**COMMONWEALTH OF KENTUCKY**

**BEFORE THE PUBLIC SERVICE COMMISSION**

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| **IN THE MATTER OF:** | **)** | |
| | **)** | |
| **THE APPLICATION OF KENTUCKY-AMERICAN** | **)** | **CASE NO. 2012-00520** |
| **WATER COMPANY FOR AN ADJUSTMENT OF** | **)** | |
| **RATES ON AND AFTER JANUARY 27, 2013** | **)** | |

# POST-HEARING BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

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## 1. STATEMENT OF THE CASE

### (a) <u>History of the Proceeding</u>

On November 29, 2012, Kentucky-American Water Company ("KAWC" or "Company") filed a Notice with the Public Service Commission of the Commonwealth of Kentucky ("Public Service Commission" or "Commission") in conformity with 807 KAR 5:001, Section 10(2), and 807 KAR 5:001, Section 9(1) expressing its intention to file an application for an increase in rates no earlier than four weeks after that Notice. The Notice specifically provided that the application for an increase in rates would be supported by a fully forecasted test year as authorized by Kentucky Revised Statute 278.192.[1]

In keeping with prior practice, simultaneously with the delivery of its Notice to seek an increase in rates, KAWC requested Commission approval for use of electronic filing procedures in the proceeding. The Commission's December 17, 2012 Order granted the Company's request and established the procedures for electronic submission.

On December 13, 2012, Lexington-Fayette Urban County Government ("LFUCG") petitioned for full intervention and agreed to waive its right to service by United States Mail. The Commission granted LFUCG's motion on December 28, 2012. On January 2, 2013, the Community Action Council of Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. ("CAC") moved for full intervention. By its January 22, 2013 Order, the Commission granted CAC's motion to intervene. CAC waived its right for service by United States Mail on January 23, 2013. On January 7, 2013, the Attorney General ("AG") filed a motion to intervene, which was granted by the Commission in its January 11, 2013 Order. On January 14, 2013, the

[1] The Notice was subsequently attached to the Application, Statement and Notice filed by KAWC in Case No. 2012-00520 as Exhibit No. 8.

AG agreed to waive the right for service by United States Mail. The adjudication of this matter has proceeded with three intervenors: LFUCG, CAC, and the AG.

**(b) <u>Proposed Rate Increase</u>**

In its Application, Statement and Notice filed with the Commission on December 28, 2012, KAWC sought the Commission's approval of an increase in its annual revenues of $12,317,702 by rates to become effective on or after January 27, 2013. Pursuant to the Commission's Order in Case No. 2007-00143, in which implementation of single-tariff pricing was approved, the proposed rates for each customer class are and will be uniform throughout the customer classes, regardless of the KAWC division to which the customer belongs.

By letter dated January 15, 2013, the Filings Division Director of the Commission informed all parties of record that the Application met the minimum filing requirements and was thus accepted for filing as of December 28, 2012. By Order dated January 22, 2013, the Commission suspended the operation of the proposed rates for a period of six months and established a Procedural Schedule providing for two rounds of data requests to KAWC, the filing of intervenors' testimony, one round of data requests to the intervenors, and the filing of rebuttal testimony by the Company's witnesses. In its Order dated April 4, 2013, the Commission scheduled an evidentiary hearing in this matter beginning June 4, 2013.

With its Application, KAWC presented the testimonies of: Jermaine K. Bates; Linda C. Bridwell; Keith L. Cartier; Paul R. Herbert; Lewis E. Keathley; Cheryl D. Norton; Scott W. Rungren; Melissa L. Schwarzell; Dr. James H. Vander Weide; Gary M. VerDouw; and Lance E. Williams. Subsequent rebuttal testimony was presented from Linda C. Bridwell; Paul R. Herbert, Carl M. Meyers; Cheryl D. Norton; Scott W. Rungren; Dr. James H. Vander Weide; and Gary M. VerDouw.

The AG and LFUCG co-presented the testimony of Brian Kalcic, Stephen Rackers, and Dr. J. Randall Woolridge. LFUCG also presented the testimony of William O'Mara. Jack Burch filed testimony on behalf of CAC.

A hearing on the merits of the proposed increase was held at the Commission on June 4 and 5, 2013. The following witnesses for KAWC were presented and subject to cross examination: David Baker; Cheryl Norton; Keith Cartier; Paul Herbert; Carl Meyers; Melissa Schwarzell; Linda Bridwell; and Gary VerDouw. The AG and LFUCG presented Brian Kalcic and Stephen Rackers and LFUCG also presented William O'Mara. CAC presented the testimony of Jack Burch. Throughout the course of the hearing, numerous hearing data requests were issued to KAWC. Pursuant to the Commission's ruling at the end of the hearing, the Company tendered its responses to these requests on June 20, 2013. Also, the Commission issued written questions to Carl Meyers and Dr. James Vander Weide, to which the Company responded on June 19, 2013.[2]

**(c) <u>Proposed Revenue Changes</u>**

In its Application, Statement and Notice filed with the Commission on December 28, 2012, KAWC requested an increase on an annual basis of $12,317,702, to be allocated among all customer classes pursuant to KAWC's tariffs. On May 15, 2013, KAWC filed its Base Period Update. As a result of the Base Period Update, the requested annual increase was revised to $12,068,431.[3]

## 2. RATE BASE

### (a) <u>KAWC's Calculated Rate Base Is Reasonable</u>

[2] The Commission also issued written questions to Dr. Woolridge, to which the AG and LFUCG responded on June 19, 2013.
[3] Base Period Update at Exhibit 37A, p. 2.

KAWC calculated its rate base by utilizing a thirteen month average of projected plant and rate base as of the end of the forecast year, which is July 31, 2014.[4] Further, many of the rate base elements were analyzed from actual, per books data as of September 30, 2012, and were later updated to include actual data through March 31, 2013.[5]

KAWC proposed $627,540,378 of Utility Plant in Service as a thirteen month average for the forecasted test year.[6] This amount was revised to $629,839,138 in the Base Period Update.[7] This was calculated through July 31, 2014, by adding net additions and retirements throughout the forecast period.[8] The thirteen month average was calculated to arrive at the utility plant balance for the forecasted test period.[9]

**(b) <u>Utility Plant Acquisition Adjustment</u>**

The Company has not proposed a Utility Plant Acquisition Adjustment because KAWC has not acquired the assets of any utility since its last rate case and the Company is no longer amortizing the acquisition of the Boonesboro Water Association.[10]

**(c) <u>Accumulated Depreciation</u>**

KAWC developed the amount of accumulated depreciation to include in rate base by starting with the actual balance as of September 30, 2012.[11] The Company then adjusted the balance to account for plant retirements, salvage credits and cost of removals.[12] Because KAWC last commissioned a full depreciation study in 2010, it did not perform a new study in

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[4] Direct Testimony of Gary M. VerDouw of December 28, 2012 (Case No. 2012-00520) ("VerDouw Direct") at 8.
[5] Direct Testimony of Linda C. Bridwell of December 28, 2012 (Case No. 2012-00520) ("Bridwell Direct") at 23; Base Period Update.
[6] KAWC Filing Exhibit 37, Schedule B-1, Page 2 of 2.
[7] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[8] Bridwell Direct at 24.
[9] *Id.* at 24.
[10] KAWC Filing Exhibit 37, Schedule B-1, Page 2 of 2.
[11] Bridwell Direct at 26.
[12] *Id.*

this proceeding.[13] The Company has utilized the depreciation rates from the 2010 depreciation study, except with respect to utility plant account 340315, pertaining to the Business Transformation assets.[14] KAWC proposes to change the depreciation rate from 20 percent to 10 percent, which more accurately reflects the expected life of the assets.[15] No party objected to this proposal, which lengthens the depreciation period for these assets.

After KAWC made its adjustments, the forecasted test year accumulation was calculated by averaging the month end accumulated depreciation balances from August 1, 2013 to July 31, 2014, which is $136,601,885.[16] This was revised to $136,633,217 in the Base Period Update.[17]

**(d) <u>Construction Work in Progress</u>**

KAWC has requested the inclusion in rate base of $6,851,268 of construction work in progress ("CWIP").[18] The Company calculated CWIP by starting with the actual September 2012 balance, and then adjusted for construction expenditures and transfers to Utility Plant in Service that are expected to occur through the forecasted test year.[19] This was revised to $6,297,179 in the Base Period Update.[20]

**(e) <u>Working Capital</u>**

KAWC proposed to include $3,946,000 of working capital in its rate base, which was reduced in the Base Period Update to $3,092,000.[21] Working capital is included in a utility's rate base to recognize the cost of funding the lag between the provision of utility service and the time

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[13] *Id.* at 22.
[14] *Id.* at 27.
[15] *Id.*
[16] *Id.*
[17] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[18] Bridwell Direct at 24.
[19] *Id.*
[20] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[21] Bridwell Direct at 25; Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.

it takes to collect revenues from customers to pay for that service.[22] Thus, working capital represents the amount of investor-supplied resources that fund the daily operations of the business.[23] The Company calculates the appropriate amount of forecasted working capital by utilizing a lead/lag study, which was based on historical data for the twelve months ending June 30, 2012.[24]

Mr. Rackers, on behalf of the AG and LFUCG, alleges that KAW overstated working capital by including non-cash items in its calculation.[25] Specifically, Mr. Rackers proposes to remove four non-cash items from KAW's calculation: depreciation expense, amortization expense, deferred income taxes, and net income, which, if accepted, would lower KAW's working capital.[26] Mr. Rackers claims that these items should be eliminated because "non-cash expenses and common equity profits should not be considered in the analysis of working capital since these items are not cash expenses necessary to fund daily operations."[27]

Mr. Rackers' adjustment to eliminate non-cash items from the calculation of working capital has repeatedly been proposed by the AG and rejected by the Commission in numerous KAWC rate cases for over twenty years, which has even been recognized by the AG's own witnesses:

- In **Case No. 92-452**, the AG recommended exclusion of all non-cash items from working capital.[28] The Commission denied the adjustment and described KAW's methodology as "theoretically sound."[29]

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[22] Bridwell Direct at 25.
[23] *Id.*
[24] *Id.* at 25.
[25] Direct Testimony of Stephen M. Rackers of April 3, 2013 in Case No. 2012-00520 ("Rackers Direct") at 15.
[26] *Id.*
[27] *Id.*
[28] Case No. 92-452, *In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Nov. 19, 1993).
[29] *Id.* at 20.

- In **Case No. 95-554**, the AG proposed the exclusion of net income from working capital.[30] The Commission denied the adjustment and noted it did not accept the AG's same adjustment in Case No. 92-452.[31]
- In **Case No. 97-034**, the AG proposed the exclusion of depreciation expense and deferred income tax expense from working capital.[32] The Commission denied those adjustments.[33]
- In **Case No. 2004-00103**, the AG proposed the exclusion of depreciation expense from working capital.[34] The Commission denied the adjustment, stating that it "continues to hold its position as stated in previous Orders…"[35]
- In **Case No. 2008-00427**, an AG witness stated in direct testimony that he disagreed with the inclusion of non-cash items and net earnings in calculating working capital, but did not propose an adjustment to remove these items because of the Commission's prior orders.[36]
- In **Case No. 2010-00036**, an AG witness stated in direct testimony that he took issue with the inclusion of non-cash items in calculating working capital, but did not propose exclusion of these items because the Commission has accepted this practice in previous rate proceedings.[37]

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[30] Case No. 95-554, *In the Matter of: Application of Kentucky-American Water Company to Increase Its Rates* (Ky. PSC Sept. 11, 1996).
[31] *Id.* at 23-24.
[32] Case No. 97-034, *In the Matter of: Application of Kentucky-American Water Company to Increase Its Rates* (Ky. PSC Sept. 30, 1997).
[33] *Id.* at 27-28.
[34] Case No. 2004-00103, *In the Matter of: Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Feb. 28, 2005).
[35] *Id.* at 17.
[36] Case No. 2008-00427, *In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After November 30, 2008*, Direct Testimony and Exhibits of Robert J. Henkes of February 23, 2009 at p. 9-10.
[37] Case No. 2010-00036, *In the Matter of: The Application of Kentucky-American Water Company for an*

The Commission has thus rejected the AG's adjustments to remove various non-cash items from KAWC's working capital calculation in ***four rate cases***. In recognition of the Commission's unequivocal position, the AG's witnesses have not proposed such an adjustment in the last two KAWC rate cases. Nevertheless, Mr. Rackers has proposed to remove the non-cash items from KAWC's rate base by restating the very argument that this Commission has repeatedly rejected, which is that non-cash items are not necessary to fund the Company's daily operations. Because Mr. Rackers has provided neither a novel nor principled basis to reverse the Commission's long-standing position with respect to this issue, KAWC respectfully requests the Commission deny Mr. Rackers' adjustment to the cash working capital calculation.

**(f) Contributions in Aid of Construction**

Also included in KAWC's forecasted test year rate base is an amount for Contributions in Aid of Construction ("CIAC"), which is a reduction in rate base for the value of mains, meters, services or hydrants that are paid for by a third party, but are fully owned and maintained by the Company.[38] KAWC calculates the CIAC balances by adjusting the prior months' account balances for activity related to contributions received and CIAC amortizations.[39] The forecasted thirteen month average balance when the application was filed was $52,238,690, which was revised to $53,051,691 in the Base Period Update.[40]

KAWC's forecasted CIAC calculation balance includes the impact of the Company's proposed revision to the tap fee tariff.[41]

**(g) Customer Advances**

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*Adjustment of Rates On and After March 28, 2010*, Public Direct Testimony of Ralph C. Smith of June 11, 2010 at p. 17-18.

[38] Bridwell Direct at 28.

[39] *Id.*

[40] Bridwell Direct at 29; Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.

[41] Bridwell Direct at 28.

Similar to CIAC, customer advances are a reduction to rate base for funds collected for new mains that are held in an account and refunded to the original customers as new customers tap onto a main.[42] The forecasted test year customer advances balance is based upon an average of the thirteen month end balances from August 2013 to July 2014, which was $13,997,843 when the application was filed, and increased to $14,176,990 in the Base Period Update.[43]

**(h) <u>Deferred Income Taxes</u>**

KAWC, in keeping with prior practice, included $57,007,044 of deferred income taxes as a reduction to rate base in its application.[44] In the Base Period Update, this number was revised to $57,453,859.[45] The Company continued to adhere to SFAS 109 – Accounting for Income Taxes in recording deferred income taxes.[46]

Mr. Rackers' challenges KAWC's calculation of its deferred income tax due to the manner in which American Water Works ("AWW"), KAWC's parent company, accounts for repairs and maintenance for its regulated subsidiaries to the Internal Revenue Service ("IRS"). As discussed below, Mr. Rackers' proposed adjustment is similar to the adjustment that the AG proposed in Case No. 2010-00036, which was rejected by the Commission.[47]

As KAWC explained in its 2010 rate case, while the IRS approved AWW's application to change its accounting method for repairs and maintenance, there is significant uncertainty surrounding the deduction the Company has made. While AWW, along with other utilities and industries across the country, has effectuated the accounting change, the appropriate deduction is

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[42] *Id.* at 27.
[43] *Id.* at 28; Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[44] Bridwell Direct at 27.
[45] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[46] Direct Testimony of Scott W. Rungren of December 28, 2012 (Case No. 2012-00520) ("Rungren Direct") at 14.
[47] Case No. 2010-00036, *In the Matter of: The Application of Kentucky-American Water Company for an Adjustment of Rates On and After March 28, 2010* (Ky. PSC Dec. 14, 2010).

unclear because the IRS has yet to define a critical component of the deduction calculation. Because the extent of the deduction is presently unknown, the deduction KAWC has taken falls within FIN 48, which describes the manner in which companies must analyze, quantify and display the consequences of uncertain tax positions.[48]

FIN 48 requires companies to identify all of its tax positions and evaluate the degree of uncertainty associated with each position.[49] If the Company has taken tax positions for which it is more likely than not that the entire deduction, or a portion thereof, will be disallowed by the IRS, the Company records the amount it expects to pay the IRS as a liability on its balance sheet.[50] KAW, after thorough review by its internal and external auditors, reasonably expects that a portion of the deduction taken in connection with the accounting change will be disallowed by the IRS, which will require KAWC to remit the disallowed portion to the IRS, with interest.[51] The Company will continue to record the amount as a liability until the uncertainty surrounding the deduction is removed.[52]

In contrast with the Company's reasoned and prudent accounting for the FIN 48 entries is Mr. Rackers' imprudent adjustment, which would require KAWC to eliminate the entire balance of FIN 48 entries attributable to the tax accounting change from KAWC's ADIT balance and instead only include the future potential annual interest cost associated with the FIN 48 reserves in the revenue requirement.[53]

Mr. Rackers fails to provide any reason for departing from the Commission's Order in KAWC's most recent rate case, which held that:

[48] Rebuttal Testimony of Carl M. Meyers of May 15, 2013 (Case No. 2012-00520) ("Meyers Rebuttal") at 2-3.
[49] *Id.* at 3.
[50] *Id.* at 2-3.
[51] *Id.*
[52] *Id.* at 3-4.
[53] Rackers Direct at 7.

> We … decline to adopt the AG's proposed adjustment to Kentucky-American's accumulated deferred income taxes. Kentucky-American determined that some uncertainty exists regarding the legality of the deduction related to the change in accounting methods. No party challenges the reasonableness of this determination or the appropriateness of establishing a reserve in the event of an adverse IRS ruling. Kentucky-American's action, moreover, is consistent with FIN 48. If the IRS ultimately allows the deduction or the statute of limitations expires without a challenge to the deduction, ratepayers and shareholders will benefit from the tax deferral. If the IRS disallows Kentucky-American's deduction, Kentucky-American has stated that it will not seek recovery for interest and penalties imposed by the IRS and the ratepayers will not be negatively affected.[54]

The AG cannot state one difference between the facts supporting the Commission's ruling in Case No. 2010-00036 and the facts in this proceeding. To be clear: (1) KAWC has still determined some uncertainty exists related to the deduction; (2) no party challenges the reasonableness or the appropriateness of establishing a reserve; (3) KAWC's actions remain consistent with FIN 48; (4) ratepayers will benefit from the deferral if the IRS ultimately allows the deduction or the statute of limitation expires; and (5) if the IRS disallows all or a portion of the deduction, KAWC will not seek recovery from customers for interest and penalties. Because the facts on which the Commission based its decision in Case No. 2010-00036 have remained constant, there is no principled reason for the Commission to depart from its precedent. As such, KAWC respectfully requests the Commission to deny Mr. Rackers' adjustment.

**(i) <u>Deferred Investment Tax Credit</u>**

KAWC calculated its deferred investment tax credit in accordance with its practice in previous cases.[55] The calculation is the average of the thirteen month-end balance of unamortized investment tax credit as of July 31, 2014, which is the end of the forecasted test

[54] Case No. 2010-00036, *In the Matter of: The Application of Kentucky-American Water Company for an Adjustment of Rates On and After March 28, 2010* (Ky. PSC Dec. 14, 2010).
[55] Bridwell Direct at 29.

year.[56] The amount in the forecasted test year is $55,276.[57] This amount was not revised in the Base Period Update.

**(j) Deferred Maintenance**

KAWC calculated the forecasted thirteen month average for deferred maintenance based upon both actual projects deferred and projects forecasted to be deferred.[58] The projects include items such as the repainting of water storage tanks.[59] The types of expenses included in deferred maintenance are analogous to those that have been afforded base rate treatment in prior Commission proceedings.[60] The forecasted thirteen month average, adjusted for amortizations, for these deferred maintenance items is $4,644,233.[61] This average was not revised in the Base Period Update.

**(k) Deferred Debits**

KAWC is requesting an additional $1,536,404 for deferred debit items.[62] This figure was unchanged in the Base Period Update. These amounts are offset by corresponding deferred taxes.[63] The Company developed its thirteen month average for deferred debits in accordance with the practice previously recognized by the Commission in prior proceedings.[64]

**(l) Other Rate Base Elements**

The final adjustment KAWC proposes is for Other Rate Base Elements.[65] In Case No. 2004-00103, the Commission reduced the Company's rate base for Contract Retentions; Unclaimed Extension Deposit Refunds; Retirement Work in Progress; Deferred Compensation;

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[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *Id.* at 30.
[63] *Id.*
[64] *Id.*
[65] *Id.*

and Accrued Pension.[66] Pursuant to this precedent, KAWC has calculated a rate base increase of $650,081 for these items.[67]

**(m) <u>Slippage</u>**

In its Base Period Update, KAWC revised its revenue requirement to apply the slippage factor addressed in response to Item No. 41 of the Commission Staff's Second Request for Information.[68] Specifically, KAWC applied the slippage factors, as calculated by the Commission, of 122.14 percent to all recurring capital expenditure projects from October 2012 through the end of the forecasted test year (July 2014), and a slippage factor of 82.25 percent to all investment project expenditures for that same time period.[69]

The Commission has explained that "[a]s part of the capital budgeting process, utilities will estimate the level of capital construction that will be undertaken during the year. Because of delays, weather conditions, or other events, the actual level of construction will often vary from the level budgeted. The difference between the actual and budgeted levels is reflected in the calculation of a 'slippage factor,' which serves as an indicator of the utility's accuracy in predicting the cost of its utility plant additions and when new plant will be placed into service."[70] The slippage factor is normally applied to the utility plant in service balance and the CWIP balance to determine the slippage adjustment.[71] The Commission has routinely applied a slippage factor in the forward-looking test period rate cases for KAWC.[72]

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[66] *Id.*
[67] *Id.*
[68] Rebuttal Testimony of Linda Bridwell of May 15, 2013 (Case No. 2012-00520) ("Bridwell Rebuttal") at 2.
[69] *Id.*
[70] Case No., 2005-00042, *In the Matter of: An Adjustment of the Gas Rates of the Union Light, Heat and Power Company* (Ky. PSC Dec. 22, 2005).
[71] *Id.*
[72] *See, e.g.*, Case No. 2000-00120, *In the Matter of: The Application of Kentucky-American Water Company to Increase its Rates* (Ky. PSC November 27, 2000); Case No. 2004-00103, *In the Matter of: Adjustment of the Rates of Kentucky-American Water Company*, (Ky. PSC February 28, 2005).

The AG opposes the use of the 122.14 percent slippage factor, alleging that a reverse slippage factor above 100 percent "removes an incentive for KAW to accurately budget and properly implement its capital construction program."[73] The AG's position is unfairly punitive because penalizing the Company for not meeting projected capital expenditures by applying a slippage factor of less than 100 percent, and penalizing KAWC by not recognizing the efforts to reduce contingency costs in the planning process when expenditures exceed the plan defeats the purpose of increasing the accuracy of managing the capital construction projects.[74] The Commission approved a slippage factor above 100 percent in KAWC's last rate case, over the objection of the AG, because the "purpose [of slippage] is to produce a more accurate, reasonable, and reliable level of forecasted construction," regardless if the factor results in an amount above or below 100 percent.[75] The Commission has approved a slippage factor above 100 percent for another utility, as well.[76] Because the AG's objection is contrary to the Commission's prior order and unreasonably penalizes the Company, KAWC requests that the Commission apply the slippage factors as set forth in the Base Period Update.

### 3. FORECASTED TEST YEAR REVENUES

#### (a) <u>Residential, Commercial, and Industrial Consumption</u>

Exhibit 37, Schedule M-3, page 1, to KAWC's Application shows $52,378,073 in anticipated revenues based upon a projected 1,343,513 residential customer bills. Exhibit 37, Schedule M-3, page 2, to KAWC's Application shows $23,290,800 in anticipated revenues based upon 107,153 commercial customer bills. KAW anticipates $2,573,282 in anticipated

[73] AG's Response to Item No. 26 of the Commission Staff's Request for Information.
[74] Bridwell Rebuttal at 3.
[75] Case No. 2010-00036, *In the Matter of: The Application of Kentucky-American Water Company for an Adjustment of Rates On and After March 28, 2010* (Ky. PSC Dec. 14, 2010).
[76] Case No., 2005-00042, *In the Matter of: An Adjustment of the Gas Rates of the Union Light, Heat and Power Company* (Ky. PSC Dec. 22, 2005) (applying a slippage factor of 100.600 percent).

revenues based upon 648 industrial customer bills.[77] The forecasted revenues were calculated by employing the rates proposed in this proceeding.

Of course, to calculate anticipated revenues, KAWC had to forecast water usage. To do so accurately, it had to account for the individual customer declining usage trend being observed throughout the water industry and it had to account for the effect of weather on water consumption. Thus, KAWC examined the significant and continuing trend of water efficiency and analyzed the magnitude and causes of this change in consumption patterns.[78] This analysis, which incorporates the effect of declining use *and neutralizes the effects of weather*, more accurately represents the usage trends the Company is experiencing.

This analysis demonstrates there is a continuing annual decline among residential customers of 780 gallons per customer per year, which is an annual decline of 1.43%.[79] To measure the amount of declining use, the Company calculated "base usage" by analyzing monthly water sales from December through April for each of the last ten years. The months of December through April were used in order to isolate base, non-discretionary usage.[80] By examining use for the months of December through April over a ten-year period, which use is largely if not completely, independent of weather, KAWC was able to produce results that are "weather neural" or "weather normalized." A corresponding analysis utilizing five years of data was also performed to determine if trends were more statistically significant in shorter or longer timeframes.[81]

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[77] Exhibit 37, Schedule M-3, page 3.
[78] Bridwell Direct at 30.
[79] *Id.* at 31.
[80] *Id.* at 34.
[81] *Id.*

KAWC then performed a four-step calculation to calculate usage trends.[82] First, monthly water sales were recorded and divided by the number of customers to yield the average usage per customer.[83] Second, base usage (as described above), expressed in gallons per customer per month, was calculated for each year from 2003 through 2012.[84] Third, a "best-fit" linear regression trend line was created by looking at both the five and ten year winter usage for residential, commercial and Other Public Authority customers.[85] The ten year winter usage per residential and Other Public Authority customer history, and the five year winter usage per commercial customer history was ultimately selected.[86] (The Company used ten years for residential and Other Public Authority customers and five years for commercial customers because the regression analysis for these time periods most closely fits the actual data experienced.)[87] Finally, KAWC utilized the base usage information to derive a full year's worth of usage as a way to best predict a base or "non-discretionary" level of consumption as opposed to a year's worth of consumption that would include the more "discretionary" usage that occurs in the warmer months.[88]

After performing this usage analysis, KAWC then had to project usage per customer class for the forecasted test year. To do so, it used the actual usage information for 2011 and 2012 and annualized that usage by averaging those two years of historical usage. After that, the declining use factor was applied.[89] Mr. Rackers, on the other hand, forecasted usage levels by relying only

[82] *Id.*
[83] *Id.*
[84] *Id.* at 35.
[85] KAWC's Response to Item No. 22 of the Hearing Data Requests allows for comparison of the five year and ten year results.
[86] Bridwell Direct at 35.
[87] Notably, the five year linear regression for residential and Other Public Authority customers and ten year regression for commercial regression results were actually *steeper* than the "best fit" time periods selected. (KAWC's Response to Item No. 22 of the Hearing Data Requests.)
[88] Bridwell Direct at 35.
[89] June 5, 2013 Hearing at VR 12:41:20-12:41:30.

on the “usage per customer actually experienced during 2012,” a year which Mr. Rackers incorrectly characterizes as “close to normal levels,” with respect to rainfall.[90] By only utilizing usage from 2012 to forecast revenues without any forecasted decline in usage per customer, Mr. Rackers ignores any future trend in water use from conservation efforts or efficiencies, as well as the impact of weather. And 2012 was not a representative year in KAWC’s service territory because of the moderate drought that occurred, resulting in the tenth warmest year and thirteenth driest summer in 118 years of data.[91] Mr. Rackers admitted this data was correct during the hearing.[92] Using such limited usage data, without accounting for the measurable trends KAWC has demonstrated, is unreasonable. KAWC’s methodology is the most reasonable and the Commission should accept it.

As stated, it is clear that KAWC, like others in the water industry, is observing a declining pattern of use on an individual customer basis. KAWC expects that the declining usage trend will continue as a result of water efficient fixtures and conservation actions by both customers and utilities.[93] Finally, it is imperative to note that even though *individual* base usage is declining as demonstrated by KAWC’s analysis, the Company’s most recent Company-wide demand forecast, which was provided in response to Item No. 11 of the Commission Staff’s Second Request for Information, remains accurate because increases in population growth have offset the effect of individuals’ declining use. In other words, demand from a single customer is declining while demand from the entire customer base as a whole is increasing.

**(b) <u>KAWC’s Customer Counts Are Representative of Usage</u>**

[90] Rackers Direct at 23.
[91] Bridwell Rebuttal at 11.
[92] June 5, 2013 Hearing at VR at 16:16:00-16:18:05.
[93] Bridwell Direct at 37.

Mr. Rackers has proposed to adjust the number of Industrial, Other Public Authority, and Sale for Resale customers.[94] Mr. Rackers claims there were more customers in these classes during the base period than utilized by KAWC in forecasting revenues.[95] As explained in Ms. Bridwell's rebuttal testimony, however, KAWC did not simply use the base period customer numbers and instead identified usage trends more accurately by performing a more fact-based examination of usage.

With respect to the Industrial class, KAWC realized in examining usage data that three of the twenty-four customers in this class have historically used little or no water.[96] In forecasting usage and revenues, KAWC excluded these three customers because their inclusion would have skewed usage trends.[97] Similarly, KAWC did not include a Sale for Resale customer in forecasting revenues for that customer class because the customer has used very little water in recent years after expanding its own water treatment plant.[98]

With respect to the Other Public Authority customers, KAWC again utilized a more fact-based analysis to forecast usage than Mr. Rackers. While Mr. Rackers includes two additional customers in this class, KAWC has experienced a sharp decline in usage among this class, which is largely attributable to a few customers' decreased consumption.[99] Moreover, usage by this class experiences seasonal fluctuations, recognizing that certain customers consume no water in certain seasons.[100] As such, KAWC has projected usage more moderately by using a ten-year decline in usage per customer while removing the fluctuation that appears to be seasonal from

[94] Rackers Direct at 23-24.
[95] *Id.*
[96] Bridwell Rebuttal at 6.
[97] *Id.*
[98] *Id.* at 7.
[99] *Id.*
[100] *Id.*

the projected number of customers.[101] Notably, KAWC projected revenues based upon 531 customers in the Other Public Authority class, and in January 2013, this was precisely the actual number of customers.[102] Cumulatively, Mr. Rackers' adjustments to the customer counts for these three classes overstate usage, and consequently revenues, for the forecast period. KAWC's forecasted customer numbers and usage, in contrast, are based on reasonable and factual analyses that result in more accurate projections. For these reasons, the Company respectfully submits that the Commission should deny Mr. Rackers' adjustments.

As explained in Ms. Bridwell's rebuttal testimony, Mr. Rackers appears to have also adjusted the number of residential and commercial customers for the forecast period, as well.[103] Although Mr. Rackers' testimony does not mention these adjustments, his schedules do not use the same forecasted number of customers as KAWC.[104] For the residential and commercial classes, he uses the July 2014 forecasted number of customers found on WP 2-2 p. 298, rather than using the customer numbers in the revenue forecast file.[105] For example, Mr. Rackers uses a residential customer count of 112,673 and a commercial count of 8,807.[106] The average number of residential customers across the forecasted period, however, is 112,015 and the average number of commercial customers across the forecasted period is 8,776.[107] Because Mr. Rackers' residential and commercial customer numbers are overstated and his adjustments are neither discussed nor explained in his direct testimony, KAWC requests the Commission decline to use Mr. Rackers' residential and customer counts in forecasting revenues.

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[101] *Id.*
[102] *Id.*
[103] *Id.* at 5-6.
[104] *Id.* at 8.
[105] *Id.*
[106] *Id.*
[107] *Id.*

## 4. ADJUSTMENTS TO OPERATING REVENUES AND EXPENSES

KAWC's Application and supporting materials set forth and explain the adjustments the Company has made to its operating revenues and expenses. The proposed expenses ensure the values contained in the forecasted test period in this proceeding represent an accurate and representative level of revenues and expenses. Exhibit 37 to KAWC's Application contains the schedules that set forth the adjustments in rates supported by the forecasted test period. Further, the Company provided a Base Period Update on May 15, 2013 which provides updated information for the twelve months ended March 31, 2013. The adjustments to operating revenues and expenses that are in dispute among the parties are discussed below.

### (a) Chemical Expense

Mr. Rackers proposes an adjustment to increase KAWC's chemical expense as an offset to the revenue adjustments he proposed.[108] He reasons that the Company will incur additional chemical costs to produce the additional water he forecasts based on the customer numbers he uses.[109] Because Mr. Rackers' customer count adjustments overstate usage and revenues, this adjustment is not necessary.

### (b) Electricity Expense

As with chemical expense, Mr. Rackers has proposed an adjustment to increase the Company's electricity expense because of the additional power needed to produce the increased water sales Mr. Rackers has forecasted.[110] Because Mr. Rackers' customer count adjustments overstate usage and revenues, this adjustment is not necessary.

## 5. RATEMAKING MECHANISMS

### (a) DSIC

[108] Rackers Direct at 25.
[109] *Id.*
[110] *Id.*

*(i) Overview of the DSIC*

KAWC proposes to implement a Distribution System Infrastructure Charge ("DSIC"), which is a tariff rate adjustment mechanism that will allow the Company to accelerate the replacement rate of its aging infrastructure.[111] Consistent with many water service providers both in Kentucky and nationally, KAWC has a pressing need to replace distribution infrastructure that has met or exceeded its life expectancy.[112] NARUC has recognized that a DSIC is a "best practice" means to address these deficiencies.[113] Adequacy of distribution infrastructure is of critical importance to the Company's ability to fulfill its obligation of providing safe, adequate, and reliable water service.[114] KAWC plans to primarily focus its replacement program on small diameter mains, meaning mains of 6" or less in diameter, which are responsible for the majority of distribution system leaks and failures.[115]

The DSIC would permit KAWC to make the necessary infrastructure improvements without requiring the Company to incur substantial regulatory lag before filing a rate case to recover the costs of these necessary expenses.[116] The DSIC mechanism the Company proposes has a host of attendant customer protection measures that dispel any suggestion that KAWC is seeking to push through costs without sufficient regulatory oversight. While the customer protection measures will be discussed below, this broad point should not be overlooked. At its core, the DSIC permits KAWC to utilize a well-accepted regulatory mechanism to address a defined and significant infrastructure deficiency. In this respect, it is no different from the

[111] VerDouw Direct at 16.
[112] *Id.*
[113] Rebuttal Testimony of Gary M. VerDouw of May 15, 2013 (Case No. 2012-00520) ("VerDouw Rebuttal") at 15.
[114] VerDouw Direct at 16.
[115] *Id.* at 19.
[116] *Id.* at 17.

mechanisms the Commission has approved for other utilities, such as accelerated main replacement programs and gas line trackers.[117]

The DSIC will only apply to qualified, non-revenue producing plant investment that has not been included in rate base in a prior rate case proceeding.[118] The DSIC would be established on an annual prospective basis utilizing thirteen month average end-of-month balances and would reflect only those qualified plant additions installed after the conclusion of the initial rate year after the Commission's final order in this case.[119] To initiate a DSIC, the Company would make its annual filing not later than ninety days prior to the effective date of each implementation.[120] To ensure sufficient regulatory review, not later than sixty days after the conclusion of each DSIC year, the Company would initiate an annual reconciliation filing which will include a detailed listing of each qualifying project completed and placed in service during the immediately preceding DSIC year.[121] The Commission would review all aspects of the filing, including evaluating the prudency of the projects.[122] Thus, Commission oversight and approval would be present, just like in a general rate case.

*(ii) Mr. Rackers' Objections to the DSIC Are Misplaced*

Despite the clear need for the DSIC and the transparent process KAWC has proposed to govern its administration, Mr. Rackers has recommended that the Commission deny the Company's proposal. While Mr. Rackers' direct testimony contains a number of superficial

[117] Case No. 2001-00092, *In the Matter of: Adjustment of Gas Rates of the Union Light, Heat and Power Company* (Ky. PSC Jan. 31, 2002); Case No. 2009-00141, *In the Matter of: Application of Columbia Gas of Kentucky, Inc. for an Adjustment in Rates* (Ky. PSC Oct. 6, 2009); Case No. 2012-00222, *In the Matter of: Application of Louisville Gas and Electric Company for an Adjustment of its Electric and Gas Rates, a Certificate of Public Convenience and Necessity, Approval of Ownership of Gas Service Lines and Risers, and a Gas Line Surcharge* (Ky. PSC Dec. 20, 2012).
[118] VerDouw Direct at 22.
[119] *Id.*
[120] *Id.*
[121] *Id.* at 23.
[122] *Id.*

objections to the DSIC, none of his objections provides a reasoned basis to deny the Company and its customers the benefit of the mechanism.

Mr. Rackers' first objection is that KAWC has not specifically identified the projects it seeks to complete and the Company does not have written prioritization guidelines for its projects.[123] This is inaccurate because the Company has detailed its infrastructure planning process; how much of the system has exceeded its useful life; its current replacement rates; and the number of years necessary to replace the infrastructure seventy-five years or older, categorized by size of main.[124] KAWC has provided the Commission and the parties to this case ample information regarding the projects for which the DSIC will be utilized.[125]

Mr. Rackers' second objection is equally unavailing. Mr. Rackers takes issue with the information provided in Mr. VerDouw's Direct Testimony regarding the United States Environmental Protection Agency's Drinking Water Infrastructure Needs Survey and Assessment Reports, which Mr. Rackers concedes shows the need for "significant" distribution facilities enhancements.[126] Mr. Rackers' claim that this information is not "Kentucky-specific" is misplaced. Mr. VerDouw included this information to demonstrate that the infrastructure challenges presently facing KAWC are likewise being faced by water utilities across the United States. Moreover, KAWC has provided substantial evidence that the replacement rate for its *own* system water mains are inadequate and must be accelerated if the Company is to address its *own* infrastructure needs.

[123] Rackers Direct at 8.
[124] VerDouw Rebuttal at 10.
[125] *See* the Direct Testimony of Lance E. Williams of December 28, 2012 (Case No. 2012-00520) at p. 14-15, as well as Exhibit LEW-1.
[126] Rackers Direct at 9.

Mr. Rackers' third objection relates to the cost savings associated with the DSIC and the frequency of rate cases.[127] Specifically, Mr. Rackers claims that the DSIC should not be approved because KAWC did not quantify the amount of cost savings that would be achieved in the near term or specify the effect of a DSIC on the frequency of rate cases.[128] Both of these claims are classic red herrings – the primary purpose of the DSIC is not to produce cost savings or delay rate cases, but to instead accelerate the needed remediation of aging water utility infrastructure on a proactive and sustained basis.[129] Incident to achieving its purpose, however, are long-term cost savings that may occur through reductions in energy usage, pumping costs, unaccounted-for water reductions, expenses related to main breaks, and a reduction in customer inquiries regarding water service interruption or quality.[130] Realizing some or all of these cost savings in the long-term will benefit customers, in addition to the *principal benefit* of receiving reliable and quality water because of the infrastructure improvements KAWC has performed. With respect to the frequency of rate cases, the Company believes that, all other things being equal, implementing a DSIC will permit the Company to reduce the frequency of base rate cases.[131] Again, this benefit is secondary to the principal benefit of the DSIC.

Next, Mr. Rackers argues that KAWC does not need a DSIC because the Company does not have a "significant water leak problem."[132] KAWC's unsold water line loss in 2012 was 11.7 percent.[133] While this may be in the low end of the range among AWW operating affiliates, KAWC's loss percentage still exceeded the American Water Works Association's 10 percent

[127] *Id.* at 10.
[128] *Id.*
[129] VerDouw Rebuttal at 19.
[130] *Id.* at 20.
[131] *Id.*
[132] Rackers Direct at 10.
[133] VerDouw Rebuttal at 16.

benchmark.[134] In the last four years, KAWC has experienced 569 main breaks in its distribution system and 68 percent of those were associated with distribution mains 6" and smaller, even though such mains only represent 37 percent of the total distribution system.[135] Moreover, the challenge the Company faces with respect to water loss in certain portions of its service area, including the Northern Division, was discussed at the hearing.[136] In short, Mr. Rackers' insinuation, which is that the Company is not "leaky enough" for a DSIC, is simply untrue and, if accepted, would be imprudent ratemaking. Delaying improvements until the Company has a dire water main break that interrupts service or until KAWC cannot keep its water line loss below 15 percent is unreasonable because the need for accelerated improvements is presently known.

Mr. Rackers' fifth objection to the DSIC is that it wrongfully constitutes "single-issue ratemaking."[137] This argument is belied by a recent Kentucky Supreme Court decision holding that the Commission has "***plenary authority to allow a utility to adjust its rates by imposing a surcharge or rider aimed at recovering costs***" outside of a rate case even in the absence of a statute specifically authorizing recovery of such costs.[138] The Commission thus has the authority to approve the DSIC. Moreover, allaying any concerns about "single issue" ratemaking and the need to match revenues and expenses is that (1) the DSIC only applies to qualified non-revenue producing plant; and (2) the Commission will have the opportunity to scrutinize the expenses during annual reconciliation filings.

[134] *Id.*
[135] *Id.* at 18.
[136] June 5, 2013 Hearing at VR 14:33:00-14:33:36.
[137] Rackers Direct at 12.
[138] *Kentucky Public Service Comm'n v. Commonwealth of Kentucky*, 324 S.W.3d 373, 374 (Ky. 2010) (emphasis added).

Next, Mr. Rackers claims that because KAWC can utilize a forecasted test year, a DSIC is not needed because of the "timely rate recognition" received in the current rate case process.[139] This argument is unavailing because the ability to use a forecasted test year does not eliminate the regulatory lag associated with capital improvements, unless the utility files a rate case as soon as the last case is complete. Because of the expense of the rate case process on a utility and its customers this is not a business practice to which a utility aspires. The DSIC will both allow KAWC to accelerate the rate of its infrastructure improvements with more timely recovery of the costs, and provide more focused regulatory oversight in an annual reconciliation filing – without having to file a rate case. A forecast test year alone cannot achieve *any* of these benefits.

*(iii) Rackers' Proposed Modifications of the DSIC*

Mr. Rackers has recommended eight modifications to the structure of the DSIC, if the mechanism is approved.[140] Many of his recommendations are not necessary because they are based on a misunderstanding of how the proposed DSIC will operate. First, Mr. Rackers proposes that if KAWC is currently earning at or above its authorized return on equity ("ROE"), the Company should not be allowed to implement a DSIC or increase the current DSIC rate.[141] While the Company has indicated its willingness to consider including a provision regarding earnings in excess of KAW's authorized ROE, the approach Mr. Rackers recommends is unnecessary because it assumes that any over-earnings applicable to the historical period used as the basis of calculation would equally apply to the prospective DSIC period. This is incorrect because the DSIC would be implemented for the prospective DSIC year based upon the applicable revenue requirement.[142]

[139] Rackers Direct at 12-13.
[140] *Id.* at 14.
[141] *Id.*
[142] VerDouw Rebuttal at 26.

Next, Mr. Rackers argues that the change in accumulated depreciation and ADIT reserves associated with the plant previously included in rate base in the most recent rate case should be an offset of the DSIC-eligible plant.[143] This recommendation also evinces a misunderstanding of how the DSIC will operate, because only a narrowly focused portion of capital improvements will be DSIC-eligible.[144] It is consequently inappropriate to offset DSIC-eligible plant with accumulated depreciation and ADIT on *all* plant, while only a *portion* of the Company's utility plant is DSIC-eligible.[145] As proposed, DSIC-eligible plant will be offset by the accumulated depreciation reserve associated with those projects. The formula the Company has proposed does not include the ADIT reserve associated with DSIC-eligible plant.[146]

While KAWC generally agrees with Mr. Rackers' next recommendation, which is that the Company should be able to include property taxes in the DSIC revenue requirement, KAWC disagrees with Mr. Rackers' emphasis that the taxes be "paid" before they are included, and instead requests that the Company's calculation reflect all applicable property taxes actually owed for the applicable DSIC investment, which is the amount that will be expensed on KAWC's income statement.[147]

Mr. Rackers' next recommendation is that the Company makes its annual filing in a docketed proceeding at least 120 days – instead of the proposed ninety days – prior to implementation of the DSIC year.[148] The Company believes this is unnecessary because it is during the annual reconciliation filing (instead of the filing before the DSIC year begins), which will be made no later than sixty days after the end of the DSIC year, in which the Commission

[143] Rackers Direct at 14.
[144] VerDouw Rebuttal at 27.
[145] *Id.*
[146] *Id.* at 27-28.
[147] *Id.* at 28.
[148] Rackers Direct at 14.

will have the opportunity to review all aspects of the DSIC investments made during the year and make any necessary adjustments to KAWC's calculated revenue requirement.[149]

Finally, Mr. Rackers proposes that the annual filing should be made a docketed proceeding in which all interested parties, which he defines as including the parties in the most recent rate case, should receive "automatic" intervention.[150] Both of these proposals unnecessarily constrain the Commission's discretion over the proceedings before it. First, whether or not a proceeding merits docketed investigation is, and should, remain the purview of the Commission based upon the situation. Second, KAR 5:001, Section 11 sets forth the standard for intervention and there is no principled reason to deviate from that standard with respect to KAWC's DSIC filings.

**(b) <u>Purchased Power and Chemical Charge Tariff Rider</u>**

*(i) Overview of the Purchased Power and Chemical Charge Tariff Rider*

Because of the unpredictability and lack of control over purchased power and chemical expenses, KAWC has proposed a Purchased Power and Chemical Charge Tariff Rider ("PPACC"). This tariff rate adjustment mechanism would recover from or credit to customers the incremental changes in purchased power and chemical costs above or below the level authorized for recovery in the Company's most recent rate case.[151]

The PPACC is important to KAWC for several reasons. First, the combined cost of purchased power and chemicals is the largest non-labor related component of the Company's operation and maintenance expenses.[152] Second, the cost of purchasing these commodities is

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[149] VerDouw Rebuttal at 29-30.
[150] Rackers Direct at 14.
[151] VerDouw Direct at 28.
[152] *Id.*

generally beyond the Company's control and pricing can often be volatile.[153] As such, these expenses do not fit well within the traditional test year ratemaking framework that requires that adjustments be known and measureable.[154] The PPACC will be based on actual historical purchased power and chemical costs incurred during a previous twelve month period.[155] To provide for regulatory oversight, KAWC will make an annual filing with the Commission that will consist of the actual purchased power and chemical costs incurred, as well as the reconciliation of any prior period PPACC rider over or under-recoveries.[156]

*(ii) Mr. Rackers' Objections to the PPACC Are Misplaced*

Mr. Rackers has recommended the Commission deny the PPACC because he claims that trackers constitute single-issue ratemaking and the rider would eliminate KAWC's incentive to minimize expenses and maximize revenues between rate cases.[157] Before responding to these arguments, it is important to note that Mr. Rackers does not appear to understand how the proposed mechanism will operate, because he states that the Company requested the tracker so that KAWC can defer cost increases until the next rate case.[158] This is false; any price changes, both increases and decreases, would ***not*** be deferred until the next rate case but would instead be recovered from or credited to customers over a one-year period as separate line item of customers' bills.[159]

Mr. Rackers advanced the same argument regarding single-issue ratemaking with respect to the DSIC. While KAWC will not repeat its same arguments in response, it is important to note that other than Mr. Rackers' theoretical rendition of the matching principle, Mr. Rackers

[153] *Id.*
[154] *Id.*
[155] *Id.* at 32.
[156] *Id.*
[157] Rackers Direct at 20.
[158] *Id.* at 19.
[159] VerDouw Rebuttal at 31.

provides no evidence that the PPACC will unduly skew the recovery of actual revenues and expenses.

Mr. Rackers' second argument, which is that KAWC will no longer have an incentive to minimize expenses and maximize revenues between rate cases, is an incorrect overgeneralization. One of the principal reasons that KAWC is seeking a tracker for chemical and purchased power expenses is that the Company has very limited ability to affect either the quantity or the price of power and chemicals.[160] This was addressed in Mr. VerDouw's direct testimony, and Mr. Rackers did not dispute that these costs are largely outside the control of the utility.[161] Between the Company's limitations to control the quantity or price of these costs, coupled with the Company's burden to demonstrate that its expenditures are reasonable and prudent, Mr. Rackers' concern that KAWC will not have an incentive to minimize these expenses is misplaced and should be rejected.

Finally, Mr. Rackers alleges that the annual changes in these costs are not "significant enough" to warrant a tracker.[162] Mr. Rackers does not define what "significant enough" constitutes and instead presents a simple comparison of the annual costs of these expenses during 2010 to 2012 and the budgeted expenses for 2013.[163] This comparison fails because it does not recognize that these expenses are impacted not only by price changes, but also by the level of actual water usage by customers.[164] The PPACC is the most accurate, fair, and efficient means of recovering purchased power and chemical expense.

Mr. Rackers then provides two "alternatives" to the PPACC, neither of which are actual alternatives. First, he states if "KAWC foresees significant changes in chemical and electric

[160] *Id.* at 32.
[161] *Id.*
[162] Rackers Direct at 20.
[163] *Id.*
[164] VerDouw Rebuttal at 32.

costs, it can file a rate case…"[165] One of the principal reasons KAWC is requesting the PPACC is that because of the volatility it continues to experience, the Company ***cannot foresee*** significant changes in these expenses. Moreover, if the Company did file a rate case to "capture these items in the cost of service" as Mr. Rackers proposes, because of the volatility of the expenses, the rate case process cannot ensure that the accurate amount of costs will be recovered from customers.[166] The tracker allows the Company to recover its actual costs for these items, but also benefits customers by more accurately, and quickly, reflecting cost decreases for these expenses.

Mr. Rackers' second "alternative" is that KAWC "file for authority to create a deferred debit" for changes in these costs.[167] The "deferred debit" approach is unlikely to be approved by the Commission, and even if approved, does not alleviate the Company's concerns about timely recovery of these costs, absent more frequently filed rate cases. In previous KAWC rate case proceedings, the Commission has utilized "deferred debit" interchangeably with "regulatory asset."[168] In KAW's 2004 rate case, the Commission held that KAW cannot begin accruing any expense as a regulatory asset until it has received affirmative determination from the Commission or Commission Staff.[169] KAWC is required to make written request to the Commission's Executive Director for the approval of any proposed deferrals.[170] The Commission Staff's review is limited to the accounting treatment of the proposed deferral and will not address the likelihood of recovery of the expense in any future rate proceeding.[171]

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[165] Rackers Direct at 21.
[166] *Id.*
[167] *Id.*
[168] *See* Order in Case No. 2004-00103 at 21-22.
[169] *Id.* at 37-38.
[170] *Id.* at 37.
[171] *Id.*

The Commission, especially in recent years, has emphasized that deferring expenses by creating a regulatory asset is only permissible if the expense falls within one of four categories: (1) an extraordinary, nonrecurring expense which could not have reasonably been anticipated or included in the utility's planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry-sponsored initiative; or (4) an extraordinary or nonrecurring expense that, over time, will result in savings that fully offset the cost.[172]

KAWC's purchased power and chemical costs do not fall within any of these categories. As to (1), while the specific costs are volatile, purchased power and chemical costs are recurring, ordinary costs. This differs from the regulatory assets the Commission has permitted for storm damage. In those cases, a severe weather event causes damage significantly above the recurring amount of annual storm damage contained in rates. The Commission has permitted utilities to create a regulatory asset for the expenses associated with the severe weather event, while the baseline amount of storm damage remains in rates.[173] This approach is incompatible with purchased power or chemical costs for two reasons. First, the Company has difficulty ascertaining the appropriate amount of expenses to include in rates because of the overall volatility of the expenses. Second, none of the discrete chemical and power costs that make up the aggregate expense is likely to be so extraordinary as to warrant regulatory asset treatment for a specific chemical or power purchase, with the baseline level of purchased power or chemical expense remaining in rates.

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[172] Case No. 2012-00102, *In the Matter of: Request of Shelby Energy Cooperative for Approval to Establish a Regulatory Asset in the Amount of $443,562.75 and Amortize the Amount over a Period of Five Years* (Ky. PSC April 16, 2012).

[173] *See*, *e.g.*, Case No. 2012-00445, *In the Matter of: Application of Kentucky Power Company for an Order Approving Accounting Practices to Establish Regulatory Assets and Liabilities Related to the Extraordinary Expenses Incurred by Kentucky Power Company in Connection with Four Major Storm Events* (Ky. PSC Jan. 7, 2013).

As to (2), (3), and (4), purchased power and chemical expenses (2) do not result from a statutory or administrative directive; (3) are not related to an industry-sponsored initiative; and (4) are not an extraordinary or nonrecurring expense that, over time, will result in savings that fully offset the cost. It is therefore unlikely that the Commission would permit KAWC to establish a regulatory asset for these costs.

Moreover, even if the Commission allowed KAWC to establish regulatory assets for these expenses, this approach does not alleviate the Company's concerns about timely recovery of these costs, and instead delays recovery. Even if KAWC proposed and the Commission allowed the Company to establish regulatory assets in this proceeding, the Commission will not allow rate recovery of the costs until the Company's ***next*** rate case proceeding, as it is the Commission's practice not to consider rate recovery of a regulatory asset until the following rate case after the asset is created. While the amount ultimately recovered in rates may be more precise, the Company cannot recover the costs without filing a rate case and the costs will likely be recovered over a period of years, further delaying KAWC's timely recovery of these prudently incurred costs. The Company thus requests the Commission approve the PPACC tracker and deny Mr. Rackers' objections and "alternatives."

### 6. RETURN ON EQUITY

#### (a) <u>KAWC's Requested Return on Equity</u>

KAWC requests that this Commission approve a ROE of 10.9 percent, which is within the 10.4 percent to 11.4 percent range recommended by the Company's expert witness, Dr. James Vander Weide.[174] In considering the appropriate ROE for KAWC, it is important to note that the Company was only able to earn a 9.21 percent ROE, which is below the authorized level

[174] Rungren Direct at 10; Direct Testimony of Dr. James H. Vander Weide of December 28, 2012 (Case No. 2012-00520) ("Vander Weide Direct") at 4.

of 9.7 percent in 2012, despite higher than expected water sales due to a moderate drought.[175] Also, as explained by Ms. Norton during the hearing, information showing that KAWC "earned" 11.8 percent in 2011 is misleading because the ROE results were affected tremendously by the tax impact of donating Jacobson Park to LFUCG.[176]

Dr. Vander Weide's direct testimony supports this ROE through his analyses that involved several equity estimation methods, including the discounted cash flow ("DCF") model, the risk premium method, and the capital asset pricing method ("CAPM") to groups of comparable risk companies.[177] Dr. Vander Weide generally gives equal weight to the results of these cost of equity methods, unless the average Value Line beta for the proxy companies is significantly less than 1.0, as it is in this case, in which case he gives little or no weight to the CAPM results because financial research provides strong support for the conclusion that the CAPM underestimates the cost of equity for companies whose betas are significantly less than 1.0.[178]

The DCF method is premised on the assumption that investors value an asset on the basis of the future cash flows they expect to receive from owning the asset.[179] This model consequently replicates the timing, magnitude, and relative risk of the expected cash flows of the investment.[180] Within this framework, there are different methods of applying the DCF – the principal difference, which is significant to this proceeding, being whether the calculation assumes dividends are paid quarterly or annually.[181] Dr. Vander Weide explains in his direct testimony that the quarterly DCF model must be used to estimate KAWC's ROE because the

[175] KAWC's Response to Item No. 28 of the AG's First Request for Information.
[176] *Id.*; June 4, 2013 Hearing at VR 14:37:36-14:37:58.
[177] Vander Weide Direct at 3.
[178] *Id.* at 3-4.
[179] *Id.* at 17.
[180] *Id.*
[181] *Id.* at 19.

companies in his proxy groups all pay dividends quarterly.[182] Another significant consideration in the DCF model is how the growth component is calculated. Dr. Vander Weide utilizes both the average analysts' estimates of future earnings per share ("EPS") growth reported by I/B/E/S Thomson Reuters and the estimate of future earnings per share growth reported by Value Line.[183] Dr. Vander Weide also includes a five percent allowance for flotation costs in his DCF calculations, which are costs that every firm selling securities in the capital markets incurs and include underwriters' commissions, legal fees, and printing expenses.[184] Although withheld from the proceeds of the stock sale, the costs must be incurred by the firm.[185]

Dr. Vander Weide's proxy groups for the DCF model included a group of publicly traded water utilities and a group of publicly-traded natural gas distribution companies.[186] The proxy groups Dr. Vander Weide selected are comparable to KAWC with respect to total risk, meaning that the effects, if any, from the Company's use of a forecasted test year or if the DSIC and PPACC are approved have been incorporated.[187] The results of Dr. Vander Weide's application of the DCF model to the Value Line water companies produce a market-weighted average result of 10.6 percent and a simple average DCF result of 10.5 percent.[188] His application of the DCF method to the natural gas distribution companies in Dr. Vander Weide's proxy group produces a market-weighted average result of 10.4 percent.[189]

The next estimation model Dr. Vander Weide applied was the risk premium approach, which is based on the assumption that investors expect to earn a ROE that reflects a premium above the return the investor expects to earn on an investment portfolio of less-risky long-term

182 *Id.*
183 *Id.* at 21.
184 *Id.* at 25.
185 *Id.*
186 *Id.* at 27.
187 KAWC's Responses to Item Nos. 28 and 29 of Commission Staff's Second Request for Information.
188 *Id.* at 29.
189 *Id.* at 32.

bonds.[190] Dr. Vander Weide applied both the ex ante premium method and the ex post risk premium method.[191] In performing the ex ante risk premium method, Dr. Vander Weide arrived at a ROE estimate of 11.4 percent.[192] The ex post premium method resulted in a ROE estimate of 10.8 percent.[193]

Dr. Vander Weide also performed the CAPM method of estimating the cost of equity, which is an equilibrium model of the security markets in which the required return on a certain security is equal to the risk-free rate of interest, plus the company equity, "beta," multiplied by the market risk premium.[194] To estimate his risk-free rate, Dr. Vander Weide used the forecast yield on twenty-year Treasury bonds.[195] Dr. Vander Weide obtained a CAPM result of 10.1 percent by applying the DCF model to the S&P 500, to which he gave less emphasis because the CAPM tends to underestimate the cost of equity for small market capitalization companies, such as the water companies in his proxy group.[196]

**(b) <u>AG's and LFUCG's Position on Return on Equity</u>**

The AG and LFUCG filed direct testimony regarding KAWC's return on equity through its jointly sponsored witness, Dr. J. Randall Woolridge. Dr. Woolridge applied the DCF and CAPM methods to two proxy groups of publicly-held water utility and gas distribution companies.[197] Dr. Woolridge contends that an equity cost rate between 7.3 percent and 8.6

[190] *Id.*
[191] *Id.* at 33.
[192] *Id.* at 35.
[193] *Id.* at 41.
[194] *Id.* at 41-42.
[195] *Id.* at 42.
[196] *Id.* at 45.
[197] Direct Testimony of Dr. J. Randall Woolridge (Case No. 2012-00520) ("Woolridge Direct") at 2.

percent is appropriate for KAWC.[198] His recommendation for KAWC's ROE in this proceeding is 8.5 percent, with an overall rate of return of 7.07 percent.[199]

When Dr. Woolridge performed the DCF model, his estimated equity cost rate for his water proxy group was 8.6 percent and 8.5 percent for his gas proxy group.[200] These results are substantially lower than Dr. Vander Weide's DCF results, which were a market-weighted average result of 10.6 percent for his water proxy group and 10.4 percent for his gas distribution proxy group.

Dr. Woolridge acknowledges that the two principal reasons for the significant divergence between his results and Dr. Vander Weide's DCF results are (1) the appropriate adjustment to the DCF dividend yield and (2) the estimation of the expected growth rate.[201] Regarding the dividend yield, Dr. Woolridge utilized an annual DCF model to estimate KAWC's cost of equity, while Dr. Vander Weide employed a quarterly model. The annual model Dr. Woolridge employed is based on the assumption that companies pay dividends only at the end of each year.[202] Using this approach is not logical, however, because all of the companies in Dr. Woolridge's proxy groups pay dividends quarterly, not annually.[203] This is contrary to Dr. Woolridge's stated concession that "one must recognize the assumptions under which the DCF model was developed in estimating its components…"[204] Using the annual DCF model, which artificially lowers the cost of equity estimate, when the companies in Dr. Woolridge's own proxy groups pay dividends quarterly, is unreasonable.

[198] *Id.*
[199] *Id.* at 2-3.
[200] *Id.* at 41.
[201] *Id.* at 4.
[202] Rebuttal Testimony of Dr. James H. Vander Weide of April 2013 (Case No. 2012-00520) ("Vander Weide Rebuttal") at 8.
[203] *Id.*
[204] Woolridge Direct at 29.

The second reason why Dr. Woolridge's DCF estimate is unreasonably low is that Dr. Woolridge relies on *historical* growth rates – as opposed to *forecasted* growth rates – to calculate his estimated growth rate. As explained by Dr. Vander Weide, historical growth rates are inherently inferior to analysts' forecasts because analysts' forecasts already incorporate all relevant information regarding historical growth rates, as well as incorporating the analysts' knowledge about current conditions and future expectations.[205] Use of historical growth rates, as Dr. Woolridge has utilized, necessarily contains less complete information than the analysts' forecasts on which Dr. Vander Weide relies. Moreover, if ratemaking is to mimic the market, the Commission should necessarily rely on the information actually used by investors. Because Dr. Vander Weide's application of the DCF model utilizes more reasonable components, his DCF results should be given more weight than those presented by Dr. Woolridge, which contain significant deficiencies.

Dr. Woolridge's application of the CAPM resulted in a cost of equity estimate of 7.5 percent for his water utility group and 7.3 percent for his natural gas distribution company group.[206] These estimates are ***more than 200 basis points lower*** than KAWC's currently authorized ROE, which alone demonstrates the unreasonableness of these results. Dr. Woolridge recognizes these results are unreasonable because his CAPM results are 150 to 120 basis points lower than his recommended 8.5 percent cost of equity.

Dr. Woolridge's CAPM results are unreasonably low because (1) the U.S. Treasury has kept interest rates low following the economic crisis as part of its efforts to stimulate the economy and (2) the betas of utilities are currently approximately 0.70 and the CAPM

[205] Vander Weide Rebuttal at 10.
[206] Woolridge Direct at 51.

underestimates the cost of equity for companies whose equity beta is less than 1.0.[207] At least one other state's public service commission has noted that the CAPM approach may provide less reliable estimates regarding a return on equity due to the current condition of the capital markets.[208] Because of these conditions and the unreasonably low cost of equity estimates Dr. Woolridge's CAPM results produced, these results should not be considered by the Commission in setting KAWC's ROE.

In considering the appropriate ROE for KAWC in this proceeding, the Commission should give weight to the overall reasonableness of the parties' positions. The 8.5 percent ROE that Dr. Woolridge has recommended is not within the zone of reasonableness, as recognized by the Kansas Corporation Commission. Dr. Woolridge, on behalf of an intervenor, recommended a ROE of 8.5 percent for Kansas City Power & Light Company.[209] In rejecting such a low ROE, the Kansas Corporation Commission stated that Dr. Woolridge's recommendation of 8.5 percent was "too low," "well below the average rates of return," and would place the utility at a "competitive disadvantage."[210] The Kansas Corporation Commission's correct reasoning applies equally to KAWC. KAWC respectfully requests the Commission likewise reject Dr. Woolridge's unreasonably low ROE and instead adopt Dr. Vander Weide's recommended ROE.

## 7. RATE ALLOCATION AND RATE DESIGN

### (a) <u>KAWC's Cost of Service and Rate Design</u>

To fairly allocate the proposed rate increase among Kentucky American Water's customer classes, Mr. Paul Herbert performed a cost of service allocation and rate design study

[207] Vander Weide Rebuttal at 27.
[208] *See* Staff Recommendation for Docket No. 080677-E1 – *Petition for Increase in Rates by Florida Power & Light Company* (December 23, 2009 Order).
[209] Docket No. 12-KCPE-764-RTS, *In the Matter of the Application of Kansas City Power & Light Company to Make Certain Changes in Its Charges for Electric Service* (Dec. 13, 2012 Order).
[210] *Id.*

for KAWC.[211] The cost of service study allocated the total costs among the residential, commercial, industrial, public authority, sales for resale, private fire protection and public fire protection customer classes.[212] That way, the proposed rate increase is spread equitably among the various customer classes.[213]

### (b) AG's and LFUCG's Cost of Service and Rate Design

The AG and LFUCG sponsored testimony regarding cost of service and rate design from Brian Kalcic. Mr. Kalcic stated in his direct testimony that he concluded that Mr. Herbert's cost of service study "reflects an appropriate application" of the cost of service methodology and "no changes in the methodology are warranted at this time."[214] Mr. Kalcic did not recommend any changes to KAWC's general meter service rate structure.[215]

Mr. Kalcic does propose a lower increase to the service charge than the $14.00 service charge on a 5/8" meter proposed by Mr. Herbert. The first reason for the disagreement is that Mr. Herbert's service charge recommendation is based upon KAWC's proposed revenue requirement and Mr. Kalcic's service charge is based on Mr. Rackers' proposed revenue requirement.[216] It is important to note, however, that Mr. Kalcic did utilize the same relative increases by customer classification as Mr. Herbert did.[217]

The second reason for the disagreement is that Mr. Kalcic does not want to increase the service charge such that there is a decrease in the consumption charge. Mr. Herbert, however, explained in his rebuttal testimony that he has not changed his proposed customer charge

[211] Direct Testimony of Paul Herbert of December 28, 2012 (Case No. 2012-00520) ("Herbert Direct") at 3.
[212] *Id.*
[213] *Id.*
[214] Direct Testimony of Brian Kalcic (Case No. 2012-00520) ("Kalcic Direct") at 4.
[215] *Id.* at 9.
[216] *Id.* at 11.
[217] Rebuttal Testimony of Paul Herbert of May 15, 2013 (Case No. 2012-00520) ("Herbert Rebuttal") at 1.

because it is not likely that the customer cost analysis under a reduced revenue requirement level would fall below $14.00 per month.[218]

#### (c) CAC's Cost of Service and Rate Design

Jack Burch filed direct testimony on behalf of CAC that largely addresses the impact of a rate increase on low-income customers. As part of his testimony, however, Mr. Burch questioned why KAWC has not proposed a rate design that includes a "graduated or tiered rate structure, which provides an initial amount of water at a free or very low cost and then charges more as consumption levels increase…"[219] Mr. Burch did not actually propose a rate design for KAWC, other than expressing his philosophical preference for a graduated or tiered rate structure. Presently, KAWC has a uniform rate structure, meaning that the first gallon, and thousandth gallon of water, has the same unit price.

There are many reasons why Mr. Burch's superficially recommended rate structure should be rejected by the Commission. First, as explained in Mr. Herbert's rebuttal testimony, graduated rate structures are not cost-based.[220] Because customer charges only recover customer costs, the only way to recover the fixed and variable costs of delivering water (intake structures, treatment plants, pumping stations, storage facilities, pipes, power, chemicals, labor, etc.) is to recover such costs in the volume charges. This means that the initial usage for each customer is the most expensive water that is delivered, not the cheapest.[221]

Second, Mr. Burch's claim that graduated rates benefit low-income customers is not supported by the record. When Mr. Burch made the same proposal in KAWC's last rate case, the Commission found there was insufficient evidence in the record to support CAC's inverted

[218] *Id.* at 3.
[219] Direct Testimony of Jack Burch (Case No. 2012-00520) ("Burch Direct") at 13.
[220] Herbert Rebuttal at 3.
[221] *Id.*

block rate design with respect to its benefit to low income customers.[222] CAC provided no additional evidence to KAWC regarding the merits of its proposed rate structure following Case No. 2010-00036, or as part of this proceeding. In contrast, Mr. Herbert explained in his rebuttal testimony that graduated rates impose a financial burden on customers that cannot conserve at or below the initial block, which would include customers with large families.[223] During the hearing, KAWC introduced an exhibit demonstrating that based on U.S. census data, the median income per household in Kentucky for households with seven or more persons is less than the income in three, four, five, or six person households.[224] Thus, large households in Kentucky, who likely would not be able to conserve at or below the initial block, will have an increased financial burden under Mr. Burch's proposal. Other customer classes, such as industrial customers, with little or no discretionary water usage will also be harmed by Mr. Burch's proposal, which could stymie economic development.

Third, Mr. Burch incorrectly states that several AWW subsidiaries, including California, New Jersey, and New Mexico, have or have proposed graduated or tiered rates.[225] Of these, only California has a tiered rate structure. Mr. Burch conceded during the hearing that California has a severe water shortage,[226] which is consistent with Mr. Herbert's rebuttal testimony that "increasing block rate structures are mainly found in areas where there is short supply, such as ground water sources where drought conditions are frequent."[227] Mr. Burch, when questioned during the hearing, could not dispute that New Jersey American has a uniform rate structure or that New Mexico is no longer an AWW affiliate.[228]

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[222] December 14, 2012 Order in Case No. 2010-00036 at 75.
[223] Herbert Rebuttal at 3-4.
[224] KAWC Hearing Exhibit 5.
[225] Burch Direct at 15.
[226] June 5, 2013 Hearing at VR 18:00:00-18:00:25.
[227] Herbert Rebuttal at 4.
[228] June 5, 2013 Hearing at VR 18:00:30-18:01:31.

Fourth, a graduated rate structure with a very low cost or free initial block of water would have the unintended effect of benefitting customers that do not need financial assistance. For example, an affluent owner of thoroughbred horses who visits his upscale condominium in Lexington twice a year to attend the Keeneland sales meets would benefit from Mr. Burch's proposed rate design. This further demonstrates that the tiered rate structure Mr. Burch proposed is unreasonable.

In short, Mr. Burch provided no evidence regarding the desirability of a graduated rate structure, other than his unsubstantiated opinions that were refuted by Mr. Herbert's rebuttal testimony and by his own testimony during the hearing. CAC has provided no reasoned basis for KAWC to depart from a uniform rate structure and the CAC's recommendation should be denied.

**(d) Proposed Tariff Changes**

KAWC has proposed several revisions to its tariffs, which are described in the direct testimony of Ms. Bridwell.[229] Specifically, KAWC is proposing a revision to its tap fee; a revision to its Activation Fee and Reconnection Fee; and is also proposing to eliminate its After Hours Activation Fee and After Hours Reconnection Fee.[230] In addition to the DSIC and PPACC tariff already discussed, the Company is proposing minor changes to its index (as appropriate), as well as text changes to revise the returned check fee to an insufficient funds fee to reflect that it covers both checks and electronic fund transfers.[231] KAWC is also proposing to include customer service classification definitions in its tariff that clearly define each service classification so that customers can more easily determine which rate class is applicable to their

[229] Bridwell Direct at 41-42.
[230] *Id.* at 41.
[231] *Id.* at 41-42.

usage.[232] Other than Mr. Rackers' objection to the DSIC and PPACC, no party has objected to the proposed tariff changes.

As noted in KAWC's response to Item No. 15 of the Commission Staff's Second Request for Information, the Company inadvertently failed to propose deleting Second Revised Sheet Nos. 58.1 and 58.2. These tariffs, which contain returned check fees for customers previously served under the Elk Lake Subdivision and Tri-Village Water District, were holdover tariffs from KAWC's acquisition of these systems that have inadvertently not been deleted in prior rate cases.[233] As explained in the data response, if amenable to the parties and the Commission, KAWC would like to correct the issue in this proceeding.[234] No party objected to these proposed deletions.

**(e) <u>Single Tariff Pricing</u>**

KAWC utilizes single tariff pricing, meaning that the Company requires the same rates for each customer class regardless of the division in which the customer is located.[235] This has not always been the case. In Case No. 2004-00103, the Company had separate tariffs for its Central Division and Northern Division customers, but indicated its intent to move to a single tariff or "unified" rate structure.[236] The Commission's order in that proceeding noted that such a move would be consistent with the accepted principles of rate design.[237]

Following Case No. 2004-00103, KAWC acquired the Owenton system. In Case No. 2005-00206, in which the Commission addressed the Company's acquisition of the Owenton system, the Commission further encouraged the Company to shift to single tariff pricing in

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[232] *Id.* at 42.
[233] KAWC's Response to Item No. 15 of the Commission Staff's Second Request for Information.
[234] *Id.*
[235] *See* KAWC's Response to Item No. 5 of LFUCG's Supplemental Request for Information in Case No. 2012-00096, the record of which has been incorporated by reference in this proceeding.
[236] KAWC's Response to Item No. 5 of LFUCG's Supplemental Request for Information in Case No. 2012-00096.
[237] *Id.*

stating that "the Commission places KAWC on notice that KAWC's next application for a general rate adjustment should contain a proposal for a single rate schedule applicable to all KAWC customers…"[238] Given the Commission's unequivocal directive, in the Company's next rate case, which was Case No. 2007-00143, KAWC proposed a single tariff structure.[239] The parties to that case (which included LFUCG) proposed an agreed resolution of the case to the Commission that included a move to a single tariff structure that was approved by the Commission.[240] The single tariff pricing structure has remained in place and KAWC agrees with the Commission that it constitutes sound rate design.

Single tariff pricing has become an issue in this matter because KAWC now seeks rate recovery for the Northern Division Connection project. In Case No. 2012-00096, the Commission granted a certificate of public convenience and necessity authorizing KAWC to construct the Northern Division Connection, which will enable the Company's Northern Division to obtain water from KRS II.[241] Because KAWC utilizes single tariff pricing, the cost of the Northern Division Connection will be borne equally among all customers, regardless of division.[242] In the Northern Division Connection proceeding, the LFUCG argued in its post-hearing brief that "the Central Division customers should not be required to pay for this proposal" because the project does not benefit Central Division customers."[243] As part of the present case, several data responses have inquired into KAWC's single tariff pricing and whether it should be retained, all of which ostensibly stem from the LFUCG's claim in Case No. 2012-00096. Despite the questions regarding single tariff pricing, no intervenor has proposed a denial

[238] *Id.* (citing the Commission's July 25, 2005 Order in Case No. 2005-00206 at 6).
[239] *Id.*
[240] *Id.*
[241] Case No. 2012-00096, *In the Matter of: Application of Kentucky-American Water Company for a Certificate of Public Convenience and Necessity Authorizing Construction of the Northern Division Connection* (Ky. PSC Feb. 28, 2013).
[242] KAWC's Response to Item No. 5 of LFUCG's Supplemental Request for Information in Case No. 2012-00096.
[243] LFUCG Post-Hearing Brief in Case No. 2012-00096 at 3.

of rate recovery for the Northern Division Connection in this rate case. Presumably, such a denial of rate recovery has not been suggested because of Commission precedent:

> In those instances where the Commission has issued a Certificate of Public Convenience and Necessity for the construction of a facility, the Commission has determined that the facility's construction is reasonable. The utility can construct the facility with reasonable certainty that the costs associated with the facility will be recovered through its rates.[244]

In fact, the Commission has held that "[i]f the Commission has issued a Certificate for the construction of a utility facility, that facility and its associated expenses are presumed to be reasonable."[245] Clearly, rate recovery for the Northern Division Connection should occur. Just as clearly, it should occur via KAWC's existing single tariff pricing.

There are many sound reasons for retaining the single tariff structure, just as there are many reasons why departing from a unified rate structure in response to one capital project is not only imprudent, but unfair. A unified rate structure: (1) spreads the cost of capital expenditures across a larger customer base, thereby decreasing the rate impact of a capital project on each customer; (2) eliminates the administrative burden of maintaining multiple sets of books and records; (3) creates economies of scale and maintains more stable, understandable and affordable rates for customers by spreading costs over the entire base of customers; (4) lowers administrative and regulatory costs; (5) improves financial capital and capital deployment; (6) achieves rate and revenue stability; and (7) improves service affordability for very small systems.[246] The equitable rate treatment of all customers, regardless of division, inures many benefits to customers.

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[244] Case No. 2000-481, *In the Matter of: Application of Northern Kentucky Water District (A) For Authority to Issue Parity Revenue Bonds in the Approximate Amount of $16,545,000; and (B) A Certificate of Convenience and Necessity for the Construction of Water Main Facilities* (Ky. PSC Aug. 31, 2001).

[245] Case No. 2000-481, *In the Matter of: Application of Northern Kentucky Water District (A) For Authority to Issue Parity Revenue Bonds in the Approximate Amount of $16,545,000; and (B) A Certificate of Convenience and Necessity for the Construction of Water Main Facilities* (Ky. PSC Oct. 8, 2001).

[246] Certain of these benefits are explained in the article *Consolidated Water Rates: Issues and Practices in Single-*

The Commission itself encouraged KAWC and other utilities to employ uniform rate structures. As mentioned above, the Commission ordered KAWC to propose single tariff pricing because the Commission found a unified rate structure to be consistent with sound rate design. In the last twenty years, KAWC is only one of ***many*** utilities the Commission has encouraged and/or approved the move to a unified rate structure.[247] The clear weight of the Commission's orders support single tariff pricing.

Ceasing to utilize single tariff pricing solely because of the Northern Division Connection capital project is an imprudent knee-jerk reaction for several reasons. First, one of the principal benefits of a unified rate structure is that the costs of capital projects are spread among the entire customer class. This is consistent with how utilities generally allocate capital expenditures. For example, when a water utility replaces a main on Elm Street, it does not expect only the customers who receive water through the main on Elm Street to pay a portion of the capital costs. Similarly, when an electric utility replaces a transformer, it does not expect only the customers

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*tariff Pricing* by Janice A. Beecher, which was published by the EPA in September 1999 as a joint publication with NARUC.

[247] *See, e.g.*, Case No. 92-0023, *In the Matter of: The Boone County Water and Sewer District's Tariff Filing to Update Its Current Sewer Tariff* (Ky. PSC Oct. 28, 1992); Case No. 9948, *In the Matter of: The Application of Western Lewis-Rectorville Water District, Mason and Lewis Counties, Kentucky, (1) for a Certificate of Public Convenience and Necessity Authorizing Said District to Construct Major Water System Additions Pursuant to the Provisions of Chapter 74 of the Kentucky Revised Statutes; (2) Seeking Approval of Water Service Rates and Charges with Respect to Such Additions; and (3) Seeking Approval of the Issuance of Certain Securities* (Ky. PSC April 8, 1988); Case No. 8965, *In the Matter of: The Proposed Merger of the Green Hills Water District, Black Mountain Water District, Cawood Water District, and Wallins Creek Water District, Harlan County, Kentucky* (Ky. PSC Feb. 8, 1984); Case No. 8974, *In the Matter of: The Proposed Merger of the McKinney Water District and the McKinney Water Association, Lincoln County, Kentucky* (Ky. PSC April 9, 1984); Case No. 2007-00496, *In the Matter of: Joint Application of Consumers Water District, Fancy Farm Water District, Hardeman Water District, and South Graves Water District for Approval of Merger and Formation of Graves County Water District* (Ky. PSC May 21, 2008); Case No. 99-162, *In the Matter of: The Application of Green River Electric Corporation and Henderson Union Electric Cooperative Corporation for Approval of Rate Decrease for Kenergy Corp., Consolidation Successor* (Ky. PSC June 14, 2000); Case No. 2008-00011, *In the Matter of: The Application of Bluegrass Energy Cooperative Corporation for an Adjustment in Its Electric Rates* (Ky. PSC August 28, 2008); Case No. 9920, *In the Matter of: The Application of Henry County Water District No. 2 of Henry, Trimble, Carroll, Oldham, and Shelby Counties, Kentucky for Approval of Construction, Financing, and Increased Water Rates* (Ky. PSC Sept. 30, 1987); Case No. 2011-00443, *In the Matter of: Application of Kentucky Frontier Gas, LLC for Approval of Consolidation of and Adjustment of Rates, Approval of AMR Equipment and a Certificate of Public Convenience and Necessity for Installation of AMR, Pipeline Replacement Program, Revision of Non-recurring Fees, and Revision of Tariffs* (Ky. PSC April 30, 2013).

who receive electric service through the transformer to pay a portion of the capital costs. These examples are no different than KAWC's use of unified pricing among its divisions. Eliminating the use of single tariff pricing because of a sole capital project is inconsistent with utilities' general approach to recovering capital costs.

Second, elimination of single tariff pricing now would work a great injustice on Northern Division customers. Since KAWC implemented single tariff pricing, it completed the largest single capital project in Company history – KRS II. Although Northern Division customers will not receive a drop of water from KRS II until the Northern Division Connection is complete, Northern Division customers have shared equally in the cost of KRS II with the Central Division. It is unfair for the Northern Division customers to have paid their share of a larger capital project for years, only to then bear the sole burden of the Northern Division Connection simply because LFUCG does not believe it benefits the Central Division. There are other examples of capital projects for which the Northern Division has arguably obtained no benefit yet shared in the cost, including the 42" transmission main from KRS II to Newtown Pike and the Woodlake Booster and storage tank.[248]

In short, KAWC implemented a unified rate structure at the Commission's directive, consistent with a host of other utilities. Disbanding this approach because of LFUCG's unreasoned argument, especially in light of the fact that the Northern Division has paid its share of all capital expenditures since single tariff pricing was established, is imprudent.

**(f) <u>Northern Division Surcharge</u>**

In addition to questions regarding eliminating single tariff pricing, there has also been a data request inquiring whether a surcharge that would apply only to Northern Division customers would be the most appropriate rate mechanism for recovery of the costs associated with the

[248] *See* KAWC's Response to Item No. 16 of the Commission Staff's Third Request for Information.

Northern Division Connection.[249] A surcharge is not appropriate because it conflicts with single tariff pricing and the attendant advantages discussed above. Also, as explained by Ms. Bridwell at the hearing, American Water Works Association guidelines state that surcharges are only appropriate for costs arising from one-day events or emergencies.[250] A capital expenditure for which a utility sought and obtained a certificate of public convenience and necessity certainly does not fall within these guidelines.

If the Commission were to find that Northern Division customers should be assessed a surcharge for the Northern Division Connection, Northern Division customers should be credited with the expenditures for supply infrastructure not used to supply the Northern Division. Such infrastructure would include the 42" transmission main from KRS II to Newtown Pike and the Woodlake Booster and storage tank, as well as the full revenue requirement of the operations associated with KRS I, and the Richmond Road station, including the Jacobson reservoir.[251] The Commission would also have to consider whether the surcharge would provide a credit for the cost of KRS II, as well.

### (g) The Division Structure

The benefit of shared personnel and knowledge between KAWC's two divisions cannot be overlooked. Although the two divisions will not be physically interconnected until the Northern Division Connection project is complete, the interconnectedness of the divisions from a personnel and management perspective has long been in place. While the two divisions are currently defined based upon a natural grouping of physical assets, the divisions are jointly operated by KAWC's employees.

[249] *Id*.
[250] June 5, 2013 Hearing at VR 11:53:25-11:54:14.
[251] KAWC's Response to Item No. 16 of the Commission Staff's Third Request for Information.

From an operating perspective, therefore, it is appropriate for the Commission to consider the operating performance of KAWC – as opposed to the operating performance of the Northern Division or Central Division. An example of this is the calculation of non-revenue water, which pursuant to 807 KAR 5:066, Section 6(3), requires a ***utility's*** unaccounted-for water loss not to exceed fifteen percent for ratemaking purposes. Neither the Northern Division nor the Central Division is a utility - KAWC is the utility. Similarly, when KAWC files its annual report, gross revenues report, and utility operating report, the Company provides one report - instead of one for each division. Thus, when evaluating the operating performance of the Company, it is KAWC's performance that should be considered.

## 8. CAPITAL STRUCTURE AND COST OF DEBT

### (a) Capital Structure

Both the AG and LFUCG, through its witness Dr. Woolridge, used KAWC's filed thirteen-month average capital structure for the forecasted test year without adjustment.[252]

### (b) Short-Term and Long-Term Debt

Dr. Woolridge, on behalf of the AG and LFUCG, has proposed to adjust KAWC's short-term and long-term debt rates.[253] Specifically, Dr. Woolridge proposed a lower short-term debt interest rate, as well as a lower long-term debt interest rate.[254] When it filed its Application, the Company used 0.81 percent as the short-term debt cost rate.[255] Dr. Woolridge, however, used 0.50 percent in his direct testimony.[256] As explained in Mr. Rungren's rebuttal testimony, the Company revised its projected cost of short-term debt for the forecast period to 0.50 percent.[257]

[252] Woolridge Direct at 16.
[253] Rebuttal Testimony of Scott W. Rungren of May 15, 2013 (Case No. 2012-00520) ("Rungren Rebuttal") at 7-8.
[254] *Id.*
[255] *Id.* at 7.
[256] *Id.*
[257] *Id.* at 7-8.

Thus, the Company is in agreement with Dr. Woolridge on the appropriate rate.[258] Although not affecting the outcome, KAWC and Dr. Woolridge disagree, however, on the appropriate methodology by which the short-term debt cost rate is calculated.[259]

Dr. Woolridge has recommended a long-term debt cost rate of 6.05 percent, which is lower than the 6.14 percent the Company calculated for the forecast period.[260] In his rebuttal testimony, Mr. Rungren explains that because of errors in the embedded cost of long-term debt, the actual long-term debt cost rate is 6.19 percent.[261] The Company does not agree with Dr. Woolridge's recommendation because Dr. Woolridge's recommendation is based solely on the fact that an AWW affiliate issued senior unsecured notes at a rate of 4.30 percent on December 17, 2012, which is lower than the 5.20 percent KAW forecasts.[262] Dr. Woolridge's adjustment, which assumes that KAWC's interest rates in 2013 and 2014 will be the same as the interest rate an AWW affiliate obtained in 2012 is unreasonable because interest rates are not static and the Company forecasts interest rates on the projections for the time period in which they will be issued.[263] Dr. Woolridge's adjustment should be denied.

It should be noted that KAWC updated its long-term debt rates in this proceeding as information became available. For example, as explained in Mr. Rungren's rebuttal testimony, KAWC deferred an $8 million issuance from November 2012 to May 2013, at an interest rate of 4.0 percent (which is lower than the original forecast).[264] The Company has endeavored to provide to customers the benefit of the highly favorable interest rates it was recently able to obtain.

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[258] *Id.* at 8.
[259] *Id.*
[260] *Id.*
[261] *Id.* at 3.
[262] *Id.* at 8-9.
[263] *Id.* at 9.
[264] *Id.* at 4-5.

## 9. OTHER ISSUES ADDRESSED IN PROCEEDING

### (a) **Business Transformation**

One of the principal drivers of this rate proceeding is KAWC's Business Transformation ("BT") project. BT refers to the development and system-wide deployment of new, integrated information technology systems and the process of implementing the new systems in a manner that properly aligns business processes with the increased capabilities of the new systems.[265] BT is being deployed by all AWW operating subsidiaries. The need for the project is particularly pressing for KAWC because the Company's information technology systems are antiquated.[266] Also, KAWC's existing technology systems are customized, stand-alone systems used by specific and discrete departments and functions, and the lack of integration capabilities has resulted in isolated information "silos."[267]

BT is more than just a new customer service system; it comprises three projects: Enterprise Resource Planning ("ERP"); Enterprise Asset Management ("EAM"), and the Customer Information System ("CIS").[268] ERP includes human resource, finance and accounting, supply chain, and procurement management.[269] EAM includes the management of asset lifecycles including the design, construction, commissioning, operations, maintenance and decommissioning/replacement of plant, equipment and facilities as well as work management for both customer service field work and Transmission & Distribution system work.[270] CIS includes all billing and personal data about customers, including billing rates, water consumption,

[265] VerDouw Direct at 36.
[266] *Id.* at 38.
[267] *Id.*
[268] *Id.* at 36.
[269] *Id.* at 36-37.
[270] *Id.* at 37.

associated charges, meter information, and the strategy for managing and nurturing interactions with customers.[271]

KAWC and its customers will receive benefits from all facets as a result of the BT project. A sampling of these benefits include: (1) optimizing material availability to field personnel, which will enhance the quality and timeliness of field service; (2) increasing efficiencies in recruiting processes to minimize work gaps and ensure continuity of service for customers; (3) improving asset reliability and fewer unexpected outages by optimizing reliability-centered maintenance programs; (4) proactively communicating to customers through automated phone messages about incidents in their area; (5) improving employee dispatch, thereby enhancing customer solutions and response times; (6) greater first contact resolution as a result of automation in the bill correction process and redirected resources providing the opportunity to resolve customer requests in a timely manner; (7) opportunities for enhanced bill presentment options; (8) ability to introduce tools that would assist customers in resolving debt issues and eliminate manually intensive collection processes; (9) improving scheduling between field service representatives and customers; and (10) the ability to track service orders that will allow customers to monitor the progress online.[272] These ten benefits, each of which will appreciably benefit customers, are a subset of an even greater number of advantages to the BT project. The fact that the Company can readily identify many benefits to KAWC's ratepayers as a result of the BT project distinguishes this undertaking from the project the Commission disallowed for Water Service Corporation.[273] The Commission denied rate recovery in that

[271] *Id.*

[272] These benefits are set forth in the Comprehensive Planning Study Report, which is a confidential document provided in response to Item No. 168 of the AG's First Request for Information.

[273] Case No. 2008-00563, *Application of Water Service Corporation for an Adjustment of Rates* (Ky. PSC Nov. 9, 2009) (Finding that the applicant did not meet its burden of proving its costs were reasonable where the utility did not "identify any benefits Project Phoenix would provide to each of its operating subsidiaries, in particular Water Service").

proceeding because the utility failed to "ascertain the potential financial impact or to identify any benefits" to the utility as a result of a computer software project.[274] In contrast, as explained in response to Item No. 25 of the Commission Staff's Third Request for Information, KAWC has explained the need for BT; the reasonableness of the selection process; the myriad of benefits inuring to KAWC, financial and otherwise; and the potential financial impact to the Company is described below.

The estimated capital cost to KAWC for the BT project is $12.3 million.[275] The costs of BT are being allocated to each of the AWW operating subsidiaries based on the percentage of their customer counts to the overall regulated utility customer count of AWW, as provided for in the agreement between KAWC and American Water Works Service Company ("Service Company").[276] KAWC's share of the BT capital costs pertaining to CIS, compared to the costs incurred by other utilities for similar customer service software projects, demonstrates that KAWC's per-customer cost is reasonable, further distinguishing the BT project from the Water Service Corporation project disallowed by the Commission.[277] Information other utilities have filed with the Commission or reported online regarding similar customer service software projects demonstrate that Louisville Water Company's software project will cost approximately $92 per customer; Louisville Gas and Electric Company's and Kentucky Utilities Company's software project cost roughly $68 per customer; while KAWC's customers will only pay $30 per customer for the BT project.[278]

No party proposed an adjustment regarding the BT project.

**(b) <u>Call Center Allocation</u>**

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[274] *Id.*
[275] VerDouw Direct at 37.
[276] *Id.*
[277] June 5, 2013 Hearing at VR 15:13:10-15:15:29.
[278] *Id.*

One of the benefits of being an AWW affiliate is KAWC's ability to obtain services from the Service Company. KAWC has had a contract with the Service Company since 1989 and KAWC obtains a host of administrative and operational services from the Service Company.[279] These services include the use of centralized call centers, water quality testing lab, IT support, accounts payable and accounts receivable, tax support and insurance, as well as corporate governance.[280] Through leveraging economies of scale, and the expertise of Service Company employees, KAWC receives high quality services at or below market prices.

One of the services KAWC receives from the Service Company is participation in the Customer Service Center, which consists of centralized call centers. Through 2011, most call center costs were allocated to KAWC based on customer counts (i.e., the percentage of KAWC customer relative to the total number of AWW customers).[281] The call centers began tracking the calls by operating affiliate, as well as the average call handling time, and found a disproportionate level of calls, and handling time, by state.[282] Therefore, beginning in 2012, the call centers began direct charging call handling, billing and collection costs that were being driven directly by the calls themselves.[283] For KAWC, approximately 63% of its call center costs are being direct charged based on the number of calls and 37% of its call center costs are for fixed overhead costs which continue to be calculated based on KAWC's relative number of customers.[284] The percentage of KAWC customers relative to the total number of AWW customers has risen slightly due to the divestiture of certain AWW operating companies.

[279] KAWC's Response to Item No. 32 of the Commission Staff's First Request for Information.
[280] Bridwell Direct at 16.
[281] KAWC's Response to Item No. 30 of the Hearing Data Requests.
[282] Bridwell Direct at 17-18.
[283] KAWC's Response to Item No. 30 of the Hearing Data Requests.
[284] *Id.*

However, despite that, the net effect of the shift of some call center costs from a customer count percentage to a customer call number will result in overall increase of only $85,416.[285]

This change in the allocation methodology of Customer Service Costs is entirely consistent with Article II, Payment for Services, in the agreement between KAWC and the Service Company.[286] Article II states that "All costs of Service Company incurred in connection with services rendered by Service Company which can be identified and related exclusively to Water Company [KAWC], shall be charged directly to Water Company [KAWC]."[287] Because the Customer Service Center is now tracking calls by each state's operating subsidiary, the Customer Service Center can identify which costs are related exclusively to KAWC, and the costs therefore shall be charged directly to KAWC. The results of tracking calls demonstrated that KAWC's customers place more calls to the Customer Service Center than the Company's proportionate share of the customer base. Without question, KAWC should pay its share of the costs that are exclusively the result of KAWC's customers' behavior.

**(c) <u>Low Income Collaborative Effort</u>**

A significant portion of the evidentiary hearing in this matter focused on the collaborative effort KAWC initiated following Case No. 2010-00036 which involved the Company, the AG, and CAC to address low income affordability issues. Setting aside the rhetoric, the facts are as follows:

- In Case No. 2010-00036, the Commission held that KAWC must develop and implement a plan to accurately record and determine the number of customers making payments after the due date, the frequency of late payments by each customer, the number of service terminations for nonpayment for each customer

[285] *Id.*
[286] KAWC's Response to Item No. 32 of the Commission Staff's First Request for Information.
[287] *Id.*

account and company-wide, and the specific services that were not paid when water service is terminated for nonpayment.[288] ***KAWC complied fully with this requirement***.[289]

- The final order in Case No. 2010-00036 required KAWC to initiate a collaborative effort by arranging, within 60 days following the Commission's order, a meeting of all interested parties to discuss and study regulatory and legislative solutions to the increasing lack of affordability of water service for low income customers.[290] ***KAWC complied fully with this requirement.***[291]
- The final order in Case No. 2010-00036 required KAWC to file with the Commission periodic written reports on the status of the meetings and submit a final written report on the collaborative group's efforts no later than November 1, 2011.[292] ***KAWC complied fully with this requirement***.[293]

Not only did KAWC fully comply with each and every requirement in the final order in Case No. 2010-00036 regarding low income affordability issues, the Company endeavored to reach a solution to the identified concerns.

The collaborative effort resulted in draft legislation on which all parties provided edits and comments. Certainly, the AG and CAC can speak for themselves on why the collaborative effort has not, to date, resulted in that legislation being introduced in the General Assembly, but the record is clear that, even after working on the legislation to bring it to a "final draft" status,

[288] December 14, 2012 Order in Case No. 2010-00036 at 74.
[289] KAWC's Response to Item No. 32 of the Hearing Data Requests.
[290] December 14, 2012 Order in Case No. 2010-00036 at 75-76.
[291] Rebuttal Testimony of Cheryl Norton of May 15, 2013 (Case No. 2012-00520) ("Norton Rebuttal") at 2.
[292] December 14, 2012 Order in Case No. 2010-00036 at 76.
[293] *See* the reports that KAWC filed with the Commission in Case No. 2010-00036 on June 1, 2011; July 1, 2011; August 1, 2011; September 1, 2011; September 30, 2011; November 1, 2011; and November 17, 2011.

full support from all parties was withdrawn.[294] Although it wishes it could, KAWC cannot magically create unanimity among the parties on this issue. Any insinuation that the collaborative effort failed because of KAWC is simply untrue. The suggestion that KAWC is the only party that can help promote the legislation is false. While Mr. Burch alleged in a discovery response that he lacked legal authority to advocate on behalf of CAC for this legislation,[295] he admitted during the hearing that Community Action Kentucky, to which CAC belongs, has a registered lobbyist that can advocate and lobby for legislation on behalf of Community Action Councils across Kentucky, including CAC. It would seem that CAC, whose mission is to address low-income issues and who intervenes in rate cases for the stated purpose of advocating for low-income customers, should do whatever it can to convince the AG and the legislature that the proposed legislation should be passed. KAWC remains ready, willing and able to assist in such an effort.

To be clear, KAWC believes that the most direct means of providing assistance to low income customers is through the legislation that was developed into "final draft" form by the collaborative effort. The legislation would put the Company's low-income customers on equal footing with gas and electric utility customers in terms of being able to offer a reduced customer charge to qualifying customers.[296] In fact, KAWC proposed just such a discount in its 2004 rate case.[297] The AG opposed that proposal on the basis that it ran afoul of KRS 278.170, which prohibits discriminatory rates. The Commission agreed with the AG's argument. As a result, the obvious solution is to enact legislation which would negate KRS 278.170. The drafted legislation does just that. KAWC remains confounded by the lack of full and earnest support for

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[294] KAWC's Response to Item No. 6 of the Hearing Data Requests.
[295] *See* CAC's Response to Item No. 2 of KAWC's Data Requests.
[296] Norton Rebuttal at 2-3.
[297] *Id.* at 3; see Case No. 2004-00103, *In the Matter of: Adjustment of the Rates of Kentucky-American Water Company* (Ky. PSC Feb. 28, 2005).

the drafted legislation. It would remove the roadblock presented by KRS 278.170 and then lead to direct assistance for the exact group of customers who need that assistance.

The best example of the importance of legislation is evidenced by West Virginia American Water, which, as Mr. Burch notes in his direct testimony, recently implemented a 20 percent rate discount for low income customers.[298] The press release Mr. Burch cites in his testimony regarding the West Virginia American program states that the program could only be implemented because legislation was passed "due to the collaborative effort of the state Legislature, Public Service Commission, Consumer Advocate Division, AARP and West Virginia American Water" that permitted water utilities to offer reduced rates in a manner consistent with electric and gas utilities.[299] While Mr. Burch states that CAC "would appreciate the same level of commitment for Kentucky customers" as in West Virginia,[300] KAWC endeavored to take the ***precise course of action*** that West Virginia American Water did.

While it is regrettable that the other parties to the collaborative group did not wish to pursue the legislation the group drafted, any suggestion that KAWC has not taken steps to assist low income customers is false. The annual donation that KAWC's shareholders make to the H20 program is the ***largest*** the Company makes.[301] The Company has also taken additional steps since the last rate case to address certain concerns CAC presented in Case No. 2010-00036. Specifically, Mr. Burch's testimony in the 2010 rate case commented on the number of shut-offs for non-payment.[302] Since the last rate case, KAWC increased the threshold outstanding balance for disconnection for non-payment from $25 to $75 and the Company has seen a marked decline

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[298] Burch Direct at 15.
[299] KAWC Hearing Exhibit 4.
[300] Burch Direct at 15.
[301] June 5, 2013 Hearing at VR 11:27:31-11:27:36.
[302] *See* the Pre-Filed Direct Testimony of Jack E. Burch (Case No. 2010-00036) at 8-10, as discussed in the hearing at June 5, 2013 Hearing at VR 17:45:10-17:45:33.

in the number of reconnection fees paid by its customers.[303] Even though KAWC took direct action to address Mr. Burch's concern, at the hearing he claimed increasing the threshold balance was not a benefit and was "not necessarily a good thing for" customers.[304] CAC's failure to acknowledge the benefit of the affirmative step the Company took in response to Mr. Bruch's direct testimony strains credibility.

In short, KAWC is concerned about the issues its low-income customers face as evidenced by its actions following the 2010 rate case. The Company, as explained by Ms. Norton during the hearing, remains interested in helping to pass legislation that would allow KAWC to provide a direct benefit to low income customers through a reduced meter charge.[305] The Company cannot, however, unilaterally improve either the posture or mindset of the other interested parties. If the collaborative effort is to succeed, all participants must be tasked with action and forthcoming with support.

#### (d) <u>Termination of Third Billing Contracts</u>

KAWC terminated its contracts with LFUCG to provide third-billing services because the Company's leadership determined that participating in these contracts negatively detracted from KAWC's core service of providing high quality water and wastewater services. There were many reasons supporting KAWC's decision and the benefits are apparent: (1) an overall lower cost for the BT project[306]; (2) fewer late fees and disconnection charges are being charged to customers[307]; (3) bills are easier to understand, thereby reducing customer confusion[308]; and (4) ending the agreement eliminated the obscured price signals customers were receiving regarding

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[303] KAWC Hearing Exhibit 2 shows the marked decline in reconnection fees as a result of increasing the threshold outstanding balance for disconnection.
[304] June 5, 2013 Hearing at VR 17:47:51-17:47:54.
[305] June 4, 2013 Hearing at VR 13:25:43-13:26:42.
[306] Norton Rebuttal at 5.
[307] *Id.*
[308] *Id.*

their efficiency efforts.[309] All of these benefits demonstrate that KAWC's decision was prudent and reasonable.

While is true that AWW decided to exit third-party billing services on a company-wide basis where possible in December 2011,[310] KAWC's leadership had already made the decision to terminate and ***had already provided legal notices of termination to LFUCG two months before*** AWW reached its decision – on October 3, 2011.[311] In fact, KAWC had informally notified LFUCG as early as July 1, 2011 that it had decided to exit the third-party billing contracts.[312] That informal notification was provided to LFUCG on July 1, 2011 for an actual cessation of billing services to occur at the end of March 2012. At LFUCG's request but without any obligation to do so, KAWC continued to provide the services until the end of August 2012 so that LFUCG could have more time to implement a replacement vendor.[313]

KAWC made its decision based on business reasons specific to the Company and its customers. While KAWC understands LFUCG may have preferred that KAWC continue the third-party billing services contracts, the Company's principal obligation is to its customers and the performance of its regulated service obligations. LFUCG has chosen not to develop the resources necessary to bill for the services it provides.[314] Given that choice and for a period of time, KAWC was willing to provide those services and to utilize revenues from those services in an "above the line" manner to assist its customers. However, for many reasons, including the

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[309] *Id.* at 6.

[310] *See* the Response to Item No. 77 of the Commission Staff's Second Request for Information at 367; June 4, 2013 Hearing at VR 9:54:43-9:55:05.

[311] *See* the Response to Item No. 77 of the Commission Staff's Second Request for Information at 1141.

[312] KAWC Hearing Exhibit 1.

[313] June 5, 2013 Hearing at VR 17:20:35-17:20:58.

[314] At the May 28, 2013 public comment session at Bryan Station High School, Mayor Gray opined that KAWC's decision on this issue caused a reduced collection rate for city services to the detriment of LFUCG. That opinion is contradicted by the evidence in the record that the collection rate for city services began its decline shortly after that rulings made in the December 2010 Order in KAW's 2010 rate case, a fact which Mr. O'Mara confirmed under cross-examination (June 5, 2013 Hearing at VR 17:14:20-17:15:05) and which is further proven by the data KAWC provided in response to Item No. 8 of the Hearing Data Requests; KAWC Hearing Exhibit 1.

confusion demonstrated by customers related to the services for which they are paying[315] and the fact that LFUCG sewer bills are going to increase dramatically in the coming years to pay for the roughly $600 million in capital costs that LFUCG must spend on its sewer system,[316] KAWC had no choice but to terminate billing services. Utility customers and Lexingtonians are entitled to know whether they are paying for KAWC services or LFUCG services when they pay their bills. The best way to ensure that was to exit third-party billing.

KAWC, as a water utility, is under no legal or regulatory requirement to engage in ancillary services – including third party billing services. As part of the Company's effort to provide service at a reasonable cost, KAWC evaluates opportunities to provide ancillary services, such as the billing services provided to LFUCG.[317] The Company always credited the revenues received from the billing services contracts to customers as a discount to the revenue requirement. No witness on behalf of the AG or LFUCG proposed an adjustment to KAWC's revenue requirement as a result of terminating the third party billing services.

Moreover, an adjustment to "impute" any of these revenues to KAWC's revenue requirement would be manifestly unjust. First, as stated above, KAWC is under no legal or regulatory obligation to engage in ancillary or non-regulated activities for the sole purpose of providing a discount to the revenue requirement for its regulated operations. Any imputation of revenues would erroneously presuppose that such a duty exists. Second, no party in this case has claimed that any of the Company's operation and maintenance expenses are unreasonable. Imputing any revenues to the revenue requirement as a result of terminating the billing services contracts would consequently disallow the recovery of expenses that no party claims are

[315] *See* KAWC's Response to Item No. 5 of the Hearing Data Requests.
[316] *See* LGUCG's Response to Item No. 15 of KAWC's Data Requests for Information.
[317] Norton Rebuttal at 5.

imprudent or excessive. Additionally, it would be confiscatory as a violation of the long-standing regulatory concept that a utility should recover its reasonable cost of service.

As a result of terminating the third party billing agreements, KAWC has eliminated an estimated $254,625 from its revenue requirement through avoided capital spending for BT customization, generation of usage data revenue, generation of third party shut-off revenue, and elimination of the labor position associated with managing the billing contract.[318] Other expenses that were shared between LFUCG and KAWC while the contracts were pending, such as meter reading, remain because these are functions necessary to the Company's provision of water service.[319]

**10. CONCLUSION**

The contested issues in this case are discrete and narrow, as the intervenors to this proceeding have proposed very few adjustments to KAWC's revenue requirement. KAWC has met its burden of proof with respect to demonstrating that its operation and maintenance expenses are prudent and reasonable.

The DSIC KAWC has proposed is critically important to the Company, as it will enable and incentivize KAWC to increase the replacement rate of mains that have reached or exceeded the end of their useful lives. The water industry is aware of this mounting concern and the DSIC has proven to be a best practice means by which to solve this pressing issue. The PPACC tracker the Company proposes is principled on fairness; increases or decreases in price are passed on to customers. It is a transparent means by which to charge rates that are representative of the actual costs of chemicals and purchased power.

[318] KAWC's Response to Item No. 78 of the Commission Staff's Second Request for Information.
[319] *Id.*

The ROE KAWC has requested is reasonable and is premised on the prudent application of a host of cost of equity estimation models. This is contrasted with Dr. Woolridge's approach, which resulted in a ROE recommendation that another public service commission stated would place the utility at a competitive disadvantage. KAWC would likewise be placed at a competitive disadvantage if Dr. Woolridge's recommended ROE is adopted. KAWC respectfully requests that the Commission approve the requested increase in rates to ensure that the Company is afforded the fair, just and reasonable rates to which it is entitled.

Respectfully submitted,

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**CERTIFICATE**

In accordance with Ordering Paragraph No. 10 of the Commission's December 17, 2012 Order, this is to certify that Kentucky-American Water Company's July 8, 2013 electronic filing is a true and accurate copy of the documents to be filed in paper medium; that the electronic filing has been transmitted to the Commission on July 8, 2013; that an original and one copy of the filing will be delivered to the Commission on July 9, 2013; and that no party has been excused from participation by electronic means.

STOLL KEENON OGDEN PLLC

By______________________________

Attorneys for Kentucky-American Water Company