

March 1, 2005

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RE: Commissioners Award Letter – Fair Market Value of Peoria District Waterworks

Dear Messrs. Conner and Howard:

Pursuant to your request, a Commission has been established to determine the fair market value of the Peoria District Waterworks (the "System") in accordance with the City of Peoria's (the "City") purchase option (the "Purchase Option"), as delineated in the Rules of Order dated October 8, 2003. The City has appointed C. (Kees) W. Corssmit, Ph.D to serve as its designated Commissioner. The Illinois American Water Company ("IAWC") has designated John P. Kelly, P.E. as its designated Commissioner. The third Commissioner is Mark Rodriguez, ASA.

The Commissioners have considered appraisals of the System performed by both Willamette Management Associates ("WMA") and Raftelis Financial Consultants ("RFC"), along with rebuttal documents provided by the respective appraisers and council, depositions of the principal appraisers – Mr. George C. Raftelis of RFC and Mr. Robert F. Reilly of WMA, transcripts of the hearings, supporting documents provided by other sources pertaining to the proceedings, and evidence presented at the hearings. The data presented were utilized by the Commissioners in determining an opinion of the fair market value of the System, as of December 31, 2003.

The Uniform Standards of Professional Appraisal Practice ("USPAP") represent the generally accepted and recognized standards of appraisal practice in the United States. The appraisal completed by RFC did not fully comply with the USPAP. The WMA report was prepared by a certified appraiser and complied with USPAP.

The scope of work attributable to this assignment has been disputed by both RFC and WMA. The Commissioners have concluded the scope of work is comprised of the tangible and intangible assets attributable to the System. Consideration of the three traditional approaches to value, as well as the weighting considered by the Commissioners, is based on a scope of work that encompasses only the assets of the System.

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The following narrative describes the findings of the Commissioners with regard to the valuation approaches. These comments are restricted to major adjustments realized by the Commissioners, along with the respective valuation approach weightings considered in determining the fair market value of the System.

Income Approach to Value

The income approach produces a fair market value that relies on estimates of future cash flows available to owners or investors and a discount rate that reflects all inherent risk factors. The unique physical and financial characteristics of the System, particularly its status as a special purpose property that produces relatively stable cash flows with quantifiable risks reflected in the discount rate, makes this approach particularly relevant in determining the fair market value of the System.

The Commissioners concluded that the income approach is applicable and considered the income approach from the perspective of both a government owned utility (“GOU”) and an investor owned utility (“IOU”). This was accomplished through adjustments made to the WMA cash flow projections and to the discount rates applicable to the discretionary and terminal cash flows.

Adjustments made to reflect the impact of a GOU buyer on the fair market value of the System include:

1. Adding a target capital structure for the terminal value consisting of 20 percent equity and 80 percent debt. This adjustment was made in order to capture the orderly retirement of debt over time.
2. Adjusting the build-up model for the cost of equity, as of the December 31, 2003 valuation date, to reflect the values provided by *Ibbotson's SBBI Valuation Edition – 2004 Yearbook*. Based upon this source, the aggregate cost of equity is 12.78 percent. This cost of equity utilizes a build-up method consisting of the risk free rate, the equity risk premium, the 10th decile small company premium, and an adjustment to reflect the specific risks inherent in the water utility industry.
3. Utilizing a municipal bond yield of 4.75 percent. This adjustment was made to capture the complete universe of potential GOU buyers of the System.

Adjustments made to reflect the impact of an IOU buyer on the fair market value of the System include:

1. Subtracting income taxes, other taxes, and regulatory fees when calculating cash flows.
2. Applying the current return on rate base of 7.39 percent to the discretionary and terminal cash flows.
3. Increasing the terminal value cash flow growth rate to 4.0 percent.

The application of the adjusted discount rates to the adjusted cash flow estimates resulted in a concluded value for the income approach of a \$122 million value for an IOU buyer, and \$235 million for a GOU buyer.

The System is a stable, income producing special purpose property to which the income approach was afforded a significant weighting in determining overall fair market value. Consequently, the Commissioners applied a *60 percent weighting (30 percent to each DCF analysis)* to the income approach values.

Asset Based Approach

The asset based approach is founded on the principle of substitution, where a prudent seller would not sell for less, and a prudent buyer would not pay more for a specific asset than the cost of creating an asset offering the same utility. The Commissioners have concluded the asset based approach is an applicable valuation approach for the System. Its classification as special purpose property, age, unique physical characteristics, and location all can be incorporated within the valuation framework relied upon within this approach.

Both IAWC and the City have stipulated to the analysis completed by Burgess & Niple for the asset based approach value of the System, with the exception of depreciation applied to unlined cast iron pipe.

Adjustments made by the Commissioners include a functional obsolescence penalty, a disregard of the “Income Shortfall/Economic Obsolescence” methodology and intangible assets, along with consideration to contributions in aid of construction. The application of these adjustments resulted in an indicated fair market value of \$282 million.

The Commissioners concluded that the asset based approach deserves significant consideration in the fair market value conclusion. Consequently, the Commissioners applied a *40 percent weighting* to the asset based value approach.

Market Approach

The market approach produces a value indication that is based on a comparison of recent sales transactions for assets similar to the subject being appraised. While both RFC and WMA consider the market approach in their analysis of the System, the two appraisals offer differing methods of this approach. This is largely the result of the difference of opinions regarding the scope of work. However, both appraisers agree that inadequate market data for similar transactions limits the ability of this approach to provide a supportable indication of value.

The effectiveness and accuracy of a market approach analysis is highly dependent on similarities between the subject and guideline transactions, as well as the availability of reliable financial data regarding those transactions. Due to the limitations previously described, existing public data analyzed through this approach were concluded by the Commissioners to provide evidence

for the existence of a market for the exchange of water utility assets. However, it is improbable that a reliable value indication can be determined from these data. Consequently, the market approach indication of value was given *zero weighting* in the calculation of the final fair market value of the System.

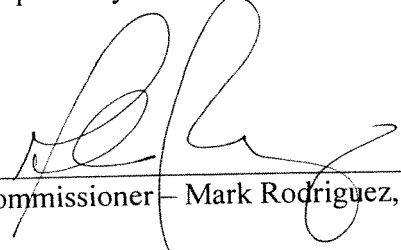
As previously discussed, the Commissioners applied a 60 percent weighting to the income approach, a 40 percent weighting to the asset based approach, and zero weighting to the market approach when determining the fair market value of the System. Upon consideration of the information discussed previously, the Commissioners determined the fair market value of the System, as of December 31, 2003 to be:

\$ 220,000,000

(TWO HUNDRED TWENTY MILLION DOLLARS)

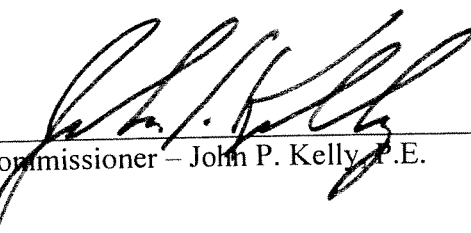
It has been the pleasure of each of the Commissioners to serve both the City and IAWC in their respective capacities.

Respectfully submitted,



Commissioner – Mark Rodriguez, ASA

Commissioner – C. (Kees) W. Corssmit, Ph.D



Commissioner – John P. Kelly, P.E.

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