

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:)
)
APPLICATION OF KENTUCKY-AMERICAN) CASE NO. 2015-00418
WATER COMPANY FOR AN ADJUSTMENT)
OF RATES

DIRECT TESTIMONY OF

ANDREA C. CRANE

RE: REVENUE REQUIREMENTS

ON BEHALF OF

**OFFICE OF THE ATTORNEY GENERAL
FOR THE COMMONWEALTH OF KENTUCKY**

AND

LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENT

May 9, 2016

PUBLIC REDACTED VERSION

TABLE OF CONTENTS

	Page
I. Statement of Qualifications	3
II. Purpose of Testimony	4
III. Summary of Conclusions	5
IV. Cost of Capital Summary	6
V. Base Period and Test Period	8
VI. Rate Base Issues	11
A. Working Capital Allowance	11
B. Accumulated Deferred Income Taxes	18
C. Deferred Maintenance Costs	21
D. Other Rate Base Elements	24
E. Capitalization of Rate Base	29
F. Summary of Rate Base Issues	31
VII. Operating Income Issues	31
A. Water Sales Revenues	31
B. Other Revenues	36
C. Salary and Wage Expense	37
D. Incentive Compensation Plan Expense	41
E. Payroll Tax Expense	45
F. Customer Accounting Expense	45
G. Insurance Other Than Group Expense	46
H. Maintenance Supplies and Services Expense	48
I. Rate Case Expense	49
J. Service Company Costs	50
K. Meals and Entertainment Expense	52
L. Miscellaneous Expense	53
M. Interest Synchronization and Tax Rates	54
VIII. Revenue Requirement Summary	55
IX. Qualified Infrastructure Plan Rider	56
Appendix A - List of Prior Testimonies	
Appendix B - Exhibits (Supporting Schedules)	

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Andrea C. Crane and my business address is 16 Old Mill Road, Redding, Connecticut 06896.

Q. By whom are you employed and in what capacity?

A. I am President of The Columbia Group, Inc., a financial consulting firm that specializes in utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and undertake various studies relating to utility rates and regulatory policy. I have held several positions of increasing responsibility since I joined The Columbia Group, Inc. in January 1989. I became President of the firm in 2008.

Q. Please summarize your professional experience in the utility industry.

A. Prior to my association with The Columbia Group, Inc., I held the position of Economic Policy and Analysis Staff Manager for GTE Service Corporation, from December 1987 to January 1989. From June 1982 to September 1987, I was employed by various Bell Atlantic (now Verizon) subsidiaries. While at Bell Atlantic, I held assignments in the Product Management, Treasury, and Regulatory Departments.

Q. Have you previously testified in regulatory proceedings?

A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 400 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii,

1 Kansas, Kentucky, Maryland, New Jersey, New Mexico, New York, Oklahoma,
2 Pennsylvania, Rhode Island, South Carolina, Vermont, Washington, West Virginia and the
3 District of Columbia. These proceedings involved water, wastewater, gas, electric,
4 telephone, solid waste, cable television, and navigation utilities. A list of dockets in which I
5 have filed testimony since January 2008 is included in Appendix A.
6

7 **Q. What is your educational background?**

8 A. I received a Master of Business Administration degree, with a concentration in Finance, from
9 Temple University in Philadelphia, Pennsylvania. My undergraduate degree is a B.A. in
10 Chemistry from Temple University.
11
12

13 **II. PURPOSE OF TESTIMONY**

14 **Q. What is the purpose of your testimony?**

15 A. On January 29, 2016, Kentucky-American Water Company (“KAWC” or “Company”) filed a
16 Petition requesting a rate increase of \$13,453,664 or approximately 15.7% in its rates for
17 water service. In addition to its requested rate increase, the Company is also seeking
18 authorization to implement a Qualified Infrastructure Program (“QIP”) and to recover the
19 associated costs through a QIP surcharge mechanism. The Columbia Group, Inc., was
20 engaged by the Office of the Attorney General for the Commonwealth of Kentucky (“AG”)
21 and by the Lexington-Fayette Urban County Government (“LFUCG”) to review the

1 Company's Application and to provide recommendations to the Public Service Commission
2 ("PSC" or "Commission") regarding the Company's revenue requirement claim and its
3 proposed QIP surcharge mechanism. In addition, the AG/LFUCG has engaged Dr. J. Randall
4 Woolridge to provide testimony on cost of capital issues, including capital structure and
5 return on equity.
6
7

8 **III. SUMMARY OF CONCLUSIONS**

9 **Q. What are your conclusions concerning the Company's revenue requirement and its**
10 **need for rate relief?**

11 A. Based on my analysis of the Company's filing and other documentation in this case, and on
12 Dr. Woolridge's cost of capital recommendation, my conclusions are as follows:

- 13 1. The Company has an overall cost of capital of 7.13% (see Schedule ACC-2).
- 14 2. The Company has a Test Period pro forma rate base of \$398,167,275 (see Schedule
15 ACC-3).¹
- 16 3. The Company has Test Period pro forma operating income at present rates of
17 \$28,121,936 (see Schedule ACC-8).
- 18 4. KAWC has a Test Period pro forma revenue deficiency of \$466,394 (see Schedule
19 ACC-1). This is in contrast to the Company's claimed deficiency of \$13,453,661.

¹ Schedules ACC-1, ACC-26, and ACC-7 are summary schedules, Schedule ACC-2 is a cost of capital schedule, Schedules ACC-3 to ACC-7 are rate base schedules, ACC-8 to ACC-25 are operating income schedules.

1 5. The Commission should reject the Company's request for an accelerated cost
2 recovery mechanism for investment related to infrastructure replacement projects.
3
4

5 **IV. COST OF CAPITAL SUMMARY**

6 **Q. What is the cost of capital and capital structure that the Company is requesting in this**
7 **case?**

8 A. The Company utilized the following capital structure and cost of capital in its filing:
9

	Capitalization Ratio	Cost Rate	Weighted Cost
Short-term Debt	1.49%	1.37%	0.02%
Long-term Debt	50.59%	6.05%	3.06%
Preferred Stock	0.56%	8.52%	0.05%
Common Equity	47.36%	10.75%	5.09%
Total			8.22%

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14 The Company's claim is based on a recommended capital structure of 1.49% short-term debt
15 at a cost of 1.37%, 50.59% long-term debt at a cost rate of 6.05%, 0.56% preferred stock at a
16 cost rate of 8.52%, and 47.36% common equity, at a cost of 10.75%.
17
18

1 **Q. Is the AG/LFUCG recommending any adjustments to this capital structure or cost of**
2 **capital?**

3 A. The AG/LFUCG is not recommending any adjustments to the capital structure claimed by
4 KAWC. However, as discussed in the testimony of Dr. Woolridge, the AG/LFUCG is
5 recommending adjustments to the cost rates for short-term debt, long-term debt, and common
6 equity.

7
8 **Q. What is the overall cost of capital that the AG/LFUCG is recommending for the**
9 **Company?**

10 A. As shown on Schedule ACC-2, the AG/LFUCG is recommending an overall cost of capital
11 for KAWC of 7.13%, based on the following capital structure and cost rates:

12
13

	Capitalization Ratio	Cost Rate	Weighted Cost
Short-term Debt	1.49%	1.00%	0.01%
Long-term Debt	50.59%	6.02%	3.05%
Preferred Stock	0.56%	8.52%	0.05%
Common Equity	47.36%	8.50%	4.03%
Total			7.13%

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19 The Attorney General's recommendations result in a reduction of 109 basis points in the
20 overall rate of return claimed by KAWC. See the testimony of Dr. Woolridge for a detailed
21 discussion of the AG/LFUCG's cost of capital recommendation.

1

2 **V. BASE PERIOD AND TEST PERIOD**3 **Q. What Base Period and Test Period did the Company utilize to develop its claim in this**
4 **proceeding?**5 A. The Company selected the Base Period ending April 30, 2016. As filed, the Base Period data
6 reflects six months of actual results and six months of forecasted data. The Company intends
7 to update its Base Period to reflect actual results in mid-June, 2016. KAWC utilized a
8 forecasted Test Period ending August 31, 2017 in its Application.

9

10 **Q. Does the use of a forecasted Test Period create specific concerns about the data**
11 **presented in the Company's filing?**12 A. Yes, it does. While I understand that state law permits the use of a forward-looking Test
13 Period, the use of forecast data does make it more difficult for regulators to assess the
14 reasonableness of a utility's claim. Moreover, the use of a fully forecast Test Period
15 combined with a partially forecast Base Period means that regulators are attempting to
16 evaluate projected data relative to a baseline that also contains at least partially projected
17 data. Although I understand that the Company will eventually update its Base Period with
18 actual data prior to the hearings in this case, the actual data has not yet been provided and
19 therefore it was not available to use in the preparation of this testimony. This further
20 complicates the regulatory review, since intervenor testimony must be filed without the
21 benefit of actual Base Period data.

1 If a utility files for a rate increase using a projected Test Period, then the utility should
2 be required to fully justify its claims with detailed supporting documentation. Utilities filing
3 a forecast Test Period should provide documentation that is sufficient to allow regulators to
4 assess those claims relative to known actual results. Any changes should be explained and
5 justified by the utility. Unfortunately, in this case, much of the Test Period data is based on
6 the Company's 2017 budget, which is not necessarily linked to actual prior period results and
7 which cannot be readily assessed for reasonableness, complicating the review process.

8
9 **Q. Are there other concerns about the use of a forecast Test Period?**

10 A. Yes, the ability to use a forecast Test Period is of tremendous benefit to the utility. The use
11 of forecast data allows the utility to reflect in rates future increases in investment and
12 increases in operating expenses that may not be recoverable if an historic Test Period is used.
13 The Commission should consider the fact that future Test Period data cannot be verified
14 prior to establishing new rates in this case. In addition, the Base Period itself could not even
15 be verified in this case prior to my testimony being submitted. I am also concerned that the
16 Company could revise various components of its revenue requirement once it files its actual
17 Base Period data, leaving the parties with limited opportunity to review any updates and any
18 supporting material prior to the hearings.

19
20 **Q. Did you request that the Company provide updated Base Period financial data as part**
21 **of the discovery process in this proceeding?**

1 A. Yes, I did. The AG/LFUCG propounded several discovery requests requesting updated
2 financial data prior to preparing our direct testimony. While the Company did provide some
3 additional actual financial data regarding pro forma revenues, it objected to our two principal
4 data requests, AG 2-18 and AG 2-19. In these requests, we sought the most recent financial
5 data available regarding the Company's rate base and net operating income claims. I was
6 hoping to have updated information at least through March 31, 2016 when I prepared my
7 recommendations in this case. The Company objected to these data requests, arguing instead
8 that it would provide updates approximately 45 days after the end of the Base Period. While
9 we will certainly review this data prior to the evidentiary hearings in this case, we will have
10 limited ability at that time to undertake a full review of the updated financial results and to
11 develop additional recommendations as a result of the updated financial information. This
12 not only puts a burden on the intervenors in this case but also limits their ability to address
13 deviations between the Base Period as projected and the actual Base Period results.

14
15 **Q. What do you recommend?**

16 A. I recommend that any revisions to revenue requirement components that may be proposed by
17 KAWC as a result of the Base Period update be limited to reductions in the revenue
18 requirement. Any attempt to increase specific revenue requirement components (e.g.
19 increase plant, reduce revenues, increase operating expenses) should be rejected, since the
20 parties will not have an opportunity for full review and investigation of any revised claims.

1 **Q. Are you in agreement with all of the components of the Company's revenue**
2 **requirement claim, other than those specifically discussed in your testimony?**

3 A. No, not necessarily. There may be additional adjustments raised by other parties to this
4 proceeding that have merit and that should be adopted by the PSC. In addition, in some
5 cases, the Company has utilized methodologies with which I may disagree but which have
6 been accepted by the PSC in the past, and I choose not to address in this testimony. For
7 example, I understand that the PSC has permitted the Company to include construction work
8 in progress ("CWIP") in rate base. Although I disagree with the inclusion of CWIP in rate
9 base, I have not reflected an adjustment to eliminate CWIP in this case. Therefore, if a
10 specific issue or methodology is not addressed in my testimony, it does not necessarily mean
11 that I support the Company's position on that issue or ratemaking methodology.

12
13 **VI. RATE BASE**

14 **A. Working Capital Allowance**

15 **Q. What is cash working capital?**

16 A. Cash working capital is the amount of cash that is required by a utility in order to cover cash
17 outflows between the time that revenues are received from customers and the time that
18 expenses must be paid. For example, assume that a utility bills its customers monthly and
19 that it receives monthly revenues approximately 30 days after the midpoint of the date that
20 service is provided. If the Company pays its employees weekly, it will have a need for cash
21 prior to receiving the monthly revenue stream. If, on the other hand, the Company pays its

1 interest expense quarterly, it will receive these revenues well in advance of needing the funds
2 to pay interest expense.
3

4 **Q. Do companies always have a positive cash working capital requirement?**

5 A. No, they do not. The actual amount and timing of cash flows dictate whether or not a utility
6 requires a cash working capital allowance. Therefore, one should examine actual cash flows
7 through a lead/lag study in order to accurately measure a utility's need for cash working
8 capital.
9

10 **Q. Did the Company provide a lead/lag study in support of its cash working capital claim
11 in this case?**

12 A. Yes, KAWC did provide a lead/lag study as well as supporting documentation for its claim.
13

14 **Q. Are you recommending any adjustments to the Company's cash working capital claim?**

15 A. Yes, I am recommending two adjustments to the Company's claim. First, I am
16 recommending modifications to the lead-lag days used by the Company for Service Company
17 charges. Second, I am recommending an adjustment in the revenue lag proposed by KAWC.
18 In addition, I recommend that all components of the Company's cash working capital claim
19 be updated to reflect the final level of operating expenses and other cash working capital
20 components authorized by the Commission.
21

1 **Q. What adjustment are you recommending to the lag days used for Service Company**
2 **charges?**

3 A. I am recommending that the Service Company lag days be increased from the (7.58) days
4 used in the Company's filing to 12.0 days, which is the expense lag associated with KAWC
5 labor costs. KAWC's lag reflects payment of Service Company charges in advance of the
6 midpoint of the service period. Thus, on average, KAWC is prepaying these charges.
7 However, the Service Company charges are largely driven by personnel costs. The Service
8 Company employees are located at the Service Company for organizational efficiency, but
9 the types of services being provided are those that would be provided internally by KAWC in
10 the absence of a centralized Service Company. The Service Company acts as a substitute for
11 each individual company having to hire its own employees. Therefore, there is no
12 justification for requiring prepayment of Service Company charges.

13
14 **Q. How do you know that the majority of the Service Company costs relate to personnel**
15 **services?**

16 A. This fact is clear from a review of the Service Company Agreement. The Service Company
17 Agreement, which was provided in response to PSC 1-33, states that,

18 Service Company maintains an organization whose officers and employees are
19 familiar with all facets of the water utility business, including the development, business and
20 property of Water Company, and are experienced in the efficient management, financing,
21 accounting and operation of water utility properties and the extension and improvement
22 thereof. The officers and employees of Service Company are qualified to aid, assist and
23 advise Water Company in its business operations through the services to be performed under
24 this Agreement.
25

1 In addition, the descriptions of the various functions included in the Service Company
2 Agreement highlight labor activities to be performed on behalf of the individual utilities. A
3 review of the Company's workpapers in this case demonstrates that out of a total Service
4 Company claim of \$8.60 million, \$5.84 million, or 67.9%, relates to labor and labor-related
5 costs. Therefore, it is entirely reasonable for the Commission to adopt the 12.0 expense lag
6 for KAWC labor as a reasonable proxy for Service Company costs, instead of the
7 prepayment of (7.58) days reflected in the Company's Application.

8
9 **Q. Other than Service Company charges, are there other vendors that require prepayment**
10 **by KAWC?**

11 A. No, there are not. A review of the Company's lag days shown in the response to PSC 2-57
12 demonstrates that the Company does not typically prepay for services from unaffiliated
13 vendors. Other Contracted Services is included in the lead/lag study with an expense lag of
14 55.83 days, Maintenance Supplies and Services with an expense lag of 56.13 days, and
15 Office Supplies and Services with an expense lag of 59.67 days. Every category of expense
16 included in the lead/lag study shows an expense lag, except for utility taxes, insurance,
17 retirement benefits, and the prepayment reflected for the Service Company charges. Given
18 that other vendors generally provide service with a much longer expense lag, the 12.0 days
19 expense lag that I recommend for Service Company charges is conservative. I recommend
20 that the Commission use 12.0 days as the lag for Service Company charges because this is
21 the lag for KAWC labor costs. The lag for costs associated with Service Company charges

1 should be no shorter than the lag for internal KAWC personnel costs. My adjustment, which
2 reflects an expense lag of 12.0 days for Service Company charges, is shown in Schedule
3 ACC-4.

4
5 **Q. Is there another reason why you believe that the PSC should reject the Company's**
6 **prepayment associated with Service Company charges?**

7 A. Yes, there is. According to Article III of the Service Agreement, the Service Company
8 charges include an amount "sufficient to cover the general overhead of Service Company...."
9 The general overhead amount included in Service Company charges includes pensions and
10 insurance premiums, legal and other fees for rendering services, taxes, other general office
11 supplies and expenses, and "interest on working capital." Thus, the Service Company
12 agreement already includes a working capital provision. KAWC has not demonstrated that
13 the amounts being charged to KAWC are insufficient to finance its working capital
14 requirements. Moreover, as discussed above, non-affiliated vendors do not receive the
15 benefit of prepayments from KAWC. Accordingly, the PSC should reject the Company's
16 claim for working capital associated with prepayments to the Service Company and should
17 instead include a working capital allowance that is no higher than the working capital
18 requirement that would result if all Service Company employees were direct employees of
19 KAWC. Moreover, given the inclusion of "interest on working capital" in the general
20 overhead allowance discussed above, the PSC may want to eliminate all working capital
21 associated with the Service Company and exclude the Service Company charges entirely

1 from the Company's lead/lag study.

2
3 **Q. What is your second cash working capital adjustment?**

4 A. I am recommending that the revenue lag of 44.65 days be reduced to 43.92 days. As shown
5 on Schedule B-5.2 of Exhibit 37, the Company has developed its Base Period revenue lag
6 based on a service lag of 15.8 days, a billing lag of 3.68 days, and a collection lag of 25.17
7 days, for a total of 44.65 days. However, the Company's Base Period collection lag is only
8 24.44 days. Therefore, the Test Period revenue lag of 44.65 days is 0.73 days longer than the
9 Base Period lag. According to the Company's workpapers, KAWC has reflected an
10 additional lag associated with lock box collection in the Test Period. However, it is my
11 understanding that a lock box is also used in the Base Period and therefore there is no reason
12 why the collection lag should increase in the Test Period. Accordingly, at Schedule ACC-4, I
13 have reflected a revenue lag of 43.92 days, which is the Base Period revenue lag reflected in
14 the Application.

15
16 **Q. Do you agree with all of the revenue requirement components that the Company has**
17 **included in its lead/lag study?**

18 A. No, I do not. As I have testified to previously, the purpose of a lead/lag study is to determine
19 how much cash is required by the utility to operate its business. In this case, the Company
20 has included several items in its lead/lag study that do not require cash, such as depreciation,
21 amortization, and deferred income taxes. In addition, the Company has included additional

1 assumptions that unreasonably increase the amount of cash working capital included in utility
2 rates. For example, the Company has included net income with a zero lag. This means that
3 KAWC is continually charging ratepayers for carrying costs on net income as it is earned
4 daily. This assumption distorts the lead/lag study results. The Company is under no
5 contractual obligation to pay any net income to its shareholders. Moreover, to the extent that
6 the Company does pay out a portion of its net income in dividends, it is paid periodically,
7 generally each quarter, regardless of when the income is earned. Therefore, a lead/lag study
8 that includes net income with a zero lag clearly overstates the utility's cash working capital
9 requirement.

10 In spite of the fact that I believe strongly that the lead/lag study should be limited to
11 cash outlays that are required, I have not made any adjustment to remove these non-cash
12 items or to modify the zero lag days reflected in the lead/lag study, since I understand that the
13 PSC has permitted such components in the past. However, it is important for the
14 Commission to recognize that these non-cash components are responsible for the
15 overwhelming majority of the Company's cash working capital claim in this case.

16
17 **Q. How large is the impact of these non-cash items on cash working capital?**

18 **A.** These three items – depreciation and amortization, deferred income taxes, and net income,
19 are responsible for almost the entire cash working capital claim. For example, if these three
20 items were eliminated entirely from the lead/lag study, the resulting cash working capital
21 requirement would decline from the \$5.2 million included in the Company's claim to

1 approximately \$800,000. If net income were added back to reflect quarterly payments to
2 shareholders, the resulting cash working capital requirement would be even lower. It is clear
3 that the cash working capital requirement is being driven by these three items. While I have
4 not reflected an adjustment to the Company's claims for depreciation and amortization,
5 deferred income taxes, and net income, the PSC may want to consider such an adjustment in
6 this case.

7
8 **Q. Should all components of the Company's cash working capital claim be updated to**
9 **reflect the actual revenue requirement found by the Commission to be reasonable?**

10 A. Yes, all components of the cash working capital claim should be updated based on the
11 Commission's findings in this case. The expense amount shown in Exhibit 37, Schedule B-
12 5.2 should be updated to reflect any adjustments made by the PSC. In addition, the interest,
13 preferred stock, and net income amounts included in the Company's lead/lag study should
14 similarly be updated to reflect the final determination of the Commission with regard to cost
15 of capital issues.

16
17 **B. Accumulated Deferred Income Taxes**

18 **Q. Are you recommending any adjustment to the Company's claim for accumulated**
19 **deferred income taxes?**

20 A. Yes, I am recommending that the deferred tax asset included by the Company relating to a
21 change in repairs and maintenance costs be denied. As a result of Statement of Financial

1 Accounting Standards Board Interpretation No. 48 (“FIN 48”)², if there is a possibility that
2 certain income tax deductions may be disallowed by the IRS, a company is required to record
3 a liability relating to the potential disallowance. In this case, the Company has recorded a
4 deferred income tax asset related to a change in its accounting method for repairs and
5 maintenance costs. This FIN 48 liability has the effect of reducing the Company’s
6 accumulated deferred income tax reserve (which is a reduction to rate base), and therefore
7 increasing its claimed rate base in this case. I recommend that the Company’s shareholders,
8 not its ratepayers, bear the risk associated with income tax compliance and therefore I have
9 eliminated the deferred tax asset from the Company’s claim. My adjustment is shown in
10 Schedule ACC-5.

11
12 **Q. Has this issue been addressed previously by the Commission?**

13 A. Yes, it has. It is my understanding that the AG has recommended in the prior two base rate
14 cases that the deferred tax asset be eliminated from rate base. The Commission has rejected
15 those proposals. Specifically, in Case No. 2012-00520, the Commission declined to accept
16 the AG’s recommendation, finding the “lack of any significant change and the absence of any
17 new argument in this matter...”

18
19 **Q. Why do you believe that the Commission should reconsider its decision in this case?**

20 A. It is my understanding that this deferred tax asset was first booked by the Company in 2009.

² FIN 48 has been codified as ASC 740-10.

1 I can understand the cautious approach taken by the Commission when the deferred tax asset
2 was first booked. Thus, in the 2010 case, it may have made sense to allow the deferred
3 income taxes associated with this potential liability to be reflected in the deferred tax
4 account. Similarly, in the 2012 case, the Commission may have felt that there was still
5 significant uncertainty with regard this issue. However, we are now in 2016, seven years
6 after the liability was first established. I understand that the IRS in fact approved the
7 Company's tax deduction for these costs in February 2010. The FIN 48 liability is based on a
8 concern by the consolidated income tax group that the IRS failed to rule on a critical
9 component of the tax deduction and therefore the Company believes that there continues to
10 be some risk of eventual disallowance. However, instead of continuing to reflect this rate
11 base addition in regulated utility rates, the Commission should determine that now, after
12 seven years, sufficient time has gone by to relieve ratepayers from any additional burden
13 relating to this liability and instead the PSC should eliminate the deferred tax asset from rate
14 base. If, at some point in the future, an adverse ruling results in an adjustment to the deferred
15 tax reserve, then it may be appropriate to reflect such an adjustment in rates. However, in the
16 interim, ratepayers should not be penalized for this uncertainty.

17 Moreover, the shareholders of a regulated utility are expected to take risks and for
18 that reason, they are awarded a return on equity that is higher than a risk-free rate. One of the
19 risks that should be included in the risk assumed by shareholders is that the Company may
20 take tax deductions that are not upheld by the IRS. This is especially true since the Company
21 files a consolidated income tax return and it is my understanding that none of the

1 consolidated income tax benefit is currently allocated to ratepayers. By filing a consolidated
2 income tax return, members of the American Water Works Company, Inc.'s ("AWWC")
3 consolidated tax group that have positive taxable income can take advantage of tax losses
4 sustained by other members of the consolidated income tax group. This effectively reduces
5 the taxable income for the group, resulting in tax benefits. However, AWWC does not share
6 those tax benefits with ratepayers. Instead, the Company's utility rates include an income tax
7 expense, based on the statutory income tax rates, even though the consolidated tax group may
8 not actually pay any income taxes to the IRS. In fact, as stated in the responses to AG 1-120
9 and AG 1-124, *****BEGIN CONFIDENTIAL***** [REDACTED]

10 [REDACTED]
11 [REDACTED] *****END CONFIDENTIAL***** Yet, the
12 Company's claim includes \$7.72 million annually for federal and state income tax expense.
13 Given the significant consolidated income tax savings accruing to the Company and its
14 shareholders, which ratepayers are not benefiting from in this case, KAWC's shareholders
15 should take on the risk of insuring that their tax returns comply with all IRS rules and
16 regulations. Accordingly, the Commission should eliminate the deferred tax asset associated
17 with FIN 48 from the Company's rate base.

18
19 **C. Deferred Maintenance Costs**

20 **Q. What are deferred maintenance costs?**

21 **A.** Deferred maintenance costs are costs for tank painting and other large facility maintenance

1 projects that are undertaken periodically. These costs are generally amortized over a 15 year
2 period and the unamortized balance has been included in the Company's rate base claim.
3 KAWC included costs for amortizations that were reviewed and authorized in prior cases. In
4 addition, it has included in rate base unamortized deferred maintenance costs of \$3.01
5 million for projects that were completed since the last base rate case, but which have not yet
6 been to be amortized on the Company's books and records of account. Since the Company
7 did not begin to amortize these costs, the unamortized costs included in rate base are
8 significantly higher than they would have been if the Company had started to amortize these
9 costs as soon as each project was completed. Finally, it also included \$3.57 million of
10 projected costs for future projects that have not yet been undertaken.

11
12 **Q. Are you recommending any adjustment to the Company's claim?**

13 A. Yes, I am recommending that projects that have not yet been undertaken be eliminated from
14 the Company's revenue requirement, for several reasons. First, these projects are speculative
15 in that we do not know whether they will actually be completed, when they might be
16 completed, or how much the actual cost will be. KAWC is projecting completion of 7
17 projects totaling \$3.57 million of deferred maintenance projects for the Test Period,
18 significantly more than annual historic levels as shown on Workpaper 1-10 of the Company's
19 filing. Moreover, not only are there more projects projected for this period but the forecasted
20 costs are significantly higher than those actually incurred in prior years.

21 In addition, it appears from the Company's workpapers that it does not begin to

1 amortize costs associated with deferred maintenance until the Company's next base rate case.
2 Therefore, in this case the Company's rate base claim includes unamortized costs for projects
3 that in many cases were completed some time ago. However, instead of beginning to
4 amortize these costs when they were incurred, it appears that KAWC is deferring all costs
5 incurred between base rate cases, which puts upward pressure on the unamortized balances
6 that are then included in rate base. Since the Company will be made "whole" for these costs
7 once rate recovery begins, there is no reason to speculate on projected future levels of
8 deferred maintenance costs. Therefore, I recommend that that Commission limit the
9 Company's deferred maintenance costs to projects that have already been completed. My
10 adjustment is shown in Schedule ACC-6.

11
12 **Q. Are there also deferred income taxes associated with deferred maintenance costs?**

13 A. Yes, there are. The deferred income taxes associated with my recommendation are also
14 shown on Schedule ACC-6. Since I am recommending a lower unamortized rate base
15 amount than the amount claimed by KAWC, the deferred taxes associated with deferred
16 maintenance are also lower than those included in the Company's filing. I have reduced the
17 Company's deferred income tax reserve to reflect the reduction in deferred income taxes
18 associated with my deferred maintenance recommendation. This adjustment is shown in
19 Schedule ACC-6 and is also incorporated in the accumulated deferred income tax adjustment
20 shown in my rate base summary schedule at Schedule ACC-3.

21

1 **D. Other Rate Base Elements**

2 **Q. What are the components of the Company's claim for Other Rate Base?**

3 A. Other rate base includes Contract Retentions, Unclaimed Extension Deposit Refunds, and
4 Accrued Pensions.

5
6 **Q. Please explain the Company's claim for accrued pensions.**

7 A. The Company is seeking to include in rate base an accrued pension asset of \$1,128,259, net
8 of tax. This amount reflects the excess of contributions to the pension fund over amounts
9 that are recognized in the annual pension cost calculation pursuant to Financial Accounting
10 Standard ("FAS") 87.³ I am recommending that the accrued pension be excluded from rate
11 base. My adjustment is shown in Schedule ACC-7.

12
13 **Q. Has this issue been addressed previously by the Commission?**

14 A. Yes, it has. The Company's response to AG 2-17 noted that the Commission approved the
15 inclusion of accrued pension balances in rate base at least as early as Case No. 97-034. In
16 that case, the accrued pension resulted in a credit balance, i.e., the amount of cumulative
17 pension expense charged to ratepayers exceeded cumulative contributions to the plan.
18 Moreover, in that proceeding, the Commission agreed with the Company that if the accrued
19 balance reversed in the future and a pension asset was created, then the asset should be
20 included as a rate base addition. The Commission found that "it would be unfair to its

³ Codified as ASC 715.

1 stockholders to recognize the accrued pension balance only when it results in a rate base
2 deduction.”

3
4 **Q. If this issue has been previously addressed, why are you recommending that the**
5 **Commission make a different determination in this case?**

6 A. I am recommending that the Commission reexamine this issue because over the past few
7 years many utility companies have used pension funding as a source for significant earnings
8 growth. Companies have increased the excess of pension funding over pension expense and
9 have enjoyed large returns on these funds. While declining interest rates over the past few
10 years have made it more difficult for investors to find investments with high returns, some
11 companies have begun to use excess funding of their pension funds as a profit center. At the
12 Company’s weighted average cost of capital of 8.22%, KAWC has an incentive to maximize
13 the investment included in rate base by this Commission. One way to do that is to increase
14 pension funding, which then results in a pension asset that the Company can include in rate
15 base.

16
17 **Q. How are pension costs determined?**

18 A. The calculation of pension costs was addressed in FAS 87. Pursuant to FAS 87, annual
19 pension costs are based on numerous factors, such as the actual formula used to determine
20 each employee’s pension payment, assumptions regarding future life expectancy of
21 employees, assumptions regarding future interest rates, actual market returns and other

1 factors. The cumulative amount of pension costs that must be paid by a company is referred
2 to as the Projected Benefit Obligation (“PBO”). Periodically, the PBO is measured against
3 the Fair Value of the Assets in the pension fund to determine if a surplus or deficit exists.
4 Annual pension cost is then determined so that over the life of the pension fund, the surplus
5 and/or deficit is eliminated and over time, the cumulative contributions to the plan and
6 associated earnings will equal the PBO. This ensures that there are sufficient funds to meet
7 the company’s pension obligations. The annual pension expense booked by a utility has
8 traditionally been used to set rates in Kentucky and in other states.

9
10 **Q. Does the Company actually make contributions to the fund that equal the amount of**
11 **the annual pension expense that is booked?**

12 A. No, it does not. Contribution requirements are governed by the Employee Retirement
13 Income Security Act (“ERISA”), as updated by the Pension Protection Act (“PPA”) of 2006
14 and subsequent amendments, and Internal Revenue Service (“IRS”) regulations regarding
15 deductibility. Thus, companies have wide discretion regarding the actual amount of pension
16 contributions to make to their pension funds in any given year. Many companies have argued
17 that since these contributions serve to reduce annual pension expense, which is dependent
18 upon the difference between the PBO and the funded status of the plan, shareholders are
19 therefore entitled to earn a return on any contributions made to the pension fund in excess of
20 what is required pursuant to FAS 87. The prepaid pension asset is the cumulative

1 contribution to the pension fund that has not yet been reflected in the annual expense
2 determined pursuant to Generally Accepted Accounting Principles (“GAAP”).
3

4 **Q. Do excess contributions to the pension fund always benefit ratepayers?**

5 A. No. The degree to which excess contributions reduce pension expense depends upon how the
6 funds are invested and what happens to the investment over time. For example, assume that
7 you have a financial obligation that will require a payment of \$100 in one year’s time and
8 that you expect the stock market to earn a 10% return over the next year. You could invest
9 \$90.90 on January 1, with the expectation of making 10% on the funds during the year and
10 having the required \$100 ($\$90.90 \times 110\%$) available at the end of the year to meet your
11 obligation. But, what happens if you invest the \$90.90 and the stock market declines by
12 50%, so at the end of the year you are left with only \$45.45? You now need to contribute an
13 additional \$54.54 of funds in order to have the \$100 that you require. In that scenario, the
14 total amount of cash that you would have needed to meet your obligation is \$145.44 (\$90.90
15 plus \$54.54), while if you had not invested in the market, you would have only needed to
16 come up with \$100.00 in cash by year’s end. Essentially, in this example, you have lost
17 \$45.44 and those funds must be made up since the original obligation still exists. The same
18 principle applies to the pension fund. The degree to which ratepayers benefit from various
19 levels of pension funding depends on how well the underlying investments perform over
20 time.

1 At the same time, KAWC's shareholders have benefitted from a new revenue stream
2 by including a prepaid pension asset in rate base. As long as the prepaid pension asset is
3 included in rate base, shareholders earn a return on those funds regardless of how the
4 underlying investment does. While ratepayers are at risk for variations in market returns,
5 shareholders are not, in that they have a revenue stream provided by the earnings on the
6 pension asset. In addition, if the investment does poorly, then shareholders are still made
7 whole because the lower returns will cause the GAAP expense to increase, an increase that
8 will be passed through to ratepayers.

9
10 **Q. What do you recommend?**

11 A. Given the wide discretion that the Company has with regard to pension funding, I
12 recommend that the Commission reject the inclusion of the prepaid pension asset in rate
13 base. My adjustment is shown in Schedule ACC-7.

14
15 **Q. Do you believe that your adjustment is unfair to the Company, in that the Company is**
16 **required to give ratepayers a credit for any funding shortfalls but shareholders do not**
17 **get credit for any excess funding?**

18 A. No, I do not. Utility rates should not be subject to funding decisions that are made for other
19 business reasons. The significant discretion afforded companies with regard to pension
20 funding is reason enough to deny utilities the ability to charge ratepayers a return on excess
21 pension funding. Pension funding should not be used as a profit center to compensate

1 shareholders in this low interest rate environment, when the Company clearly has an
2 incentive to maximize the amounts included in rate base.

3
4 **E. Capitalization of Rate Base**

5 **Q. What is the total rate base requested by the Company in this case?**

6 A. As shown in Exhibit 37, Schedule B-1, the Company's revenue requirement is based on an
7 average Test Period rate base of \$403,866,142.

8
9 **Q. How does the Company's proposed rate base compare with its proposed capitalization?**

10 A. The Company's proposed average Test Period capitalization is \$398,755,027, as shown in
11 Exhibit 37, Schedule J-1. Thus, the Company's claimed rate base exceeds its proposed
12 capitalization by \$5,111,115.

13
14 **Q. Should the Company earn a return on projected rate base amounts that exceed the
15 Company's capitalization?**

16 A. No, it should not. By definition, the utility's required return is intended to provide investors
17 with a return on amounts actually invested in utility operations. This would include
18 bondholders, providers of short-term debt, preferred debt holders, and common equity
19 holders. If a utility's rate base exceeds its capitalization, then rates are set to provide returns
20 to investors that exceed the returns explicitly authorized by the regulatory agency. Moreover,
21 since the payments to debt holders and owners of preferred stock are fixed, any excess

1 earnings accrue to the benefit of common stock holders. While a utility's capitalization can
2 and usually does exceed its rate base, due to non-jurisdictional activities or investment that is
3 excluded from rate base, a regulated utility's capitalization should serve as an upper limit on
4 the rate base used to establish an overall return.

5
6 **Q. What do you recommend?**

7 A. I recommend that the Commission limit the Company's rate base in this case to no more than
8 its projected average Test Period capitalization. Assuming that there were no other
9 adjustments to the claimed rate base filed by KAWC in this case, the Commission should
10 authorize a rate base of no higher than the capitalization of \$398,755,027, which result in a
11 rate base reduction of \$5,111,115. However, in addition to recommending that KAWC's rate
12 base be limited by its average Test Period capitalization, I am also recommending several
13 other adjustments to the Company's rate base claim. These other adjustments serve to reduce
14 the claimed rate base amount of \$403,866,142 to an amount that is below the claimed
15 capitalization of \$398,755,027. Therefore, I have not reflected an additional adjustment
16 related to capitalization in my rate base recommendation. However, if the Commission
17 rejects any of my rate base adjustments, then the result could be a pro forma rate base that
18 exceeds the Company's capitalization. In that event, the Commission should make an
19 additional adjustment to ensure that the authorized rate base is no greater than the average
20 Test Period capitalization claimed by KAWC.

21

1 **F. Summary of Rate Base Issues**

2 **Q. What is the impact of all of your rate base adjustments?**

3 A. My recommended adjustments reduce the Company's rate base claim from \$403,866,142 to
4 \$398,167,275, as summarized on Schedule ACC-3.

5
6 **VII. OPERATING INCOME ISSUES**

7 **A. Water Sales Revenues**

8 **Q. Are you recommending any adjustments to the Company's pro forma revenue claim?**

9 A. Yes, I am recommending adjustments to the Company's claims for residential and
10 commercial water sales revenue.

11
12 **Q. How did the Company develop its claim for pro forma residential consumption in this
13 case?**

14 A. As described in the testimony of Dr. Spitznagel, the Company undertook a regression
15 analysis to develop a normalized level of consumption per customer. This regression
16 analysis examined the impact of consumption on such variables as calendar month, calendar
17 year, drought severity index, and cooling degree days. Dr. Spitznagel then developed a
18 regression based on those variables that gave the best statistical fit to ten years of utilization
19 data. As a result of that analysis, Dr. Spitznagel is recommending a residential consumption
20 of 130.37 gallons per day per customer or 47.59 thousand gallons (tgs) per year.⁴

⁴ Dr. Spitznagel reports a finding of 130.34 gallons per day on page 5 of his testimony, but Exhibit 37 Schedule I to

1

2 **Q. Did the Company utilize the same revenue sales model in its last base rate case?**

3 A. No, it did not. Apparently, the Commission expressed concerns regarding the revenue model
4 utilized by KAWC in its last base rate. As a result, Mr. Spitznagel indicates that he returned
5 to using a weather normalization model that had been utilized previously, although
6 modifications to the model have been made since it was first presented by Dr. Spitznagel in
7 1997. In this case, Mr. Spitznagel utilized a ten year trend for water sales and a thirty-year
8 period for determining “normal” weather.

9

10 **Q. Does the Company know how much of its consumption is weather-related?**

11 A. No, it does not. According to the response to AG- 1-41, “Although Kentucky American
12 realizes swings in water demand in extreme weather conditions, Kentucky American has not
13 attempted to approximate the percentage of water sales that are weather sensitive.”

14

15 **Q. Do you agree that water consumption has generally declined over the past ten years?**

16 A. Yes, I do. I agree with Ms. Bridwell’s testimony on page 32 where she states that water
17 consumption has declined due to the use of more efficient fixtures, conservations programs,
18 and price elasticity. There has been a clear decline in average usage by KAWC customers
19 over the past ten years, as shown below:

20

the Company’s Application is based on 130.37 gallons per day.

	Annual Residential Consumption Per Customer (tgs)
2006	62.01
2007	63.16
2008	60.64
2009	55.58
2010	57.55
2011	53.73
2012	55.43
2013	49.64
2014	50.74
2015	50.65
Base Period Projection	49.59
Test Period Projection	47.59

1

2

3 The Company's Test Period projection reflects a 4.0% decline from the projected Base
4 Period consumption.

5

6 **Q. Do you believe that KAWC has adequately supported this projection?**

7 A No, I do not. While I agree that consumption has declined over the past ten years, this
8 decline has slowed considerably over the past three years. In fact, sales increased in 2014
9 relative to 2013 and stayed flat between 2014 and 2015. This suggests that the trend of
10 declining water sales may have stopped, or at least the pace has slowed considerably relative
11 to the declines experienced earlier in the period. A leveling off of consumption levels would
12 be expected, as the use of more efficient fixtures becomes widespread and as many

1 consumers have already adjusted their consumption patterns to increase conservation.
2 Therefore, this data suggests that the additional 4.0% decrease projected for the Test Period
3 is unrealistic.

4
5 **Q. Do you have similar concerns about the Company's commercial sales forecast?**

6 A. Yes, I do. I believe that the commercial sales forecast is also understated. Following is the
7 actual annual usage per customer over the past ten years, as well as the projections for the
8 Base Period and Test Period:

9

	Annual Commercial Consumption Per Customer (tgs)
2006	497.86
2007	500.03
2008	477.58
2009	433.63
2010	465.89
2011	428.06
2012	450.36
2013	399.73
2014	413.94
2015	434.66
Base Period Projection	423.14
Test Period Projection	386.23

10
11 As shown above, commercial consumption has actually increased each year from 2013 to
12 2015. In spite of this increase, the Company is projecting a decline in the Base Period

1 consumption. In addition, it is projecting a further 8.7% reduction in consumption per
2 customer between the Base Period and Test Period. I do not believe that such a projection is
3 reasonable.

4
5 **Q. Has the Company provided any data updating its actual Base Period consumption?**

6 A. Yes, it has. As shown in the response to AG 2-4, which is based on actual results through
7 March 31, 2016, the actual residential consumption for the eleven months ending March 31,
8 2016 results in a Base Period forecast of 49.44 tgs, very close to the Base Period forecast
9 reflected in the Application. That response also indicates that updated Base Period
10 commercial consumption is 431.16 tgs, well above Base Period consumption of 423.14 tgs
11 assumed in the Application.

12
13 **Q. What do you recommend?**

14 A. I recommend that the Commission utilize the Base Period consumption for residential and
15 commercial customers to establish utility rates in this proceeding. Any further reduction is
16 unsupported and speculative. Since we do not yet have a fully updated Base Period, I have
17 used the Base Period consumption reflected in the Company's Application to develop my
18 adjustment. I have applied this consumption to the pro forma average Test Period customers
19 to develop Test Period pro forma sales for these classes. My adjustment is shown in
20 Schedule ACC-9.

1 **Q. Did you also make an adjustment to reflect incremental costs associated with these**
2 **additional sales?**

3 A. Yes, I did. On Schedule ACC-9, I have reduced the impact of my adjustment to reflect the
4 incremental costs relating to fuel and purchased power costs and chemicals. I also made an
5 adjustment to reflect additional uncollectible expense and the PSC assessment. I did not
6 include purchased water costs in my incremental cost adjustment because it is my
7 understanding that the Company minimizes its water purchases and that these purchases are
8 not directly proportional to water sales. My adjustment results in a net revenue increase of
9 \$2,533,943, as shown on Schedule ACC-9.

10
11 **B. Other Revenues**

12 **Q. Are you also recommending an adjustment to Other Revenues?**

13 A. Yes, I am. Other revenues include late payment charges, rent, application fees, reconnect
14 fees, and fees for other miscellaneous services. In its filing, the Company projected a
15 decrease in Test Period Other Revenues, from \$2,285,688 in the Base Period to \$2,174,648.
16 I am recommending that the Base Period claim of \$2,285,688 be reflected in the Test Period
17 as well.

18
19 **Q. What is the basis for your adjustment?**

20 A. While various components of Other Revenues have fluctuated from year-to-year, Other
21 Revenues in total have increased in each of the past three years. The Company has not

1 supported claims that Other Revenues will decline by almost 5% in the Test Period. In
2 addition, according to the response to AG 2-3, antennae rent revenue was significantly higher
3 in March 2016 than in prior months, suggesting that the Company has renegotiated the rental
4 contracts on favorable terms. Accordingly, I recommend that the Commission reject the
5 Company's unsupported and speculative Test Period adjustment to Other Revenue. My
6 adjustment is shown in Schedule ACC-10.

7
8 **C. Salary and Wage Expense**

9 **Q. How did the Company determine its salary and wage claim in this case?**

10 A. As described in the testimony of Donald Petry at page 5, the Company's labor claim is based
11 on a full complement of 138 full-time equivalent employees. The Company also included
12 budgeted overtime hours and shift premiums for each position, if applicable. For non-union
13 employees, the Company included projected wage increases of 2.75% effective April 2016
14 and of 3% effective April 2017. Non-union employees received increases of 2.47% to 2.67%
15 annually from 2011 to 2015, as shown in the response to PSC-2-48. For union employees,
16 the Company used the contractual labor rates pursuant to its current labor contract, which is
17 effective through October 31, 2017. Union increases averaged 2.25% to 2.84% annually over
18 the last five years. The Company's total projected Test Period salary and wage cost is
19 \$9,209,772. A portion of the labor costs is allocated to non-water operations and a portion is
20 capitalized. The resulting salary and wage expense projected for the Test Period is
21 \$7,352,130.

1

2 **Q. Are you recommending any adjustment to the Company's salary and wage claim?**

3 A. Yes, I am recommending adjustments relating to vacant employee positions and the costs for
4 overtime hours.

5

6 **Q. Does the Company have any employee vacancies?**

7 A. Yes, in its response to Data Request PSC 2-47, the Company indicated that there are
8 currently seven vacant employee positions.

9

10 **Q. Is it normal and customary for a company like KAWC to have unfilled positions at any
11 given time?**

12 A. Yes, it is normal and customary for companies to have unfilled positions at any given time as
13 a result of terminations, transfers, and retirements. Moreover, when setting utility rates, it is
14 important for regulators to recognize that vacant positions are likely to exist in a utility as
15 large as KAWC. If utility rates are set based on a full complement of employees, and if these
16 employee positions remain vacant, then ratepayers will have paid rates that are higher than
17 necessary to the benefit of shareholders. Therefore, I recommend that the Commission
18 consider the likelihood of vacant positions when setting rates in this case.

19

20 **Q. What do you recommend?**

21 A. I recommend that salary and wage costs for the positions that are currently vacant be

1 eliminated from the Company's revenue requirement claim, in recognition of employee
2 vacancies. This recommendation provides a good balance between the need to provide
3 flexibility to the Company to decide when additional employees are necessary and the need
4 to protect ratepayers from paying excessive rates. While I have noted that the Company
5 currently has seven vacancies, my recommendation is not to disallow these seven particular
6 employee positions, but simply to recognize that the Company often has unfilled positions
7 and those costs for unfilled positions should not be included in regulated utility rates. Thus,
8 the cost for these seven positions reflects a proxy for the fact that vacant positions will
9 continue to occur. The currently vacant positions include three non-union hourly employees,
10 three union employees, and one salaried exempt employee. Therefore, the currently vacant
11 positions provide a good representative sample of the entire employee base.

12
13 **Q. Is your recommendation consistent with the Company's actual experience?**

14 A. Yes, it is. As shown in the response to PSC 1-21, KAWC had vacant positions in every
15 month over the past five years. Moreover, as shown in the response to PSC 1-15, in each of
16 the past two years (the period for which data was provided in this response), the Company's
17 actual labor costs have exceeded its labor budget. While the Company claims that this is due
18 to "operational efficiencies," I suspect that vacant positions contributed to this variance.

19
20 **Q. How have you quantified your adjustment?**

21 A. In order to quantify my adjustment, I utilized the total employee-related costs included in the

1 Company's claim, as shown in the response to PSC 2-47. My adjustment is shown in
2 Schedule ACC-11. Again it should be emphasized that I am using these current vacancies as
3 a proxy. I recognize that these particular positions may be filled in the near future but
4 nevertheless additional positions are likely to become vacant during the Test Period.
5

6 **Q. Please explain your adjustment relating to overtime costs.**

7 A. In at least some prior cases, the Commission has been reluctant to make an adjustment
8 related to employee vacancies because it has accepted the Company's argument that
9 additional overtime hours are needed to cover the activities associated with employee
10 vacancies. In fact, in this case, the Company has reflected a level of overtime that is less than
11 what has typically been incurred by KAWC. Therefore, since I am recommending an
12 adjustment to reduce labor costs to eliminate costs for vacant positions, it is necessary to
13 make a corresponding adjustment to increase the Test Period overtime hours to reflect a more
14 typical level of employee overtime. As shown in the Company's workpapers, over the past
15 three years KAWC has incurred an average of 25,593 overtime hours. However, its Test
16 Period claim includes costs for only 16,947 overtime hours. Therefore, I am recommending
17 an adjustment to increase the Test Period overtime hours to reflect the three-year average.
18 This adjustment is consistent with my recommendation regarding the elimination of costs for
19 employee vacancies.
20

21 **Q. How did you quantify your adjustment?**

1 A. My adjustment is based on an additional 8,645 hours of overtime and on an average hourly
2 overtime rate of \$40.09, which was developed from the Company's workpapers. My
3 adjustment is shown in Schedule ACC-12.

4
5 **D. Incentive Compensation Plan Expense**

6 **Q. How much did the Company include in its filing associated with incentive plan awards**
7 **to employees and officers?**

8 A. KAWC included incentive compensation expense of \$318,405 in its filing for KAWC
9 personnel. This included \$303,870 of expense for the Annual Performance Plan ("APP")⁵
10 and \$14,535 for the Long-term Incentive Plan ("LTIP"). All non-union KAWC employees
11 are eligible for the APP while the KAWC LTIP costs relate to awards to only one individual.
12 In addition, the Company included \$781,048 of incentive compensation expense for Service
13 Company employees, including \$537,596 for the APP and \$243,452 for the LTIP.

14
15 **Q. What are the criteria for award of the APP?**

16 A. The APP funding pool is first based on the Company meeting an earnings per share ("EPS")
17 threshold. If actual EPS are at least 90% of the target, then the APP pool will be funded. Once
18 the pool is funded, 55% of the APP award is dependent upon financial performance and 45%
19 of the award is dependent upon other factors.

20

⁵ The APP was previously known as the Annual Incentive Plan ("AIP").

1 **Q. Please describe the LTIP.**

2 A. According to the plan description provided in response to AG 2-7, the LTIP “includes stock
3 options, Restricted Stock Units (RSUs), and a performance-based stock component, which
4 awards Performance Stock Units (PSUs) based on American Water’s Total Shareholder
5 Return (TSR) ranking among peer companies, and Earnings Per Share (EPS) growth.” Thus,
6 the LTIP is exclusively based on financial criteria.

7
8 **Q. Have costs for the APP and LTIP been excluded from KAWC’s rates in prior cases?**

9 A. Yes, they have. In Case No. 2004-00103, the Commission eliminated all incentive
10 compensation costs from the Company’s revenue requirement. Since that time, incentive
11 compensation costs have not been included in rates. I recommend that the Commission
12 continue this practice and deny the Company’s proposal to include these awards in regulated
13 rates.

14 These awards are primarily based on financial criteria that benefit shareholders, not
15 ratepayers. To the extent that financial performance meets or exceeds certain guidelines,
16 shareholders benefit through higher earnings. But, such financial measures can be directly at
17 odds with ratepayer benefit. For example, one way of meeting financial benchmarks is to
18 raise utility rates, an action that has a direct and detrimental impact on ratepayers. Given the
19 significant dependence on financial criteria, the Commission should continue to exclude
20 these awards from regulated rates.

21

1 **Q. Didn't the Company provided testimony from Willis Towers Watson that concluded**
2 **that the KAWC's total compensation package, including its incentive awards, is**
3 **comparable to other companies in the industry?**

4 A. Yes, it did. However, the benchmark studies sponsored by Willis Towers Watson are not
5 only inadequate to support the Company's claim, more importantly they are dangerous to the
6 ratemaking process. Willis Towers Watson, or other compensation consulting firms,
7 sponsors similar studies in most utility rate proceedings in which I am involved. The
8 problem with these studies is that they do not objectively report compensation results – they
9 are being used to drive incentive compensation claims across the country. The use of
10 industry benchmarks, which are widely used by utility companies to support their
11 compensation policies, results in a spiraling of compensation costs as companies that are
12 below the market median attempt to improve their position relative to the utilities at or above
13 the median. These surveys compare the subject company's compensation to compensation in
14 a range of other firms. Since most companies do not want to find themselves in the lower
15 half of the benchmark group, companies that typically fall below the median respond by
16 increasing compensation – and by doing so, push the median higher for the benchmark
17 group. Thus, every effort that is made by a company to meet or exceed the median serves to
18 move the median higher. That is why benchmarking steadily increases compensation levels
19 for all utility employees to which it is applied, regardless of their actual job performance.
20 The Commission should be particularly wary of any compensation plans that are justified by
21 means of comparisons to benchmark studies. While the Company may utilize industry

1 benchmarks to justify its compensation levels, benchmarking does not insure that the level
2 of compensation is reasonable or that the full amount should be recovered from ratepayers,
3 since benchmarking tends to drive up overall compensation levels within the industry.
4 While benchmarking has some intuitive appeal, in my opinion the use of benchmarking
5 “studies” is one of the most detrimental trends in utility ratemaking that has occurred over
6 the past few years.

7 Moreover, the use of benchmarking studies, often by Willis Towers Watson or
8 similar firms, is driving up costs associated not only with incentive compensation programs
9 but with overall levels of compensation awarded to utility officers and executives. Most
10 utility companies rely on such studies to justify to shareholders the large executive
11 compensation payments to corporate officers, which must be reviewed by shareholders in
12 non-binding votes. According to the AWWC 2016 Proxy Statement, the top five executives
13 had base salaries totaling over \$2.5 million in 2015. When stock awards, options, and other
14 compensation is considered, the AWWC President and Chief Executive Officer earned total
15 compensation of \$3.27 million in 2015, while total compensation for the top five individuals
16 totaled \$8.94 million. Yet AWWC justified such compensation to its shareholders at least
17 partly on the basis of benchmarking studies. In addition, the Company noted on page 34 of
18 its Proxy Statement that it had “returned significant value to our shareholders over the past
19 five years” including stock returns that were well above the market.
20

1 **Q. What do you recommend?**

2 A. I recommend that the Commission continue its policy of excluding incentive compensation
3 costs from utility rates. At Schedule ACC-13, I have made an adjustment to eliminate the
4 KAWC incentive compensation costs. I have made a similar adjustment with regard to
5 Service Company costs in Schedule ACC-14.

6

7 **E. Payroll Tax Expense**

8 **Q. Did you make a payroll tax adjustment to reduce payroll taxes consistent with the labor
9 adjustments discussed above?**

10 A. Yes, I did. The payroll tax impact of my recommended adjustments relating to overtime
11 costs and incentive compensation costs is shown in Schedule ACC-15. I did not include a
12 tax adjustment associated with my employee vacancy cost adjustment, since payroll taxes
13 were already included in the total vacancy cost adjustment shown in Schedule ACC-11.

14

15 **F. Customer Accounting Expense**

16 **Q. Please discuss the Company's claim with regard to customer accounting costs.**

17 A. The Company has included a Test Period adjustment of \$318,000 relating to a credit card
18 program that it proposes to implement whereby transaction costs for credit card processing
19 would be included in its revenue requirement and allocated to all ratepayers. According to
20 the response to AG 2-13, the Company began accepting credit card payments in 2005. The
21 current credit card vendor charges \$1.95 per transaction, which is currently paid directly by

1 the customer. The Company states in this response that 16.9% of its customers currently pay
2 by credit cards each month. Customers that pay online by e-check do not incur a fee.

3
4 **Q. Are you recommending any adjustment to the Company's claim?**

5 A. Yes, I am recommending that the credit card cost adjustment be denied. KAWC has not
6 provided any studies in support of its proposal to have credit card transaction costs allocated
7 to all customers instead of just to those customers that use credit cards. There is the
8 possibility that some customers who do not currently use credit cards would do so if there
9 was no transaction fee in order to obtain points and rewards associated with various credit
10 card loyalty programs. It seems unfair to require other customers to subsidize those
11 customers that pay by credit card in order to enhance their rewards under these programs.
12 Accordingly, I recommend that the Company's request to impose these costs on the entire
13 customer body be rejected. My adjustment is shown in Schedule ACC-16.

14
15 **G. Insurance Other Than Group Expense**

16 **Q. What has the Company included in its revenue requirement for Insurance Other Than**
17 **Group?**

18 A. KAWC has included \$808,380 in its Test Period for Insurance Other Than Group. These
19 costs include general liability costs, workers' compensation costs, and property insurance
20 costs.

1 **Q. How does this claim compare with historic results?**

2 A. While the Company's claim is not significantly higher than its projected Base Period cost of
3 \$798,704, it is significantly higher than actual costs incurred in prior years. Following are the
4 Insurance Other Than Group costs incurred in each year from 2011-2015, as well as the costs
5 projected for the Base Period and Test Period:
6

2011	\$532,057
2012	\$489,805
2013	\$551,349
2014	\$512,046
2015	\$529,189
Base Period	\$798,704
Test Period	\$808,380

7
8 Based on my review of the underlying workpapers, it appears that the Company's claim is
9 being driven largely by the General Liability insurance costs, which KAWC projects will
10 jump 82% between 2015 and the Base Period.
11

12 **Q. Has the Company adequately explained the rationale for this increase?**

13 A. No, it has not. While the Test Period claim is not substantially higher than the Base Period,
14 KAWC needs to fully explain and justify any material increase between the Base Period
15 actual costs and the costs incurred in prior years. Moreover, the Company should be required
16 to demonstrate that the Base Period costs are representative of Test Period costs and that any
17 such increase is expected to reoccur in the Test Period. Since we do not know what the

1 actual Base Period cost is as yet, it would be premature to allow the Company to reflect such
2 a large projected increase in regulated utility rates.

3
4 **Q. What do you recommend?**

5 A. I have utilized the actual 2015 Insurance Other Than Group expense in my revenue
6 requirement calculation. My adjustment is shown in Schedule ACC-17. In its Rebuttal
7 Testimony, KAWC should identify the actual Base Period cost for Insurance Other than
8 Group, it should fully explain any material increases from costs incurred in prior years, and it
9 should provide documentation showing that any such increases are expected to continue into
10 the Test Period. At that time, I will review the Company's additional documentation and
11 adjust my recommendation, if necessary.

12
13 **H. Maintenance Supplies and Services Expense**

14 **Q. Did you include an expense adjustment related to amortization of deferred
15 maintenance costs?**

16 A. Yes, I did. As discussed in the Rate Base section of this testimony, I am recommending that
17 the Company's claim for deferrals associated with certain deferred maintenance projects be
18 rejected. Specifically, I recommended that the deferred maintenance projects that have not
19 yet been completed be excluded from rate consideration in this case. Therefore, at Schedule
20 ACC-18, I have made a corresponding adjustment to eliminate the amortization expense
21 associated with these deferred costs from the Company's rates.

1

2 **I. Rate Case Expense**3 **Q. Please describe the Company's rate case expense claim.**4 A. KAWC is requesting a three-year recovery of total rate case costs for the current case of
5 \$884,370. These costs are composed of the following:

6	Service Company	\$177,000
7	Legal	458,000
8	Rate of Return Consultant	35,000
9	Weather Normalization	21,820
10	Cost of Service Study	77,550
11	Depreciation Study	32,000
12	Customer Notice	60,000
13	Miscellaneous	<u>23,000</u>
14		
15	Total	<u>\$884,370</u>

16

17 **Q. Are you concerned about the level of rate case costs claimed in this proceeding?**

18 A. Yes, I am. The Company's claim is approximately 26.1% higher than the actual costs
19 incurred for the last base rate case. Moreover, costs in that case were 43% higher than the
20 costs incurred for Case No. 2008-00427, although the 2008 case was settled while the last
21 two cases were litigated. Rate case costs actually remained relatively stable until the 2008
22 rate proceeding. Thus, I am concerned about the significant acceleration in rate case costs
23 since that time.

24 Given the significant increase in rate case costs, the Commission may want to take a
25 fresh look at how such costs are recovered in Kentucky. For example, the Commission could
26 require a 50/50 sharing of rate case costs as some states do, such as New Jersey, where

1 another large AWW subsidiary is regulated. The basis for a sharing is the fact that both
2 shareholders and ratepayers benefit from a rate case – shareholders by obtaining higher
3 earnings and ratepayers by getting a financially strong utility. Thus, a sharing of rate case
4 costs can be justified from that perspective.

5
6 **Q. What level of rate case costs do you recommend be reflected in KAWC's rates?**

7 A. I am recommending that the Commission authorize recovery of \$701,178 in utility rates,
8 which is the actual amount of rate case costs incurred in the last base rate case. I believe that
9 this recommendation represents a reasonable compromise between the Company's right to
10 cost recovery and the recognition that shareholders are also benefiting from the filing of rate
11 cases. My adjustment is shown in Schedule ACC-19.

12
13 **J. Service Company Costs**

14 **Q. How much has the Company included in its filing for charges from the Service**
15 **Company?**

16 A. As shown in Exhibit 35 to the Application, KAWC is projecting Test Period Service
17 Company costs of \$8.604 million. This represents an increase of 5.36% over the estimated
18 Base Period costs of \$8.166 million.

19
20 **Q. Are you recommending any adjustment to the Service Company costs included in**
21 **KAWC's Test Period revenue requirement?**

1 A. Yes, in addition to my recommended adjustment to remove incentive compensation costs,
2 discussed above, I am also recommending that Business Development, Government Affairs,
3 and Regulatory Policy costs be disallowed.
4

5 **Q. What is the basis for your recommendation?**

6 A. According to the response to PSC 3-27, the business development function is primarily
7 related to identifying and evaluating various merger and acquisition candidates. These costs
8 should not be charged to regulated ratepayers. These activities instead should be financed by
9 the Company's shareholders who are the principal beneficiaries of merger and acquisition
10 activity.

11 With regard to Government Affairs costs, these activities primarily involve
12 monitoring of proposed legislation and providing "assistance with any emerging issues" as
13 described in the response to PSC 3-28. These costs appear to be related to lobbying activities
14 and should therefore be excluded from regulated rates. I also recommend that regulatory
15 policy costs allocated from the Service Company be disallowed, unless the Company can
16 demonstrate a direct customer benefit associated with these costs. My adjustments to
17 eliminate Business Development, Government Affairs, and Regulatory Policy costs from the
18 Company's revenue requirement are shown in Schedule ACC-20.
19

20 **Q. How did you quantify your adjustment?**

21 A. To quantify my adjustment, I eliminated the Business Development, Government Affairs,

1 and Regulatory Policy costs identified in the response to PSC 2-52. However, I excluded
2 incentive compensation costs from my Service Company adjustment, since these costs were
3 already addressed earlier in my testimony, where I recommended that all incentive
4 compensation plan costs be disallowed.

5
6 **K. Meals and Entertainment Expense**

7 **Q. Are you recommending any adjustment to the Company's meals and entertainment**
8 **expense claim?**

9 A. Yes, I am. The Company has included in its filing \$35,937 of means and entertainment
10 expenses, \$17,963 of which are not deductible on the Company's income tax return. The
11 IRS typically limits recovery of meals and entertainment expenses to 50% on the basis that a
12 portion of these expenditures are not appropriate deductions for federal tax purposes. If these
13 costs are not deemed to be appropriate business expenses by the IRS, it seems reasonable to
14 conclude that they are not appropriate business expenses to include in a regulated utility's
15 cost of service. Accordingly, at Schedule ACC-21, I have made an adjustment to eliminate
16 these costs from the Company's revenue requirement. While there may be certain costs for
17 meals that should be borne by ratepayers, there are also likely to be costs included in this
18 category that should be entirely excluded from the Company's revenue requirement.
19 Therefore, my recommendation to use the 50% IRS criteria provides a reasonable balance
20 between shareholders and ratepayers and should be adopted by the Commission.

21

1 **L. Miscellaneous Expense**

2 **Q. How did the Company determine its claim for Miscellaneous Expenses in this case?**

3 A. As shown in the Company's workpaper 3-20, KAWC's claim for miscellaneous expenses
4 includes numerous adjustments to its projected Base Period costs. This includes the
5 elimination of various categories of Charitable Contributions as well as elimination of certain
6 other costs that should not be charged to ratepayers, such as tax penalties. However, the Test
7 Period does reflect certain other costs that I believe are inappropriate to charge to Kentucky
8 ratepayers. Specifically, I am recommending that costs for Community Partnerships and
9 Community Relations costs be disallowed.

10
11 **Q. What is the basis for your adjustment?**

12 A. In the response to PSC 2-46, KAWC indicated that Test Period costs for certain
13 miscellaneous expense components was based upon the actual types of costs incurred for the
14 first six months of the Base Period. As shown on this response, the actual Base Period costs
15 for Community Partnerships appear to relate to goodwill advertising and other corporate
16 promotional activities. For example, these costs include Ice Rink Panel Sponsorship, various
17 business meeting sponsorships, Friday Flick Fun Zone Sponsorships, and similar activities.
18 While sponsorship of these functions is admirable, these costs do not relate to the provision
19 of safe and reliable utility service and therefore they should not be charged to ratepayers.
20 These costs are more akin to donations, which the Company explicitly excluded from its
21 revenue requirement claim. Therefore, these community partnership costs should be

1 similarly disallowed.

2 I have similar concerns with regard to the Community Relations costs included in the
3 Company's Miscellaneous Expense claim. This same data request response also
4 demonstrates that these costs relate to promotional activities. These marketing opportunities
5 are directed toward corporate promotion and are designed to favorably influence customer
6 opinion. These activities constitute "soft-lobbying" of ratepayers on behalf of the Company.
7 Such promotions are not necessary to the provision of regulated utility service and should
8 not be paid for by ratepayers. Accordingly, I recommend that both Community Partnership
9 costs and Community Relations costs be disallowed. My adjustment is shown in Schedule
10 ACC-22.

11
12 **M. Interest Synchronization and Tax Rates**

13 **Q. Have you adjusted the pro forma interest expense for income tax purposes?**

14 A. Yes, I have made this adjustment at Schedule ACC-23. It is consistent (synchronized) with
15 my recommended rate base, and with Dr. Woolridge's capital structure and cost of capital
16 recommendations. The AG/LFUCG's recommendations result in a lower rate base and a
17 lower cost of debt than the rate base and cost of debt included in the Company's filing. The
18 AG/LFUCG's recommendations, therefore, result in lower pro forma interest expense for the
19 Company. This lower interest expense, which is an income tax deduction for state and
20 federal tax purposes, will result in an increase to the Company's income tax liability under
21 the AG/LFUCG's recommendations. Therefore, these recommendations result in an interest

1 synchronization adjustment that reflects a higher income tax burden for the Company, and a
2 decrease to pro forma income at present rates.

3
4 **Q. What composite income tax rate did you use to quantify your adjustments?**

5 A. My adjustments are based on a composite income tax rate of 38.90%, as shown on Schedule
6 ACC-24. This reflects a state income tax rate of 6.00% and a federal income tax rate of 35%.

7
8 **Q. What revenue multiplier did you use in your revenue requirement calculation?**

9 A. I used a revenue multiplier of 1.6527. This is also the revenue multiplier used by KAWC in
10 its Application. In addition to the state and federal income tax rates referenced above, this
11 revenue multiplier includes uncollectible costs of 0.7815% and a PSC assessment of
12 0.1901%.

13
14 **VIII. REVENUE REQUIREMENT SUMMARY**

15 **Q. What is the result of the recommendations contained in this testimony?**

16 A. My adjustments indicate a revenue requirement deficiency at present rates of \$466,394, as
17 summarized on Schedule ACC-1. This recommendation reflects revenue requirement
18 adjustments of \$12,987,268 to the Company's requested revenue increase of \$13,453,661.

19
20 **Q. Have you quantified the revenue requirement impact of each of your**
21 **recommendations?**

1 A. Yes, at Schedule ACC-26, I have quantified the revenue requirement impact of the rate of
2 return, rate base, revenue and expense recommendations contained in this testimony.

3
4 **Q. Have you developed a pro forma income statement?**

5 A. Yes, Schedule ACC-27 contains a pro forma income statement, showing utility operating
6 income under several scenarios, including the Company's claimed operating income at
7 present rates, my recommended operating income at present rates, and operating income
8 under my proposed rate increase of \$466,394. My recommendations will result in an overall
9 return on rate base of 7.13%, as recommended by Dr. Woolridge.

10
11 **IX. QUALIFIED INFRASTRUCTURE PLAN RIDER**

12 **Q. Please provide a brief description of the Company's water distribution system.**

13 A. As discussed on pages 20-21 of Mr. O'Neill's testimony, the Company has three major
14 vintages of distribution pipe in its system. Approximately 4% of the system was constructed
15 between 1885 and 1940, predominately with cast iron mains. Another 23% of the system
16 was constructed in the 1950s and 1960s, using both cast iron and asbestos cement pipes. The
17 remaining distribution system was constructed from the 1970s to the early 2000s, originally
18 with asbestos cement pipe and later with ductile iron main, which is the predominate material
19 used during this period.

1 **Q. Please summarize the Company's proposal in this case relating to infrastructure**
2 **replacement.**

3 A. KAWC is proposing to implement a Qualified Infrastructure Program ("QIP") to accelerate
4 replacement of various components of its system. In addition, the Company is proposing to
5 implement a QIP surcharge mechanism to recover costs associated with the QIP program on
6 a contemporaneous basis from ratepayers. KAWC argues that given the age of its
7 distribution system, an accelerated program is necessary and will best serve "the long term
8 interests of our customers."⁶

9 As described on page 25 of Mr. O'Neill's testimony, KAWC is proposing to first
10 replace cast iron mains and galvanized steel, which collectively account for 62% of all main
11 breaks. The Company is proposing a 25-year replacement program, with replacement of 9.6
12 miles per year at an annual cost of \$6.59 million.

13
14 **Q. How does the Company propose to recover these costs?**

15 A. KAWC proposes to collect these costs through a surcharge or rider mechanism. The
16 proposed QIP mechanism would be established on a prospective basis based on projected
17 investment costs. The Company would make annual QIP filings that would compare the
18 actual revenue requirement related to the plant investment relative to the amounts collected
19 under the surcharge. Differences between the surcharge revenues and the actual revenue
20 requirement would be trued-up subject to interest at a short-term interest rate. The revenue

⁶Testimony of Mr. O'Neill, page 23.

1 requirement associated with the investment would include return on investment at the
2 Company's weighted average cost of capital, based on a 13-month average investment
3 balance, depreciation and property taxes, and would reflect any retirements related to the QIP
4 plant additions. The costs associated with the QIP investment would be rolled into base rates
5 with each new base rate case filing.
6

7 **Q. How has utility plant traditionally been recovered from ratepayers?**

8 A. For most of the past century, utilities had traditionally recovered the cost of their investment
9 in infrastructure through base rates. Between base rate cases, utilities funded infrastructure
10 investment that was necessary to provide safe and reliable utility service to regulated
11 ratepayers. As plant was completed and placed into utility service, the utility began to record
12 depreciation expense, which reflected recovery of the investment over its useful life. When
13 new utility rates were established in the next base rate case, the utility began to recover its
14 annual depreciation expenses from ratepayers. In addition, the new utility rates also reflected
15 a return on the undepreciated investment included in rate base. It was up to the utility to
16 decide when it would file for a base rate increase. Between base rate cases, utility
17 shareholders took the risk of under-earning but shareholders also benefitted from any
18 overearnings during this period.

19 Many utilities are now arguing that they cannot afford to replace obsolete
20 infrastructure without an additional assessment on regulated ratepayers. In its last base rate
21 case, KAWC requested that the Commission authorize a rider to recover the costs of

1 infrastructure replacement projects between base rate cases. That request was denied.
2 KAWC is back before the Commission with a similar request in this case, but has provided
3 no compelling argument as to why a new regulatory mechanism is required.
4

5 **Q. What are the issues that must be addressed by the Commission as it evaluates the**
6 **Company's proposal?**

7 A. First, the Commission should consider whether current investment plans of the utility are
8 adequate to ensure the continued provision of safe and reliable water service to Kentucky
9 ratepayers or if an accelerated infrastructure replacement program is necessary. Second, if
10 the Commission finds that an accelerated program is necessary, then the PSC has to
11 determine whether it should be financed through the traditional base rate case process or if it
12 should be subject to some special ratemaking treatment. Third, if the PSC finds that some
13 extraordinary ratemaking treatment is appropriate, then the Commission needs to design an
14 appropriate cost recovery mechanism, including any parameters that should be adopted or
15 limitations that should be applied.
16

17 **Q. Is a new cost recovery mechanism required in order for the Company to provide safe**
18 **and reliable service?**

19 A. No, it is not. Mr. O'Neill acknowledges on page 22 of his testimony that KAWC "will
20 always make the needed investments to maintain or replace infrastructure. In other words,
21 we continue to all make [sic] necessary investments for adequate sources of supply,

1 treatment, pumping transmission and distribution facilities, as well as to comply with
2 applicable laws and regulations – that is our public service obligation.” Thus, KAWC
3 recognizes that as a regulated monopoly utility, it has an obligation to provide safe and
4 reliable utility service at reasonable rates. This obligation has existed since regulation of
5 utilities in Kentucky began. KAWC will continue to make the investments necessary to
6 operate its system in a safe manner, regardless of whether an accelerated infrastructure
7 program is authorized by the Commission.

8
9 **Q. Do you believe that utilities have a responsibility to continually replace their**
10 **infrastructure?**

11 A. Yes, I do. Infrastructure replacement should be an integral part of managing any utility
12 operation. In this case, Mr. O’Neill has testified that KAWC is currently replacing pipe at an
13 average rate of 0.2 percent. At the current rate, it would take 500 years for the Company’s
14 infrastructure to be replaced. While I am not a water engineer and do not know the optimal
15 replacement period, I can confidently state that a replacement period of 500 years is
16 excessive. Therefore, it may be appropriate for the Commission to require KAWC to
17 accelerate its replacement of its infrastructure. In fact, in this case, the Company is
18 requesting new depreciation rates. Before approving new depreciation rates, the
19 Commission should ensure that the actual replacement practices of the utility are consistent
20 with the replacement assumptions reflected in depreciation charges that are being passed
21 through to ratepayers.

1

2 **Q. What factors should the PSC consider when determining whether to authorize an**
3 **accelerated cost recovery mechanism?**

4 A. There are many factors that should be considered by the Commission. These include whether
5 the utility has been reasonable in its past investment strategies, the impact on the utility's
6 shareholders if accelerated cost recovery is not authorized, the frequency of rate case filings
7 by the utility, the impact on ratepayers of an accelerated recovery plan, and others. It is
8 critical for the Commission to recognize that the implementation of an accelerated
9 investment program does not necessarily require the implementation of an accelerated cost
10 recovery mechanism.

11

12 **Q. What would be the impact on the utility's shareholders if the traditional base rate case**
13 **process was utilized to fund accelerated infrastructure programs.**

14 A. It is important to remember that the traditional base rate case process does not require
15 shareholders to forego the entire revenue requirement associated with the accelerated
16 program – it only requires them to forego the return of and the return on the investment until
17 the Company's next base rate case. Moreover, regulatory lag associated with recovery of
18 costs related to an accelerated replacement mechanism is further mitigated by the use of a
19 future Test Period, which is permissible in Kentucky.

20 Regulatory lag is not a new concept. It has existed as long as the current regulatory
21 mechanism has been in place. Moreover, regulatory lag is not always detrimental to the

1 utilities - it can work to the benefit of shareholders. For example, in a period of declining
2 capital costs and/or sales growth, regulatory lag can provide a benefit to shareholders because
3 shareholders enjoy increased returns between base rate case filings. In addition, it is the
4 utility that generally decides when to file for a base rate change so utilities take advantage of
5 regulatory lag and avoid rate cases when regulatory lag makes it advantageous for them to do
6 so.

7
8 **Q. Do increases in utility investment benefit utility shareholders?**

9 A. Yes, absolutely. It is undeniable that increased investment helps utility shareholders.
10 KAWC suggests that the additional financing requirements caused by accelerated
11 replacement programs put a strain on investors – but actually the opposite is true. A review
12 of the presentation made by AWWC to investors in March 2016 makes it clear that capital
13 investment in regulated utilities is the primary driver of future earnings growth. Moreover,
14 shareholders benefit from accelerated replacement programs even if an accelerated cost
15 recovery mechanism is not approved. Under the traditional rate case process, utility
16 shareholders may have to wait a few years for new investment to be reflected in utility rates.
17 However, given the long lives of utility assets, shareholders will receive a long revenue
18 stream once those costs are reflected in rates. Even if shareholders must wait a few years to
19 begin collecting these revenues, they will enjoy many, many years of higher earnings if the
20 utility continues to invest. Moreover, this investment is substantially less risky than
21 investing in many competitive companies.

1

2 **Q. But isn't it correct that additional investment does not change the rate of return, it**
3 **simply changes the amount of dollars earned on a larger investment base?**

4 A. Yes, however, shareholders still stand to benefit even if there is no change to the actual rate
5 of return authorized by a regulatory commission. The stock market is largely driven by
6 earnings per share, which is the measure generally used by publicly-traded companies to
7 provide earnings guidance to the financial community. In addition, because much of the
8 equity capital used by utilities to fund infrastructure replacement projects is internally
9 generated, utilities do not routinely issue new equity in order to fund additional investment.
10 Therefore, increases in a utility's rate base generally result in increases in earnings per share,
11 which is the primary measure used by investors to evaluate performance. In fact, earnings
12 per share is a key metric in AWWC's investor presentations. Increasing rate base does
13 increase earnings per share, thereby making the utility's stock more attractive to investors, all
14 other things being equal. Of course, there are many factors that have an impact on stock
15 prices, some of which are outside of the control of utility management, such as the overall
16 market environment. But, increasing rate base is one way that utility management can grow
17 earnings, and AWWC has made it a point to inform investors of its plans to increase earnings
18 per share by increasing rate base in its regulated jurisdictions.

19

20 **Q. Do other AWWC jurisdictions have infrastructure replacement recovery mechanisms**
21 **in place, similar to the mechanism proposed by KAWC?**

1 A. While about half of the AWWC jurisdictions have some mechanism to provide for recovery
2 of infrastructure replacement projects outside of a base rate case, the majority of such
3 mechanisms are based on actual investment, not projected investment, as is proposed here.
4 In addition, at least some of the jurisdictions that do provide for infrastructure replacement
5 outside of a base rate case use historic test years, unlike Kentucky which permits a fully
6 forecast Test Period.

7
8 **Q. Do you believe that a new accelerated cost recovery mechanism is necessary in order to**
9 **fund infrastructure replacement projects?**

10 A. No, I do not. I am not convinced that any new cost recovery mechanism is required in order
11 to fund infrastructure replacement projects. KAWC already files for a base rate case
12 approximately every two years. Therefore, regulatory lag is already minimized. In addition,
13 there is no indication that KAWC or its parent company is having difficulty attracting capital
14 to fund infrastructure projects. It is to the benefit of KAWC and its shareholders to increase
15 investment in the regulated utility, regardless of whether an accelerated cost recovery
16 mechanism is approved. Therefore, even if the PSC finds that an accelerated infrastructure
17 investment program should be adopted, it does not follow that an accelerated cost recovery
18 mechanism is required.

19
20 **Q. If the PSC decides to reverse its earlier ruling and adopt a surcharge mechanism, then**
21 **would you recommend any changes to the mechanism proposed by KAWC?**

1 A. Yes, I would. If the Commission were to adopt a new infrastructure recovery mechanism for
2 KAWC, then I recommend that it be accompanied by a lengthening of time between base rate
3 cases. The Company is currently filing cases on a cycle of approximately every two years. If
4 the Commission approves a new infrastructure recovery mechanism, then it should be
5 contingent upon the Company's agreement not to file a base rate case for at least a four-year
6 period. This would provide an incremental benefit to ratepayers and would mitigate some of
7 the harmful rate impacts that would result from an accelerated recovery mechanism.

8 In addition, I recommend that the Commission apply a lower return on equity to
9 investment that is recovered pursuant to an accelerated recovery mechanism. Since
10 shareholders are effectively guaranteed recovery of these costs between base rate cases, this
11 investment should be subject to a lower return on equity than investment recovered in the
12 traditional base rate case process. I recommend at least a 100 basis point adjustment for
13 investment recovered pursuant to an accelerated recovery mechanism. This would allow
14 shareholders to be compensated more quickly than they would be through a base rate case
15 process but would provide some temporary relief to ratepayers and recognizes the financial
16 benefits that shareholders accrue as a result of accelerated investment programs.

17
18 **Q. Please summarize your recommendations with regard to the Company's QIP and the**
19 **associated cost recovery mechanism.**

20 A. While I am unable to recommend a specific replacement period for KAWC's infrastructure, I
21 believe that the current 500 year period is inadequate and does not represent a reasonable

1 replacement period under the current regulatory compact. Therefore, the Commission should
2 review KAWC's current practices to determine if some acceleration of infrastructure
3 replacement should be required.

4 Even if an acceleration of the current 500 year replacement period is found to be
5 appropriate, I recommend that the Commission reject the request by KAWC to implement a
6 new accelerated cost recovery mechanism for infrastructure replacement projects.
7 Regulatory lag for KAWC is already minimized by the use of a fully forecast Test Period and
8 by the filing of base rate cases on a two-year filing cycle. In addition, there is no evidence
9 that KAWC, or its parent company, is having difficulty raising the capital necessary for
10 infrastructure replacement. Therefore, if the PSC requires KAWC to accelerate replacement
11 of its distribution system, the associated costs should be recovered through the traditional
12 base rate case process.

13 However, if the Commission does decide to adopt an accelerated infrastructure
14 replacement mechanism, any such mechanism should be based on actual completed plant in
15 service and should utilize a discounted return on equity. Moreover, KAWC should be
16 required to agree to a four-year rate case moratorium if it chooses to utilize an accelerated
17 recovery mechanism for infrastructure replacement.

18
19 **Q. Does this conclude your testimony?**

20 **A.** Yes, it does.