COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS)
RATES OF THE UNION LIGHT,) CASE NO. 2005-00042
HEAT AND POWER COMPANY)

NOTICE OF FILING AND CERTIFICATION OF SERVICE

I hereby give notice that in accord with the Order of April 28, 2005, I have filed the seven true copies of these Responses to the Requests for Information to the Attorney General from the Union Light, Heat and Power Company with the Executive Director of the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601 this the 6th day of July, 2005, and certify that this same day I have served the parties by overnight mailing a true copy, postage prepaid, to the following:

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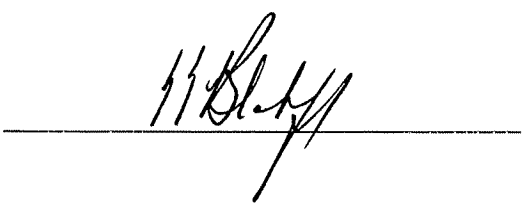

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
Union Light Heat & Power Company
Case No. 2005-00042

Witness Responsible:
ROBERT J. HENKES

Question 1: Do you agree that the purpose of the slippage factor adjustment is to adjust the Company's forecasted capital construction budget to reflect the amount of capital construction expense the Company is expected to incur during the forecasted period?

Response: Agree.

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ROBERT J. HENKES

Question 2: Do you agree that in prior cases where the Commission has performed a slippage factor adjustment, the Commission has calculated the adjustment by comparing the Company's actual capital construction expense versus budgeted capital construction expense for the prior ten years?

Response: Mr. Henkes has been involved as a witness in two prior Kentucky utility rate cases which used fully forecasted test periods as the basis for setting rates in these cases. Those two prior rate cases involved Kentucky American Water Company's 1997 and 2000 rate cases, Case No. 97-034 and Case No. 2000-120. In both these cases, the Commission applied a slippage factor adjustment and determined these slippage factors by comparing actual capital construction expenditures versus the corresponding budgeted capital construction expenditures for the prior ten years.

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Witness Responsible:
ROBERT J. HENKES

Question 3: Isn't it true that, in the present case, you recommend a slippage factor adjustment which excludes a comparison of the Company's actual capital construction expense versus budgeted capital construction expense for AMRP construction?

Response: Mr. Henkes, would like to answer this question as follows.

The 6.048% slippage factor recommended by Mr. Henkes represents the 10-year average actual vs. budgeted slippage factor experienced for the Company's non-AMRP construction. In other words, it represents the actual vs. budgeted slippage factor experienced during the last 10 years for all of the Company's construction *that is not subject to a rate adjustment Rider*, such as Rider AMRP, that would allow the Company dollar-for-dollar rate recovery with significantly reduced regulatory lag.

This 6.048% slippage factor was then applied by Mr. Henkes to all construction expenditure growth projections from the end of the base period to the average of the forecasted period, *which also consists of construction that is not subject to an automatic adjustment Rider*. Thus, even though this construction expenditure growth includes construction projects that would otherwise be AMRP-eligible investment under Rider AMRP, and would otherwise be recoverable in this Rider on a dollar-for-dollar basis with significantly reduced regulatory lag, in this particular case, this construction growth no longer represents AMRP-eligible investment since the recovery of this construction growth will now no longer be on a dollar-for-dollar basis with significantly reduced regulatory lag. Rather, the construction growth from the end of the base period to the average of the forecasted period will now be recoverable in the Company's base rates that provides no dollar-for-dollar recovery guarantee and would potentially have a significantly longer regulatory lag.

Thus, Mr. Henkes' recommended slippage factor approach is internally consistent in that it applies a slippage factor for base rate-recoverable construction to base rate-recoverable construction projections for the forecasted period.

In Mr. Henkes' opinion, the 4-year average slippage factor for AMRP-eligible construction that is recoverable under Rider AMRP on a dollar-for-dollar basis with significantly reduced regulatory lag does not represent an appropriate slippage factor to be applied to projected construction expenditures that are to be recovered in base rates with no guarantee of dollar-for-dollar recovery and with potentially a significantly longer regulatory lag. As explained on page 17 of

Response to Question 3, page 2 of 2:

Mr. Henkes' testimony, Mr. Henkes believes that construction expenditure decisions made under a Rider mechanism are potentially much different than construction decisions made for the Company's non-AMRP projects, the costs of which are recovered in base rates. Mr. Henkes submits that it shouldn't be surprising that the average slippage factor for AMRP construction from 2001-2004 is positive[1] given that ULH&P management is assured that its actual expenditures will be recovered on a dollar for dollar basis with significantly less regulatory lag than if these expenditures had to be recovered under traditional base rate recovery. Given the fact that all construction expenditures subject to the slippage adjustment in this case are to be recovered under traditional base rate recovery, with no opportunity to recover on a dollar for dollar basis with significantly less regulatory lag, Mr. Henkes submits that, therefore, it would be wrong to apply these same historic AMRP construction slippage factors to the portion of the forecasted period plant growth that, under the Rider AMRP mechanism, would be considered AMRP-eligible projects.

[1] Actual expenditures are in excess of budgeted expenditures.

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
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Witness Responsible:
ROBERT J. HENKES

Question 4: Do you agree that, during the four-year life of the AMRP, most of ULH&P's capital construction expense has been for AMRP construction?

Response: Based on a comparison of the non-AMRP and AMRP construction on pages 1 and 2 of the response to PSC-2-105, Mr. Henkes agrees that the AMRP construction during the 4-year period 2001-2004 was larger than the non-AMRP construction.

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
Union Light Heat & Power Company
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Witness Responsible:
ROBERT J. HENKES

Question 5: What proportion of ULH&P's capital construction expense has been related to the AMRP during the four-year life of the AMRP?

Response: Based on the information contained on pages 2 and 5 of the response to PSC-2-105, it appears that the total AMRP construction during the 4-year period 2001-2004 was 59.72% of the overall total construction.

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
Union Light Heat & Power Company
Case No. 2005-00042

Witness Responsible:
ROBERT J. HENKES

Question 6: List any prior Kentucky forecasted test period rate cases you have reviewed where the Commission has performed a slippage factor adjustment. Provide the case numbers and copies of the orders.

Response: See the response to Question 2.

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
Union Light Heat & Power Company
Case No. 2005-00042

Witness Responsible:
ROBERT J. HENKES

Question 7: In any of the prior Kentucky forecasted test period rate cases you have reviewed, did the Commission's slippage factor adjustment exclude any part of a company's actual versus budgeted capital construction expense during the prior ten years?

Response: It is Mr. Henkes' understanding that the Commission's slippage factor adjustment in KAWC Case No. 97-034, in which he was involved as a witness for the AG, was adjusted to exclude part of KAWC's actual versus budgeted capital construction expenditures during the prior ten years. Specifically, in calculating the actual versus budgeted construction expenditure slippage factor for the 10-year period preceding KAWC's test period in Case No. 97-034, the Commission removed the actual vs. budgeted construction expenditures associated with the Louisville Pipeline project, based on the fact that the slippage factor for this project was not representative of the slippage factor to be applied to the projected construction expenditures included in the test period in that case.

Mr. Henkes also notes that all of KAWC's construction expenditures in the two referenced cases were recovered in base rates and none of KAWC's construction expenditures were recovered through a Rider similar to Rider AMRP in ULH&P's case.

Response of the Attorney General to
Initial Data Request of Union Light Heat & Power Company to the Attorney General
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Case No. 2005-00042

Witness Responsible:
ROBERT J. HENKES

Question 8: List any prior Kentucky forecasted test period rate cases where you have calculated a proposed slippage factor adjustment. Provide the case numbers and a copy of your testimony.

Response: See response to Question 2. Copies of Mr. Henkes' testimony are attached.

ATTACHMENT TO
ULHP QUESTION 8

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)	
	)	
NOTICE OF ADJUSTMENT OF THE RATES	)	Case No. 97-034
OF KENTUCKY-AMERICAN WATER COMPANY	)	
EFFECTIVE ON AND AFTER MARCH 30, 1997	)	

DIRECT TESTIMONY OF ROBERT J. HENKES ON BEHALF OF THE OFFICE OF RATE INTERVENTION OF THE ATTORNEY GENERAL FOR THE COMMONWEALTH OF KENTUCKY

Corrections: - page 70, line 1
- Sch RJH-8, line 2

JUNE 2, 1997

GEORGETOWN CONSULTING GROUP
456 MAIN STREET
RIDGEFIELD, CONNECTICUT

Kentucky-American Water Company
Case No. 97-034
Direct Testimony of Robert J. Henkes

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B. OPERATING INCOME (Continued) Page

I. STATEMENT OF QUALIFICATIONS

Q. WOULD YOU STATE YOUR NAME AND ADDRESS?

A. My name is Robert J. Henkes and my business address is 456 Main Street, Ridgefield, Connecticut.

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. I am a principal in the firm of Georgetown Consulting Group, Inc., which is a financial management consulting firm specializing in utility regulation.

Q. WHAT IS YOUR REGULATORY EXPERIENCE?

A. I have prepared and/or presented numerous testimonies in rate proceedings involving electric, gas, telephone and water companies in a number of jurisdictions including Arkansas, Delaware, District of Columbia, Georgia, Kentucky, Maryland, New Jersey, New Mexico, Ohio, Pennsylvania, Vermont, the U.S. Virgin Islands and before the Federal Energy Regulatory Commission ("FERC"). A complete listing of jurisdictions and rate proceedings in which I have been involved is provided in Appendix I supplementing this direct testimony. All of my regulatory work has been on behalf of the ratepayers.

Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?

A. Prior to joining Georgetown Consulting Group, Inc., I was employed by the American Can Company as Manager of Financial Controls. Before joining the American Can Company, I was

employed by the Management Consulting Division of Touche Ross & Co. for six years. At Touche Ross, my experience, in addition to regulatory work, included numerous projects in a wide variety of financial areas including cash flow projections, bonding feasibility, capital and profit forecasting, and the design and implementation of accounting and budgetary reporting and control systems.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I hold a Bachelor degree in Management Science, received from the University of Utrecht, The Netherlands in 1966; a Bachelor degree in Marketing, received from the University of Puget Sound in 1971; and an MBA degree in Finance, received from Michigan State University in 1973. I have also completed the CPA program of the New York University Graduate School of Business.

II. SCOPE AND PURPOSE OF TESTIMONY

Q. WHAT IS THE SCOPE AND PURPOSE OF THIS TESTIMONY?

A. I was engaged by the Office of Rate Intervention of the Attorney General of Kentucky ("AG") to conduct a review and analysis and present testimony regarding the petition of Kentucky-American Water Company ("KAWC" or "the Company") for an increase in its rates for water service.

The purpose of this testimony is to present to the Kentucky Public Service Commission ("PSC" or "the Commission") the appropriate rate base and pro forma operating income, as well as the appropriate revenue requirement for the Company in this proceeding.

In the determination of my recommended rate base, pro forma operating income and revenue requirement, I have relied on and incorporated the recommendations of AG witness James Rothschild concerning the appropriate capital structure, capital cost rates and overall rate of return for the Company in this proceeding.

In developing this testimony, I have reviewed and analyzed the Company's petition, testimonies, exhibits, workpapers and filing requirements; responses to interrogatories and other relevant financial documents and data. In addition, I reviewed the Commission Orders in KAWC's most recent five base rate proceedings, involving Case Nos. 95-554, 94-197, 92-452, 91-361 and 90-321.

III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. MR. HENKES, PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS IN THIS CASE.

A. The findings and conclusions reached by me in this case are as follows:

1. The appropriate pro forma forecasted period rate base amounts to $125,721,549, which is $4,849,251 lower than KAWC's proposed pro forma rate base of $130,570,800 (see Schedule RJH-3).

2. The appropriate pro forma forecasted period operating income amounts to $11,337,493, which is $437,851 higher than KAWC's proposed pro forma operating income of $10,899,642 (see Schedule RJH-4).

3. The appropriate overall rate of return, as recommended by the AG's rate of return witness James Rothschild, is 8.77%, incorporating a recommended return on equity rate of 10.00%. This compares to KAWC's proposed overall rate of return of 9.56%, incorporating a proposed return on equity rate of 12.00% (see Schedule RJH-2).

4. The appropriate revenue conversion factor to be used for rate making purposes in this case is 1.6837199 (see Schedule RJH-1).

5. The combination of the aforementioned four rate making components indicate that KAWC's appropriate annual revenue requirement is a negative amount of $524,838, which is $3,212,028 lower than KAWC's proposed revenue requirement of $2,687,190 (see Schedule RJH-1). In summary, I recommend that the Company's current rates be reduced so as to generate an annual rate reduction of $524,838.

IV. ACCOUNTING ISSUES

A. RATE BASE

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED AND YOUR RECOMMENDED PRO FORMA NET RATE BASE LEVELS FOR THE FORECASTED PERIOD IN THIS CASE.

A. The Company's proposed pro forma rate base of $130,570,800 is summarized by specific rate base component on Schedule RJH-3. With the exception of cash working capital, other working capital and contract retentions, all of the Company's proposed rate base components are based on projected 13-month average balances for the forecasted period October 1, 1997 through September 30, 1998. The Company's proposed cash working capital requirement is based on a detailed lead/lag study and the proposed other working capital balance represents the actual 13-month average balance for the twelve-month period ended November 30, 1996. The proposed contract retention rate base component was determined by the Company based on the 24-month average balance during the 24-month period November 1994 to November 1996.

As shown on Schedule RJH-3, I have recommended a large number of rate base adjustments with the effect of reducing the Company's proposed rate base by a total amount of $4,849,251 to a recommended rate base level of $125,721,549. Each of the recommended rate base adjustments are explained and quantified in more detail in the supporting rate base schedules referenced on Schedule RJH-3 and will be discussed in detail in the subsequent

sections of this testimony.

- Utility Plant in Service

Q. HOW DID THE COMPANY DERIVE ITS PROPOSED AVERAGE FORECASTED PERIOD UTILITY PLANT IN SERVICE RATE BASE COMPONENT?

A. The Company derived its proposed average forecasted period utility plant in service investment level by taking the actual plant balance as of November 30, 1996 as the starting point and then adding to this balance the projected plant additions from its construction budget for the months of December 1996 through September 1998 and subtracting from this balance the projected plant retirements for this same time period. The Company then calculated the 13-month average of the projected plant balances from September 1997 through September 1998.

Q IS IT IMPORTANT THAT THE PROPOSED PLANT IN SERVICE PROJECTIONS BE REVIEWED FOR ACCURACY IN SETTING THE RATES FOR THIS COMPANY?

A. Yes. Since the Company has chosen to base this rate filing on a fully-forecasted test period, it is particularly important to conduct analyses to verify whether the Company's projections are reasonably on target. Since the non-Company parties in this proceeding do not have access to all of the details and assumptions underlying the Company's construction budget and the projected closings to plant of the numerous construction projects, the only way for these parties to verify the accuracy of the Company's projections is to perform an historic analysis to determine how the Company's past projections have compared to actual results.

Q. HAS INFORMATION REGARDING SUCH A COMPARATIVE ANALYSIS BEEN PROVIDED TO THE PARTIES IN THIS CASE?

A. Yes. In response to data request PSC 2-7, the Company provided information showing, in total and separately for the "routine"and "special budget" construction projects, a comparison of actual versus originally budgeted results for each of the 10 years from 1987 through 1996. The Company presented three different scenarios in this analysis.

Scenario A represents an unadjusted analysis. This analysis indicates that, on average for each of the 10 years in the analysis period, the Company's actual routine construction has been at 96.993% of the budgeted routine construction and the Company's actual special budget construction has been at 82.812% of the budgeted special budget construction. These actual-to-budget ratios are referred to as the "slippage factors".

Scenario B represents an adjusted slippage factor analysis in which the Company removed the actual and budgeted results associated with the Louisville Pipeline project (BP 92-12) from the 10-year actual-to-budget analysis. This scenario indicates slippage factors of 96.993% and 84.726%, respectively, for the routine and special budget construction.

Scenario C is the same as Scenario B, except that the Company limited the analysis to the 4-year period 1993-1996 rather than the 10-year period 1987-1996. Under this scenario, the respective slippage factors are 96.873% and 87.315% for the routine and special budget construction.

Q. HAVE YOU ALSO REVIEWED HOW THE COMPANY'S PROJECTED PLANT BALANCES IN CASE NO. 95-554 HAVE COMPARED TO ACTUAL PLANT

BALANCES?

A. Yes. This analysis is shown in the response to data request AG 1-14, page 1 of 6 (updated 5/21/97). In this data response, the Company presents the actual monthly plant in service balances for the months of April 1996 through March 1997 as compared to the corresponding monthly plant in service balances it had projected in Case No. 95-554. As can be seen, in each month the actual plant in service balance is substantially lower than the budgeted balance. In fact, for this 12-month period the average variance between the actual and budgeted plant balances is approximately $3.2 million.

Q. WHAT IS YOUR RECOMMENDATION BASED ON YOUR REVIEW OF THE SLIPPAGE FACTOR ANALYSES AND THE CASE NO. 95-554 ACTUAL-TO-BUDGET PLANT VARIANCES?

A. Each of the slippage factor analyses, as well as the Case No. 95-554 actual-to-budget plant variances clearly indicate that the Company has generally overprojected its construction expenditures during the most recent 10 years and has continued to do so as recent as in Case No. 95-554. Based on this information, I recommend that the Company's proposed average forecasted period plant in service balance be reduced to reflect the appropriate slippage factors experienced by the Company for routine and special budget construction during the 10-year period 1987-1996. As will be discussed in a subsequent section of this testimony, I am also recommending that all investment related to the Louisville Pipeline project (BP 92-12) be removed from this case. Because of this recommendation, I would agree with the Company's suggested use of the Scenario B slippage factors, i.e., 96.993% for routine construction and

84.726% for special budget construction. As shown on Schedule RJH-5, my recommended slippage factor adjustment reduces the Company's proposed average forecasted period plant in service balance by $1,091,065.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE AREA?

A. Yes. First, should the PSC decide to include the Louisville Pipeline construction investment in rate base in this case, then I would recommend that the plant in service adjustment be based on the slippage factors of 96.993% and 82.812% from the unadjusted Scenario A slippage factor analysis. Second, the Company has suggested that if the PSC were to use a plant slippage factor adjustment in this case, then the routine and special budget slippage factors should be based on Scenario C, i.e., the average slippage factors based on the limited 4-year period 1993-1996. The Company has obviously made this suggestion because this scenario generates slippage factors of 96.873% and 87.315% which are more favorable to KAWC. I would recommend that this suggested approach be rejected by the PSC because it is arbitrary and inconsistent with the 10-year slippage factor analysis approach used by the PSC in the Company's prior rate cases. It would not be appropriate to now start "picking and choosing" among the slippage factor analysis periods in order to advance its own interests. For example, the routine, special budget and overall total construction slippage factors based on the Company's suggested limited slippage factor analysis for the most recent 4-year period 1993-1996 are 96.873%, 87.315% and 91.525%, respectively. However, had the Company chosen to limit the slippage factor analysis period to the most recent 5-year period 1992-1996, the slippage factors for routine, special budget and overall total construction would have been

97.164%, 78.844% and 85.510%[1], respectively.

- Accumulated Depreciation

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD ACCUMULATED DEPRECIATION RESERVE BALANCE.

A. As shown on Schedule RJH-6, my recommended accumulated depreciation reserve adjustment is a direct result of my recommendations to adjust the Company's proposed forecasted plant in service balance and associated forecasted period depreciation expenses for the slippage factors of 96.993% for routine construction and 84.726% for special budget construction.

- Construction Work In Progress

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD CONSTRUCTION WORK IN PROGRESS ("CWIP") BALANCE.

A. As shown in more detail on Schedule RJH-7, my recommended CWIP balance adjustment is a direct result of: (1) my recommendation to adjust the Company's proposed construction for the slippage factors of 96.993% for routine construction and 84.726% for special budget construction; and (2) my recommendation to remove from the Company's proposed average

[1] See response to data request AG 2-3.

forecasted period CWIP balance all investments associated with special budget projects BP 90-13, BP 90-14 and BP 92-12.

Q. WHY ARE YOU MAKING THIS LATTER RECOMMENDATION?

A. Special budget projects BP 90-13, BP 90-14 and BP 92-12 are all related to the Louisville Pipeline project which is currently the subject of a separate proceeding in Case No. 93-434. While I am not involved in Case No. 93-434, the AG has informed me that it is its position that until Case No. 93-434 is concluded and an order is issued granting KAWC a Certificate of Public Convenience and Necessity, the construction of the Louisville Pipeline project is speculative and, for that reason, no investments, expenses or taxes directly or indirectly related to this project should be included for rate making purposes in this case. I have incorporated this AG position in this testimony.

- Cash Working Capital

Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE COMPANY'S PROPOSED CASH WORKING CAPITAL CLAIM IN THIS CASE.

A. The Company has proposed a total cash working capital ("CWC") requirement of $986,000 in this case based on the results of a detailed lead/lag study. Virtually the entire CWC requirement amount[2] is caused by the inclusion (with a 0 payment lag) in the Company's lead/lag study of

[2] [Net Income of $4,684,472 + depreciation of $4,405,413 + deferred taxes of $815,052] divided by 365 days, times revenue lag of 35.88 days = CWC requirement of $974,000.

(1) non-cash expense items such as depreciation expenses and deferred taxes; and (2) the return on equity component (Net Income). I do not agree that depreciation expenses and deferred taxes should be included in a lead/lag study with a 0 payment lag because such expenses do not require a cash outlay in the lead/lag study period. Neither do I agree with the proposition that the entire return on equity be included in the lead/lag study with a 0 payment lag based on the assumption that the stockholder is entitled to his return at the exact time that service is rendered. The simple fact is that the stockholder receives his return through common dividend payments[3] and any gain in the Company's stock. This is the mechanism by which the common shareholder is compensated in the real world, and this mechanism would suggest a payment lag significantly higher than 0 days.

However, based on my review of prior PSC Orders involving KAWC, I understand that the PSC has consistently allowed depreciation expenses, deferred taxes and the return on equity in the lead/lag study with a 0 payment lag for purposes of determining the Company's CWC requirement. In recognition of this and in an attempt to limit the issues in this case, I have chosen (1) not to re-litigate the return on equity lead/lag study issue; and (2) only re-litigate a certain limited portion of the Company's proposed depreciation expense inclusion in the lead/lag study based on the introduction of new evidence which the PSC may not previously have considered. I am, however, challenging the Company's proposal to include deferred taxes in its lead/lag study, also based on information which the PSC may not previously have been aware of.

[3] With a payment lag of 134.7 days, as confirmed by KAWC in its response to AG 1-31.

Q. PLEASE EXPLAIN WHY YOU RECOMMEND THAT A PORTION THE COMPANY'S PROPOSED DEPRECIATION EXPENSES SHOULD BE EXCLUDED FROM THE LEAD/LAG STUDY.

A. As described on page 12 of Mr. Grubb's direct testimony, it is the Company's position that depreciation expenses should be included in the lead/lag study because ..."The investors supplied the cash to fund the investment in the new plant". Thus, the Company's rationale is that since the investors funded the investment in plant, the investors should also be assigned the cash working capital requirement associated with the depreciation expenses on such investor-funded plant. However, what is not recognized here is that a portion of the Company's investment in plant is funded by customer advances as opposed to the Company's investors, and the plant funded by customer advances is being depreciated by the Company. Specifically, as confirmed by the Company in its response to AG 1-28, of the Company's proposed average forecasted period plant in service investment, an amount of $5,321,568 has been funded by customer advances and the Company's proposed forecasted period depreciation expenses -- that are also incorporated in the lead/lag study -- include $75,869 of depreciation expenses directly associated with such customer advances-funded average forecasted period plant in service. Thus, the Company's claim that there is a CWC requirement associated with the depreciation expenses on its investor-funded plant investment does not apply to this $75,869 of depreciation expense. It is therefore my recommendation that an amount of $75,869 be removed from the depreciation expenses included in the Company's lead/lag study. Failing to do so would inappropriately allow the stockholder to earn a return on a CWC requirement that is properly assignable to the Company's customers.

Q. PLEASE EXPLAIN WHY YOU RECOMMEND THAT DEFERRED TAXES SHOULD BE REMOVED FROM THE LEAD/LAG STUDY.

A. As previously referenced, Mr. Grubb, on page 12 of his testimony states that depreciation should be included in the lead/lag study with a 0 payment lag because the investors supplied the cash to fund the investment in plant. Mr. Grubb then provides an elaborate illustration on pages 13 and 14 of his testimony showing why this is his position. He explains that depreciation expenses are booked to the depreciation reserve which is used as an immediate rate base deduction but, in the meantime, the Company has to wait 36 days to receive the revenues for the depreciation expenses. Since the Company claims that all of its depreciation expenses represent funds supplied by its investors, it concludes that the CWC requirement associated with the 36-day revenue lag to collect the investor-supplied depreciation expenses should be assigned to the investors. Mr. Grubb then spends 3 lines of his testimony stating that the same principle applies to deferred taxes. Specifically, Mr. Grubb states on page 14, lines 11-13 of his testimony that:

> "The Company makes a cash expenditure for an asset, begins recording deferred taxes, but must wait 36 days before the deferred taxes are collected from the customers".

While Mr. Grubb, advertently or inadvertently, does not make it immediately apparent in the above-referenced statement, *it is the Company's position that deferred taxes should be included in the lead/lag study because, similar to depreciation, the investors supplied the cash to fund the plant investment*[4]. This is obviously entirely incorrect and maybe this is the reason why the language used by Mr. Grubb regarding deferred taxes on page 14, lines 11-13 of his

[4] Mr. Grubb, in this instance, refers to the investment in plant in service as the investment in "an asset".

testimony is more ambiguous than the clear statement made by him regarding depreciation on page 12, lines 24-26 of his testimony.

Deferred taxes, used by the Company to fund investment in plant (or, as Mr. Grubb describes it, to fund investment in an asset), do not represent investor-supplied funds. Rather, deferred taxes represent cost-free funds provided to the Company through rates collected from the ratepayers.

Q. WHY IS THIS SO?

A. The IRS allows the Company to use accelerated depreciation for tax purposes. Since this tax depreciation is higher than book depreciation, the Company receives a tax benefit. However, for rate making purposes, the Company removes ("normalizes") this actual tax benefit by assuming that it pays income taxes based on the use of book depreciation. Therefore, the rates paid by the ratepayers incorporate the assumption that the Company did not receive the accelerated depreciation related tax benefits, even though the Company actually did receive such tax benefits. The difference between the income taxes included in the rates paid by the ratepayers and the income taxes actually paid by the Company (which incorporate the previously discussed tax benefits) is deferred and booked in the Company's accumulated deferred income tax account. In summary, the Company's deferred taxes are made possible as a result of certain IRS rules advantageous to the Company and represent ratepayer supplied funds which are available to the Company on a cost-free basis.

Q. ARE ACCUMULATED DEFERRED INCOME TAXES USED AS A RATE BASE

DEDUCTION FOR RATE MAKING PURPOSES?

A. Yes. Similar to the depreciation reserve, accumulated deferred taxes are used as a rate base deduction for rate making purposes. This is because both the depreciation reserve and the accumulated deferred taxes have been funded by ratepayer supplied funds.

Q. IS THERE A CWC REQUIREMENT ASSOCIATED WITH DEFERRED TAXES THAT SHOULD BE ASSIGNED TO THE COMPANY'S INVESTORS, SIMILAR TO THE CWC REQUIREMENT ASSOCIATED WITH DEPRECIATION EXPENSES?

A. Absolutely not. It may be true that the Company has to wait 36 days for the receipt of revenues that cover the Company's deferred taxes, however, contrary to depreciation expenses, deferred taxes do not represent funds advanced to the Company by the investors. Therefore, any alleged CWC requirement associated with deferred taxes cannot and should not be assigned to the Company's investors. In summary, while I am aware that the PSC has previously allowed deferred taxes to be included in the lead/lag study for CWC requirement purposes, I am respectfully recommending that the PSC reconsider its position on this matter based on the additional evidence presented here, and remove all deferred taxes from the Company's lead/lag study.

Q. ARE YOU AWARE OF COMMISSIONS IN OTHER JURISDICTIONS WHO HAVE REMOVED DEFERRED TAXES FROM LEAD/LAG STUDIES FOR THE SAME REASONS AS THOSE PRESENTED BY YOU IN THIS TESTIMONY?

A. Yes. The New Jersey Board of Public Utilities has a long-standing and well-established policy

of excluding deferred taxes from lead/lag studies for CWC purposes because of its conclusion that deferred taxes do not represent investor-supplied funds.

Q. HAVE YOU CALCULATED THE IMPACT ON THE COMPANY'S PROPOSED CWC REQUIREMENT OF YOUR RECOMMENDATIONS THAT DEFERRED TAXES AND DEPRECIATION RELATED TO PLANT FUNDED BY CUSTOMER ADVANCES BE REMOVED FROM THE COMPANY'S PROPOSED LEAD/LAG STUDY?

A. Yes. On Schedule RJH-8, I have presented all of my recommended adjustments to the Company's proposed CWC requirement of $986,000. On line 3 of Schedule RJH-8, I have calculated that my recommendation to remove the deferred income taxes from the lead/lag study decreases the Company's proposed CWC requirement by $80,031. On line 4 of Schedule RJH-8, I have calculated that my recommendation to remove the customer advances related depreciation expenses from the lead/lag study decreases the Company's proposed CWC requirement by $7,450.

Q. COULD YOU NOW EXPLAIN THE OTHER RECOMMENDED CASH WORKING CAPITAL ADJUSTMENTS SHOWN ON SCHEDULE RJH-8?

A. Yes. As confirmed in response to data request AG 2-5, the correct composite revenue lag, incorporating the lags associated with the Company's "other operating revenues", is 35.84 days rather than the revenue lag of 35.88 days proposed by KAWC. The correction for this reduces the Company's proposed CWC requirement by $3,825, as shown on line 2 of Schedule RJH-8.

Line 5 of Schedule RJH-8 shows that I have reduced the Company's proposed CWC

requirement by $3,682 to reflect a correction for the amount of amortization expenses that should have been included in the Company's lead/lag study[5].

Finally, on line 6 of Schedule RJH-8 I have reduced the Company's proposed CWC requirement by $21,200[6] to reflect the Company's updated revised position that all pension expenses should be removed from the lead/lag study analysis.

Q. PLEASE EXPLAIN WHY THE COMPANY HAS REMOVED PENSION EXPENSES FROM THE LEAD/LAG STUDY ANALYSIS AS PART OF ITS FILING REVISIONS.

A. The Company's annual pension expenses that are included in rates are determined based on the actuary-calculated FASB87 accrual method. On the other hand, the Company's actual contributions (cash payments) to its pension plan are independently calculated under the so-called ERISA rules, as required by the IRS. As confirmed in the Company's response to data request AG 1-33, the Company's current pension plan funding status under ERISA rules is such that no pension contributions will be necessary at least through the end of the forecasted period. Therefore, while the Company is still claiming pension expenses (as determined through the FASB87 accrual method) for rate inclusion during the forecasted period, and has included these FASB87-based pension expenses in the lead/lag study with a 0 payment lag, no actual contribution payments will be made to the Company's pension plan at least through the end of the forecasted period. For that reason, the Company has now revised its original position by proposing that all of its claimed forecasted period FASB87 pension expenses be removed from

[5] See response to data request AG 2-7.

[6] See response to data request AG 1-33.

the lead/lag study.

Q. DOES THE REMOVAL OF THE PENSION EXPENSES FROM THE LEAD/LAG STUDY RESOLVE ALL CASH WORKING CAPITAL ISSUES RELATED TO PENSION EXPENSES?

A. No, it does not. As previously discussed, the Company's forecasted period operating expenses include pension expenses as determined under the FASB87 accrual method and these pension expenses will be included in the Company's rates. While the Company will receive cash for these pension expenses through the collection of rates from the ratepayers, it does not have to make actual cash contribution payments to its pension plan. This means that there is a substantial payment lag associated with the Company's pension expenses claimed in this case; a payment lag of such an extent that it will provide a significant *source* of cash working capital to the Company. This cash working capital source has been eliminated by the Company by virtue of its revised proposal to remove all pension expenses from the lead/lag study rather than leaving the pension expenses in the lead/lag study with a substantial payment lag.

Q. ARE YOU THEREFORE RECOMMENDING THAT THE PSC GIVE PROPER RECOGNITION TO THE CASH WORKING CAPITAL REDUCTION IMPACT RESULTING FROM THE DIFFERENCE BETWEEN THE COMPANY'S FASB87 PENSION EXPENSES AND THE ACTUAL ERISA-DETERMINED PENSION PLAN CASH CONTRIBUTION PAYMENTS?

A. Yes. One way of recognizing this cash working capital reduction impact is to leave the

Company's proposed FASB87 pension expenses in the lead/lag study and assign an appropriate payment lag to this pension expense. The problem with this approach is that, while we know that no pension plan contribution payments need to be made throughout the forecasted period, it is not known for how long this will continue after the end of the forecasted period and the length of the payment lag will determine the amount of the CWC requirement reduction to be recognized in this case. For example, assuming a 365 day payment lag associated with the pension expenses included in the Company's lead/lag study would indicate a CWC requirement reduction of approximately $158,000[7].

Q. IS THERE ANOTHER WAY OF DETERMINING THE PROPER CWC REQUIREMENT REDUCTION IMPACT RESULTING FROM THIS PENSION EXPENSE ISSUE?

A. Yes. The difference between the Company's annual FASB87 pension expenses and the Company's annual ERISA pension plan contribution cash payments are being recorded in a liability reserve account entitled "Accrued Pensions". As confirmed in the response to data request AG 2-2, the current balance in this Accrued Pensions account represents the accumulated excess of the Company's FASB87 pension expenses included in rates over the actual pension plan payments made by the Company. In other words, this Accrued Pension balance represents funds provided through rates collected from the ratepayers, which funds will be available to the Company for general working capital purposes until such time that this balance will be reduced if and when the Company's actual pension plan contribution payments

[7] [Company's revised pension expenses of $175,814 (see Schedule RJH-25, line 1) divided by 365 days] times 329 days (difference between revenue lag of approximately 36 days and pension payment lag of 365 days) equals CWC requirement reduction of $158,473.

start exceeding the FASB87 pension expense accruals. Schedule RJH-9 shows the average accrued pension balances for the the years 1994, 1995 and 1996, as well as the actual balances for the first 3 months of 1997. In its response to data request AG 2-2 the Company has also confirmed that the current accrued pension balance will continue to increase, *at least* through the end of the forecasted period, because the Company will not make any pension plan contibutions during this time period, while it will collect rates for the FASB87 pension expense accruals proposed to be included in the forecasted period expenses. Specifically, as shown on Schedule RJH-9, the Company has projected that the average accrued pension balance for the forecasted period will be $242,540.

Based on this information, I recommend that this average forecasted period accrued pension balance of $242,540 be used as a rate base deduction, thereby serving as the proper substitute for the offsetting CWC source caused by the large pension expense payment lag that should be recognized in this case.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ACCRUED PENSION ISSUE?

A. Yes. In response to AG 2-2e., the Company states that if the PSC were to treat this balance as a rate base deduction in this case, then it should include language in its Order setting forth that if the accrued balance reverses itself in the future and creates an asset, then this asset should be included as a rate base addition. The AG has no problem with this suggested approach. If and when the Company's ERISA pension plan contribution payments in the future will start exceeding its FASB87 pension expense accruals to the extent that this will eliminate

this accrued pension balance and, instead, will create an asset, then the Commission may consider to treat such an asset as a rate base prepayment component after a review of all interested parties has indicated that this would be an appropriate action. This could be accomplished either by adding this asset to rate base or by reflecting the pension expenses in the Company's future lead/lag study with an appropriate negative payment lag[8].

Q. DO YOU HAVE ANY FINAL COMMENTS REGARDING THE CASH WORKING CAPITAL ISSUE AREA?

A. Yes. It has come to my attention that when the Company makes a revision to remove certain expenses from its lead/lag study, its computer model does so incorrectly, thereby understating the CWC reduction impact of such lead/lag study expense removals. For example, in response to data request AG 2-6, the Company shows the calculations underlying its claim that the removal of pension expenses of $215,902 from the lead/lag study would decrease its CWC requirement by $13,000. The AG maintains that the correct CWC reduction associated with the removal of these pension expenses from the lead/lag study is approximately $21,000, as shown on Schedule RJH-8, line 6. Page 2 of the response to AG 2-6 shows why the Company's calculations are incorrect. On this page it is apparent that the Company indeed removed the $215,902 pension expenses, but then added the same amount of $215,902 to the "Other Operating Expense" line item below the pension line item. Because of this modeling "glitch", the Company's calculated CWC reduction impact is only $13,000 rather than the correct reduction amount of $21,000. Therefore, if the PSC were to adopt the recommended

[8] A negative expense payment lag indicates that the expense is prepaid.

expense and deferred tax removals from the lead/lag study that are listed on Schedule RJH-8, lines 3-6, it should use the calculation method detailed in lines 3-6 rather than relying on KAWC's lead/lag computer model.

- Other Working Capital

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD OTHER WORKING CAPITAL BALANCE.

A. The Company has proposed to add to its forecasted period rate base an average projected balance for other working capital which it has assumed to be equivalent to the actual average plant materials and chemical stock balance for the 24-month period November 1994 through November 1996. Consistent with my recommendation regarding contract retentions --which will be discussed in a subsequent section of this testimony -- , I recommend that the forecasted period other working capital balance be based on the average for the most recent 24 months for which actual other working capital balances are available at the time of this testimony preparation. Schedule RJH-10 shows that this results in a recommended forecasted period other working capital balance of $405,004. This recommended balance is $1,024 lower than the Company's proposed forecasted period other working capital balance of $406,028. While this recommended rate base reduction has a negligible revenue requirement impact, I felt it necessary to make the adjustment in order to be consistent with my recommended rate base adjustments for contract retentions, customer deposits and unclaimed extension deposit refunds.

- Contributions In Aid of Construction (CIAC)

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD CIAC BALANCE.

A. As shown on Schedule RJH-11, the recommended CIAC balance adjustment is a direct result of my recommendation to adjust the Company's proposed construction for the slippage factors of 96.993% for routine construction and 84.726% for special budget construction.

- Customer Advances

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD CUSTOMER ADVANCES BALANCE.

A. As shown on Schedule RJH-12, the recommended customer advances balance adjustment is a direct result of my recommendation to adjust the Company's proposed construction for the slippage factors of 96.993% for routine construction and 84.726% for special budget construction.

- Deferred Income Taxes

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD DEFERRED INCOME TAX BALANCE.

A. As shown on Schedule RJH-13, the recommended deferred income tax balance adjustment is

a direct result of : (1) my recommendation to adjust the Company's proposed construction for the slippage factors of 96.993% for routine construction and 84.726% for special budget construction; (2) my recommendation to increase the Company's proposed rate base for the "shared" unamortized current rate case expense balance; and (3) my recommendation to remove from the Company's proposed rate base the deferred debit balance associated with the AMR study. The recommended rate base treatments for the items listed under points (2) and (3) above will be discussed in more detail in subsequent sections of this testimony.

- Deferred Debits

Q PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD DEFERRED DEBIT BALANCE.

A. As shown on Schedule RJH-14, I recommend at this time that the Company's proposal to include in rate base the unamortized AMR study costs be rejected. Until such time as the PSC has made a decision with regard to this issue in the rehearing phase of Case No. 95-554, I am reflecting the position taken by the AG and the Commission's original ruling in Case No. 95-554 that this item should not be included in rate base.

- Source of Supply Investigation

Q. WHY HAVE YOU REMOVED THE DEFERRED SOURCE OF SUPPLY INVESTIGATION EXPENSES FROM THE COMPANY'S PROPOSED AVERAGE

FORECASTED PERIOD RATE BASE?

A. These deferred expenses represent the funds actually expended and projected to be expended by the Company on Case No. 93-434, which case addresses the Louisville Pipeline project. The total deferred expense amount proposed for rate base inclusion by KAWC in this case amounts to $969,811. While the Company has projected that this total amount of $969,811 will have been spent by May 1997[9], response to data request AG 1-19 (updated 5/21/97) indicates that the Company has actually spent a total amount of $598,974 as of March 31, 1997.

In Case No. 95-554, the PSC ruled that these deferred source of supply investigation expenses should be considered as Account 183 preliminary investigation charges and should be afforded the same rate making treatment as any other Louisville Pipeline related costs. Since it is the AG's position that any investments and expenses directly or indirectly related to this pipeline project should not be included in this case, I have also removed these deferred expenses from the Company's proposed rate base.

- Contract Retentions

Q. PLEASE EXPLAIN YOUR RECOMMENDED ADJUSTMENT TO THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD CONTRACT RETENTION BALANCE.

A. The Company has proposed to reduce its forecasted period rate base with an average projected balance for contract retentions which it has assumed to be equivalent to the actual average contract retention balance for the 24-month period November 1994 through November 1996.

[9] See Filing W/P-1-12, page 1

Since the Company's actual contract retention balances have recently experienced significant increases, I recommend that more of the higher recent contract retention balances be incorporated in the average balance calculation for the forecasted period. As shown on Schedule RJH-15, the recalculated forecasted period contract retention balance based on the average for the most recent 24 months for which actual balances are available at the time of this testimony preparation amounts to $173,792. This recommended balance is $29,506 higher than the Company's proposed forecasted period contract retention balance of $144,286.

- Customer Deposits and Unclaimed Extension Deposit Refunds

Q. PLEASE EXPLAIN WHY YOU HAVE TREATED CUSTOMER DEPOSITS AND UNCLAIMED EXTENSION DEPOSIT REFUNDS AS REDUCTIONS TO THE COMPANY'S PROPOSED FORECASTED PERIOD RATE BASE.

A. Customer deposits and unclaimed extension deposit refunds are funds that are available to the Company on a continuous basis throughout the year. Each year, and in each month within each year, the Company carries a certain level of customer deposits and unclaimed extension deposit refunds on its books. For example, during the years 1995 and 1996 the monthly customer deposit balances on the Company's books have consistently been between $50,000 and $60,000, with average monthly balances of $56,441 for 1995 and $57,148 for 1996[10]. For the first 3 months of 1997, the monthly customer deposit balances continue to average $57,625[11]

[10] See responses to PSC 1-25, page 4 in current case and PSC 1-26, page 4 in Case No. 95-554.

[11] See response to AG 2-4.

and there is no reason to expect that the average customer deposit balance for the forecasted period will be any different. Similarly, the average unclaimed extension deposit refund balances carried on the Company's books during 1994, 1995 and 1996 were $72,856, $73,861 and $75,212[12], respectively, and for the first three months of 1997 averaged $76,472. There also would be no reason to expect that the average unclaimed extension deposit refund balance for the forecasted period will be any different.

Q. ISN'T IT TRUE THAT CUSTOMER DEPOSITS ARE EVENTUALLY REFUNDABLE TO THE COMPANY'S CUSTOMERS ONCE CERTAIN CONDITIONS ARE MET AND THAT UNCLAIMED EXTENSION DEPOSIT REFUND BALANCES MAY EVENTUALLY BE CLAIMED BY THE CUSTOMERS?

A. Yes, that is true. However, the relevant point to recognize here is that at the same time that "old" customer deposits are refunded, the Company has received "new" customer deposits with the end result that the Company's net customer deposit balance will always remain at approximately the same level. The same is true for the unclaimed extension deposit refund balances. In fact, in this regard there is *no conceptual difference* whatsoever between the Company's continuous customer deposit and unclaimed extension deposit refund balances and, for example, the Company's contract retention balances. Contract retentions are eventually payable to the Company's contractors, but at the time such payments are actually made, the Company has accumulated new contract retentions with the end result that the Company's net contract retention balance will continue to be at the same or even at a higher level, as is evident

[12] See response to AG 2-1 and response to PSC 1-25.

from filing W/P-1-13 supporting the Company's rate base deduction proposal for contract retentions.

Q. PLEASE SUMMARIZE YOUR RECOMMENDED POSITION REGARDING THE RATE MAKING TREATMENT FOR CUSTOMER DEPOSITS AND UNCLAIMED EXTENSION DEPOSIT REFUNDS.

A. As previously discussed, similar to contract retentions, the Company at any point in time will have available a certain known and measurable level of customer deposit and unclaimed extension deposit refund balances. These balances represent semi-permanent customer supplied funds that are available to the Company for general working capital purposes on a continuous basis and, therefore, should be treated as rate base deductions. As shown on Schedules RJH-16 and RJH-17, I recommend that the Company's average forecasted rate base be reduced by $57,091 for customer deposits and $74,882 for unclaimed extension deposit refunds. Consistent with my recommended contract retention rate base deduction, the recommended rate base deduction amounts for customer deposits and unclaimed extension deposit refunds are based on the average balance for the most recent 24 months for which actual balances are available at the time of this testimony preparation.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE AREA?

A. Yes. Since customer deposits have an associated interest cost to the Company at a rate of 6%, I am also recommending that the Company's proposed forecasted period operating expenses be increased by $3,425, as shown on Schedule RJH-16. It should be noted that, as an

alternative to my recommended customer deposit and unclaimed extension deposit refund rate base deductions and above-the-line customer deposit interest expense recognition, the PSC could treat customer deposits and unclaimed extension deposits refunds as capital structure components with cost rates of 6% for customer deposits and 0% for unclaimed extension deposit refunds in the determination of the Company's overall rate of return in this case. This rate making approach is being proposed, for example, by Delta Natural Gas Company in its current base rate proceeding, Case No. 97-066[13].

- Unamortized KU Refund

Q. WHY DO YOU RECOMMEND THAT THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD RATE BASE BE REDUCED BY $47,562 FOR THE UNAMORTIZED KENTUCKY UTILITIES ("KU") REFUND?

A Based on the response to data request AG 1-60A., I understand that KAWC received a total refund amount of $168,871 from KU in August and September 1994 for power expense overpayments paid by KAWC to KU during the preceding 6 years. KAWC is amortizing this KU refund over a 6-year period through an annual credit of approximately $28,140 to its fuel and power expenses. However, while the PSC in its Order in Case No. 92-452 ruled that..."The customers should receive the benefit of the KU refund"..., the Company is not providing to the ratepayers the benefit of the rate base deduction for the unamortized balance of this KU refund. If my understanding is correct that KAWC received a cash refund of $168,871 from KU in

[13] See FR #6-h, Schedule 9 of Delta's filing in Case No. 97-066.

August and September 1994, then the Company, not the ratepayers, has so far received the benefit of these cost-free unamortized refunds, and it would be my recommendation that the PSC now order that this additional benefit be shifted from the Company's shareholders to the ratepayers. In response to AG 1-60C., the Company has confirmed that the average unamortized KU refund balance during the forecasted period is $47,562. I therefore recommend that this amount be treated as a rate base deduction in this case.

Q. WHAT IS THE REASON WHY THE COMPANY HAS NOT TREATED THIS UNAMORTIZED REFUND BALANCE AS A RATE BASE DEDUCTION IN THIS CASE?

A. The Company answered this question in its response to AG 1-60C. as follows:

> "No rate base reduction has been reflected because the Company believes that during the six-year period in which the Company paid the expense to Kentucky Utilities, the Company did not earn its authorized return for more than one of those years".

In this regard, it should first be noted that "during the six-year period in which the Company paid the expense to Kentucky Utilities", the Company's rates at that same time included a level of expense equivalent to the actual expense payments to KU. Thus, any overpayments made by KAWC to KU during that six-year period were funded by customer rates. With regard to the Company's argument that it "did not earn its authorized return for more than one of those years", this is not a valid or appropriate reason for ignoring the issue at hand in this case. Not only does this Company argument rely on an inappropriate retroactive rate making application, the Company also has not provided any evidence regarding the conclusion and underlying calculations that it "did not earn its authorized return for more than one of those years".

- Unamortized Rate Case Expense

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED AVERAGE FORECASTED PERIOD RATE BASE BY $148,913 FOR UNAMORTIZED RATE CASE EXPENSES?

A. The reasons for this recommended rate base addition are explained in detail in the subsequent operating income testimony section entitled "Regulatory Expenses".

- Meter Deviation Net Plant and Depreciation Expense Savings

Q. PLEASE EXPLAIN YOUR RECOMMENDED RATE BASE AND OPERATING INCOME ADJUSTMENTS RELATING TO THE COMPANY'S APPLICATION IN CASE NO. 96-569 FOR A DEVIATION FROM THE 10-YEAR METER TESTING REQUIREMENT.

A. In this case, the Company has proposed to include in rate base, as part of its proposed deferred debit balance, an amount of $22,500 for legal and consultant fees associated with its application for a deviation from the 10-year meter testing requirement, currently pending in Case No. 96-569. As stated in the response to data request AG 2-26, the Company's application in Case No. 96-569 is premised on the fact that new metering manufacturing technology has improved sufficiently to enable meters to operate accurately for longer periods of time, thereby requiring tests for accuracy less frequently. In this same response the Company also confirmed that if its request for a deviation is granted, it would realize savings by avoiding the costs of some new meter purchases. With regard to such savings, the Company stated in Case No. 96-569:

"The estimated potential capital cost savings attributable to not purchasing replacement meters over the next ten years with no offset for the costs of the meter sampling procedure is $1,720,783".

In response to PSC information request No. 8 in Case No. 96-569, the Company provided a breakdown of this estimated 10-year capital cost savings amount of $1,720,783 for each of the years 1997 through 2006. Based on this information, I have calculated that the average projected capital cost savings for the forecasted period would be $64,913. These calculations are shown on Schedule RJH-18. On this schedule it is also shown that the average net plant savings for the forecasted period would be $63,940 and that the forecasted period income would be increased by $1,161 for the associated depreciation expense decrease. I therefore recommend that if the Company's application for deviation from the 10-year meter testing requirement in Case No. 96-569 were to be granted by the PSC, then the Company's rate base should be reduced by $63,940 and the Company's income should be increased by $1,161 to reflect the estimated cost savings associated with the deviation. If such savings were not to be recognized by the PSC in this case, then I would recommend that the Company's proposed deferred debit rate base addition of $22,500 similarly be rejected.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS REGARDING THIS ISSUE?

A. Yes. If the Company is allowed to conduct its meter testings less frequently, there will be additional cost savings in the form of O&M expense savings. In addition, there will be property tax expense savings. These expense savings are not reflected on Schedule RJH-18 because they were not available to me at the time of this testimony preparation. However, these additional cost savings should be considered as an offset to any costs that may be incurred by the

Company in case the PSC were to order the suggested sampling procedure mentioned in the Company's response to AG 2-26.

B. OPERATING INCOME

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED AND YOUR RECOMMENDED PRO FORMA OPERATING INCOME FOR THE FORECASTED PERIOD IN THIS CASE.

A. The Company's proposed and my recommended pro forma operating income positions are summarized on Schedule RJH-4. The starting point on that schedule is KAWC's proposed net operating income for the forecasted period of $10,899,642. I then adjusted this Company-proposed income number with a large number of operating income adjustments in order to arrive at the recommended pro forma operating income level of $11,337,493 for the forecasted period. Each of the recommended operating income adjustments listed on Schedule RJH-4 represent revenue, expense or tax adjustments that have been stated on an after-tax net income basis, as explained and quantified in more detail in the supporting operating income schedules referenced on Schedule RJH-4. They will be discussed in detail in the subsequent sections of this testimony.

- Adjustments for Impacts of Conservation on Sales

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $35,910 AS SHOWN ON SCHEDULE RJH-4, LINE 2?

A. This operating income adjustment represents the net after-tax income impact of my recommendation to adjust the Company's projected forecasted period sales losses resulting from the Company's projected conservation program efforts in the forecasted period. The

calculations underlying my recommended operating income adjustment are presented in more detail on Schedule RJH-19. As shown on this schedule, I recommend that the Company's proposed forecasted period conservation related sales losses for residential and quarterly commercial sales be reduced by 50% and for industrial sales be reduced from 25,666 thousand gallons to 5,015 thousand gallons. After taking into account the associated impacts on expenses[14] and income taxes, my recommended conservation related sales loss adjustments increase the Company's proposed forecasted period operating income by $35,910.

Q. PLEASE EXPLAIN WHY YOU HAVE ADJUSTED THE COMPANY'S PROPOSED FORECASTED PERIOD SALES LOSSES RESULTING FROM CONSERVATION.

A. The Company has reflected projected forecasted period conservation-related sales reductions for residential, quarterly commercial and industrial sales of 22,000, 14,666 and 25,666 thousand gallons, respectively. As will be discussed in detail in a subsequent section of this testimony[15], from the start of its conservation program implementation the Company has been unsuccessful in getting any meaningful conservation response from the customers subject to its conservation program activities. As a result, the Company's actual conservation expenses have been at a level of only about 36% of its budgeted conservation expenses. In this regard, the Company states in response to data request AG 1-109: "The programs that were directed at specific customers saw very little response in the pilot phases and were delayed for further evaluation".

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[14] Fuel/power, chemical, waste disposal, uncollectible and PSC fee expenses.

[15] Testimony section entitled "Miscellaneous Other and Conservation Expenses".

In this same data request, the AG also asked KAWC to provide a comparison of the budgeted sales reductions from conservation for the years 1995 and 1996 to the actually experienced sales reductions for these same years. In response to this data request (AG 1-109A.), the Company stated:

> "At present time, Kentucky-American has been unable to come up with an accurate method for determining actual sales reduction based on the conservation programs. As the programs that have seen the greatest response targeted outdoor water usage, it would be impossible to separate conservation program results from weather influences".

Thus, the Company's specific conservation related sales reduction projections in this case are not in any way based on actual, empiric experience as the starting point of its projection analysis. This leaves one to wonder how exactly the Company derived its (very specific) conservation sales loss estimates and to what extent such projections can be considered reliable.

Q. COULD YOU POINT TO AN EXAMPLE THAT WOULD INDICATE THAT THE COMPANY'S PROJECTIONS ARE NOT RELIABLE AND REASONABLE?

A. Yes. Let's consider, for example, the Company's industrial sales. The actual total sales (in thousand gallons) for the same 14 industrial customers upon which the Company's proposed forecasted period industrial sales is based is as follows for the years 1995 and 1996, as compared to the Company's unadjusted and conservation-adjusted forecasted period total sales:

- Actual 1995 sales for 14 forecasted period industrial customers:	978,781
- Actual 1996 sales for 14 forecasted period industrial customers:	982,013
- Forecasted period sales projected for 14 industrial customers:	987,028
Less: KAWC projected conservation adjustment:	(25,666)
- Cons. adj. forecasted period sales for 14 industrial customers:	961,362

What the data in this table indicate is that, despite the Company's conservation program efforts in 1996 and despite the fact that 1996 was an extremely abnormal year in terms of rainfall[16], the actual total sales for these 14 industrial customers was higher in 1996 than in 1995. Given this information, I believe that the Company's projection that its forecasted period sales will suddenly decrease to 961,362 thousand gallons as a result of its conservation program efforts is unreasonable and unrealistic.

Q. WHAT LEVEL OF FORECASTED PERIOD SALES FOR THE COMPANY'S 14 INDUSTRIAL CUSTOMERS DO YOU RECOMMEND BASED ON THE PREVIOUSLY DISCUSSED INFORMATION?

A. I recommend that the level of conservation-adjusted forecasted period sales for the Company's 14 industrial customers be set at 982,013 thousand gallons, i.e., at a level equal to the actual sales experienced for these same 14 customers in 1996. Since the Company's forecasted period industrial sales projection without the conservation adjustment is 987,028 thousand gallons, my recommendation to reflect a conservation-adjusted forecasted period industrial sales level of 982,013 thousand gallons would incorporate an assumed conservation adjustment of 5,015 thousand gallons. Given that the Company is experiencing growth in its industrial sales, and given that the 1996 sales level of 982,013 was achieved in a year with an abnormal amount of rainfall, I believe that my recommendation to substitute the actual 1996 sales level for the conservation-adjusted forecasted period sales level is reasonable and, in fact, conservative.

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[16] The Company may argue that weather is not a sales-influencing factor for this customer class. On the other hand, in its responses to AG 1-109 and AG 1-143 the Company states that ..."With weather being a factor in water sales...it would be impossible to separate conservation program results from weather influences".

Q. IS THERE MORE RECENT INFORMATION AVAILABLE CONFIRMING THAT YOUR RECOMMENDATION WITH REGARD TO THIS ISSUE IS REASONABLE AND CONSERVATIVE?

A. Yes. Company response to data request AG 1-148 (updated 5/19/97) shows that the thousand gallon sales to KAWC 14 industrial customers during the first 5 months[17] of 1997 is substantially higher than the thousand gallon sales to these same customers during the corresponding period in 1996:

	1996	1997	97 over 96
Actual sales in thousand gallons	375,039	415,401	40,362

This information also indicates that the 1997 sales to the 14 industrial customers would be 996,962 thousand gallons on an annualized basis.

Q. HAVE YOU PERFORMED A SIMILAR TYPE ANALYSIS FOR THE RESIDENTIAL AND QUARTERLY COMMERCIAL SALES AS YOU DID FOR THE INDUSTRIAL SALES?

A. No, I did not because the relevant data for this similar type analysis were not available to me. Instead, I recommend that the Company's projected forecasted period conservation adjustments for these two customer classes be cut in half. I believe that these recommended adjustments are reasonable and appropriate based on all of the information previously discussed in this section of my testimony.

[17] First 4 months of 1997 for Crest and Pepsi Cola and first 5 months of 1997 for the other 12 industrial customers.

- Monthly OPA Sales

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $4,789 AS SHOWN ON SCHEDULE RJH-4, LINE 3?

A. In response to data request AG 2-16a., the Company presented revised monthly OPA sales revenue projections for the forecasted period based on its agreement that the forecasted period revenues for the monthly OPA sales customers should be calculated based on weather normalized sales data with the sales to Bluegrass Army Depot removed. As shown on Schedule RJH-20, this corrected sales forecast increases the Company's proposed forecasted period operating income by $4,789.

- Quarterly OPA Sales

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $5,562 AS SHOWN ON SCHEDULE RJH-4, LINE 4?

A. The table below presents the actual average sales per quarterly OPA customer experienced during the 7-year period 1990-1996:

	000 gallons
1990	135.4386
1991	107.8193
1992	110.7512
1993	112.6256
1994	122.1915
1995	102.8867
1996	118.9383

The Company's proposed forecasted period quarterly OPA sales is based on the 4-year average of the average sales per customer numbers for the years 1991, 1992, 1993 and 1995. In other words, the Company picked the lowest 4 average sales per customer years in this 7-year historic period as the basis for its forecasted period sales projections. When the Company was asked for the rationale underlying this approach, it stated in response to data request AG 2-16c.:

> "Sales data for 1990 and 1994 indicated sales levels much higher than in 1995, the most recent full year available when the budget was being prepared. In forecasting sales for this class, we used operational judgement to forecast at a level we felt was most realistic".

Q. DO YOU AGREE WITH THIS SALES FORECAST APPROACH PROPOSED BY THE COMPANY?

A. No, I do not. The Company's proposed approach implies that it believes that the average per customer sales levels in 1990 and 1994 were abnormal as compared to the average per customer sales in 1995. However, a review of the results in the table above would support the *opposite* conclusion that the average sales per customer in 1995 is abnormal as compared to the corresponding sales numbers for the other 6 years.

It is my opinion that if one chooses the use of an historical average as the basis for future sales projections, it is not appropriate to selectively exclude certain years based on judgement that such years "were not reflective of the current trend"[18]. In fact, the actual average sales per customer data for 1996 indicates that the 7-year (1990-1996) average sales per customer number is much more "reflective of the current trend" than the Company's proposed selective

[18] See response to data request AG 1-173b.

4-year (1991, 1992, 1993 and 1995) average per customer sales number. As shown on Schedule RJH-21, the 7-year average sales per customer number is 116.5087 thousand gallons, the Company's proposed 4-year average is 109.3838 thousand gallons, and the actual 1996 average sales per customer number is 118.9383 thousand gallons.

Q. WHAT IS YOUR RECOMMENDATION BASED ON THE PREVIOUSLY DISCUSSED INFORMATION?

A. I recommend that the forecasted period sales for the quarterly OPA customer class be based on the 7-year average of the average sales per customer numbers during the period 1990-1996. As shown in detail on Schedule RJH-21, I have calculated that this recommendation increases the Company's proposed forecasted period operating income by $5,562.

- OWU Sales

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $12,570 AS SHOWN ON SCHEDULE RJH-4, LINE 5?

A. This represents my recommended adjustment to the Company's proposed forecasted period sales projection for the OWU customer Spears. KAWC's proposed OWU sales for the forecasted period consist of projected sales to five OWU customers: Spears, LSE, Midway, Versailles and N. Middletown. While the Company assumed that the forecasted period sales for LSE, Midway, Versailles and N.Middletown would be equal to the actual sales for these customers during the twelve-month period ended August 31, 1996, for Spears it assumed that

the forecasted period sales would be equal to the actual sales to Spears during 1995.

Q. WHAT HAS BEEN THE ACTUAL SALES TO SPEARS DURING THE LAST FIVE YEARS?

A. KAWC's actual sales (expressed in CCF) to Spears during the last five years has been as follows:

1992	67,416
1993	62,868
1994	52,955
1995	47,276
1996	65,744

For the twelve-month period ended August 31, 1996 the sales to Spears was 65,228, or approximately the same as the actual sales for the full year 1996. Thus, the Company has picked the lowest sales year (1995) in this 5-year historic period as the basis for its forecasted period sales projection.

Q. WHY HAS THE COMPANY USED THIS SALES FORECAST APPROACH FOR SPEARS?

A. In response to data request AG 1-174, the Company states that ..."Although 1996 sales increased, due to a current dispute with Spears regarding service territory the 1995 level of sales to Spears was used in the forecast". When the Company was asked to elaborate on this matter in data request AG 2-17, it responded as follows:

> "Regarding the dispute, it has now reached the status of a complaint filed by Spears in Franklin Circuit Court naming Kentucky-American Water Company and the Public Service Commission as defendants. The complaint followed the Commission's denial of a rehearing in Case No. 96-449 in which Spears Water Company, among other things, requested that the Commission instruct Kentucky-

American to refrain from providing service to any of Spear's existing customers".

Q. BASED ON THE PREVIOUSLY DISCUSSED INFORMATION, DO YOU AGREE WITH THE COMPANY'S PROPOSED SALES PROJECTION APPROACH FOR SPEARS?

A. No, I do not. I do not see why the actual 1996 sales to Spears would be less representative of the sales that can reasonably be expected during the forecasted period than the actual 1995 sales level proposed by KAWC. As indicated above, the PSC has already denied a rehearing regarding the dispute in Case No. 96-449. Moreover, it is not known at this time when the Franklin Circuit Court will make a ruling on the dispute and whether any eventual Court ruling will be favorable or unfavorable to Spears. Finally, I understand that even if the Court were to rule favorable to Spears, this would not resolve the dispute at that time because the matter would then be remanded to the PSC for a rehearing of the issue and it would be pure speculation to predict the timing and outcome of such a potential rehearing. In summary, it is my opinion that there is no support for the Company's assumption that the sales to Spears during the forecasted period will be equal to the actual 1995 sales level as a result of the current dispute.

Q. WHAT IS YOUR RECOMMENDATION REGARDING THE PROJECTED SALES TO SPEARS DURING THE FORECASTED PERIOD?

A. I recommend that the projected sales to Spears for the forecasted period be based on the actual sales to Spears during 1996. As shown in more detail on Schedule RJH-22, I have calculated that this recommendation increases the Company's proposed forecasted period operating

income by $12,570.

- AFUDC

Q. WHY HAVE YOU DECREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $88,831 AS SHOWN ON SCHEDULE RJH-4, LINE 6?

A. As presented in more detail on Schedule RJH-7, this recommended operating income adjustment represents the difference between the Company's proposed and my recommended AFUDC income to be recognized for rate making purposes in this case. As shown under footnote (2) on Schedule RJH-7, the total average forecasted period CWIP balance adjusted for the recommended slippage factors discussed earlier in this testimony amounts to $5,726,786. I then removed from this adjusted average CWIP balance all CWIP related to special budget projects BP 90-13, BP 90-14 and BP 92-12 ($1,895,439) to arrive at the remaining average adjusted CWIP balance of $3,831,347. Of this remaining CWIP investment, a balance of $2,776,807 represents the CWIP that accrues AFUDC. Finally, I applied the AG's recommended overall rate of return of 8.77% to this AFUDC-accruing CWIP balance to arrive at the recommended AFUDC income of $243,526. Since this AFUDC level is $148,952 less than the Company's proposed AFUDC income of $392,478, my recommendation reduces the Company's proposed other operating revenues by $148,952 and this, in turn, reduces the Company's proposed forecasted period net operating income by $88,831.

Q. DO YOU HAVE ANY COMMENTS ON THE COMPANY'S PROPOSED AFUDC

INCOME OF $392,478?

A. Yes. As can be calculated from the response to data request AG 1-23, the Company's proposed average forecasted period AFUDC-accruing CWIP amounts to $4,497,902. Based on the Company's proposed overall rate of return in this case of 9.57%, one would expect the Company's proposed AFUDC income for this case to be $4,497,902 x 9.57%= $430,449. However, the Company only proposes AFUDC income of $392,478. As explained in its response to data request AG 1-153, the Company has calculated its proposed AFUDC amount of $392,478 as follows: [$4,497,902 / 1.0957] x 9.57% = $392,478. In other words, the Company has first restated its proposed AFUDC-accruing CWIP balance of $4,497,902 to a pro forma CWIP balance without previously accumulated capitalized AFUDC and then applied its proposed overall rate of return of 9.57% to this pro forma restated CWIP balance. The end result of this is that the Company's proposed effective AFUDC rate is not 9.57% but 8.73% ($392,478 / $4,497,902). As claimed by the Company in its response to AG 1-153, this pro forma method would be "more appropriate" than using the method that has always been employed by the PSC for rate making purposes and that has been used by me to determine the recommended AFUDC amount on Schedule RJH-7. The PSC should reject this pro forma AFUDC calculation method introduced by the Company in this case. The Company has inappropriately and incorrectly assumed that each of the CWIP projects included in its proposed forecasted period AFUDC-accruing CWIP balance of $4,497,902 has accrued AFUDC at a rate of 9.57% on a continuous basis since the start of the construction for each of these CWIP projects. This has simply not been the case. Therefore, this assumption is inappropriate and should be rejected by the PSC. The PSC should continue to calculate the pro forma AFUDC

based on the method approved and applied in KAWC's prior rate cases.

- Labor Expenses

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED FORECASTED PERIOD OPERATING INCOME BY $148,648 AS SHOWN ON SCHEDULE RJH-4, LINE 7?

A. This operating income adjustment represents the combined after-tax operating income impact of three recommended adjustments I have made to the Company's proposed forecasted period payroll expenses. These three recommended payroll expenses adjustments are summarized on Schedule RJH-23, page 1 and are further detailed on Schedule RJH-23, pages 2-5.

Q. COULD YOU NOW EXPLAIN THE FIRST OF YOUR RECOMMENDED THREE PAYROLL EXPENSE ADJUSTMENTS?

A. Yes. This recommended adjustment is presented in more detail on Schedule RJH-23, page 2. In this case, the Company has proposed that 87.21% of its projected forecasted period payroll costs will be charged to O&M expense. I believe that this proposed O&M ratio of 87.21% is too high given the actual historic payroll O&M ratios experienced by KAWC and given the fact that KAWC's own Business Plan projections indicate payroll O&M ratios for 1997, 1998 and 1999 that are significantly lower than 87.21%. Instead, I recommend that the O&M ratio to be applied to the Company's forecasted period payroll costs be set at 86.30% for rate making purposes in this case. As shown in Schedule RJH-23, page 2, this recommendation reduces the Company's proposed forecasted period payroll expenses by $53,472.

Q. HOW DID YOU DERIVE THE RECOMMENDED PAYROLL O&M RATIO OF 86.30?

A. The table below provides the actual payroll O&M ratios experienced by KAWC during the period 1992 through 1996:

	Total Payroll Cost	O&M Payroll Expense	O&M Ratio
1992	$ 4,927,797	$ 4,309,797	87.46%
1993	$ 4,936,673	$ 4,289,072	86.88%
1994	$ 5,136,326	$ 4,490,611	87.43%
1995	$ 5,200,441	$ 4,451,430	85.60%
1996	$ 5,309,543	$ 4,522,170	85.17%
5-Year Average 92-96			86.51%
3-Year Average 94-96			86.07%
Mid-Point of 5-Year and 3-Year Averages			86.30%

This table shows that KAWC's actual payroll O&M ratio has experienced a steady decline from approximately 87.5% to approximately 85.2% over the last 5 years. It is reasonable to assume, however, that this downward trend may not necessarily continue in the future. It is also reasonable to assume that the Company's payroll O&M ratios will vary from year to year, depending upon a number of factors that are difficult, if not impossible, to predict at this time. Considering these facts, it would be reasonable and appropriate to base the projected forecasted period payroll O&M ratio on the average payroll O&M ratio actually experienced by KAWC in the recent past. From the data in the above table, I have calculated that the actual 5-year average (1992-1996) and 3-year average (1994-1996) payroll O&M ratios experienced by KAWC ranged from 86.51% to 86.07%, with a mid-point average ratio of approximately 86.30%. This calculated mid-point average ratio is at approximately the same level as the annual payroll O&M ratios projected for each of the years 1997 through 1999 in KAWC's own Business Plan. As shown in filing Exhibit No. 22, the Company's Business Plan indicates

projected payroll O&M ratios of 86.27% for each of the years 1997 through 1999.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE AREA?

A. Yes. I would also note that in Case No. 95-554, the Company had projected a payroll O&M ratio of 86.60% for the forecasted period ending August 31, 1997 in that case. By comparison, the actual payroll O&M ratio for 1996 was 85.17% and the payroll O&M ratio for the base period ending May 31, 1997 projected by the Company in the current case is 85.55%. This is another illustration regarding the difficulty of predicting accurate payroll O&M ratios for future periods. This information may also be indicative of the fact that, in projecting its forecasted periods' payroll O&M ratios, the Company would rather err on the high side than on the low side.

Q. COULD YOU NOW EXPLAIN THE SECOND OF YOUR RECOMMENDED THREE PAYROLL EXPENSE ADJUSTMENTS?

A. Yes. In projecting its proposed forecasted period payroll expenses, the Company reflected the payroll reductions associated with two employees who resigned in early 1997 and who will not be replaced by the Company. In filing Exhibit No. 21, the Company also made reference to two other employee retirements:

> "Two other employees have indicated that they may retire, one in late 1997 and the other in mid-1998, respectively. Since these employees have not formally notified the Company in writing of their retirement intentions, the filing at this time includes these employees".

In response to data request AG 1-69, the Company confirmed that one of these employees, an

office supervisor, has formally announced his retirement effective December 1, 1997 and that the other employee referenced in Exhibit No. 21, a distribution superintendent, would be retiring effective July 1, 1998 once he has formally announced his retirement. As indicated in the response to AG 1-69, the Company does not plan to replace these positions with new hires. As shown on Schedule RJH-23, page 3, the Company has calculated that the reflection of the office supervisor retirement as of December 1, 1997 would decrease the forecasted period payroll expenses by $41,094 and the reflection of the distribution superintendent retirement as of July 1, 1998 would decrease the forecasted period payroll expenses by $17,757. I recommend that both of these employee retirements be recognized for rate making purposes. This recommendation decreases the Company's proposed forecasted period payroll expenses by a total amount of $58,851.

Q. COULD YOU NOW EXPLAIN THE LAST OF YOUR RECOMMENDED THREE PAYROLL EXPENSE ADJUSTMENTS?

A. Yes. This payroll expense adjustment concerns my recommendation that, in addition to the two previously described employee retirements, the Company's proposed level of employees for the forecasted period should be further reduced. Specifically, I recommend that the Company's forecasted period payroll expenses be based on a total average number of 142 employees as opposed to KAWC's proposed average number of 148 employees. My recommended average employee level of 142 is 6 employees lower than the Company's proposed average employee level of 148. However, through the previously discussed adjustment for the 2 employees to be retired in late 1997 and mid-1998, I have already accounted for 2 out of the total recommended

employee reduction of 6. Therefore, my recommended additional employee reduction adjustment is for the additional removal of 4 employees from the Company's proposed forecasted period payroll expenses. As shown on Schedule RJH-23, page 4, based on a per-employee average salary analysis, my recommendation to remove an additional 4 employees decreases the Company's proposed forecasted period payroll expenses by $136,929.

Q. DID YOU PERFORM A DETAILED EMPLOYEE LEVEL ANALYSIS TO SUPPORT YOUR RECOMMENDED ADDITIONAL EMPLOYEE REDUCTION ADJUSTMENT?

A. Yes. The results of this analysis is presented on Schedule RJH-23, page 5. At the top of page 5, my analysis shows that during the most recent 5 years from 1992 through 1996, KWAC has over-budgeted its actual level of total employees by an average of 5 employees per year.

The next analysis on page 5 shows a comparison of the Company's employee level projections made in Case No. 95-554 for the period September 1996 through April 1997 to the actual employee levels for that same period. In Case No. 95-554, the Company had projected a total level of employees of 150 for each month from September 1996 through April 1997, broken out as 7 incremental employees to accommodate monthly meter reading and billing and 143 remaining employees. During this same period, the Company actually had 6 incremental employees for monthly meter reading and billing, an average monthly level of 135 for the remaining employees, and a total average monthly employee level of 141. This is 9 employees less than the average employee level of 150 projected by KAWC in Case No. 95-554 for this same period, and only 1 out of this total 9 employee variance is explained due to the fact that the actual incremental monthly reading and billing employee level was 6 rather than the 7

projected by the Company.

The page 5 analysis also shows that the Company has projected a total level of 148 employees for the forecasted period, broken out as 7 incremental employees for monthly meter reading and billing and 141 remaining employees.

The analysis further shows the derivation of the AG-recommended total level of employees of 142 for the forecasted period, broken out as 7 incremental employees for monthly meter reading and billing and 135 remaining employees. This recommended total employee level of 142 is equivalent to actual average number of employees for the period September 1996 through April 1997 (141) plus 1 additional employee for monthly meter reading and billing.

Q. DID YOU ALSO PERFORM A DETAILED PAYROLL AND CONTRACT LABOR COST ANALYSIS TO SUPPORT YOUR RECOMMENDED ADDITIONAL EMPLOYEE REDUCTION ADJUSTMENT?

A. Yes. This analysis is also shown on Schedule RJH-23, page 5. In this analysis, I have compared the Company's total budgeted payroll costs and contract labor costs for each of the 5 years 1992 through 1996 to the corresponding actual costs for that same time period. This analysis indicates that the Company has over-budgeted its total payroll and contract labor costs during this 5-year period by an average amount of $72,476 per year. Thus, this would refute the Company's potential argument that its over-budgeted payroll costs are equally or more than offset by under-budgeted contract labor costs. The last line on page 5 shows that the Company's projected forecasted period filing results include $5,870,671 for total payroll costs and $156,897 for total contract labor costs, for a grand total cost amount of $6,027,568. While

I have not accepted the Company's proposed forecasted period total payroll cost amount, I have taken no exception to the Company's proposed forecasted period total contract labor amount of $156,897.

Q. HAVE YOU PERFORMED A "REASONABILITY CHECK" CONCERNING YOUR RECOMMENDED FORECASTED PERIOD PAYROLL O&M EXPENSES IN COMBINATION WITH THE RECOMMENDED FORECASTED PERIOD CONTRACT LABOR EXPENSES?

A. Yes, this "reasonability check" is presented on the lower part of Schedule RJH-23, page 1. This analysis first shows that the Company's actual payroll O&M and contract labor expenses for 1995 and 1996 were $4,534,205 and 4,728,000, respectively. By comparison, for the forecasted period in this case, KAWC has proposed a total payroll O&M and contract labor expense amount of $5,276,758, while the corresponding AG-recommended total expense level is $5,027,506. In my opinion, this comparison clearly indicates that KAWC's proposed total expense amount for the forecasted period is unreasonably high and that the AG-recommended adjusted total expense amount for the forecasted period is within a much more reasonable range.

- Incentive Compensation

Q. HAS THE COMPANY CLAIMED RATE RECOVERY IN THIS CASE FOR INCENTIVE COMPENSATION EXPENSES?

A. Yes. The forecasted period in this case includes total incentive compensation expenses of $79,626, consisting of $15,870 for "direct" KAWC incentive compensation expenses and $63,756 for incentive compensation expenses allocated to KAWC by the Service Company. As confirmed by the Company in response to data request AG 1-158, the "direct" KAWC incentive compensation expenses of $15,870 consist of $14,100 related to Mr. Mundy's participation in the Annual Incentive Plan ("AIP") and $1,770 related to Mr. Mundy's participation in the Long Term Performance-Based Incentive Plan ("LTIP")[19]. The Company did not provide a similar breakdown for the $63,756 of incentive compensation expenses allocated to KAWC by the Service Company. All that is known is that these allocated incentive compensation expenses are for senior level management executives of the Service Company.

Q. WHAT ARE THE PERFORMANCE GOALS AND PERFORMANCE AWARD CRITERIA UNDERLYING THESE INCENTIVE COMPENSATION EXPENSES?

A. As indicated in the response to AG 1-158, the performance goals for the LTIP are 100% based on earnings per share growth and total return to stockholders. Response to data request AG 1-77 further states that the purpose of the LTIP is as follows:

> "The purpose of the Plan is to promote the success of the Company by linking incentive opportunities to stockholder gains and enabling the Company to attract and retain individuals of outstanding ability".

With regard to the AIP, response to data request AG 1-77 states that the objective of this plan is as follows:

> "This annual incentive program is based upon achieving performance levels that will

[19] Response to AG 1-158 also indicates that Mr. Mundy will no longer participate in the LTIP after 1997.

increase value for shareholders and assure safe, reliable water service that meets customer requirements and expectations".

Response to AG 1-158 further clarifies that the performance goals of the AIP are 50% for financial goals (earnings per share, return to stockholders, etc.) and 50% for customer service and operational goals.

Q. DO YOU AGREE WITH THE COMPANY'S PROPOSAL THAT THE RATEPAYERS FUND 100% OF THESE INCENTIVE COMPENSATION EXPENSES AND, IF YOU DO NOT AGREE, WHAT IS YOUR RECOMMENDATION IN THIS CASE CONCERNING THESE EXPENSES?

A. I do not agree with the Company's proposal. The Company's LTIP awards only get triggered when certain pre-determined financial performance goals such as earnings per share growth and return on stockholder equity are met or exceeded; and this would be the case for 50% of the AIP awards. Once these financial goals are reached or exceeded, the stockholder would be a primary beneficiary as this would tend to increase the value of his/her investment in the Company. In addition, other than stating that one of the purposes of these plans is to enable the Company to "attract and retain individuals of outstanding ability", the Company has not presented any evidence showing the specific benefits that are accruing to the ratepayers as a result of these incentive compensation plans for which these same ratepayers are asked to pay 100% of the costs.

Based on this information, I recommend that the Company's claimed incentive compensation expenses be shared equally between the ratepayers and shareholders. This

recommendation is (1) consistent with the fact that 50% of the AIP incentive plan expenses are directly tied to stockholder values, and (2) conservative given that 100% of the LTIP incentive plan expenses are a function of meeting financial performance goals of which the stockholders are the primary beneficiaries. Moreover, one could argue that attracting and/or retaining outstanding management people benefits ratepayers and shareholders alike. On Schedule RJH-4, line 8 and Schedule RJH-24, I show that my recommendation increases the Company's proposed forecasted period operating income by $23,743.

Q. ARE YOU AWARE THAT YOUR RECOMMENDATION IN THIS CASE IS NOT CONSISTENT WITH THE RATE MAKING TREATMENT ALLOWED BY THE PSC IN CASE NO. 95-554 CONCERNING INCENTIVE COMPENSATION EXPENSES?

A. Yes, I am fully aware of that. However, I am respectfully recommending that the PSC reconsider its treatment of this issue based on the aforementioned reasons which the PSC may not previously have considered. In addition, if the PSC were not to adopt my recommendation to share the incentive compensation expenses between the ratepayers and stockholders on a 50/50 basis, I recommend that the Commission at least remove the $1,770 for Mr. Mundy's LTIP award expenses that are included in the forecasted period. These expenses should be considered non-recurring since Mr. Mundy will no longer participate in the LTIP after 1997.

- <u>Employee Benefit Expenses</u>

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME

BY $116,881 AS SHOWN ON SCHEDULE RJH-4, LINE 9?

A. This adjustment represents the combined after-tax operating income impact of my recommended adjustments to the Company's proposed forecasted period employee benefit expenses. As shown in more detail on Schedule RJH-25, I recommend that adjustments be made to the Company's proposed forecasted period pension, OPEB and 401(k) expenses. I also recommend adjustments to the Company's proposed employee benefit expenses as a direct result of the recommended employee level adjustments that were previously discussed in this testimony. Below, I will discuss each of these recommended employee benefit expense adjustments.

Pension Expenses

Q. WHY HAVE YOU REDUCED THE COMPANY'S PROPOSED PENSION EXPENSES BY $40,088?

A. In response to data request AG 1-163, the Company has confirmed that its originally projected forecasted period pension expenses of $215,902 should be reduced to $175,814 based on the results of its most recent updated actuary study for 1997. Accordingly, I have reduced the Company's as-filed pension expenses by $40,088.

OPEB Expenses

Q. WHY HAVE YOU REDUCED THE COMPANY'S PROPOSED OPEB EXPENSES BY

$88,895?

A. In response to data request AG 1-84, the Company has confirmed that its OPEB costs for the forecasted period should be reduced to $497,995 based on the preliminary results from its most recent 1997 OPEB actuary study. This actuary-determined OPEB cost amount was based on a total level of 141 active employees for KAWC. The Company then applied an O&M ratio of 91.18% to this total OPEB cost amount of $497,995 to arrive at OPEB expenses of $454,072 to be charged to O&M for the forecasted period. Finally, the Company adjusted this OPEB expense amount of $454,072 to account for a total level of 148 active employees rather than the level of 141 employees upon which the actuary study results were based[20]. This resulted in the Company's revised OPEB expense claim of $470,967 for the forecasted period.

I have accepted all of the Company's proposed revised OPEB expense calculations with the exception of KAWC's proposed adjustment to restate the actuary-determined OPEB expense based on 148 active participants. Rather, I have restated the actuary-determined OPEB expense based on 142 active participants consistent with my previously discussed recommendation that KAWC's projected labor force during the forecasted period should be at a level of 142 employees. As shown in footnote (3) of Schedule RJH-25, my calculations indicate that the appropriate OPEB expenses for KAWC during the forecasted period should amount to $457,668. This OPEB expense amount is $88,895 lower than the OPEB expense amount of $546,563 included in KAWC's original as-filed forecasted period operating expenses.

[20] The Company calculated this adjustment by applying a ratio of 148/141.

401(k) Expenses

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED 401(K) EXPENSES BY $7,218?

A. In response to data request AG 1-167, the Company indicated that it made an error in calculating its proposed forecasted period 401(k) expenses. The correction for this error increases KAWC's forecasted period expenses by $7,218. I have reflected this expense increase on line 3 of Schedule RJH-25.

Payroll Overhead Related to Recommended Employee Reductions

Q. PLEASE EXPLAIN THE EMPLOYEE BENEFIT EXPENSE ADJUSTMENTS MADE BY YOU FOR RECOMMENDED EMPLOYEE REDUCTIONS, AS SHOWN ON LINES 4 AND 5 OF SCHEDULE RJH-25.

A. As previously discussed in the "Labor Expenses" section of this testimony, I have recommended several adjustments to the Company's proposed forecasted level of employees. First, I reduced the Company's as-filed operating expense projections for the salary reductions to be experienced during the forecasted period related to two employee retirements. Second, over and above these two employee retirements, I have recommended salary reductions related to the removal of four additional employee positions that were included in KAWC's proposed forecasted period. While the above-referenced salary reduction adjustments are reflected on pages 3 and 4 of Schedule RJH-23, it is also necessary to eliminate the payroll overhead

by a total amount of $84,220.

- Fuel and Power Expenses

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $52,784 AS SHOWN ON SCHEDULE RJH-4, LINE 10?

A. Schedule RJH-26 provides a summary of KAWC's actual fuel and power expenses as compared to its budgeted fuel and power expenses for the 10-year period 1987 through 1996. This data shows that, with the exception of the year 1995 when the Company's actual expenses were slightly above its budgeted expense level, the Company has consistently over-budgeted its fuel and power expenses during this 10-year period. Specifically, KAWC's actual expenses have averaged 94.3% of its budgeted expenses from 1987 through 1996. This over-budgeting trend appears to be continuing into 1997 as the Company's actual fuel and power expenses are 90.87% of the budgeted expense level used by KAWC in Case No. 95-554 for the 12-month period May 1, 1996 through April 30, 1997. For the first 4 months of 1997, the actual expenses were $394,302, or 86.04% of the budgeted expenses of $458,296 for that same 4-month period. Based on this over-budgeting history and based on the fact that KAWC has previously indicated that its fuel and power expenses do not always vary directly with water sales[21], I recommend that the forecasted period fuel and power expenses be set at a level of 94.3% of KAWC's proposed forecasted fuel and power expenses. As shown on Schedule RJH-26, this recommended expense adjustment increases KAWC's proposed forecasted period

[21] As stated on page 25 of the Commission's Order in KAWC's Case No. 92-452.

operating income by $52,784.

- Chemical Expenses

Q. WHY HAVE YOU DECREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $8,418 AS SHOWN ON SCHEDULE RJH-4, LINE 11?

A. In response to data request AG 1-63, KAWC has indicated that it made an error in its calculations to determine the forecasted period chemical expenses and I have corrected for this error. As shown in more detail on Schedule RJH-26, lines 6-8, this error correction decreases KAWC's proposed forecasted period operating income by $8,418.

- Current Waste Disposal Expenses

Q. WHY HAVE YOU INCREASED THE COMPANY'S PROPOSED OPERATING INCOME BY $12,062 AS SHOWN ON SCHEDULE RJH-4, LINE 12?

A. This represents my recommended adjustment to the Company's proposed forecasted period current waste disposal expenses in account 643.3. The Company's actual account 643.3 current waste disposal expenses for the last 4 years has been as follows:

1993	$44,720
1994	$33,730
1995	$37,926
1996	$34,926

By contrast, the Company has projected account 643.3 expenses of $70,225 for the forecasted

period. When the Company was asked in data request AG 1-159c. to provide the reasons for the substantial (more than 100%) increase of its projected forecasted period expenses over the recent actual expense levels, it responded as follows:

> "The cost of lagoon cleaning is competitively bid. The cost also varies depending on the amount of residuals which have collected in the lagoons. A portion of this increase is due to an overlap of amortization for the cleaning and increased costs for chemicals associated with dechlorination of settled filter washwater which is no longer recycled through the treatment facility. A permitted discharge of the washwater to the Kentucky Rover is now in place in lieu of recycling of this water".

The Company has also projected forecasted period account 643.31 expenses of $72,501[22] for waste disposal amortization expenses associated with the cleaning of its lagoons. Therefore, the statement in the above-referenced date response that a portion of the projected expense increase in account 643.3 for current waste disposal " is due to an overlap of amortization for the cleaning" is puzzling. After all, any projected increases in lagoon cleaning amortizations are separately accounted for and have been separately reflected under account 643.31 in the forecasted period, and should therefore not be a reason for the projected increase in account 643.3 for current waste disposal expenses.

The other reason provided by the Company for the projected increase concerns ..."the increased costs of chemicals associated with the dechlorination of settled filter washwater which is no longer recycled through the treatment facility". In my opinion, it seems unreasonable to assume that this increased cost of chemicals would result in a 100% increase over current waste disposal expenses. In addition, the Company indicates that this increased chemical cost is associated with a dechlorination procedure which has taken the place of a previously employed

[22] See Filing W/P-3-4, Page 2.

water recycling procedure. Therefore, there may well be offsetting expense savings as a result of the Company no longer having to recycle settled filter washwater through the treatment facility. In summary, I do not believe that the Company has adequately supported its proposed substantial increase in account 643.3 for current waste disposal expenses.

Q. WHAT FORECASTED PERIOD CURRENT WASTE DISPOSAL EXPENSE LEVEL DO YOU RECOMMEND BE USED FOR RATE MAKING PURPOSES IN THIS CASE?

A. I recommend that the PSC adopt a forecasted current waste disposal expense level of $50,000 rather than the expense level of $70,225 proposed by KAWC. This recommended expense level is substantially higher than the actual 1996 expense level of $34,926. As shown on Schedule RJH-27, the actual expenses for the most recent 7-month period for which data were available at the time of this writing totaled $21,620 which would suggest an expense amount of approximately $37,000 on an annualized basis. The recommended $50,000 would also appear reasonable and conservative in comparison to this annualized expense level. Schedule RJH-27 also shows that the actual expenses for the most recent 7-month period are below the corresponding expenses that were projected by KAWC for the same period in Case No. 95-554. My recommendation increases the Company's proposed forecasted period operating income by $12,062, as detailed on lines 1-5 of Schedule RJH-27.

- Regulatory Expenses

Q. PLEASE SUMMARIZE THE TOTAL AMOUNT OF REGULATORY EXPENSES KAWC