STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: IOWA-AMERICAN WATER COMPANY	DOCKET NO. RPU-2011-0001

FINAL ORDER AND ORDER APPROVING SETTLEMENT

(Issued February 23, 2012)

I. PROCEDURAL HISTORY AND INTRODUCTION

On April 29, 2011, Iowa-American Water Company (Iowa-American) filed with the Utilities Board (Board) a proposal for a general increase in temporary and final water rates. Iowa-American proposed a temporary increase that would produce additional annual revenue for Iowa-American of approximately $4.4 million, or about 13.72 percent, and a permanent increase that would produce additional annual revenue of approximately $5.1 million, or 16.4 percent more than existing rates. On May 26, 2011, the Board docketed the proposed increases for further investigation and set a procedural schedule. The proceeding was identified as Docket No. RPU-2011-0001. Iowa-American and the Consumer Advocate Division of the Department of Justice (Consumer Advocate) are the only parties to this proceeding.

Iowa-American serves customers in two districts, the Quad Cities district and the Clinton district. The Board held consumer comment hearings in the Clinton district on June 14, 2011, and the Quad Cities district on June 16, 2011. In Iowa-

American's most recent rate case, Docket No. RPU-2009-0004, the Board equalized the rates between the two districts, except for private fire service rates.

On July 28, 2011, the Board issued an order allowing Iowa-American to increase its total revenue on a temporary basis by approximately $2.29 million, or about 6.93 percent. Iowa-American opted to have the Board decide temporary rates rather than implementing temporary rates itself within ten days of filing. Iowa Code § 476.6(10).

In its decision on temporary rates, the Board emphasized that its decision regarding private fire service rate design was for temporary rate purposes only and that, based on information received at the consumer comment hearings, the Board intended to look at private fire service rate design in the full rate case. On August 1, 2011, the Board issued an order requiring Iowa-American to file additional information about rate design for private fire service rates. Iowa-American filed additional information on private fire service on August 16, 2011

On October 14, 2011, Iowa-American and Consumer Advocate filed a "Settlement Agreement" and a motion to approve the agreement. The Settlement Agreement resolved all outstanding issues except three: 1) whether Iowa-American's proposed Revenue Adjustment Clause (RAC) should be approved; 2) whether Iowa-American's proposed Qualified Infrastructure Plant Adjustment Clause (QIP) should be approved; and 3) whether double leverage should be applied in this case. The Settlement Agreement did not specifically address private fire service rates; the settling parties accepted Iowa-American's initial position that private fire service rates would continue but the rates for the two districts would be equalized.

The parties filed a "Joint Statement of Issues" on October 19, 2011. In the joint statement, Iowa-American said it was withdrawing the RAC issue, leaving only QIP and double leverage as contested issues between the parties.

On October 20, 2011, the Board issued an order requiring additional information concerning the rates necessary to produce the proposed settlement increases and the billing units that would be used to establish the final rates to be approved by the Board. Iowa-American filed the required information on November 1, 2011. The Board also asked for additional information regarding private fire service and rates on October 24, 2011; Iowa-American filed its response on November 1, 2011.

A hearing was held on November 7, 2011. At the hearing, the Board asked for certain additional information. The information was subsequently filed and identified as Exhibits 3, 4, 5, 6, 7, and 8. All the exhibits were admitted into the record.

Iowa-American and Consumer Advocate each filed initial and reply briefs. A motion to file an amicus brief was filed jointly by MidAmerican Energy Company and Black Hills/Iowa Gas Utility, LLC, on December 5, 2011. On December 13, 2011, the Board denied the motion.

II. SUMMARY OF SETTLEMENT AGREEMENT

The Board has the authority to resolve contested cases, in whole or in part, by settlement. In evaluating a proposed settlement, the Board examines whether the settlement is reasonable in light of the whole record, consistent with law, and in the public interest. Iowa Code § 17A.12(5) (2011); 199 IAC 7.18(6).

The Settlement Agreement contains two revenue requirements, one if the Board applies double leverage ($2,500,000 annual increase) and another if the Board does not apply double leverage ($3,563,481 annual increase). The Settlement Agreement states that the parties have agreed that the return on equity to be used by the Board in deciding the double leverage issue shall be 10.3 percent.

In addition to the agreement regarding the annual increase, the parties have agreed that Iowa-American will also be permitted to recover in rates its actual reasonable rate case expenses, amortized over a three-year period; this amount is not yet known. Because either annual increase exceeds the $2.29 million allowed in temporary rates, there will be no refunds if the Settlement Agreement is approved.

The Settlement Agreement, as modified by the Joint Statement of Issues, resolves all but two issues between the parties. In addition to double leverage, the Board must decide whether Iowa-American's proposed QIP clause should be approved.

The Settlement Agreement contains language in Article IV that it does not become effective "unless and until the Board enters an order approving the

Agreement in its entirety without condition or modification, unless otherwise agreed by the Parties." In other words, if the Board wants to modify certain portions of the Settlement Agreement, both parties would have to agree to the modifications, or the Settlement Agreement does not go into effect.

While the Settlement Agreement does not explicitly address private fire service, Article X of the Settlement Agreement states that the parties agree that the rate design proposed by Iowa-American will be used. Iowa-American's rate design proposal retains private fire service rates but equalizes the rates between Iowa-American's two districts.

The Board asked the parties to address in brief whether a Board decision modifying the parties' proposal on rate design with respect to private fire service would render the Settlement Agreement null and void. Consumer Advocate in its reply brief (p. 13) said that a change in private fire service rate design might result in a change in the terms of the Settlement Agreement, but based on Consumer Advocate's understanding of the proposed modifications it believes the Settlement Agreement could be modified to accommodate the changes. In its initial brief, Iowa-American said (p. 26) that if the Board modifies the private fire rate design proposal, the parties would have the option to accept the modification; if the modification was not accepted, the settlement would be null and void. In other words, the parties have not committed to accepting any changes in the proposed private fire rate design and any change to private fire rates (other than equalizing rates between the two districts) would have to be accepted by both Iowa-American and Consumer Advocate or the settlement is null and void.

Before discussing the Settlement Agreement, the Board will separately address the two contested issues, QIP and double leverage, as well as private fire service rates.

III. QIP

Iowa-American proposed an automatic adjustment mechanism for qualified infrastructure plant replacement, or QIP, to assist in the replacement of Iowa-American's aging infrastructure. Iowa-American said its QIP proposal is designed to recover a return on and return of capital investments to replace or rehabilitate qualified non-revenue producing plant, including transmission and distribution mains and hydrants. Under Iowa-American's proposal, the surcharge would only apply to eligible completed plant additions that were installed after the first month of the effective date of new base rates approved by the Board; the investment would be recorded for each six-month period and filed with the Board for approval. Iowa-American said the surcharge would be cumulative until its next full rate case, when the completed plant would be placed in rate base. Iowa-American proposed to cap the surcharge at 5 percent of revenue billed to customers with an annual reconciliation to ensure that actual revenues collected equaled the level of revenue allowed by the Board.

Iowa-American said a substantial portion of its infrastructure is between 50 and 100 years old and nearing the end of its useful life; at Iowa-American's current replacement rate of 0.3 percent annually for buried infrastructure, it will take 300 years to replace these facilities, well beyond the useful life of the current facilities. Iowa-American said its goal is to increase replacements over a period of years to reach a 1 percent annual level for mains and a 2 percent annual level for valves and hydrants. Iowa-American said establishment of a QIP would provide Iowa-American with an incentive to increase the rate of targeted infrastructure improvement by reducing regulatory lag. Iowa-American said the frequency of its rate cases might not decrease but infrastructure replacement would increase.

Consumer Advocate argued there was insufficient evidence for establishment of a QIP and that regulatory lag acts as a deterrent to the tendency of monopoly companies to make spending decisions without sufficient consideration of alternatives, which drives up costs. Consumer Advocate noted that Iowa-American did not want to share any benefits of QIP with its customers, either in the form of a lower rate of return to reflect reduced risk or a commitment to file rate cases less frequently. Consumer Advocate said Iowa-American failed to present sufficient evidence to support QIP, including a proposed timetable for replacement of infrastructure and a study showing the amount of increased investment expected each year.

The use of automatic adjustment mechanisms to address specific costs is authorized by Iowa Code § 476.8 and the Board has approved such mechanisms when they meet certain criteria. The Board has also rejected adjustment mechanisms proposed by Black Hills/Iowa Gas Utility Company, LLC (Black Hills), or its predecessors. See, Black Hills/Iowa Gas Utility Company, LLC d/b/a Black Hills Energy, "Order Approving Modified Settlement and Tariffs Implementing Modified Settlement," Docket Nos. RPU-2010-0002, TF-2011-0024, TF-2011-0076 (2/10/2011). Black Hills' proposal would have allowed recovery of a return on and return of eligible capital infrastructure improvements through a surcharge between general rate proceedings. Like Iowa-American, Black Hills typically files general rate proceedings every two years.

Traditionally, an automatic adjustment mechanism is a device that permits utility rates to be adjusted up or down automatically in relation to fluctuations in certain defined operating expenses, allowing increases or decreases in costs to be passed on to customers with no profit or loss to the utility. Many states, including Iowa, have adopted adjustment mechanisms for electric utilities for fuel costs. Automatic adjustment clauses have also been used by various states for certain other expenses.

The Board has established standards for automatic recovery of fuel costs. The costs must be incurred in supplying energy, beyond the direct control of management, subject to sudden important changes in level, an important factor in determining the total cost to serve, and readily, precisely, and continuously separated in the accounts of the utility. 199 IAC 20.9(1). The rule allows the utility to recover fuel costs on a dollar-per-dollar basis, but does not allow the utility any profit on these expenses.

The Board found the mechanism proposed by Black Hills did not meet the factors outlined in the fuel adjustment rules that the Board has used to evaluate proposed adjustment mechanisms for other purposes. However, the Board recognized that for natural gas utilities an automatic adjustment mechanism that allowed for a recovery of and return on investments that were required because of government action or federal and state pipeline safety regulations might be appropriate. The Board adopted rules (199 IAC 19.18) which provide for such an adjustment clause, as long as the particular investment being recovered (a) does not increase revenues by directly connecting the infrastructure replacement to new customers, (b) is in service but was not included in the gas utility's rate base in its most recent general rate case, and (c) replaces or modifies existing infrastructure in a manner required by state or local government action or is required to meet state or federal natural gas pipeline safety regulations. The Board adopted a four-year sunset provision in the rule to allow the Board to review the workings of the adjustment mechanism to ensure that there are no unforeseen adverse impacts. <u>See</u>, <u>Capital Infrastructure Investment Automatic Adjustment Mechanism for Rate-</u>

Regulated Natural Gas Utilities, "Order Adopting Rule," Docket No. RMU-2011-0002 (10/13/2011).

Iowa-American's proposed QIP does not meet the traditional factors evaluated in determining whether to allow an automatic adjustment mechanism. The first factor is whether the costs proposed for automatic recovery are beyond the direct control of management. Iowa-American has not argued that the capital investments that would be recovered through QIP meet this test. Iowa-American's argument is focused on regulatory lag and the need to increase the rate of Iowa-American's infrastructure replacement, which are considerations that management can control to a significant extent.

The second factor is whether the costs are subject to significant variations. Iowa-American said that its annual expenditures for replacing infrastructure have been generally constant the last five years, with variations primarily due to road projects; there have not been significant changes in expenditure levels and Iowa-American does not foresee any major road projects for 2014 or 2015. (Tr. 212). The second factor is not satisfied either.

The third factor to consider is whether the proposed QIP costs are a significant part of Iowa-American's costs of providing service. In this proceeding, Iowa-American presents a rate base of $88,690,000. Iowa-American's total investment in 2010 for hydrants, valves, services, and meters was $2,589,958, and continued investment at this level might not be completely eligible for inclusion in

Iowa-American's proposed QIP. Thus, based on historical data, the level of investment potentially eligible for the QIP is less than 3 percent of Iowa-American's rate base. Iowa-American has not shown that the proposed QIP costs are significant enough to justify an automatic adjustment clause.

The proposed QIP does not satisfy any of the three traditional factors that the Board normally considers when deciding whether to approve a proposed automatic adjustment clause. Under the traditional test, the QIP should be rejected.

As the Board recognized in the natural gas adjustment clause rules, there can be circumstances that justify adjustment clauses (at least on a trial basis) that do not comport with the traditional regulatory scheme for adjustment clauses. However, Iowa-American has not made a case for approval on this basis. The identified justifications (regulatory lag and infrastructure replacement) do not amount to such unusual circumstances as would justify a departure from traditional standards.

Regulatory lag is not a sufficient justification for implementing the proposed QIP. Based on the Board's statutes and rules, Iowa-American can recover capital infrastructure investment placed in service within nine months after the close of the test year through a general rate case. Iowa-American can also begin recovering capital infrastructure placed in service within ten days of the filing of a general rate increase filing through temporary rates. See, Iowa Code § 476.6(10). If Iowa-American continues to file a rate case every two years, recovery of capital expenditures will begin no later than 12 to 18 months after each investment was placed in service, meaning that there is little regulatory lag. Moreover, the company's rate of return on its investment is based, in part, on the risks it bears, including any risks associated with regulatory lag. If that risk were reduced or eliminated, it would be appropriate to reconsider the company's allowed return on equity to determine whether the risk-reward relationship should be adjusted. In any event, Iowa-American's situation with respect to regulatory lag is not unusual and does not provide a basis for the QIP.

As for the need to replace aging infrastructure, Iowa-American presented no real, immediate, concrete plan for replacing water mains and did not indicate that the QIP would result in acceleration of those plans; Iowa-American appears to be more reactive than proactive in replacement, driven by breakage and highway relocations and not a systematic replacement schedule. For example, Iowa-American states that it wants to increase the main replacement program from 0.3 percent of mains per year to 1.0 percent of mains per year, but it has no immediate plans to reach the 1.0 percent level, saying that it wants to increase the percentage over a 20-year period. This raises questions whether aging infrastructure for mains is a serious problem for Iowa-American or whether Iowa-American has reasonably and prudently implemented its past and current main replacement program.

Similarly, Iowa-American's witnesses testified that Iowa-American loaded construction costs into the test year period before a general rate filing, which could increase the apparent average annual cost of infrastructure improvements. Rather than supporting a QIP mechanism, these construction timing decisions also raise questions about management practices, as it appears the company may be more concerned with financial matters than with infrastructure issues.

For hydrants, valves, services, and meters, Iowa-American has systematic maintenance and replacement programs that are included in its budget and which appear to be adequately funded. For mains, the primary driver for replacement appears to be breakage and highway relocations with no systematic replacement schedule; this type of maintenance practice does not support an automatic adjustment mechanism like QIP.

In addition, Iowa-American has not demonstrated that ratepayers will benefit from a QIP, either in the form of increased time periods between general rate cases (which Iowa-American declined to commit to) or a reduction in the rate of return on the QIP investment to reflect reduced regulatory lag. The Board is particularly concerned about the time between rate cases for a relatively small company like Iowa-American because of the amount of rate case expense generated by these every-other-year filings as compared to the increase ultimately approved by the Board. Reasonable rate case expense is recovered from Iowa-American's ratepayers and approval of the QIP mechanism would likely mean mini-increases for Iowa-American's customers every six months and larger increases every two years, with no reduction in overall rate case expense because of fewer rate filings.

Iowa-American's five-year plan has projected investments covered by its proposed QIP and those proposed investments are not dramatically different in amounts than investments Iowa-American made in the previous five years. Also, Exhibit 6, Schedule 3, shows that only 15 percent of Iowa-American's system is over 80 years old. Replacement of aging infrastructure is an important issue for Iowa-American, but the record in this case does not demonstrate that a QIP clause is necessary or reasonable, particularly when the traditional tests for an adjustment clause have not been satisfied, Iowa-American's plans are so indefinite, and there are no tangible ratepayer benefits.

IV. DOUBLE LEVERAGE

In looking at a rate-regulated utility's capital structure, the Board traditionally considers the capital structure of the utility company, which includes debt, or the first layer of leverage, as well as any debt at the parent holding company level that could be used for a capital infusion into the utility, which is the second layer of leverage. Without the double leverage adjustment, a parent company could manipulate its debt and equity at the parent and subsidiary levels to earn an equity return on long-term debt that is actually invested in its utility subsidiary.

The Board has rejected utility efforts to avoid double leverage adjustments in several cases, including Docket Nos. RPU-02-3, RPU-02-8, and ARU-02-1. However, the Board in those cases said it would not apply double leverage mechanically in each case, but rather would examine the particular facts and circumstances in each case where the adjustment is proposed.

The Iowa Supreme Court has affirmed the Board's use of double leverage on two occasions, although it is important to note the Court did not mandate that double leverage be applied in all situations. General Telephone Co. of the Midwest v. Iowa State Commerce Comm'n, 275 N.W.2d 364, 369 (Iowa 1979); United Telephone Co. v. Iowa State Commerce Comm'n 257 N.W.2d 466, 479-80, 482 (Iowa 1977). The Board made a narrow exception to the application of double leverage in an Iowa Electric Light and Power rate case. In Docket No. RPU-89-3, the utility provided four factors that demonstrated how the parent's debt did not result in an increase in the utility's common equity. In other words, it was shown in the record in that case that the parent company's debt did not support the utility's capital structure. (Docket No. RPU-89-3, "Final Decision and Order" (4/30/1990), pp. 47-49). In Docket No. RPU-91-9, one of the factors changed so the Board once again applied double leverage to the company.

Double leverage has been addressed in recent cases involving Interstate Power and Light Company (IPL), a subsidiary of Alliant Energy. In Docket No. RPU-02-3, a debt issue by Alliant Energy Resources (AER), an Alliant Energy subsidiary, was at issue because Alliant Energy fully and unconditionally guaranteed that debt in 2000. Consumer Advocate proposed including this debt issue as part of Alliant Energy's capital structure and then applying double leverage because Alliant Energy guaranteed the debt. The Board denied Consumer Advocate's adjustment because the evidence showed that none of the proceeds from that debt could have been used to support the equity in Alliant Energy's utility subsidiaries. The Board said:

> Consumer Advocate in its double leverage adjustment not only included the $24 million debt issue but also included Alliant Resources' debt that is guaranteed by Alliant Energy. This is a non-traditional use of double leverage and is contrary to the premise that the parent issues debt in order to infuse equity into a utility subsidiary. (Tr. 1610, 1699-1700). Alliant Resources is the non-regulated subsidiary of Alliant Energy, IPL's parent. Alliant Resources' debt is kept separate from IPL and has not been used to infuse equity into IPL. Each company issues its own debt to fund its own operations. Consumer Advocate admitted that Alliant cannot use the proceeds from Alliant Resources' debt issues. (Tr. 2099-2101).
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> While Alliant Energy has fully and unconditionally guaranteed Alliant Resources' debt, IPL is not responsible for paying the debt if there is a default and none of its assets were pledged as collateral for the debt. Alliant Energy can use any source of funds it has to pay the debt in the event of a default, such as dividends or the issuance of equity or debt. IPL noted that it has several restrictions on its bonds and equity ratios such that it is unlikely that IPL could be a significant source of money for Alliant Energy to repay the debt. (Tr. 1701-1701A). Even if Alliant Energy wanted to sell some or all of IPL's assets to pay the debt, Board approval would be required pursuant to Iowa's reorganization statutes, Iowa Code §§ 476.76 and 476.77. Most importantly, the proceeds from the debt were not used to invest in the common equity of IPL or any other subsidiary, so the underlying theory behind a double leverage adjustment is not present.

<u>Interstate Power and Light Company</u>, "Final Decision and Order," Docket No. RPU-02-3, pp. 59-60 (4/15/2003).

After the Board's decision in IPL's rate case in Docket No. RPU-02-3, Alliant Energy assumed AER's debt, meaning that the debt was included on Alliant Energy's books and was part of the parent company's capital structure. Also, the AER debt that was assumed by Alliant Energy had been largely replaced by new debt issued by Alliant Energy. Alliant Energy initially used cash on hand and a bridge loan to fund the replacement, later issuing $250 million worth of five-year notes.

In a subsequent IPL rate case, Docket No. RPU-2009-0002, the Board found that there had been no real change from Docket No. RPU-02-3 in the sense that none of the proceeds from that debt could have been used to support the equity in Alliant Energy's utility subsidiaries. The Board did not apply double leverage. Because the proceeds from the debt were not used to invest in the common equity of IPL, a utility subsidiary, or any other subsidiary, the Board found that the underlying basis for a double leverage adjustment was not present. However, the Board indicated that if there was an equity infusion into IPL after the date of the debt issuance, then a double leverage adjustment might be appropriate.

IPL's next rate case was Docket No. RPU-2010-0001. Since the Board's decision in Docket No. RPU-2009-0002, IPL had received two equity infusions of $25 million each in January and February of 2010; both of these were subsequent to the issuance of Alliant Energy debt in October 2009. Because of the recent equity infusions, the Board found it was once again appropriate to apply the double leverage adjustment.

Since 1977, double leverage has been applied to Iowa-American. Iowa-American in this case argues that it qualifies for an exception like IPL had in the cases described above because there were no cash proceeds from debt issues available to invest in Iowa-American's common equity. Iowa-American's arguments are based on events that began in 2006 when RWE, the parent of American Water Works (AWW), wanted to divest the part of the company containing AWW, Iowa-American's parent. Iowa-American witness Rogers explained the merger and divestiture between RWE and AWW:

> RWE, through a company called Thames Water, which was an English company, made an offer of cash to then American Water Works shareholders. It paid cash to American Water Works shareholders, and then set up an intermediate holding company between RWE well technically Thames Water—and American Water, which issued preferred stock. As I discussed earlier, their reason for issuing preferred stock was to manage relative tax laws. So they became the sole shareholder of the preferred, as well as the sole shareholder of the common. Not too many years after RWE bought American Water Works from the shareholders, they decided that they did not want that investment anymore, so they needed to do two things: They needed to refinance the preferred stock that they held, as well as sell out the common shares. The way that they elected to do that was to refinance the preferred stock with debt, and then in the course of the 2007-2009 time period, sell common equity to individual and institutional shareholders here in the United States. Back to the preferred stock. They refinanced the preferred that they held with debt where they were the sole lender, and then over time, that debt, which was $1.75 billion, was refinanced with other debt in the public markets with American Water Works Capital Corporation as an intermediary. That 1.75 billion of preferred became the

> 1.158 billion on the 13-month rolling average here or the 1.17 billion at year-end 2010. (Tr. 548-50).

Iowa-American argued that since the long-term debt issued in 2007 by AWW could not have been used to infuse equity into Iowa-American and there were no cash proceeds available to invest into Iowa-American's common equity, double leverage should not be applied because the parent's debt was not used to infuse equity into the utility subsidiary. (Tr. 45-47).

Consumer Advocate argued that an appropriate balancing of shareholder and customer interest requires the application of double leverage so that the utility's return on its equity investment is neither below nor above what is fair and reasonable. Because Iowa-American is not owned by individual investors but by AWW, the weighted average cost of capital for AWW should be used for determining the cost of equity for Iowa-American.

Consumer Advocate said the Board's prior exceptions to the application of double leverage are not applicable to this proceeding. Consumer Advocate noted that AWW's debt issue used to redeem the preferred stock simply replaced one source of capital with another source of capital that was used to invest in AWW's subsidiaries; refinancing capital does not qualify for one of the Board's exceptions to the application of double leverage.

Fungibility of capital is important to understanding the concept of double leverage. When sources of capital are part of an overall holding company pool of funds available for investment, the funds cannot be separately identified and assigned. Here, AWW replaced one source of capital (preferred stock) with another source of capital (debt), but those funds remained part of the capital pool that could be invested in AWW's subsidiaries, including Iowa-American.

Iowa-American does not qualify for an exception to the application of double leverage simply by replacing one source of capital with another. While the refinancing proceeds paid off the preferred stock, the debt became part of AWW's capital pool available for investment. The overall capital available did not change with the refinancing. In addition, like in IPL's last rate case where double leverage was applied, the record shows that Iowa-American received a subsequent equity infusion in December 2010. (Tr. 42).

V. PRIVATE FIRE SERVICE

Based on public comments received at the consumer comment hearings in Clinton, the Board took a close look at rate design issues for private fire service in this proceeding. Some Iowa-American customers at the consumer comment hearings expressed the belief that the costs of private fire service should be shared by all Iowa-American customers. On August 1 and October 24, 2011, the Board issued orders requiring that additional information regarding private fire service be filed.

Iowa-American provides three separate and distinct services to its customers. Iowa-American's primary business is supplying general metered service, or potable water, to its customers. Iowa-American also provides public fire service, which consists of the delivery of water to public fire hydrants for the purpose of fighting fires. The costs of the service are spread among all of Iowa-American's customers because all customers benefit. The third type of service, private fire service, is provided to customers with fire protection facilities specifically dedicated to their property (i.e., sprinkler systems) to protect the property from fires. Currently, private fire service is paid for by the customer requesting the service; private fire service customers are predominately commercial, industrial, and other public authority customer classifications.

The Settlement Agreement adopts the rate design proposed by Iowa-American in this case, which includes uniform percentage increases across all customer classes, including private fire, and the equalization of private fire service rates between the Clinton and Quad Cities districts. Private fire service is the only rate that has not been equalized between the two districts.

Iowa-American said its proposal regarding private fire service should be approved and that requiring the costs of that service to be shared by all other customers violates cost-of-service ratemaking principles and would be inherently unfair to customers who do not choose to have private fire service. Iowa-American said its facilities dedicated to general metered service and public fire service benefit all customers and the costs of those facilities are appropriately spread to all customers. However, the facilities to provide private fire service benefit only a small portion of Iowa-American's customers and the costs of those facilities should be paid by those customers. Iowa-American said any reduction or elimination of private fire service rates which is not based on a cost-of-service study would be arbitrary.

Consumer Advocate also recommended that the Board approve the Settlement Agreement, arguing that rate design changes to private fire service might result in customers who do not contract for the service having to pay a portion of the costs of the service. Consumer Advocate said the Board should be guided by the basic regulatory principle that costs should be borne by those requesting and benefiting from the service that the costs support.

Consumer Advocate said that it understood the potential justification for spreading some or all of the costs of private fire service to all customers because a sprinkler system might prevent a fire from spreading to surrounding structures. However, Consumer Advocate said, the fundamental difficulty with the argument is that it is a benefit those customers did not request and arises because of a risk created by others due to their own circumstances. Consumer Advocate pointed out that there is nothing in the record of this proceeding that would provide a way to quantify customers' reduced risk of fire in order to determine the percentage of the charge that could fairly be allocated to general metered customer classes. Consumer Advocate also noted that those with private fire service likely offset the cost with lower property insurance rates that reflect the reduced risk of fire and that reallocation of private fire service rates would effectively be a reallocation of property insurance costs.

As discussed in Section VI, the Settlement Agreement equalizes private fire service rates, which would reduce private fire service rates to Clinton customers by over 9 percent. Several Clinton customers voiced concerns about private fire service rates at the consumer comment hearings; equalizing private fire service rates will provide those customers with some relief.

However, additional information is necessary for the Board to consider any other changes for private fire service rates. The record in this proceeding does not support an arbitrary percentage reduction or elimination of private fire service rates, in part because no new class cost-of-service study was performed. Because rates are generally based on the cost of providing service, the Board cannot determine what the actual costs of private fire service are without a new class cost-of-service study. It is important to note that any percentage reduction to private fire service rates would be assessed to all general metered service customers (including residential customers), increasing their rates; only a small percentage of general metered service customers subscribe to private fire service.

The Board will rectify the lack of information in this proceeding by imposing additional filing requirements for Iowa-American's next rate filing. In its next rate filing, Iowa-American will be required to provide the following:

1. A new class cost-of-service study for all services, including the cost basis for private fire service rates.

2. Information on the incremental cost to Iowa-American associated with adding an additional private fire service customer. This analysis is to include a discussion of whether private fire service reduces demand for public fire protection service.

3. The private fire service rates charged by each AWW affiliate and a detailed explanation of the methodology used for determining those rates.

4. Information on what similar-sized Iowa cities charge for private fire service and, if available, the methodology those cities use to determine private fire service rates.

5. Information on how Iowa-American's private fire service rates might change if a building's occupancy or use changes.

6. Information on how subscribing to private fire service impacts subscribers' insurance rates.

7. A detailed record of all customer complaints or other communications regarding private fire service rates from January 1, 2012, to the date of the filing of Iowa-American's next rate proceeding.

VI. SETTLEMENT AGREEMENT

The Board has the authority to resolve contested cases, in whole or in part, by settlement. In evaluating a proposed settlement, the Board examines whether the settlement is reasonable in light of the whole record, consistent with law, and in the public interest. Iowa Code § 17A.12(5) (2011); 199 IAC 7.18(6).

The Settlement Agreement provided revenue requirements for Iowa-American with and without double leverage. Because the Board has decided to apply double leverage, the Settlement Agreement provides a $2.5 million annual increase for Iowa-American, slightly above temporary rates. The revenue increase provided for in the Settlement Agreement is reasonable; for example, there were some capital improvement adjustments that were deemed inappropriate for temporary rate purposes that would be appropriate for inclusion in final rates.

The Settlement Agreement provides for an across-the-board uniform percentage increase to the monthly service charge and consumption rates to implement the revenue increase. Exhibit 3 reflects the rates provided for in the Settlement Agreement, with and without the application of double leverage. Private fire service rates will be equalized, completing the equalization process begun in Iowa-American's last rate case, Docket No. RPU-2009-0004. Equalizing private fire service rates will reduce rates for the higher-priced Clinton district by over 9 percent, providing relief to those who spoke about private fire service at the consumer comment hearings. The Settlement Agreement will also allow increased charges for reconnection of service, returned check charge, and new customer activation; these changes were implemented in temporary rates. Finally, the Settlement Agreement provides that actual and reasonable rate case expense will be amortized over a three-year period.

With the filing requirements imposed by the Board for Iowa-American's next rate case in Section V regarding private fire service, the Settlement Agreement is reasonable in light of the whole record, consistent with law, and in the public interest. The Settlement Agreement will be approved.

VI. FINDINGS OF FACT

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

1. It is reasonable for purposes of this proceeding to apply double leverage to Iowa-American.

2. It is unreasonable based on the record in this proceeding to allow Iowa-American to recover qualified infrastructure improvement expenditures through an automatic adjustment clause.

3. Based on the evidence in this proceeding, it is unreasonable to make changes to private fire service rates beyond equalization of rates between the Clinton and Quad Cities districts.

4. The Settlement Agreement entered into between Iowa-American and Consumer Advocate is reasonable, consistent with law, and in the public interest.

V. CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to Iowa Code chapter 476 (2011).

VI. ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposed tariffs filed by Iowa-American Water Company on April 29, 2011, identified as TF-2011-0053 and TF-2011-0054, and made subject to investigation as part of this proceeding, are declared to be unjust, unreasonable, and unlawful.

2. The Settlement Agreement filed by Iowa-American Water Company and the Consumer Advocate Division of the Department of Justice on October 14, 2011, is approved.

3. Iowa-American Water Company shall file tariffs reflecting the consolidation of the Clinton and Quad Cities zones and in compliance with the settlement and this order within 20 days from the date of this order, reflecting rates that produce additional annual revenues (above test year revenues) of no more than $2,500,000. Iowa-American shall include with its compliance tariff filing a revised version of Post-Hearing Exhibit 3, filed November 15, 2011, in electronic and hardcopy format. The compliance tariffs shall become effective upon approval by the Board.

4. In its next general rate case filing, Iowa-American shall include with its initial filing the information regarding class cost-of-service and private fire service identified in the body of this order.

5. This order constitutes the final decision of the Utilities Board in Docket No. RPU-2011-0001.

UTILITIES BOARD

/s/ Elizabeth S. Jacobs

/s/ Darrell Hanson

ATTEST:

/s/ Judi K. Cooper
Executive Secretary, Deputy

/s/ Swati A. Dandekar

Dated at Des Moines, Iowa, this 23rd day of February 2012.