COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF THE RATES OF KENTUCKY AMERICAN WATER COMPANY	))	CASE NO. 2004-00103

COMMISSION STAFF'S FIRST SET OF INFORMATION REQUESTS TO THE ATTORNEY GENERAL

Pursuant to Administrative Regulation 807 KAR 5:001, Commission Staff requests that the Attorney General ("AG") file the original and one paper and one electronic copy of the following information with the Commission no later than September 24, 2004, with a copy to all parties of record. Each copy of the information requested shall be placed in a bound volume with each item tabbed. When a number of sheets are required for an item, each sheet should be appropriately indexed, for example, Item 1(a), Sheet 2 of 6. Include with each response the name of the witness who will be responsible for responding to questions relating to the information provided. Careful attention shall be given to copied material to ensure its legibility. When the requested information has been previously provided in this proceeding in the requested format, reference may be made to the specific location of that information in responding to this request.

1. At page 7 of his direct testimony, Scott J. Rubin states that it is not clear that Kentucky-American Water Company's ("Kentucky-American") proposed Emergency Pricing Tariff "would meet legal requirements for ratemaking by KAWC or any other investor-owned utility." Identify the statute(s), administrative regulation(s), or legal doctrine(s) to which Mr. Rubin is referring.

2. Describe the program or pricing method that Mr. Rubin believes that Kentucky-American should implement to reduce water consumption during severe drought or emergency periods.

3. At page 9 of his direct testimony, Scott J. Rubin states that Kentucky-American's proposed low-income customer rate is unlawful. Identify the statute(s), administrative regulation(s), or legal doctrine(s) that lead the AG to believe the proposed rate is unlawful.

4. Refer to the Direct Testimony of Scott J. Rubin at 10. State whether the AG believes that tax credits and direct subsidies from the Commonwealth of Kentucky or Lexington-Fayette Urban County Government ("LFUCG") are the most appropriate means of assisting low-income water customers.

5. At page 11 of his direct testimony, Scott J. Rubin states that Kentucky-American's proposed economic development rate is unlawful.

a. Identify the statute(s), administrative regulation(s), or legal doctrine(s) that lead the AG to believe the proposed rate is unlawful.

b. State whether the AG takes the position that all economic development rates are unlawful.

c. Explain how the AG's position regarding Kentucky-American's proposed economic development rate is consistent with the position that the Commission adopted in Administrative Case No. 327.[1]

[1] Administrative Case No. 327, An Investigation into the Implementation of Economic Development Rates By Electric and Gas Utilities (Ky.PSC Sep. 24, 1990).

6. Refer to the Direct Testimony of Scott J. Rubin at 11 – 12.

a. State whether Mr. Rubin holds the position that the AWWA Manual M1 requires a miscellaneous or special charge to meet all of the stated six principles to be a proper charge. If yes, identify the specific portion of the AWWA Manual M1 that supports this position.

b. Provide all legal or regulatory authorities for Mr. Rubin's proposition that a customer's ability to pay should be considered in assessing the reasonableness of a miscellaneous or special charge.

c. Explain why ability to pay should be considered as a factor in assessing the reasonableness of a miscellaneous or special charge.

7. Does the AWWA Manual M 1 provide a method or guideline for establishing rates based on a customers ability to pay? If yes, site the location of this in the Manual M 1.

8. At page 15 of his direct testimony, Scott J. Rubin recommends that, if the Commission approves the proposed activation fee and "the overall level of rate increase allowed by the Commission is less than the $672,000 that would be generated from the activation fee . . . [then] all Central Division charges should be reduced by an equal percentage." State whether, in Mr. Rubin's opinion, Central Division charges should be increased by an equal amount if the Commission permits an overall level of rate increase that exceeds $672,000. Explain.

9. At page 2 of his Direct Testimony, Dr. J. Randall Woolridge states: "The benchmark for long-term capital costs is the rate on ten-year Treasury bonds." Provide all reports, studies, and publications upon which Dr. Woolridge relies for this statement.

10. List all other term lengths of U.S. Treasury bonds that are currently available.

11. At page 3 of his Direct Testimony, Dr. Woolridge compares the yield differential between Baa-rate corporate bonds and 10-year Treasuries. Explain why 10-year Treasuries should be compared to Baa-rated corporate bonds rather than other rated bonds.

12. Provide a copy of J.R. Siegel, "The Shrinking Equity Risk Premium," The Journal of Portfolio Management (Fall l999).

13. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 7 – 8 and Exhibit JRW-3.

a. Provide August 2004 report from the C.A. Turner Utility Reports for each company within Dr. Woolridge's comparison groups.

b. Explain why Dr. Wooldridge used water revenues of at least 80 percent of total revenues as a criterion for selecting his comparison group.

c. Explain why Dr. Wooldridge did not use a lower percentage of water revenues of total revenues as a criterion for selecting his comparison group.

d. State Kentucky-American's percentage of total revenues derived from water sales.

14. Provide a copy of James M. McTaggart, "The Ultimate Poison Pill: Closing the Value Gap," Commentary (Spring 1988).

15. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 18. Describe Kentucky-American's position within the Three-Stage DCF Model.

16. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 20 and Exhibit JRW-7 at 2.

a. State whether the monthly dividend yield for August 2004 is an estimate.

b. List the source(s) used to derive the monthly dividend yield for August 2004.

17. Refer to the Direct Testimony of Dr. J. Randall Woolridge at Exhibit JRW-7.

a. State whether the supporting data for this Exhibit is for periods ending August 2004.

b. Provide a copy of all supporting documents and reports used to prepare the Exhibit.

c. Page 3 of the Exhibit shows members of the Small Water Company Group experienced negative growth rates.

(1) State the reasons for these negative values.

(2) Explain why it is appropriate to include negative growth in determining the historic growth rate.

18. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 22 and Exhibit JRW-7 at 1. Describe how the "Adjustment Factor" used to adjust the dividend yield was derived.

19. a. State whether Dr. Woolridge is aware of the AG's recommendation of a return on equity ("ROE") of 10.3 percent for a local gas distribution company in Case No. 2004-00067[2] in July 2004.

b. Identify any event or occurrence since July 2004 that lowers or lessens ROE expectations for a regulated utility.

20. Describe how the expectation of increasing interest rates would affect Dr. Woolridge's recommendations regarding the cost of equity.

21. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 24 and Exhibit JRW-7 at 3.

a. Describe how Dr. Woolridge developed an annual historic growth rate of 3.5 percent for the Small Water Companies Group and of 4.75 percent for the Large Water Companies Group.

b. Describe the predictive value of Dr. Woolridge's "annual historical growth rate."

c. Describe the following categories that are found in Exhibit JRW-7:

(1) Sales.

(2) Earnings per share (EPS).

(3) Dividends per share (DPS).

(4) Book Value per share (BVPS).

d. For each category listed in Item 21(c), explain how the category is is derived and describe how the category relates to the other listed categories computationally and behaviorally.

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[2] Case No. 2004-00067, An Adjustment of the Rates of Delta Natural Gas Company, Inc.

e. For each company listed in the Exhibit, explain why the company is a suitable proxy for Kentucky-American.

f. Dr. Woolridge states: “For the SWC Group, EPS growth is the lowest and also the most volatile. The other growth rates are more consistent over time, with sales growth in the 5.0% range, and DPS and BVPS growth in 4.0% range.” Describe how Dr. Woolridge derived these ranges.

22. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 25 and Exhibit JRW-7.

a. Describe how Dr. Woolridge derived an average of 3.4 percent growth for the Large Water Companies Group.

b. Describe how Dr. Woolridge derived an average growth rate for 3 of the 4 companies in the Large Water Companies Group in Value Line as 7.2 percent.

c. List all reports, articles, studies, and analyses upon which Dr. Wooldridge has based his methodology for developing an average historical growth rate.

d. List all reports, articles, studies, and analyses that support Dr. Woolridge’s methodology for developing an average historical growth rate.

23. At page 26 of his direct testimony, Dr. J. Randall Woolridge states: “Given a historic and projected growth rate range of 3.5% to 7.1% for the SWC Group, and giving slighter greater weight to the projected growth rate figures, an expected growth rate of 5.5% is reasonable for these smaller water companies.” State why greater weight is given to the projected growth rate.

24. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 26. Describe how Dr. Woolridge derived an expected growth range of 5.0 – 5.5%.

25. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 26. Describe how Dr. Woolridge derived the dividend yield used in the DCF analysis.

26. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 31. Explain why betas for only 3 of the 5 Small Water Companies Group members are listed.

27. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 39. Explain why use of an average inflation rate is more appropriate than using the current inflation rate.

28. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 40. Explain why use of the Standard and Poor's 500 ("S&P 500") is appropriate to develop an expected real growth in earnings.

29. Provide a copy of Marc H. Goedhart, Timothy M. Koller, and ZaneD. Williams, "The Real Cost of Equity," McKinsey on Finance (Autumn 2002).

30. Provide a copy of Richard Bower, "The N-Stage Discount Model and Required Return: A Comment," Financial Review (February 1992).

31. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 55. State whether, in Dr. Woolridge's opinion, historical growth rates are biased. Explained.

32. At page 67 of his direct testimony, Dr. Woolridge states: "Using the arithmetic mean overstates the return experienced by investors." Provide an estimate of how much its use overstates the return.

33. Refer to the Direct Testimony of Dr. J. Randall Woolridge at 69 – 70. List all reports, articles, studies, and analyses that discuss the "Peso Problem" and its effect on the use of historic stock returns as a measure of expected returns.

34. List the last 5 state utility regulatory proceedings in which Dr. Woolridge appeared as a witness on the issue of return on equity and provide a copy of his testimony.

35. At pages 9 and 10 of his direct testimony, Dr. Woolridge states that he used the average of the quarterly capitalization ratios over the prior 3 years as the basis for his proposed capital structure.

a. State whether Dr. Woolridge is aware that Administrative Regulation 807 KAR 5:001, Section 10(c), requires the capitalization and net investment rate base to be based on a 13 month average for the forecasted period.

b. Explain how the use of a capital structure based upon a 3-year average of Kentucky-American's quarterly capital structures complies with Administrative Regulation 807 KAR 5:001, Section 10(c).

36. Refer to Direct Testimony of Andrea C. Crane at Schedule ACC-43.

a. Provide a revised schedule that lists each of Ms. Crane's recommended adjustments.

b. For each recommended adjustment, show the calculations used to derive the adjustment.

c. Multiplying the taxable income listed in the pro forma present rate column of $9,366,284 by 40.37 percent results in income taxes of $3,781,168, which is $272,982 greater than the reported income tax expense of 3,508,186. Explain this discrepancy.

d. Multiplying the taxable income listed in the per company column of $5,680,443 by 40.37 percent results in income taxes of $2,293,194, which is $79,913 greater than the reported income tax expense of $2,213,281. Explain this discrepancy.

37. At pages 19 through 21 of her direct testimony, Andrea C. Crane proposes to eliminate Construction Work In Progress ("CWIP") from Kentucky-American's forecasted rate base. Historically, the Commission has allowed Kentucky-American to include CWIP in rate base but offset the return by including Allowance for Funds Used During Construction ("AFUDC") in operating revenues. Provide a comparison between the two methodologies and explain the differences between Ms. Crane's proposal for CWIP and the method that the Commission has previously used to determine Kentucky-American's rates.

38. State the net revenue requirement effect of Ms. Crane's proposal to exclude CWIP from rate base and move AFUDC "below-the-line."

39. Explain why, as the Commission has permitted a cash return on CWIP for the jurisdictional electric and gas utilities, it should not afford the same ratemaking treatment to Kentucky-American.

40. At page 26 of her direct testimony, Ms. Crane states: "Only items for which actual out-of-pocket cash expenditures must be made are included in a cash working capital calculation." State whether Ms. Crane agrees with the following statement and why or why not:

> While it is true that recording depreciation does not require the expenditure of cash at the time the expense is recorded and charged to the customer, cash was expended at the time the property was acquired, and the recorded depreciation is used to reduce the investment in that property even though approximately one-and-one half month's depreciation (equivalent to the revenue lag) has not been received from the consumer . . . . [T]he question involved in the depreciation issue is the recognition of the time differential between the reduction of the rate base and the receipt of funds applicable to the provisions 45 days

latter. Clearly, it is not a question of whether cash has been expended in the test year.[3]

41. List all state jurisdictions that permit a utility to include depreciation in its lead/lag study and provide copy of the statute(s), administrative regulation(s), or utility regulatory commission decision that authorizes such action.

42. List all accounting publications, journal articles, and studies that support the proposition that depreciation should be excluded from any lead/lag study.

43. Refer to the Direct Testimony of Andrea C. Crane at 27. Provide a copy of the decisions of the Pennsylvania Public Utility Commission and West Virginia Public Service Commission in which depreciation expense was excluded from a utility's cash working capital study.

44. List all state utility regulatory commissions, other than Pennsylvania Public Utility Commission and West Virginia Public Service Commission, that exclude depreciation expense from a utility's cash working capital study. Provide a copy of each listed commission's decisions on this subject.

45. State whether, in Ms. Crane's opinion, the use of the 1/8 formula approach to calculate Kentucky-American's cash working capital is a reasonable alternative to the use of a cash working capital study. Explain.

46. State whether, in Ms. Crane's opinion, Kentucky-American complied with Financial Accounting Standards Board Statement No. 71 when it established regulatory asset accounts for:

a. Shared Services Center costs.

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[3] Robert L. Hahne and Gregory E. Aliff, Accounting for Public Utilities, §5.08[2] (1991).

b. Customer Call Center transition costs.

c. Security costs.

47. State whether, for each deferred debit that Ms. Crane in her direct testimony proposed to eliminate, Ms. Crane's position would be different if Kentucky-American's rates were established using a historical test period.

48. Refer to Kentucky-American's Response to Commission Staff's First Set of Information Requests, Item 4. State Ms. Crane's opinion on the accuracy of Kentucky-American's performance over the past three years in budgeting for maintenance expense.

49. Ms. Crane proposes to reduce Kentucky-American's Annual Incentive Plan ("AIP") by 60 percent or the portion of the AIP that is based upon financial performance goals of Kentucky-American. Explain why Ms. Crane did not propose the total removal of AIP.

50. State whether, in Ms. Crane's opinion, her rate case expense adjustment should be adjusted to reflect Kentucky-American's revised cost estimates provided in response to Item 19 of the Commission Staff's Third Set of Information Requests.

51. Explain how Ms. Crane determined that Kentucky-American's forecasted advertising costs include institutional advertising of $72,415

52. State whether, in Ms. Crane's opinion, business development costs that are primarily used to expand regulated operations should be included in rates.

53. At pages 60 and 61 of her direct testimony, Ms. Crane proposes to eliminate the amortization expense associated with deferral of the security costs, Shared Service Company transition costs, and Customer Care Center transition costs. State whether, given Ms. Crane's proposed adjustments to eliminate CWIP from rate

base and the AFUDC from operating revenues, Ms. Crane believes that the AFUDC equity gross-up amortization of $25,728 should be removed from Kentucky-American's forecasted operating expenses.

54. At page 72 of her direct testimony, Ms. Crane proposes to eliminate the amortization expense of the acquisitions of the Tri-Village Water District and the Elk Lake Homeowners Association. Identify the account in which these amortization expenses are recorded.

55. At page 74 of her direct testimony, Ms. Crane states that, Pennsylvania, New Jersey, and West Virginia have adopted consolidated income tax adjustments for ratemaking purposes.

a. Provide a copy of all orders of the utility regulatory commissions of these states addressing the use of consolidated income tax adjustments for ratemaking purposes.

b. State whether Ms. Crane's proposal to use the effective tax rate methodology to calculate the consolidated income tax adjustment rate is based upon these states' methodologies.

56. List all other state regulatory commissions, other than the Pennsylvania Public Utilities Commission, New Jersey Board of Public Utilities, West Virginia Public Service Commission, that have adopted consolidated income tax adjustments for ratemaking purposes. Provide a copy of each listed commission's decisions on this subject.

57. List all state regulatory commissions, that have rejected the use consolidated income tax adjustments for ratemaking purposes. Provide a copy of each listed commission's decisions on this subject.

58. Refer to Direct Testimony of Andrea C. Crane at 74. State whether Ms. Crane's proposed consolidated income tax adjustment conforms to the federal income tax normalization requirements. Explain.

Robert A. Amato for
Beth O'Donnell
Executive Director
Public Service Commission
P. O. Box 615
Frankfort, Kentucky 40602

DATED: September 10, 2004

cc: Parties of Record