by the Public. (JRS-R at 22). This is a reasonable requirement, and we will so direct.

Intervenors' witness John M. Seever stated that, if the bond issue is to be sold on the open market, it should be amortized or "wrapped" around the outstanding bond issue. (JMS at 26-27.) Mr. Seever's assertion that Petitioner should wrap the proposed debt was addressed during cross-examination and re-direct of Mr. Cameron. Mr. Cameron stated that in this situation wrapping the debt could be detrimental to Petitioner because it could increase the interest cost. In order to wrap the proposed debt issuance, repayment of the principal would have to be pushed out until 2016. Effectively, Petitioner would have to pay back all of the principal associated with the twenty (20) year bond issue during the last six years. Intervenors' Exhibit JMS-3 contains an amortization schedule showing the impact of wrapping.

(e) Discussion and Findings. Petitioner presented evidence that the failure to complete the projects for which financing is sought will have a potentially serious effect on Petitioner and its customers, especially those customers located within the Northern Pressure Zone. Petitioner's evidence suggested that if Petitioner is not able to complete the projects it may be in a position of having to require customers in the Northern Pressure Zone to limit their water usage and/or stop adding new customers in the area. The assertions from the wholesale customers that are part of the Intervenors' group that they do not currently need additional water, and do not take all of the volumes they may contractually be entitled to, does not negate Petitioner's evidence, which shows that, if the proposed projects are not completed, Petitioner could be unable to provide adequate and reliable service to customers in the Northern Pressure Zone. We find, with one exception, that Petitioner's proposed capital improvement program is reasonably necessary to enable the Petitioner to render adequate and efficient utility service to its customers. The Public recommended and Petitioner agreed that Petitioner should postpone its proposal to purchase an additional lime feeder. We, therefore, find that Petitioner should postpone the purchase of the lime feeder and accordingly find that the amount of its proposed bond issue should be reduced by $70,000. We find that Petitioner should be authorized to issue bonds in the amount of $25,380,000 in order to finance the proposed capital projects, as revised,

and it will be so ordered. We further find that there is sufficient evidence to approve Petitioner's financing request, without Petitioner having submitted bid tabulations prior to the close of the evidence. We believe Petitioner provided substantial, credible evidence regarding the manner in which its estimates were calculated that is sufficient for us to approve the requested financing, as revised.

Once the bonds are sold, Petitioner shall file with the Commission, Intervenors and the OUCC, a report reflecting the final terms of the financing, including the interest rate. Petitioner should also include its calculation of any rate adjustment and its revised tariff. Such filing should reflect a rate adjustment created by a different interest rate than as used in arriving at the debt service requirement. Petitioner's filing should be made within sixty (60) days following the sale of the bonds. The OUCC and Intervenors have fifteen (15) days to review the filing and to file an objection thereto. If the OUCC or Intervenors object and the parties are not able to resolve their concerns then, upon request of the OUCC or the Intervenors, the Commission will promptly hold a summary hearing to address any unresolved issues. We find this procedure to be fair and reasonable to the ratepayers and Petitioner, and find that Petitioner's debt service to be approximately $2,897,648, which amount should be adjusted to reflect the actual terms of the issuance of the bonds in accordance with the outlined procedure.

We find, however, that Petitioner should be required to obtain as many bids as possible before issuing the proposed bonds. Additionally, Petitioner should be required to file annually with the Commission, and serve the Public with, a copy of a report outlining the status of each project. The status report should include for each project the initial estimated cost, the actual cost to date, the total cost after completion of the project, and the date of completion of the project. In the event that all the projects are completed and excess bond funds remain, then we find that any excess funds must be spent by Petitioner on additional water utility capital improvement projects as outlined in Petitioner's Master Plan. Petitioner should inform the Commission if it has any excess bond funds and which projects it proposes to complete with those excess funds.[1]

7. **Total Operating Revenues Under Current Rates**. Petitioner reported its test year operating revenues from water sales, per books, to be $9,988,651. (JRS-1, Exhibit C.) Petitioner had test year revenues from public and private fire protection of $1,210,381, and $102,984 from forfeited discounts. Petitioner also had test year revenues of $36,150 from other sources. Petitioner's total operating revenues from the test year were $11,338,166.

Both Petitioner and the Public proposed adjustments to Petitioner's operating revenues. Petitioner proposed three adjustments. Petitioner proposed an upward adjustment to its operating revenues from water sales to industrial customers in the amount of $44,912 to account for usage of water not recorded during the test year. Petitioner also proposed an upward adjustment of $1,445 to sales for private fire protection to account for the current number of sprinkler connections. Neither the Public nor the Intervenors' opposed these adjustments. Thus, we accept Petitioner's adjustments. The third adjustment proposed by Petitioner was a downward adjustment to revenues from sales to industrial customers in the amount of $138,171 to account for the loss of Indiana-American as a customer. However, Indiana-American will continue to be

[1] See the Debt Service Section on pages 21-22 for further findings on the proposed method of financing.

connected to Petitioner's system as a backup to a new source of supply. Due to the continued connection, and the possibility that, at some point in the future, Indiana-American may need to use its backup water supply, Intervenors' witness Kerry Heid proposed that a standby charge be applied to Indiana-American. In his prefiled testimony, witness Heid calculated a standby charge based on Indiana-American's test year average daily usage of 542,000 gallons per day. Using this average daily usage, he determined that the annual revenues from an Indiana-American standby rate should produce revenue for Petitioner of $197,980. Witness Heid recommended that Petitioner's revenue requirement be adjusted upward to reflect revenues of $197,980 from Indiana-American. We decline to require Petitioner to make Intervenors' proposed upward adjustment for several reasons: 1) The proposed adjustment is $59,809 more than Indiana-American paid in its final year of purchasing water from Evansville; 2) a fixed, monthly charge that is independent of water usage is inappropriate in this case; and 3) any amount that Indiana-American may or may not purchase in the future is not fixed, known, and measurable and therefore would not properly be included in Petitioner's adjusted test year operating revenues.

The Public proposed two additional revenue adjustments. OUCC witness, Dana Lynn proposed an adjustment to Petitioner's test year operating revenues for residential growth that occurred within the test year. Her adjustment normalized the effect of residential customer growth on a per bill basis, which increased operating revenues by $7,790. Ms. Lynn testified that she did not adjust test year operation and maintenance expense because the fee for the EA2 contract covers the cost of chemical expense and all utilities except water. "The fees for this contract are not based on the growth of customers, but through negotiations with the utility. Thus, no adjustment was made."(Lynn, Pg. 7)

In his prefiled rebuttal testimony, Petitioner's witness Mr. Skomp questioned Public's proposed adjustment, stating that there were no work papers to support Public's calculation. Mr. Skomp also stated that if such an adjustment were warranted, a corresponding adjustment should be made to Petitioner's pro forma operation and maintenance expenses. Mr. Skomp testified that Public's witness Lynn did not adjust operation and maintenance expenses because she incorrectly assumed that Petitioner's contract with EA2 is fixed and does not increase due to customer growth. Mr. Skomp further stated that in the past, EA2 has sought "reimbursement for increased expenses such as postage and chemicals, which may be related to customer growth." (Skomp, rebuttal, pg. 13-emphasis added)

We find that although Mr. Skomp stated that EA2 has previously sought reimbursement from Petitioner under the contract that may have been related to customer growth, the record is void of any support to that claim. In addition, the adjustment made by the Public only normalized the growth within the test year. The Public provided support (DML Attachment 6, pgs. 2-4) for the testimony of Ms. Lynn that the EA2 contract is negotiated for an annual fixed fee. In addition, Attachment 6, DML Page 3 of 4 states that "Unit prices defined in this new Appendix G will be negotiated annually. . ." Furthermore, this Commission would note that Petitioner made a pro-forma expense adjustment in its schedules to account for the already agreed to contract fee it has with EA2 for the twelve months following the end of the test year, which already takes into consideration the growth the public normalized. The Public did not oppose this expense adjustment. It should also be noted that Petitioner adjusted test year

revenues for the loss of revenues from Indiana-American Water, but made no adjustment for the decreased operation and maintenance expenses for chemicals and utilities. We believe the Public's customer growth normalization adjustment would not increase operation and maintenance costs beyond that which would be saved from the reduced usage by IAWC. Thus, we find that the Public's customer growth adjustment should be accepted.

GIS Revenue. The public's second revenue adjustment was made to include a full year of revenues received from Vanderburgh County for its portion of GIS expenses incurred by Petitioner. Ms. Lynn testified that Mr. Cameron stated that the charge to the county for its first semi-annual payment for 2002 GIS costs was $100,455. (Lynn, Pg. 8) Thus, she annualized this number and made a pro-forma adjustment to increase operating revenues by $112,547. Petitioner and Intervenor did not dispute this adjustment. The Commission finds that Public's proposed adjustment to increase operating revenues to include a full year of revenues from Vanderburgh County should be accepted.

The Commission finds that Petitioner's pro forma operating revenue from the sale of water at current rates is $9,903,182. In addition, Petitioner's pro forma revenue from public and private fire protection is $1,211,826 and its pro forma revenue from forfeited discounts is $102,984. Petitioner's pro forma miscellaneous revenue is $237,060, which includes GIS revenues, and its total pro forma operating revenue is $11,455,052.

8. Petitioner's Revenue Requirements. Indiana Code 8-1.5-3-8 sets out a list of revenue requirement elements which this Commission should consider in determining "reasonable and just rates and charges for services" rendered by a municipally owned utility. These elements are addressed in subsections (b) through (f) of I.C. 8-1.5-3-8, and the Commission has considered these elements when making our findings of fact and conclusions of law. Our findings with respect to the individual elements of the total revenue requirements requested by Petitioner are set forth below.

(A) Operation And Maintenance Expense. During the test year, Petitioner calculates Operation and Maintenance ("O&M") expense of $9,312,962. Petitioner calculated its pro forma O&M expense to be $8,394,021, whereas the Public's calculation was $8,064,885. Intervenors calculated Petitioner's pro forma O&M expense to be $7,758,592.

(1) Petitioner's Proposed Adjustments. Petitioner proposed nine operation and maintenance expense adjustments and restated an expense adjustment made during the test year that allocated certain utility expenses to the sewer utility. Adjustments made were to salaries and wages, FICA, PERF, and for each of the contracts for engineering, customer service and management. Adjustments were also made to depreciation, utility receipts tax, and Payment in Lieu of Taxes ("PILT"). Each of these adjustments were opposed by one party or both and are discussed below.

(a) Wages and related benefits. Petitioner increased test year salaries and wages $302,594, PERF $6,550, and FICA $11,952. Petitioner testified that pay rate and salary increases were obtained from the various contracts and ordinances that are approved on a regular basis by the Board. (Skomp, direct, at 6) Changes in the utility's contributions to the Public

Employees Retirement Fund ("PERF") and the Federal Insurance Contribution Act ("FICA") resulted from the pro forma salaries and wages calculations that were made. (Skomp, at 7.) Mr. Seever, a consultant for the Intervenors' testified that Petitioner has appeared to incorrectly include in operation and maintenance expense a portion of payroll that was actually capitalized during the test year. (JMS, at 31.) Because this payroll is related to installing new meters and new distribution lines, proper accounting and rate-making practice requires that amounts spent on installing new utility plant should be capitalized. (JMS at 31.) In his rebuttal testimony, Mr. Skomp stated that it is his understanding that Petitioner's personnel do not install new meters or distribution lines. (JRS-R at 20.) Beginning in December of 2000, Petitioner began having either developers or private contractors install new distribution lines and related equipment.

The Public opposed Petitioner's adjustment and provided increased adjustments for salaries and wages of $291,596, PERF of $6,708 and FICA of $13,341. Ms. Lynn and Mr. Skomp both testified that Petitioner appropriates a share of general operating expenses to the wastewater utility. (Petitioner's Exhibit JRS, Q.&A.-20, Page 7.) Thus, Petitioner's wage adjustment should not have factored the wages allocated to the wastewater utility. The Public calculated Petitioner's pro-forma wage adjustment by reducing half of the salaries and wages that are allocated to the wastewater utility from both the budgeted and test year totals before calculating an increase of $291,596. Petitioner did not dispute the Public's adjustments nor that Petitioner's pro-forma salary and wage adjustment was based on Petitioner's projected 2002 budget. We find that Ms. Lynn's adjustment is conservative based on the historical data provided by Petitioner that reflected test year capitalized salaries and wages. Her adjustment does not capitalize any pro-forma wages. Because Mr. Seever offered no substantial evidence to support his statement that a portion of Petitioner's proposed adjustment relates to installing new utility plant, we find that the Intervenors' adjustment to O&M expense should be denied and that the Public's adjustment for salaries and wages should be accepted.

For the aforementioned reasons, we also accept the Public's adjustments that are based on wages for both PERF and FICA expense. This will result in a test year PERF expense increase of $6,708 and a test year FICA expense increase of $13,341

(b) Contract Adjustments. Petitioner made three pro-forma adjustments to annualize the engineering, customer service and management contracts that were entered into by the Board. Mr. Skomp testified that Environmental Management Corporation ("EMC") manages various functions of the Utility's operations and these adjustments are needed to allow for the increased cost of these contracts. (Skomp at 7.) The Public did not oppose Petitioner's adjustments. Intervenors' witness, Mr. Seever accepted the pro forma expense amounts that were included in Petitioner's Adjustments (6), (7) and (8) of Schedule C-1 of the Report, but rejected the calculation of Petitioner's test year amounts because the test year amounts did not coincide with the amounts shown on Petitioner's Exhibit D pages 14 and 15 for the same expense account. Mr. Seever testified that without a valid expense analysis, there is no way to determine the nature of the discrepancy. (JMS at 30.)

In Petitioner's rebuttal, Mr. Skomp testified that it is not an unusual occurrence for a test year amount shown in the detail of an adjustment to not exactly match the amount shown in a certain expense account, especially when working with larger utility companies. (JRS-R at 18.)

We find that the Public conducted a field audit of the utility's books and records (DML at 2), and accepted Petitioner's adjustments for all three contract agreements. Therefore, we accept Petitioner's adjustments for each of the three contracts.

(c) Depreciation Expense. Both Petitioner and the Public made a pro-forma adjustment for depreciation expense. Petitioner calculated depreciation expense by applying a 2% composite depreciation rate to all of its plant is service as of March 31, 2002 with the exception of communication, auto, office and miscellaneous equipment in which it applied a 10% depreciation rate. The Public's calculation differed from Petitioner's in that Ms. Lynn applied the composite rate of 2% to all of Petitioner's depreciable plant in service. Ms. Lynn's testimony was undisputed that Petitioner had not completed a depreciation study as part of any rate proceeding before this Commission. (DML at 18.) The Commission's Engineering Division issued a memo dated December 28, 1987 as a result of a depreciation study that, in part, determined that a composite depreciation rate of 2% should be applied to all depreciable plant of water utilities that have a complete water system. (DML at 18-emphasis added.) The study was attached to Ms. Lynn's testimony for the Commission's review. As noted in the asset headings of the study, communication equipment, transportation equipment, office furniture and equipment were all factors considered when our Engineering Division determined the 2% composite rate. The study also provided the service lives assigned to each asset classification. For example, transportation equipment has a service life of seven years and transmission mains have a service life of 75 years. The composite depreciation rate as defined by NARUC "is a percentage based on the weighted average service life of a number of units of plant, each of which may have a different individual life expectancy." (DML at 18-19.)

In his rebuttal, Mr. Skomp testified that Petitioner's calculation of pro forma depreciation expense follows the Petitioner's actual historical practice, which has been approved by this Commission and accepted by the OUCC in past cases. He stated that the OUCC's Exhibit, P. Sue Haase, Schedule 5, Page 3 of 3 was prefiled in the Petitioner's last rate case, Cause No. 40488, and shows that Ms. Haase accepted the Petitioner's calculation of pro forma depreciation expense and also used a 10% depreciation rate on "Capitalized Office and Transportation Equipment." Therefore, he argues, the OUCC accepted and used Petitioner's current practice in Cause No. 40488. (JRS-R at 10.) Mr. Skomp also testified that the Commission's April 1, 1987 Order in Cause No. 38128, specifically approved the use of a 10% depreciation rate on certain plant accounts.

The Commission notes that Cause No. 40488 was a settled case, which stipulated that the results of the agreement were a compromise of all parties. Furthermore, Ms. Haase, was not present at this hearing to question her about the position she took on her depreciation expense adjustment in Cause No. 40488. Thus, we can not conclude whether the OUCC accepted the 10% depreciation rate based on a former employee's prefiled testimony to a prior case. Further, after our review of the evidence, we found that the Final Order in Cause No. 38128 was issued prior to the issue date and effective date of the memo from the Commission's Engineering Division that set the composite depreciation rates used by the Public. Thus, Petitioner incorrectly applied a 10% depreciation rate to assets that were already taken into consideration when the Engineering Division of the Commission calculated it's 2% composite depreciation

rate. Therefore, we find that Petitioner should apply the 2% composite rate to all of its depreciable plant in service and accept the Public's proposed depreciation expense of $1,925,040.[2]

(d) Utility Receipts Tax. Adjustment 10 shown on Page 11 of Petitioner's Financing Report calculated pro-forma utility receipts tax of $157,435 to annualize the utility receipts tax on Petitioner's proposed total operating revenues of $11,246,352.

Ms. Lynn's methodology differed from Petitioner's. She testified that HB 1001 discontinued the state's 1.2% gross income tax imposed on municipalities. It was replaced with a utility receipts tax of 1.4% on certain utility receipts. She explained that Petitioner calculated its utility receipts tax on its total proposed operating revenues in error. Per HB 1001, revenue received from wholesale customers, refundable customer deposits and bad debts are not taxable. The $1,000 exemption that was available for the gross receipts tax is also available for the utility receipts tax. Ms. Lynn's adjustment reduced pro-forma present rate operating revenues by the deductions mentioned above. In addition, she eliminated the revenue collected from the city based on Petitioner sharing in a corporate return, thus, elimination of interfund transfers would occur. This resulted in a reduction to Petitioner's utility receipts tax of $1,211. (DML at 20 - 21)

In his prefiled rebuttal testimony, Mr. Skomp indicated that he agreed with Ms. Lynn that wholesale revenues should be excluded because the utility receipts tax applies to retail sales only, but he disagreed that sales to the City of Evansville would be exempt from utility receipts tax. The utility receipts tax statute contains an exemption for sales to an "affiliated group." By definition, an "affiliated group" means an affiliated group of corporations. Petitioner is not a corporation. (Skomp rebuttal at 16 and 17.

During the hearing, Ms. Lynn indicated that she had obtained a letter from Everett Layton, a Tax Policy Analyst of the Indiana Department of Revenue staff that supported her position. During cross examination, Ms. Lynn cited that portion of the advisory letter that states: "Here, it is clear that the provision of water by one division of a nonprofit corporation (including political subdivisions as defined by IC 36-1-13) to other divisions of the nonprofit corporation is a transaction that is eliminated for financial statement and tax return preparation, hence, is not subject to Utility Receipts Tax." We note that the advisory letter from the Indiana Department of Revenue was also signed by the Administrator of its Legal Division, Mike Ralston. Based on the content of the advisory letter, it is clear that in the opinion of the Indiana Department of Revenue, municipal water utilities can eliminate utility receipts taxes on retail sales to their municipalities. Furthermore, Petitioner's concern about SB494 is not of issue here. That bill is an amendment to clarify the specific exemption from tax gross receipts received by "(7) a political subdivision for sewer and sewage service. We note, that the advisory letter submitted during cross-examination as Public's Exhibit CX-1 concurs with SB494 in that sewage services are exempt and not subject to Utility Receipts Tax. Moreover, Petitioner offered no evidence or documents to support its position.

Thus, we find that the Public's proposed adjustment to utility receipts tax related to sales to the City of Evansville should be accepted. We, therefore find, based on pro forma operating

[2] See Section 8(B), pages 20-21, for depreciation amount to be included in revenue requirements.

revenues of $11,455,052 less sales to the city of $660,592, wholesale sales of $410,065, recovery of bad debts of $8,757 and the $1,000 exemption that the adjustment for utility receipts tax should be a decrease of $1,211.

(e) Allocation of Expenses to Sewer Works. Petitioner reallocated a line item on the Utility's income statement to the appropriate expense categories to perform its cost of service analysis. Petitioner explained that the City's Sewage Works pays an appropriate share of general operating expenses and the Utility records this as an entry to "Sewer Utility Proportion of General Expenses" in its financial records. (JRS at 7)

The Public opposed Petitioner's allocation to its sewer utility and filed the workpapers Petitioner used to support its test year joint cost allocation and the detail provided to the Public through discovery to verify Petitioner's joint cost allocation. Those work papers provide estimated joint costs for the years 2000, 2001, 2002 and the test year. The work papers do not explain that Petitioner took 75% of 2001's estimated joint costs and 25% of 2002's estimated joint costs to arrive at its test year joint cost totals before allocations.

The test year costs shown on these work papers do not agree with actual test year totals, nor do they agree with Petitioner's budget totals for 2002 or 2003. Ms. Lynn explained that she made numerous attempts to receive support from Petitioner as to why estimated data was being used instead of actual data. But Petitioner provided nothing to support the need to use estimated data. Ms. Lynn also explained that Petitioner improperly calculated the 2002 G.I.S. Director's and Technician's salary. To correct Petitioner's allocation adjustment, Ms. Lynn allocated 50% of the shared actual costs to the sewer utility. In addition, Ms. Lynn's adjustment also allocated 50% of the actual costs of the meter department's salaries to the sewer utility. Public's witness, Scott Bell supported this adjustment with the following.

> Petitioner has approximately 30 employees in the meter department. Fifteen of the employees in the meter department have job descriptions listed as meter readers. Petitioner allocated 50% of those 15 employees' salaries to the wastewater utility and 50% to the water utility. Petitioner has chosen to allocate, without explanation 100% of the remaining 15 employees' salaries to the municipal water utility.
>
> These meters are used to gather water consumption information for the water utility customers. This information is the basis for billing the water utility customers for water usage and for billing the wastewater utility customers for wastewater utility service. Each meter department employee's salary is paid to ensure the proper installation and continual operation of the meters. Since the information retrieved from these meters is necessary to billing customers for both water and wastewater utility service, I believe that all costs associated with the meter department should be allocated 50% to the water utility and 50% to the wastewater utility. (SAB at 16-17.)

In his prefiled rebuttal testimony, Petitioner's witness, Mr. Skomp testified that Public's assessment of the duties of meter department employees was accurate only with respect to the 15 employees that have the job description "meter reader." Petitioner allocated 50% of the costs associated with those 15 meter readers to the water utility and 50% to the Sewage Works. However, the 15 employees who are not meter readers do not have similar duties. While those 15 employees work in the "Meter Department" for reasons related to efficient supervision, their responsibilities relate solely to Petitioner's waterworks operations. (JRS at 14) The Commission has reviewed Attachment DML-2, Page 3 of 5 that lists all the job titles for the employees in the meter department and compared it to the job titles allocated by Petitioner.

We note that titles such as Install/Remove, Meter Pick-up Man, Meter Relief, and Meter Maintenance were not allocated at all. None of these titles suggest that the employee would work solely for the water utility to repair water main breaks as Petitioner suggested nor did Petitioner file evidence to support its claim. The Commission finds that 50% of the actual total costs associated with the employee's salaries and benefits in the meter department should be allocated to Petitioner's sewer utility. In addition, we agree with Ms. Lynn that budgeted or estimated data should only be used if actual data does not exist. (Lynn, page 14) We find Petitioner's joint costs adjustment should be an allocation of actual test year expenses to the wastewater utility. We accept the Public's allocation of an additional $422,387 allocation to the wastewater utility.

(2) Additional Adjustments from Public. Neither Petitioner nor the Intervenors' made a pro-forma adjustment for Petitioner's increased cost for health insurance. Petitioner provided data to the Public that supported the Public's adjustment. Neither party opposed this adjustment. We find Petitioner should increase its operation and maintenance expense for health insurance costs by $94,812.

(a) Rate Case Expense. The Public proposed to reduce Petitioner's pro forma O&M expense by $13,000 related to rate case expenses. Public's witness Lynn testified that upon reviewing Petitioner's expense accounts she discovered an invoice from Municipal Consultants, Petitioner's rate consultants in this case, in the amount of $13,000. Ms. Lynn stated that Petitioner made no adjustment for rate case expense in its O&M expense adjustments and, "thus it appears Petitioner will fund its rate case expense through its bond issuance." Ms. Lynn also stated that the detail supporting the invoice was a paragraph consisting of less than 100 words.

Petitioner's witness Skomp testified there was no basis for Ms. Lynn's assumption that Petitioner intended to fund its rate case expense through the proposed bond issuance. To the contrary, the fact that Petitioner paid the invoice from cash on hand seemingly creates an inference that it intends to fund rate case expense from operating revenues. Mr. Skomp also explained that the invoice contained little detail because $13,000 was a "not-to-exceed" amount that Crowe Chizek and the City has agreed upon for "rate study" and "cost-of-service" study purposes.

In her testimony, Ms. Lynn cited a case involving Indianapolis Water Company where the Commission indicated that it would disallow rate case expense in the Petitioner's next case if more detail was not provided on the statements. Cause No. 39128 (approved Nov. 6, 1991).

However, the invoices in that case did not involve a "not-to-exceed" contract. In this case, Petitioner does not appear to have included an adjustment to amortize rate case expenses over the expected life of the new rates and charges. This has the effect of not including any rate case expense in Petitioner's revenue requirement. The Commission, therefore, finds Public's proposed adjustment for rate case expense should be rejected as unnecessary.

(3) Additional Adjustments proposed by Intervenors. Intervenors proposed certain adjustments to Petitioner's pro forma O&M expense. Petitioner opposed all of Intervenors' proposed adjustments.

(a) $420,760 Cash Credit from EA2. Witness Seever proposed a downward adjustment of $105,190 to Petitioner's revenue requirement to reflect a credit Petitioner received from EA2. (Hearing Tr. At page C-64, lines 10-19). Petitioner admits it received a credit of $420,760 that covered a four (4) year period. Petitioner, however, opposes the adjustment on grounds it has already spent the credit on other improvements.

Petitioner has contracted with an independent company, EA2, to operate its water utility. According to Section 6.29A of the contract between Petitioner and EA2, Petitioner pays EA2 an annual increase of approximately 3%. The contract indicates that if the Consumer Price Index ("CPI") increases by more than 3% on an annual basis, Petitioner agrees to reimburse EA2 for the difference. If the adjustment to the CPI increases by less than 3% per year, EA2 agrees to reimburse Petitioner for the difference. Within twelve (12) months of the close of the test year, Petitioner received a $420,760 credit from EA2. The $420,760 credit represents a reimbursement to Petitioner for a lower than anticipated rate of inflation during a four (4) year period, which includes the test year. Because the rate of inflation for the test year was lower than anticipated, Petitioner's expense to EA2 for the test year was overstated by ¼ of $420,760 or $105,190. (Int. Exhibit JMS-1, page 33, lines 9-14; Hearing Tr. at page C-61, line 20 to page C-64, line 19).

Petitioner's argument that such credit should be offset by the fact that Petitioner spent the money on "other improvements" is not persuasive. There is no evidence of record as to what these "other improvements" were or if and when the "other improvements" were made. Assuming the "other improvements" actually occurred, there is no evidence indicating that the cost of the "other improvements" was not included in Petitioner's test year expenses.

We have included this issue here to ensure that Petitioner's ratepayers receive the appropriate credit. The Commission finds that Petitioner's O&M Expense should be reduced by $105,190 to reflect the credit from, and the lower than anticipated expense for contract operations with, EA2.

(b) Reimbursement from Municipal Sewer Department. Intervenors also proposed that Petitioner's O&M expense be reduced by $87,964 "to provide for a pro forma level of reimbursement from" the City's municipal Sewage Works. The City's "Refuse Department" does not appear to provide any reimbursement to Petitioner for the shared expense of billing, even though the refuse bill is incorporated on the water bill and prepared by the same personnel. (JMS-1 at 32-33.)

Petitioner's witness Mr. Skomp stated that the Refuse Department is not a separate entity or utility but is simply a department of the City's municipal sewage works. The sewage works pays an allocated share of billing and collection costs and should not have its share increased simply because "multiple charges from the Sewage Works are shown separately." (JRS-R at 21.) Based on Mr. Skomp's explanation, the Commission finds that Intervenors' proposed adjustment should be rejected.

(c) Allowance to Reflect Estimated Savings from the Installation of a SCADA System. Intervenors proposed that Petitioner's O&M expense be reduced by $154,000 "to reflect savings in power and labor costs related to the SCADA system." In his direct testimony, Petitioner's witness Mr. Thais stated that Petitioner expects to enjoy operational savings related to manpower and energy expenses that will "more than offset its total estimated cost of almost $1,540,000." (JMS-1 at 32.) Intervenors' witness Mr. Seever argued that this anticipated reduction in expense should have been reflected in Petitioner's Cost Of Service study.

Evidence from Petitioner's witness Mr. Skomp indicates that Petitioner's SCADA system is scheduled for installation in 2004. (JRS-R at 20.) Therefore, any savings that could occur as a result of placing the SCADA system into service would not begin until early 2005. The Commission finds that Intervenors proposed adjustment to offset the expense of a SCADA system with possible future savings should be denied. Intervenors proposed adjustment would take estimated 2005 savings as an offset to pro forma test year expenses. That approach falls well outside the Commission's normal parameters that accounting adjustments be fixed, known and measurable and occur within twelve (12) months following the close of the test year.

(d) Adjustments to Petitioner's Calculation of Pro Forma Revenue Requirements. Intervenors propose that Petitioner's O&M expense be reduced by $192,588 "to correct pro forma expenses." Intervenors' witness Mr. Seever argued that Petitioner failed to update its expense analysis for the test year ending March 31, 2002. (JMS-1 at 30.) Mr. Seever states that an expense analysis including an analysis of relevant invoices is available for only the first three months of the test year. (Id. at 30-31.) Mr. Seever cites three specific pro forma adjustments Petitioner proposed to test year revenues and argues that the test year amounts should exactly match the amounts shown in Petitioner's expense accounts. Mr. Seever describes the fact that the test year amount shown in the detail of an adjustment does not exactly match the amount shown in a specific expense account as a "discrepancy" or an "irregularity." (Id. at 31.)

In his rebuttal testimony, Mr. Skomp testified that he previously completed a Cost-Of-Service report for Petitioner using a June 30, 2001 test year. At that time, Mr. Skomp conducted a thorough analysis of Petitioner's expense accounts in order to prepare that report. During that analysis, Mr. Skomp discovered no items that caused him to believe an adjustment was required to test year expenses. Based on Mr. Skomp's experience with Petitioner's Manager Mr. Cameron, he did not feel it was necessary to conduct a second expense analysis, when Petitioner was required to update the cost-of-service study using a March 31, 2002 test year. (JRS-R at 19.).

Mr. Skomp stated that it is normal when working with larger utility companies that the test year amount shown in the detail of an adjustment does not exactly match the amount shown in a specific expense account. (JRS-R at 18.) Mr. Skomp stated that the fact the test year amount ($864,344) that is used in Petitioner's Adjustment (7) to annualize the cost of the customer service contract with Environmental Management Corporation ("EMC") is less than the amount shown in Petitioner's "Outside Services Employed" expense account, simply means that the cost of other outside services that were employed in addition to the EMC contract were accounted for in the "Outside Services Employed" expense account. The same would be true for the test year amounts shown on the other two adjustments identified by Mr. Seever.

Mr. Skomp also noted that the Public conducted a field audit of Petitioner's books and records and accepted each of the three adjustments disputed by Mr. Seever. (JRS-R at 19.) It appears that Mr. Seever conducted no independent analysis of Petitioner's expense accounts prior to proposing the adjustment. In contrast, the Public reviewed Petitioner's books and records and does not dispute the test year amounts and pro forma adjustments made by Petitioner. We therefore find that Intervenors' proposed adjustment should be rejected.

The Commission accepts certain adjustments proposed by the Public, including its adjustments related to salaries and wages, PERF, the additional allocation to the sewer utility, Engineering Contract, Customer Service Contract, Management Fee Contract, and health insurance. Public's adjustment for rate case expense is unnecessary and therefore is denied. The Commission accepts or denies Intervenors' proposed adjustments to Petitioner's pro forma O&M expense for the reasons set forth above. Based upon the evidence presented, the Commission finds that Petitioner's pro forma O&M expense is $7,972,698.

(B) Extensions and Replacements/Depreciation Expense. Indiana Code 8-1.5-3-8(b) provides that the rates and charges rendered by a municipal utility must be "nondiscriminatory, reasonable, and just." Indiana Code 8-1.5-3-8(c) contains a list of revenue requirement elements which this Commission should consider in determining "reasonable and just rates and charges for services" rendered by a municipally owned utility. Indiana Code 8-1.5-3-8(c)(3) provides that "reasonable and just rates and charges for services" are rates and charges that, among other things, "[p]rovide adequate money for making extensions and replacements to the extent not provided for through depreciation." This subsection gives municipal utilities the flexibility of requesting as part of their cash revenue requirements the greater of either: (i) the amount needed for making extensions or replacements, or (ii) the amount of the utility's annual depreciation expense. Specifically, I.C. 8-1.5-3-8(c), allows municipal utilities to elect to recover the higher of the two. See, Board of Directors for Utilities v. Office of Utility Consumer Counselor, 473 N.E.2d 1043, 1052 (Ind. Ct. App. 1985).

In this case, Petitioner sought an increase in revenues that was less than what would have been fully supported by its statutory revenue requirements due to use of an amount for extensions and replacements that was less than test year depreciation expense. When it filed its case-in-chief, Petitioner indicated that it was electing to recover the amount of extensions and replacements, $1,196,412, in lieu of electing to recover its higher depreciation expense requirement, $2,171,229, to reduce the resulting percentage rate increase. This decision resulted in Petitioner seeking a rate increase of 25.99% instead of 34.89%.

Based on the Petitioner's decision to seek a rate increase substantially less than what could be justified by its full revenue requirements, Mr. Skomp indicated in his direct testimony that "it should be understood that the Utility is not anticipating that the 26% increase would be used as a starting point for other parties to make further reductions." (Id. at 3-4.) Petitioner felt that a 26% increase in operating revenues was the minimum necessary to allow it to continue to operate in a safe and reliable manner.

Petitioner included within its case-in-chief a Statement of Revenue Requirements delineating the calculation of a 34.89% rate increase based upon its full revenue requirements. (JRS-1, Exhibit E.) Petitioner apparently anticipated that the Public and Intervenors would make proposed adjustments based on the amount of Petitioner's full revenue requirements, not its minimum rate increase of 26%. If the amount of revenue requirements that the parties calculated based on adjustments to the full revenue requirements differed from 26%, Petitioner expected that the parties would be able to reach agreement on the level of revenue that the new rates and charges should produce. (JRS-R at 9.)

No such agreement was reached. Instead, Public and Intervenors made proposed adjustments to Petitioner's lower revenue requirement, which was calculated using Petitioner's pro forma requirement for extensions and replacements (determined at a level that is even less than test year depreciation expense). Therefore, through Mr. Skomp's rebuttal testimony, Petitioner indicated that based on the adjustments proposed by Public and Intervenors, Petitioner "should be allowed to include its annual depreciation expense in the calculation of its statutory revenue requirements." (JRS-R at 8.)

Public and Intervenors indicated in their respective cases-in-chief that they disagreed with Petitioner's approach of seeking an increase in revenues from water rates based on the lesser of its amounts shown for extensions and replacements and depreciation, with the expectation that the other parties would begin adjustments from the full statutory revenue requirements. However, there appears to be virtually no difference between Petitioner's current proposal than if it had originally sought approval of a 34.89% rate increase using its revenue requirement for depreciation, with the intention of ultimately settling for, or accepting proposed adjustments that resulted in, a 26% increase. If the Commission were to deny Petitioner's election to include depreciation expense as a revenue requirement, we effectively would be punishing Petitioner because it originally requested an annual amount of operating revenues that is less than its full statutory revenue requirements.

Moreover, the Commission questions whether it can deny Petitioner the ability to elect to include its annual depreciation expense in the calculation of its statutory revenue requirements. The Indiana Court of Appeals has stated that the intent of I.C. 8-1.5-3-8 is to allow the greater of depreciation expense or extensions and replacements. Board of Directors for Utilities, 473 N.E.2d at 1052. To the extent that a municipally owned utility elects to include depreciation expense, in lieu of extensions and replacements in its rates, the depreciation expense is a cash revenue requirement of the utility. See, Re Town of Lowell, Cause No. 39747 (approved Dec. 1, 1993). The Commission's failure to allow a reasonable amount of depreciation expense in a municipal utility's rates could result in the gradual confiscation of the utility's investment in

depreciable property. Re Crawfordsville Electric Light & Power Co., Cause No. 39381 (approved Dec. 2, 1992). This was explained in our Order in Re Columbia City, Cause No. 39808 (approved June 1, 1994), wherein we found:

> The requirement to include depreciation expense in rates charged by municipally owned utilities has been in the statute for many years. Indiana Code 8-1-2-96, the predecessor to I.C. 8-1.5-3-8, provided that the Commission must allow revenue in rates sufficient '(1) to pay all the legal and other necessary expenses incident to the operation of such utility, including . . . depreciation, ...' Petitioner has requested sufficient revenues from rates to recover its $226,139 pro forma depreciation expense, which normally would not cover its expenditures for extensions and replacements which exceed depreciation expense. However, the Public's proposal [which reduced depreciation expense by using cash on hand] would deny Petitioner the recovery of the statutory ratemaking element of depreciation expense and effectively confiscate Petitioner's property. (emphasis added)

However, in this case, the Commission also does not feel it would be appropriate to approve a rate increase for Petitioner greater than its original proposal of 25.99%, based simply on the substitution of depreciation expense for extensions and replacements. Petitioner presented evidence that its Board intended to "temper the overall revenue request in order to reduce the impact" on Petitioner's customers. (JRS at 3.) Public and Intervenors expressed concern if Petitioner were allowed, at a late point in the regulatory process, to switch its preference between extensions and replacements and depreciation. As we discussed above, we cannot deny Petitioner's preference. However, the timing of the switch in this case disturbs us. As a nod toward Public and Intervenors' concerns, Petitioner has proposed, and the Commission finds and accepts, that Petitioner should be permitted to include its annual depreciation expense in the calculation of its statutory revenue requirements, but only to the extent that such amount does not exceed Petitioner's original estimated revenue requirement for annual extensions and replacements, or $1,196,412.

Public proposed an adjustment to Petitioner's proposed pro forma depreciation expense of $227,829 resulting in a total pro forma depreciation expense of $1,925,040. We accept this as the actual amount of depreciation expense. However, because Public's adjusted depreciation expense exceeds the amount Petitioner originally requested for extensions and replacements, we find that Petitioner should be permitted to include in its revenue requirement an annual amount for depreciation expense of $1,196,412.

In addition to Petitioner's requirement for normal extensions and replacements, all parties to this Cause have included an amount of $346,385 for "EA2 average portion of extensions and replacements." The Commission, therefore, finds that the inclusion of $346,385 for EA2's portion of extensions and replacements is reasonable and should be accepted.

(C) Taxes Other Than Income Taxes. Petitioner calculated its pro forma revenue requirement for taxes other than income taxes based on present rates to be $358,531, excluding payment in lieu of property taxes, whereas the Public's calculation of taxes other than income

taxes was $325,451. Intervenors made no adjustment to Petitioner's proposed pro forma revenue requirement for taxes other than income taxes. There are two significant differences between Petitioner's and Public's calculation of taxes other than income taxes. First, Public calculated Petitioner's pro forma adjustment for FICA expense to be $1,388 greater than Petitioner's calculation. Petitioner did not oppose this adjustment and we find that it should be accepted. Second, Public's witness Lynn testified that Petitioner should not calculate its obligation for Indiana utility receipts tax on all of its proposed revenue requirements. Based on the findings above, [See Section 8(A)(d) Utility Receipts Tax] we agree with the Public and find that a pro-forma adjustment for Taxes Other Than Income Taxes of $325,451 should be accepted and we so order.

(D) Debt Service. Petitioner calculated its pro forma revenue requirement for debt service to be $3,221,950. The Public stressed caution in approval of debt financing on Petitioner's proposed project that neither has final design work completed nor bids. The practice of using engineering estimates rather than actual bids to determine the appropriate amount of bond to issue is a concern expressed by Public's witness Bell. A problem could occur if more debt is issued than necessary. (SAB at 5.) As discussed above, Mr. Bell testified and Petitioner agreed that bids and reporting requirements can help mitigate the Public's concern. Mr. Bell further suggested that Petitioner be required to inform the Commission should it have any excess bond funds and identify the Master Plan projects it intends to complete. Intervenors calculated Petitioner's revenue requirement for debt service to be $2,209,023. Three differences between the calculation of the debt service revenue requirement advocated by Petitioner and that of Intervenors exist. The amount of the proposed capital improvements, which has been discussed above, the interest rate of the debt, and the concept of wrapping the bond issue. Petitioner proposed a bond issuance on the open market and to have equal annual payments on the contemplated bonds.

Intervenors' witness Mr. Seever questioned why Petitioner did not take into consideration retirement of old debt and why Petitioner did not consider the Drinking Water State Revolving Loan Fund ("State Revolving Loan Fund") program that has much lower interest rates than that proposed by Petitioner. Furthermore, he recommended that if Petitioner issued bonds, Petitioner should "wrap" the bond issue or amortize the bond issue so that principal payments increase as Petitioner's prior bond issues are retired. Petitioner offered no explanation as to why it decided to issue its debt on the open market and provided no objection in its prefiled rebuttal testimony to Intervenors' witness Mr. Seever's recommendation to reduce Petitioner's debt service revenue requirement by "wrapping" the proposed bond issue. Petitioner did, however, oppose the idea of "wrapping" in its Proposed Order and orally at the Evidentiary Hearing. The concept of wrapping debt is not new to this Commission. In fact, Petitioner has previously sought and obtained Commission approval for "wrapping" its bonds to minimize the impact on its customers. Furthermore, in Petitioner's Cause No. 38898, we directed Petitioner to demonstrate why Petitioner's proposed terms were a reasonable method of financing. In making our decision, we specifically found the following:

> No evidence was provided by the Petitioner [i.e., the City of Evansville] as to any alternative interest rates, time periods, inclusion with outstanding debt or other alternatives which would give us evidence of the reasonableness of the petitioning

> utility's proposal. Thus, the only evidence of record from the Petitioner is that it proposes a 7-year bond issue, for a project which admittedly has a life of 10 years or more, without consideration of outstanding debt. Based upon this evidence, we cannot find that the proposed bond issue is a reasonable method of financing the proposed capital improvements. Accordingly, we find that Petitioner's bond request should be denied. (Cause No. 38898, order issued on July 3, 1991).

Some of the same issues are present in this case. Petitioner has presented no evidence as to any alternative interest rates, financing vehicles or amortization periods which would give the Commission evidence of the reasonableness of Petitioner's financing proposal. As witness Seever summarized,

> This [wrapping] will allow the utility to achieve overall level debt service over the life of the proposed debt and it avoids any possible future 'double-recovery' of debt service resulting from retired bond issues. The 'wrapping' of the propose bonds also serves to smooth out spikes in Petitioner's revenue requirements allowing for more stable rates.
>
> (Int. Exhibit JMS-1, page 27, lines 14-19).

Thus, the Commission agrees with Intervenors that for very little cost, Petitioner can wrap the proposed bonds around existing bond issues so as to minimize the impact on Petitioner's ratepayers. By using Petitioner's proposed level of debt of $25,380,000, adjusted due to postponement of the $70,000 limefeeder, (See Petitioner's Schedule E-3) combined with Intervenors' interest rates and its proposal to wrap the debt issuance (See Exhibit JMS-3) it will result in an annual debt service of approximately $2,897,650. We find that Petitioner should wrap the proposed bonds to avoid rate shock on Petitioner's customers. In addition, Petitioner should perform a true-up as detailed at page 9 of this Order to take into consideration any changes from the proposed interest rate to the actual interest rate obtained for the bonds and it will be so ordered.

(E) Payment In Lieu Of Taxes. Petitioner calculated its pro forma revenue requirement for payment in lieu of taxes ("PILT") to be $575,095, whereas the Public's calculation was $524,186. Intervenors calculated Petitioner's pro forma revenue requirement for PILT to be $517,585. Public's witness Lynn testified that Petitioner's PILT calculation made no adjustment for the fixed property located outside its corporate boundaries. Petitioner did not oppose the Public's proposed adjustment to its pro forma revenue requirement for PILT to account for property located outside the City. Public's calculation of $524,186 was based on work done in Petitioner's last rate case, Cause No. 40488, in which Public determined how much of Petitioner's plant is located outside of the corporate boundaries. Intervenors' calculation of $517,585 is less accurate because it estimates the amount of outside the city limit plant. More than once, we've reminded Petitioner that plant that is located outside the city limits should be removed from PILT calculations. The Commission, therefore, finds that Petitioner's revenue requirement for PILT is $524,186.

(F) Working Capital. Petitioner did not include any revenue for working capital in its revenue requirement and, accordingly, we find that no additional revenue is necessary to meet working capital requirements.

(G) Interest Income Offset. Public and Intervenors originally proposed that Petitioner's test year interest income be used as an offset to Petitioner's future revenue requirements. Petitioner's interest income during the test year was $224,290. Petitioner's witness Skomp stated that while Petitioner's cash balances have remained relatively stable, its ability to earn investment income has significantly decreased during recent years. Petitioner's interest income during the calendar year 2002 was only $122,452. Based on Mr. Skomp's testimony, Ms. Lynn recommended that Petitioner's revenue requirement be offset by $122,452 as an estimate of future earnings from interest income. The Commission finds that Petitioner's cash revenue requirement should be offset by $122,452, the estimated amount of its pro forma interest income.

(H) Pro-Forma Proposed Adjustments. The Public and Intervenors proposed that forfeited discounts be included in the calculation of overall percentage increase in revenues. Petitioner had excluded forfeited discounts from the amount shown as adjusted operating revenues. With regard to the issue of whether forfeited discounts should be included in operating revenues in order to calculate the overall percentage increase in revenues that is required, the Commission finds that both the Petitioner's and the Public's approach reach similar results. Petitioner's witness, Mr. Skomp, excluded forfeited discounts from his calculations and, therefore, did not include an adjustment to Bad Debt Expense, which might also increase with higher rates. Public's witness Lynn, argues that forfeited discounts should be included, but also revised her exhibits to allow for an adjustment to Bad Debt Expense that would be required if her method were used. However, no evidence was provided as to how the Bad Debt Expense adjustment was calculated. Based on Mr. Skomp's rebuttal testimony that the two approaches would have immaterial differences if calculated properly, the Commission finds that forfeited discounts should not be included in operating revenue when calculating the overall percentage increase.

9. Aggregate Annual Revenue Requirement. Based on the evidence, the Commission finds that Petitioner's aggregate annual revenue requirement is as follows:

Revenue Requirement Elements	
Operation and Maintenance Expense	$ 7,972,698
Depreciation	1,196,412
EA2 Average Portion of Extension and Replacements	346,385
Taxes Other Than Income Taxes	325,451
Debt Service	2,897,648
Working Capital	- 0 -
PILT	524,186
Total Revenue Requirement	13,262,780
Less: Adjusted Operating Revenue	11,115,008
Revenues not subject to Rate Increase	340,044

Interest Income	122,452
Deficit	1,685,276
Plus: Utility Receipts Tax Increase	23,929
Revenue Increase Required	1,709,205
Divide by: Adjusted Operating Revenue	$11,115,008
Percentage Rate Increase Required	15.38%

Petitioner's aggregate annual revenue requirement of $13,262,780 is $2,025,320 greater than its total pro forma operating revenue of $11,115,008, when offset by interest income of $122,452. We, therefore, find that Petitioner's pro forma operating revenues from water sales should be increased by $1,709,205, or approximately 15.38%. Petitioner will generate operating revenue from water sales of $12,824,213, which when combined with Petitioner's pro forma other operating revenue of $340,044 will generate total operating revenue of $13,164,257.

The resulting rates, not including current Fire Protection Surcharges, for a typical customer will compare as follows:

Average Monthly Usage	Monthly Bill at Present Rates	Monthly Bill at 15.38% Across-the-board increase
5,000	$8.89	$10.26
7,000	$12.34	$14.24

10. Other Items: Proposed Monthly Service Charge, the Proposed "Out of Town" Surcharge and Rates for Wholesale Customers.

a. Monthly Service Charge. Exhibit O of Petitioner's Exhibit JRS-1 contains a calculation of Petitioner's proposed Monthly Service Charge by meter size. Exhibit O also reflects proposed changes in Petitioner's Equivalent Meter Factors. Mr. Skomp's proposed Monthly Service Charge for 5/8" and 3/4" meters of $3.71 is supported by his Exhibit; however, the Equivalency Factors used by Mr. Skomp appear to be excessive, have no cost support, and are not mentioned in Mr. Skomp's testimony. The purpose of the Equivalent Meter Factor is to assign meter-related costs based on meter size so that a customer with a larger meter will pay its proportionate share of the meter-related costs, typically through a higher Monthly Service Charge. Since no basis was provided for the dramatic increase in the Equivalent Meter Factors, and consistent with past Commission practice, the presumption should be that the current Equivalent Meter Factors remain valid. Petitioner has not demonstrated that the current Factors are unreasonable or that the proposed Factors are more reasonable. We therefore find that no change should be made to the Equivalency Factors when Petitioner calculates Total Service Charges.

b. Declining Block Rate Structure. Petitioner also proposes to change rate structure by reducing declining blocks from five to three. Rate design changes should be supported by cost data and a rationale provided. We find, as described in (c) following, that cost of service study in this Cause is flawed and that the rationale for this proposal is weak. We therefore find that Petitioner's proposal to change the declining block rate structure should not be accepted.

c. Proposed Surcharge. For the first time in its history of providing water service, Petitioner proposes to assess a 35% "surcharge" on customers who are located outside the City of Evansville. Petitioner's surcharge, which would be collected indefinitely, is based on the asserted premise that it costs at least 35% more across the board to serve customers who are outside Evansville's municipal boundaries than those who lie within those municipal boundaries. More specifically, Petitioner's premise urges the assumption that utility plant located outside the city limits benefits only customers located outside the city limits; whereas utility plant located inside the city limits benefits all customers of the utility including those located outside the city limits.

Petitioner's witness advocating the 35% surcharge, Mr. John Skomp of the accounting firm of Crowe, Chizek, articulated this rationale by testifying that some of the increased costs of serving outside customers would include, but not be limited to:

> The cost of capital improvements which are made outside the City Limits and provides no benefit to inside customers;
>
> The annual cost of depreciation and debt service on utility plant which is located outside the City Limits and provides no benefit to inside customers; and
>
> The annual cost of repairs and maintenance to utility plant and equipment that is located outside the City Limits and which provides no benefit to inside users.

In his testimony, Mr. Skomp explained that the 35% surcharge used in his "Prefiled Cost of Service Study and Financial Report" ("COSS") was developed as a proxy to recover a portion of these costs. Mr. Skomp acknowledged that nowhere in Petitioner's case is Petitioner's 1.35 equivalency factor demonstrated to be the result of a computation. (Hearing Tr. at A-145) In fact, while his Cost of Service Study and Financing Report was dated July 22, 2002, Mr. Skomp testified that the 1.35 equivalency factor was selected in 2001. (Hearing Tr. at A-149) Moreover, Mr. Skomp acknowledged that at the time Crowe Chizek was first engaged, Petitioner asked him to look to see if there was a cost basis to have an outside city surcharge. (Hearing Tr. at - B-21) However, in support of its argument that a surcharge is appropriate, Petitioner provided no calculation in its COSS and Financing Report showing an actual cost of serving its in-town and out of town customers. Nor did Petitioner provide this Commission any detailed engineering study comprehensively allocating specific costs to out of town customers. Nonetheless, Mr. Skomp maintained that if all the increased costs to serve customers outside the City Limits were allocated to only those customers, the percentage surcharge or "true cost" would be even greater.

First, we note that what Mr. Skomp called the "true cost" of serving the customers located outside the city limits, was never presented. The Commission can not consider a particular equivalency factor as a compromise or deviation from a more "accurate" number when

the more accurate number is not placed in evidence. A number that is not presented, in addition to being unknown, is not subjected to any scrutiny by this Commission, the Public, and Intervenors. The Commission may not accept the unsubstantiated assertion of any witness that we should adopt a particular number because he believes that the true number is much larger. Moreover, a review of cross-examination of Mr. Skomp casts some doubt as to whether such "true cost" had ever been written down and shared. (Hearing Tr. at A-142 – 143)

Second, even if we had been presented with what Mr. Skomp would call the "true cost" of serving out-of-town customers, we consider Mr. Skomp's methodology that would yield that value to be fundamentally flawed. Mr. Skomp asserted that the outside city surcharge developed and used in this Report is in compliance with the principles and methods outlined in the AWWA Manual. Mr. Skomp was of the opinion that the AWWA Manual (Hearing Tr. at B-2) provides in its entirety that the cost of the system located within the city limits should be borne by both inside city and outside city customers. The AWWA Manual in fact suggests the opposite. On the very page Mr. Skomp relied on for his assertion, the AWWA Manual provides the following:

> A government-owned utility, in most cases, where not regulated by a state public utility commission, determines its total revenue requirements, or costs of service, on a cash-needs basis; that is, it must develop sufficient revenue to meet cash needs for O&M expense, debt-service requirements, capital expenditures not debt-financed, and possibly other cash requirements as described in chapter 1. Such cash needs must be met by the utility as a whole. However, when that utility serves outside-city, non-owner customers, it is most appropriate to measure the costs of such service on a utility basis; that is, assign costs to outside-city customers for O&M expense, depreciation expense, and an appropriate return on the value of property devoted to serving them. <u>It is then the responsibility of the inside-city customers to meet all remaining cash requirements not derived from outside-city customers.</u> (emphasis added.)

But nowhere in Petitioner's entire case has Petitioner set forth cash requirements it did not regard to be derived from outside city customers. There is no single cost or revenue requirement associated with the Petitioner's system that the Petitioner's out of town customers will not be paying at least a proportionate share. Conversely, there is no single cash requirement that Petitioner would make the responsibility of the inside city customers.

For instance, Petitioner proposes that all customers located outside the jurisdictional limits of the city, and only those customers, should bear the burden of all infrastructure located outside the city and the cost of all other associated cash requirements. Conversely, Petitioner's Cost Of Service analysis assumes that all out of town customers receive the same benefit and should bear the same cost as the inside city customers for all infrastructure located <u>within</u> the city limits. If Mr. Skomp had consistently applied the methodology described in the AWWA Manual, he would not have relied on the premise that the outside city customers should equally bear the cost of improvements located inside the city limits. Moreover, there is simply no credible evidence that would support the proposition that the infrastructure located outside Evansville's municipal boundaries only provides a benefit to those located outside Evansville's

municipal boundaries while the infrastructure located inside the city limits provides an equal benefit to everyone.

Mr. Skomp's premise in this regard is speculative and not based on any specific information but depends on general, unquantified assumptions. There is no evidence such assumptions yielded quantified values that were factored into the COSS analysis. For instance, during his cross-examination Mr. Skomp claimed his analysis assumed there are improvements within the municipal limits that provide no benefit to outside city customers. But asked the value of such assets, Mr. Skomp responded that he did not look into that, and added that the engineers and Mr. Cameron have been working on that but at the time of his analysis, it was not written down. (Hearing Tr. at - B-9) Thus, it would appear that assumptions made by Mr. Skomp that would have made the "true cost" of serving out of town customers less, were never factored in. Nor were such factors even quantified as late as the evidentiary hearing. As such, even if we were to accept all of Mr. Skomp's assumptions, it is doubtful that what he would call the "true cost" was ever truly determined.

In Petitioner's last general rate case, Cause No. 40488, we ordered Petitioner to "prepare a new Cost Of Service study as part of its general rate proceeding" and added that "no party shall be bound to any specific methodology." Our statement did not relieve Petitioner of the obligation to chose a reasonable methodology and adhere to its principles. Mr. Skomp's Cost of Service Study and financing report neither satisfies our requirement that Petitioner provide a Cost Of Service study, nor does it justify imposing a 35% out of town surcharge.

Petitioner attempted to mathematically justify the 35% equivalency factor proxy for the first time in its rebuttal case, through Mr. Skomp's Exhibit JRS-5. But this five page exhibit underscores Petitioner's failure to adhere to the AWWA methodology for serving outside city customers. The AWWA manual states that after allocating costs to outside city customers, it is the responsibility of the inside-city customers to meet all remaining cash requirements not derived from outside-city customers. JRS-5 allocates revenue requirement percentages between inside city limits and outside city limits. But according to Mr. Skomp, costs in JRS-5 allocated 100% to Inside City Limits are to be borne by every customer including the out of town customers. Conversely, all revenue requirement allocation percentages attributed to Outside City Limits are to be borne only by the customers located outside the city limits. Again, nowhere in JRS-5 did Petitioner set forth a value or described cash requirements not derived from outside city customers. There is no single cost or revenue requirement associated with Petitioner's system of which the Petitioner's out-of-town customers could not be paying at least a proportionate share. Petitioner maintains it has followed the AWWA Manual's cost of service methodology for establishing out of town rates. We do not agree that the AWWA manual's allocation principle supports a 35% surcharge in this case.

In addition to failure to follow the AWWA Manual's directive to make inside city customers responsible for "all remaining cash requirements not derived from outside-city customers," JRS-5 demonstrates other inherent flaws in Petitioner's cost allocation. For example the very last line on page 3 of JRS-5 is for bad debt expense. Mr. Skomp has allocated that cost of $24,644 at 89% to Inside-City Limits and 11% to Outside City Limits. In order to attempt to justify a 35% surcharge, costs allocated to the Inside-City Limits are in fact allocated system

wide. (A review of page 4 of JRS-5, shows that 66.03% of the system wide costs are allocated to customers inside the city limits and that 33.97% of system wide costs are allocated to customers outside the city limits. Thus, $14,483 (58.72%) of bad debt expense would be allocated to the inside city customers and $10,161 (41.23%) of bad debt expense would be allocated to the outside city customers. Thus, outside city customers who represent no more than 25% of the customer base would bear more than 41% of bad debt expense. There is no evidence or analysis in the record that would support such an unbalanced allocation.

We also find that, in focusing its surcharge on whether the customer is located outside the municipal limits, Petitioner has chosen a broad classification that does not reflect the diverse use characteristics and other factors that affect the cost of providing service. Nor has Petitioner established that out of town customers necessarily have any use characteristics that are different from in town customers. So far as cost is concerned, the classification appears to be arbitrary. Based on the evidence of record, Petitioner has had out of town customers for many decades. Petitioner's efforts to create classifications based on municipal citizenship status does not reflect a policy of growth paying for the cost of increased demand. For instance, at the field hearing, we received the written comments of John Gerard, an out of town customer. Mr. Gerard testified that his home was built in 1956, less than one mile from the reservoir, that the original line was built in 1944, and that the last house was built on his road over 30 years ago. Mr. Gerard, along with his immediate neighbors, is an example of individuals who have invested in the system over many years through the payment of rates. The only basis for separate treatment is their lack of City of Evansville citizenship. There is no logical, equitable or natural basis provided for imposing a higher charge on such individuals.

It appears that Petitioner has arbitrarily drawn a line delineating customer classification along its corporate limits and then asserted that every customer on one side of the line should be considered to have one use characteristic and everyone on the other side of the line should be considered to have another more costly use characteristic. This type of allocation guarantees that customers who are on the outside of the line will be allocated a significantly larger proportion of costs than customers who are inside of the line. Even if we accept Mr. Skomp's theories and assumptions about a greater cost being created by new service demands somewhere outside the municipal boundaries, there has been no factual basis provided that would justify lumping all out of town customers together and drawing a line of demarcation at the municipal border.

Petitioner proposes that any customer outside the city limits must pay for 100% of the plant on their side of the line plus a proportionate share for all plant on the other side of the arbitrary line. This allocation guarantees that customers who are on the outside wherever the line is drawn, will be allocated a significantly larger proportion of costs than customers who are inside of that line. Yet, that mere allocation does not establish that customers who are outside of the line cost more to serve than customers who are inside. The methodology proposed by Petitioner is not based on the actual cost to serve its customers. And the fact that this line would move if the City of Evansville annexed water customers who currently live outside the limits, further demonstrates that the line is not based on cost to serve but is merely an arbitrary demarcation of rates.

Contrary to Mr. Skomp's suggestion, a municipal boundary is not a natural boundary. Whether a person lives on one side or the other of a municipal boundary does not by itself establish the cost of serving that customer. Nor does it change his or her use characteristics. It does affect whether the individual pays taxes to the city or votes in the municipal election. The obvious fact that an individual who lives outside the corporate limits has less political voice than the municipal utility's other customers and hence less recourse to address an unfairly discriminatory rate structure, renders it to be even more important for this Commission to scrutinize the cost assumptions made in setting rates for such customers.

While a customer who is not a taxpayer of the municipality is not subject to the possibility of subsidizing the utility through taxes paid, there is no evidence in this case that such subsidization has occurred or will occur. Mr. Skomp acknowledged that the customers of the system have for the most part invested in the system through the payment of rates and that the out of town customers have paid these same rates. (Hearing Tr. At A-137) Mr. Skomp further acknowledged that the proposed investment in the system will be done through rates and bonds, the latter of which will be retired through rates. Thus, there is simply no reason provided that would justify treating Petitioner's out of town customers differently than its in town customers.

Moreover, Petitioner's proposal would involve charging different rates within the same interconnected system. Petitioner's proposal would violate principles we have embraced when considering the approval of single tariff rate making. Under single tariff ratemaking a utility with multiple disconnected systems would charge the same rate for each system. In our final order in Indiana American's rate case, Cause No. 40703, discussing single tariff ratemaking, we stated the following:

> We already have a policy against considering geographical differences in costs within an interconnected system. For example, customers on the north side of town pay the same rates as customers on the south side of town even though the sources of supply, transmission mains, pumping stations and distribution lines serving these areas may have different costs.

Final Order Cause No. 40703 at p. 81 (emphasis added.)

The Commission places a heavy burden of proof on Petitioners seeking to impose disparate rates on its customers. This is particularly true when a significant portion of those customers would have no recourse by virtue of the ability to vote for or against those imposing the rates, or to this Commission. In such cases, we will seek to determine:

a. Are the proposed rates discriminatory;[3]
b. Is the Petitioner's system interconnected and functionally integrated;

[3] In Re In the Matter of the Petition of Eastern Heights Utilities, Inc. for: (1) Authority to Incur Indebtedness to the USDA Rural Utility Services; (2) Authority to Commence a Construction Program; (3) Approval of a New Unified Schedule of Rates and Charges; (4) and Authority to Issue Taxable Revenue Refunding Bonds, July 29, 1999, p. 11.

c. Do Petitioner's customers receive essentially the same type and quality of service, that is, that there is no undo discrimination among customers "so long as they are paying an equivalent price for an equivalent product". In Re Petition of Indiana American Water Company, Cause No. 40703, December 11, 1997, at p. 81.

d. Can Petitioner demonstrate, by sufficient evidence, that the cost of providing service between the customer classes can be clearly delineated and shown to be uneven.

Petitioner's proposal does not satisfy any of these criteria. If we were to accept Petitioner's proposal, we violate the policies that we affirmed in numerous prior Orders. Petitioner has not provided any compelling evidence that would leads us to abandon our current policies.

In its proposed order, Petitioner provides several assertions that relate to a Cost Of Service Study (COSS) filed in Cause No. 39554, the City of South Bend rate case. The COSS prepared by the City of South Bend employee references the "Rate and Financing Report" prepared by Municipal Consultants to acquire the rate increase data necessary to complete the COSS. A review of the South Bend COSS reveals one of the numerous shortcomings of Petitioner's cost allocation report. From the South Bend COSS, one can readily see that it costs $92,661 out of its total $7,058,393 costs to serve its "Suburban Residential" customer class (JRS-11, p.19, Table 13). Petitioner's cost allocation report does not provide such critically important information. Petitioner has failed to provide evidence necessary to support its proposal. This Commission has no idea what it costs to serve the customers living outside Evansville's city limits.

Petitioner also asserted in its proposed order that the Public agreed that the Cost Of Service Study provided in the South Bend case was "reasonable and should be used for the establishment of a new schedule of rates and charges." (Petitioner's Proposed Order at p.43.) However, as previously indicated, the Public and Intervenor identified several flaws in the cost allocation report filed in this case that were not present in the South Bend COSS. Further, a review of the South Bend COSS indicates that its "Suburban Residential" customer class was in existence when the COSS was prepared. We cannot determine the facts, circumstances and evidence that were presented to support the establishment of such a class or in what case it was presented, but it is clear that in this case, Petitioner has not supported its request to establish its proposed out-of-town customer class.

In support of its proposed surcharge, Petitioner relies on several cases from other states. We note that such cases are not binding on this Commission and can only be considered persuasive at most. We also note that in each of these cases, there does not appear to be a Commission such as ours that had jurisdiction and a statutory obligation to set just and reasonable rates. For instance, encouraging annexation is not a basis that would support a surcharge approval by this Commission. (See Mitchell v. Supreme Court of Kansas 12 P.3d 402 (Kansas, 2002)). In order to establish just and reasonable rates, we must look to the costs of providing the service to the various classes of customers. We can only approve the creation of different classes where we can reasonably distinguish the costs of serving each such class.

If we were to look to the iterations of courts of other jurisdictions, we would adopt the language of the Supreme Court of Texas in City of Texarkana v. Wiggins 246 S.W.2d 622, 626 (Texas, 1952) which stated the following:

> We are brought again, then, to what is apparent from the record of this case: the only difference between consumers who pay more and those who pay less for Petitioner's utility service lies in the fact that the former reside north of 29th Street while the latter reside south of 29th Street. The limits of a municipal corporation, of themselves, do not furnish a reasonable basis for rate differentiation.

The OUCC witness, Ms. Gemmecke also noted that, while the AWWA manual indicates that costs to be borne by outside-City customers include O&M expense, depreciation expense and an appropriate return on the value of property to serve the outside-city customers, the utility does not keep its records in such a way that this would be possible. Also, Ms. Gemmecke noted that Petitioner has failed to recognize the economies of scale that can be produced by adding customers outside the city limits. Page 12 of Ms. Gemmecke's testimony clearly illustrates that the vast majority of Petitioner's growth has been from customers outside of the city limits. Ms. Gemmecke quoted from USEPA and NARUC as follows:

> The key issue in implementing zonal rates is one of cost justification. If substantial cost differences exist within a service area, then zonal rates may be an appropriate for of rate unbundling that ostensibly attains more efficient water rates.
> JIG at 9.

The AWWA Manual, upon which the Petitioner claims to have relied in forming its COSS and Financing Report, sets forth five separate steps necessary to complete a valid Cost Of Service Study pursuant to the AWWA methodology. These include: selection of cost functions; allocation of cost to cost functions; selection of customer classes; allocation of costs to customer classes; and rate design. (Int. KAH-1, p. 9). The lengthy well-stated review of the five-step AWWA Cost Of Service analysis provided by Intervenors' witness Heid (Intv. KAH-1) would provide guidance to future applications.

We have consistently held that it is a petitioning utility's burden of proof to demonstrate that it is entitled to the relief it requests. (City of Evansville, Cause No. 38898, order issued on July 3, 1991; Michigan City, Cause No. 39994, order issued on February 8, 1995; and Indiana-American, Cause No. 40103, order issued on May 30, 1996. These cases affirm the longstanding Commission practice that Petitioner, as the proponent of change, has the burden of proof, and once the reasonableness or validity of its proposals are challenged, it cannot merely rest on its theories. As reflected in our finding below, the errors contained within the Petitioner's Cost Of Service Study are so significant that we do not believe it has offered us a valid, accurate or persuasive cost of service reallocation.

Petitioner has not provided and does not possess the information necessary to accurately calculate service costs and this can be demonstrated by Petitioner's inability to ascribe historical cost data to its infrastructure by location. We also note I.C. 8-1.5-3-10 *requires that the charges*

for service outside the corporate boundaries may not differ from the charges for service inside the corporate boundaries unless the utility clearly demonstrates significant costs that make the different charges nondiscriminatory, reasonable and just. We find that attempting to distinguish a "class" of customer based upon a political boundary has nothing to do with the cost to serve those customers, and this Petitioner has not provided sufficient evidence to justify such or distinction in this case under any reasonable theory.

d. Rates for Wholesale Customers. Petitioner currently charges its wholesale customers in the same manner as all other retail customers. Because the wholesale users use extremely large amounts of water, most of their water is billed at the lowest block rate which is currently $.65 per thousand gallons. Petitioner proposes to change the way it charges wholesale customers by implementing a flat fee of $1.17 per thousand gallons.

Petitioner's Mr. Skomp readily admits that his Cost Of Service Study does not, in any way, support or calculate the cost to serve the wholesale users. In support of the proposed rate for its wholesale users, Petitioner's witness Skomp testified that Petitioner had an agreement with the wholesale customers under which the wholesale customers would be charged $1.17 per thousand gallons. Mr. Skomp could point to no agreement, only stating that he was told that such an agreement existed by Petitioner's General Manager, Mr. Cameron.

However, when asked at the hearing about this alleged agreement with the wholesale users, Mr. Cameron testified as follows:

> Q. Mr. Skomp testified that the rate for Gibson Water is set at the second-tiered rate based upon an agreement between you and Gibson Water. Do you agree with that?
> A. I would agree that we had the conversation as to - - that they would have a separate rate separate from all of the other customers we have. I would not agree that Gibson and I spoke about what their rate would be.
> Q. Did you have any conversations with German Township regarding an agreement that they should be charged at the second-tiered rate?
> A. No.
> Q. Elberfeld?
> A. No.
> Q. So, you'd agree there is no agreement?
> A. I would say that there is no set agreement with any of the wholesale for resale as to what their rate would be. . .

(Hearing Tr. 2 p. A-51, line 18 to p. A-52, line 11).

Mr. Cameron's testimony is entirely consistent with the prefiled testimony of witnesses Seever and Burch. Witnesses Burch and Seever testified that Petitioner had no agreement with the wholesale users to charge a flat fee based upon the second block rate. Mr. Burch indicated that his firm had represented Gibson Water and German Township since their inception and no such agreement had ever existed. In its rebuttal testimony, Petitioner did not oppose Intervenors'

contention that Petitioner had no agreement with its wholesale users to charge a flat fee per thousand gallons.

Based on the evidence, the Commission concludes that Petitioner has no agreement with its wholesale customers to charge the flat, "second-block" rate proposed by Petitioner in this Cause. Mr. Skomp readily admits that his Cost Of Service Study does not calculate the cost to serve the wholesale customers or support the proposed flat rate. Thus, this Commission has no evidentiary basis for the proposed change to the wholesale customers' rates.

Petitioner did not provide the evidence required to permit the Commission to determine that the rates produced for the new proposed rate class are nondiscriminatory, reasonable and just. This Commission holds Petitioner to its burden to prove the appropriateness of the new rate classifications, and that evidence has not been provided by Petitioner in this cause. Given the lack of credible evidence proving otherwise, we find Petitioner's current rate design should continue.

e. Conclusion. Due to the numerous critical flaws in Petitioner's Cost Of Service Study and proposed rate design, the revenue increase we have previously found appropriate must, by necessity, be spread across-the-board on the existing rate structure. Further, we note the relative stability of this petitioning utility's customer base as reflected in the evidence before us.

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

1. The Petitioner is hereby authorized to commence and complete the capital improvement projects outlined in Finding No. 6 of this Order.

2. Petitioner shall file annually with the Commission and provide the Public and Intervenors, through counsel, and individually with Intervenors, a copy of the report outlining the status of each capital improvement project funded by the proposed bonds. In a manner consistent with this order, Petitioner shall be and is hereby authorized to issue waterworks revenue bonds in a principal amount not to exceed $25,380,000 in order to fund the capital improvement projects approved herein.

3. Prior to issuing such waterworks revenue bonds, Petitioner shall endeavor to obtain as many bids as reasonably possible and shall file a bid tabulation report with the Public and Intervenors.

4. Petitioner shall file a true-up report reflecting the actual debt service, debt service reserve requirements and actual cost of the capital improvement project in accordance with Finding No. 6 of this Order.

5. Petitioner is hereby authorized to increase its rates and charges for utility service by $1,709,205, and to place into effect new schedules of rates and charges so as to produce total

annual operating revenues of $13,164,257 representing a 15.38% overall increase in its rates and charges.

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

7. In accordance with I.C. § 8-1-2-85, Petitioner shall pay a fee of twenty-five cents ($0.25) for each $100 of revenue bonds issued, into the Treasury of the State of Indiana, through the Secretary of this Commission, within thirty (30) days of the receipt of the financing proceeds authorized herein.

8. In accordance with I.C. 8-1-2-70, Petitioner shall pay the following itemized charges within twenty (20) days from the date of this Order, into the Treasury of the State of Indiana, through the Secretary of this Commission:

Commission Charges	$200.00
Reporting Charges	356.12
Legal Advertising Charges	105.35
OUCC Charges	500.00
TOTAL	$1,161.47

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

McCARTY, HADLEY, LANDIS, RIPLEY AND ZIEGNER CONCUR:
APPROVED:

FEB 18 2004

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

Nancy E. Manley

Nancy E. Manley
Secretary to the Commission