

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

**NOTICE OF ADJUSTMENT OF THE RATES OF)
KENTUCKY-AMERICAN WATER COMPANY)
EFFECTIVE ON AND AFTER MAY 30, 2004)**

CASE NO. 2004-00103

BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

CERTIFICATION

This is to certify that a true and accurate copy of the foregoing has been electronically transmitted to the Public Service Commission on January 4, 2005; that the Public Service Commission and other parties participating by electronic means have been notified of such electronic transmission; that, on January 4, 2005, the original and one (1) copy in paper medium will be hand-delivered to the Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; and that on January 4, 2005, one (1) copy in paper medium will be served upon the following via U.S. Mail:

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INDEX

Page No.

I.	STATEMENT OF THE CASE	1
	A. HISTORY OF THE PROCEEDING	1
	B. PROPOSED RATE INCREASE	3
	C. PROPOSED REVENUE CHANGES	5
II.	RATE BASE	8
	A. INVESTMENT BUDGET	10
	B. UTILITY PLANT ACQUISITION ADJUSTMENT	10
	C. CONSTRUCTION WORK IN PROGRESS	14
	D. CASH WORKING CAPITAL	16
	E. DEFERRED DEBITS	18
	(1) Security Costs	18
	(2) Shared Services and Customer Call Center	27
III.	FORECASTED TEST YEAR REVENUES	29
	A. RESIDENTIAL CONSUMPTION	29
	B. COMMERCIAL CONSUMPTION	31
	C. RESIDENTIAL CUSTOMERS	31
	D. COMMERCIAL CUSTOMERS	32
IV.	EXPENSES	33
	A. SALARY AND WAGE ADJUSTMENTS	33
	B. INCENTIVE COMPENSATION PLANS	34
	C. OTHER POST-EMPLOYMENT BENEFITS	36
	D. WASTE DISPOSAL COSTS	37
	E. MAINTENANCE EXPENSE	38
	F. REGULATORY EXPENSE	39
	G. BUSINESS DEVELOPMENT COST	39
	H. CONSOLIDATED TAX ADJUSTMENT	40
V.	LOW INCOME DISCOUNT TARIFF	43
VI.	ACCOUNT ACTIVATION FEE	45
VII.	EMERGENCY PRICING TARIFF	46
VIII.	HYPOTHETICAL CAPITAL STRUCTURE	48
IX.	COST OF EQUITY	50
X.	CONCLUSION	55

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KENTUCKY-AMERICAN WATER COMPANY)
EFFECTIVE ON AND AFTER MAY 30, 2004)

BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

I. STATEMENT OF THE CASE

A. HISTORY OF THE PROCEEDING

On March 26, 2004, Kentucky-American Water Company ("Kentucky American Water") filed a Notice with the Public Service Commission of the Commonwealth of Kentucky ("Public Service Commission" or "Commission") in conformity with 807 KAR 5:001, Section 10(2), and 807 KAR 5:001, Section 8(1), expressing its intention to file an application for an increase in its rates no later than four weeks subsequent to March 26, 2004. The Notice specifically provided that the application for an increase in rates would be supported by a fully forecasted test year as authorized by Kentucky Revised Statute 278.192.¹

¹ The Notice was subsequently attached to the Application, Statement and Notice filed by Kentucky American Water in Case No. 2004-00103 and marked as Filing Exhibit No. 8.

As it has done in previous cases, simultaneously with the delivery of the notice of its intention to seek an increase in rates, Kentucky American Water asked for the Commission's consideration of the continuance of the use of electronic technology in the rate setting process to eliminate the need for multiple paper copies. Kentucky American Water asked for the Commission to accept the filing in electronic form only and that the regulatory requirement for service of paper copies is waived. By Order dated April 22, 2004, the Commission found that good cause existed to permit a deviation from the requirements of 807 KAR 5:001 and to allow the submission and service of documents electronically. The Order provided an opportunity for any party to the proceeding to object to its participation electronically.

The Attorney General of the Commonwealth of Kentucky ("Attorney General") and the Lexington-Fayette Urban County Government ("LFUCG") moved to intervene on April 20 and April 22, 2004, respectively.

On April 27, 2004, the Attorney General filed his notice objecting to the "procedure that eliminates the regulatory requirement that documents and pleadings filed with the Commission be served upon all parties in paper medium." This pleading included a notice that the Attorney General "does not waive any right to service of Commission Orders by United States mail." Thereafter, on April 29, 2004, the LFUCG joined the Attorney General's notice, alleging that it was a local government with limited resources and its ability to access or share electronic information was often restricted, limited or unavailable because of technical problems.

Kentucky American Water responded to the protestations of the Attorney General and the LFUCG on May 4, 2004. After a careful evaluation of the positions taken by

Kentucky American Water, the Attorney General and the LFUCG, on May 27, 2004, the Commission “reluctantly” concluded that allowing a deviation from the requirement of the service of a paper copy of filings would be inappropriate at that time. As a part of the process of continuous improvement, the Commission’s Order made public its internal review of the requirement for the filing of paper copies and its intention to broaden the use of available technology.

On May 18, 2004, Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. (“CAC”) moved for a full intervention. On June 15, 2004, Bluegrass FLOW, Inc. (“Flow”) moved for a full intervention. The request of Flow was opposed by Kentucky American Water who filed its response and thereafter the Attorney General and the LFUCG responded indicating their belief that Flow should be permitted to intervene. Those motions were subsequently granted on June 7, 2004 and September 12, 2004, and the matter has proceeded with four intervenors—CAC, LFUCG, the Attorney General and Flow.

B. PROPOSED RATE INCREASE

In its Application, Statement and Notice filed with the Commission on April 30, 2004, Kentucky American Water sought the Commission’s approval of an increase in its annual revenues of \$7,297,443 by rates to become effective on and after May 30, 2004. The percentage increase for volumetric consumption was applied ratably with the exception that the full request was not apportioned to the Northern Division consisting of customers in Gallatin, Grant and Owen Counties. By letter dated May 20, 2004, the Executive Director of the Commission informed all parties of record that the application had met the minimum filing requirements. Shortly thereafter, by Order dated May 28,

2004, the Commission suspended the operation of the proposed rates for a period of six months and entered a Procedural Schedule providing for two series of data requests to Kentucky American Water, the filing of the testimony of intervenors, one round of requests to intervenors, and the filing of the testimony of any rebuttal witnesses for Kentucky American Water. On July 8, 2004, the Commission found that “the scope and complexity of the issues presented require greater time for review than originally allowed” and modified the Procedural Schedule to allow an additional round of data requests to Kentucky American Water for operations during the base period and its rebuttal testimonies. The modified Procedural Schedule also established a hearing “for the sole purpose of receiving public comment on the proposed rate adjustment” to be held on November 4, 2004, with an evidentiary hearing beginning November 8, 2004. Eighteen (18) people spoke at the public hearing. Only seven people came to express their opinions in a negative fashion to Kentucky American Water’s requests. Those opinions ranged from a legitimate question about the currency exchange rate to the often heard inappropriate suggestion of the utilization of a “net profit” method of regulation.

With its application Kentucky American Water presented the direct testimonies of Mr. Patrick Baryenbruch, Ms. Linda Bridwell, Mr. Coleman Bush, Mr. Chris Jarrett, Mr. Bruce Larson, Mr. Michael Miller, Dr. Kenneth Rubin, Mr. James Salser, Dr. Edward Spitznagel, Ms. Sheila Valentine and Dr. James Vander Weide. Subsequently rebuttal testimony was presented from Ms. Linda Bridwell, Mr. Coleman Bush, Mr. Michael Miller, Mr. James Salser, Dr. Edward Spitznagel, Dr. James Vander Weide and Mr. James Warren.

The Attorney General presented the testimony of Mr. Scott Rubin, Ms. Andrea Crane and Dr. J. Randall Woolridge.

Dr. James H. Vander Weide was unable to appear at the evidentiary hearing but by agreement with counsel and the permission of the Commission, Dr. Vander Weide was presented for cross-examination by videoconferencing on November 23, 2004.

C. PROPOSED REVENUE CHANGES

In its Application, Statement and Notice Kentucky American Water sought an increase on an annual basis of \$7,297,443 to be allocated to three different groups of customers, those in the Central Division, being the customers served who reside in Fayette and contiguous counties, those customers formerly served by the Tri-Village Water District (“Tri-Village area”) and those customers formerly served by the Elk Lake system (“Elk Lake area”). Kentucky American Water proposed an allocation of \$6,919,910 of the increase for the Central Division, \$338,208 for those customers in the Tri-Village area and \$39,325 for those customers in the Elk Lake area. As a result of this case Kentucky American Water believes 11 changes should be made to its initial request, reducing it to \$7,290,776, apportioned \$6,955,692 to the Central Division, \$307,331 to the Tri-Village area and \$27,753 to the Elk Lake area. Those changes are:

(1) An overstatement of Contributions In Aid of Construction (“CIAC”) of \$2,095,255² resulting in an additional revenue requirement of \$226,371 apportioned \$221,057 to the Central Division, \$5,350 to the Tri-Village area and a reduction of \$36.00 to the Elk Lake area.

² Response to Attorney General Data Request No. 1, Item 111.

(2) An understatement of the 13-month average of the forecasted period of rate base in the amount of \$609,399 with an attendant revenue increase of \$70,983 apportioned \$71,023 to the Central Division and a reduction of \$40.00 to the Tri-Village area.³

(3) The 13-month average for the forecasted test period of the Deferred Investment Tax Credits and the average balance for the 13-month forecasted test period were reversed on Schedule B-1, page 2 of 2, resulting in a difference of \$4,247.00. This results in a revenue decrease of \$378.00 applicable only to the Central Division.

(4) Deferred debits were overstated in the Central Division for the 13-month average for the forecasted period by \$76,130 and by \$213,532 for the Tri-Village area.⁴ The associated revenue impact is a reduction of \$7,799 for the Central Division, \$25,712 for the Tri-Village area, and \$12,110 for the Elk Lake area.

(5) Omission of amortizations for Tri-Village of \$5,676 and Elk Lake of \$2,688 and inadvertent inclusion of Pineville operation and maintenance agreement startup costs resulting in a revenue decrease for the Central Division of \$29,119, an increase of \$1,847 for the Tri-Village area, and \$758.00 for the Elk Lake area.⁵

(6) Correction of forecasted fire service revenues resulting in a revenue decrease of \$120,023 for the Central Division and \$115.00 for the Tri-Village area.⁶

³ Work Paper 1-12, p. 8 of 13, shows an average forecasted period rate base deduction of \$1,544,944 for “other net rate base elements” which was improperly linked to Exhibit No. 37B, p. 2 of 90, which initially showed a deduction of \$2,154,343. The Work Paper calculation was correct.

⁴ Attorney General Data Request No. 1, Item 108.

⁵ See PSC Data Request No. 2, Item 79.

⁶ LFUCG Data Request No. 2, Item 24.

(7) Overstated waste disposal cost for the Richmond Road Station resulting in a revenue decrease of \$12,085 to the Central Division.⁷

(8) Forecasted rent expenses were inadvertently overstated by \$58,295 resulting in a revenue decrease of \$47,841 to the Central Division and \$11,094 to the Tri-Village area.⁸

(9) Updating the lead/lag study for 12 items resulting in a revenue requirement deduction of \$63,816 for the Central Division, \$1,404 for the Tri-Village area, and \$121.00 for the Elk Lake area.⁹

(10) Inadvertent omission of the monthly depreciation expenses for water treatment structures and improvements from Work Paper 1/3, p. 2, resulting in revenue decrease of \$24,860 for the Central Division.¹⁰

(11) Correction of the AFUDC rate for the base period, resulting in an \$80.00 revenue increase for the Central Division, and for the forecasted test period resulting in a \$49,541 rate increase for the Central Division, \$289.00 revenue increase for the Tri-Village area and \$62.00 rate decrease for the Elk Lake area.¹¹

The \$7,290,776 in increased annual revenues proposed by Kentucky American Water stands in stark contrast to the increase proposed by the Attorney General of \$111,933. The very best indicator of the complete unreasonableness of the Attorney General's position is a quick review of Kentucky American Water's financial statements filed with the Commission by letter dated November 22, 2004. For the

⁷ PSC Data Request No. 2, Item 99.

⁸ Attorney General Data Request No. 1, Item 138.

⁹ Attorney General Data Request No. 2, Item 29.

¹⁰ Hearing Data Request No. 26.

¹¹ Post-Hearing Data Request No. 4.

12 months ending October, 2004, Kentucky American Water achieved a return on equity of 5.33%.¹² The ratepayers of Kentucky American Water have received a significant benefit since Kentucky American Water's Case No. 2000-120 and Kentucky American Water must now be restored to a healthy financial condition.

II. RATE BASE

The Attorney General's witness, Ms. Andrea Crane,¹³ castigates Kentucky American Water's use of a forecasted test year for ratemaking purposes, implicating the General Assembly for allowing it, the Commission for permitting its historical use and Kentucky American Water because of the "tremendous benefit[s] received."¹⁴

This is not the first time the Attorney General has attempted to undermine the rate setting process that uses a forecasted test year. Kentucky American Water filed an application to increase its rates on January 22, 1993,¹⁵ utilizing a forecasted test year then recently authorized by the General Assembly in Kentucky Revised Statute 278.190(2). At that time the Attorney General argued that the process was unconstitutional because it would require ratepayers to pay for a return on plant which did not exist, that the financial information presented by the applicant was flawed and speculative and that Kentucky American Water included no allowance for the elimination of regulatory lag by changing from a historical basis to a forecasted basis for ratemaking. Appropriately the Commission rejected all of these items with this conclusion:

¹² Net income available to equity of \$3,364,789 with common equity of \$63,165,645.

¹³ This apparently is the first time that The Columbia Group, Inc. has testified for the Attorney General.

¹⁴ Direct Testimony, Ms. Andrea C. Crane, p. 9, line 5.

¹⁵ Case No. 92-452.

“Its [Kentucky American Water’s] ability to forecast correctly individual operating expense accounts is of no consequence. What is significant is Kentucky-American’s overall ability to forecast total revenues and expenses, as it is the totals that affect rates. In forecasting these totals, Kentucky-American has been highly accurate over the years.”¹⁶

Since that time Kentucky American Water has filed four additional rate cases utilizing a forecasted test year without any apparent difficulty encountered by the Commission.¹⁷

Shortly after the modification to KRS 278.190(2) allowing utilities to use a forecasted test year the Commission modified 807 KAR 5:001, Section 10, to describe in detail the requirements for seeking an adjustment in rates based upon a forecasted test year. Those requirements are designed to provide all appropriate and necessary information for a careful evaluation of the utility’s costs and expenses to be incurred in the forecasted test year. The most basic ratemaking principle is that revenues should be cost based. Utilization of a forecasted test year allows the Commission to prescribe a set of rates that will be utilized during the forecasted test year and should produce a level of revenues that are cost based for the forecasted test year. Utilization of a historical test year, even accompanied with known and measurable expense changes, does not provide rates that are cost based for a forecasted test year. This use of a forecasted test year is not a benefit for Kentucky American Water—any utility may avail itself of the use of the forecasted test year.

¹⁶ Order, Case No. 92-452, November 19, 1993, p. 6.

¹⁷ Cases No. 94-197, 95-554, 97-034 and 2000-120.

A. INVESTMENT BUDGET

Kentucky American Water proposed \$287,861,620 of Utility Plant in Service as a 13-month average for the forecasted test year.¹⁸ Consistent with its previous regulation the Commission determined that the 10-year average ratio of actual to budgeted capital construction for recurring items B through H is 105.43% and 86.12% for Kentucky American Water's Investment Projects. Recalculating Kentucky American Water's requested Utility Plant in Service in conformity with these "slippage factors" results in a decrease of \$8,165 for the Utility Plant in Service to \$287,853,455.¹⁹

Kentucky American Water continues to express its philosophical disagreement with this concept but accedes to it only because of precedent.

B. UTILITY PLANT ACQUISITION ADJUSTMENT

Since Kentucky American Water's last rate case it has, with the approval of the Public Service Commission, acquired the assets of the Tri-Village Water District and Elk Lake Property Owners Association, Inc.²⁰ Kentucky American Water has proposed a \$208,310 acquisition adjustment for Tri-Village²¹ and a \$106,123 acquisition adjustment for Elk Lake²² (40-year amortizations). In the attachments to the third Public Service Commission's Data Requests, Items 31a and 31E, Kentucky American Water recalculated the utility plant acquisition adjustments for Elk Lake to be \$112,497.10 and for Tri-Village to be \$222,197.24. The Attorney General objects to these requests

¹⁸ Filing Exhibit No. 37, Schedule B-1, p. 2 of 2.

¹⁹ PSC Data Request No. 2, Item 115.

²⁰ Cases 2001-00094 and 2002-00094.

²¹ Work Paper 1-2, p. 2.

²² Work Paper 1-2, p. 3.

arguing that the acquisitions were viewed as business development opportunities. This rhetoric is an attempt to mischaracterize the transactions. It cannot withstand a thoughtful analysis.

Kentucky American Water occupies a unique position in the Commonwealth of Kentucky. As the largest investor-owned water utility much is expected of it and much has been delivered by it. Case No. 2002-00277, the Compliance of Kentucky American Water and its associated entities of the orders approving the transfer of control of Kentucky American Water, is replete with the benefits it extends to its service territory, all the way from the leasing of the 386 acres known as Jacobson Park to the Lexington-Fayette Urban County Government for \$10.00 a year until 2018 (originally a 20-year lease with a 20-year extended term) to significant charitable contributions. A part of its responsibility is to provide assistance to other water purveyors. It has done so from Martin County to Pineville and for places in between. It also has a responsibility to participate in the consolidation of water purveyors as determined by the General Assembly to be in the public interest.²³

The appropriate evaluation process is not to infer some alleged inappropriate motivation (“business development opportunities”)²⁴ but whether or not the acquisitions meet the Delta Natural Gas requirements as set forth in the Order in Case No. 9059 dated September 11, 1985. Each of the requirements was put in question form by the Commission in its second set of data requests, Item 82.

²³ Kentucky Revised Statute 224A.300.

²⁴ Kentucky American Water believes that it should be run as a business and that it should avail itself of business opportunities that benefit the Commonwealth, its ratepayers and investors, as set forth in the response to question No. 5 in the Rebuttal Testimony of Coleman D. Bush.

The first Delta question is whether or not the purchase price was established upon arms-length negotiations. The agreements for acquisition were developed through consultation with the Tri-Village Water District Board and the Elk Lake Homeowners Association. The Tri-Village Board demanded slightly more than the depreciated value for its assets because it needed the money to pay off its existing debt and to meet its commitment to the then existing customers for expansion.²⁵ The same situation was encountered in negotiations to acquire the Elk Lake system. The Homeowners Association needed to satisfy all of its liabilities and make promised improvements in the remaining infrastructure.²⁶

The second Delta question is whether or not the initial investment, plus the cost of restoring the facility to required standards will not adversely impact the overall costs and rates of the existing and new customers. Prior to the acquisition by Kentucky American Water the customers of Tri-Village and Elk Lake simply did not have a reliable water treatment and distribution system and, in the case of Tri-Village, one that could meet or exceed water quality standards. Elk Lake had its own treatment system which needed significant expenditures. Additional clarification needed to be added or existing clarification needed to be rehabilitated, filter media which had not been changed since 1962 needed to be replaced and improvements needed to be made to the chemical feed process.²⁷ The expertise of Kentucky American Water determined that it was more cost effective to connect Elk Lake to the existing Tri-Village distribution system than to have Elk Lake or any other entity rehabilitate the production infrastructure. The Tri-Village

²⁵ PSC Data Request No. 4, Item 15.

²⁶ PSC Data Request No. 4, Item 15.

²⁷ PSC Data Request No. 4, Item 13.

problem was several years history of elevated trihalomethanes. The agreement to acquire the assets of Tri-Village was contingent upon satisfactory solution of the disinfection by-product problem. The expertise and efforts of Kentucky American Water to solve the problem are detailed in the article published in the April, 2004 addition of Opflow, a publication of the American Water Works Association, attached to the direct testimony of Coleman Bush as Exhibit 3. The second Delta question does not require a precise mathematical answer in the context of these acquisitions. The overall costs and rates of the customers in the Elk Lake area have not been adversely impacted as they would have been if Elk Lake had been required to make the necessary improvements to its treatment facilities. While costs are always important, they are not the prime consideration in the effort to provide potable water that does not exceed trihalomethane standards. The problem was solved by the expertise of Kentucky American Water without changing sources or spending significant sums of money on the treatment process. Enhanced coagulation, changes in disinfection substances and contact time, source management and distribution system optimization were the answers supplied by Kentucky American Water. Significant Kentucky American time and expertise was involved in achieving the remarkable results.

The third Delta question is whether or not operational economies can be achieved through the acquisition. The answer here is obvious and yes. Operational economies have been achieved by connecting the Elk Lake system to the Tri-Village system and by the application of Kentucky American Water's efficiencies. Quantification of the operational efficiencies would involve measuring current efficiencies against those that would have existed without the acquisitions. The Delta question does not require that

analysis as there is no reasonable way to estimate the cost Elk Lake would have incurred to correct its production problems or the measures Tri-Village would have taken on its own to correct its water quality problems.

The fourth Delta question is whether or not the purchase price of utility and non-utility property can be clearly identified. The answer is yes as those costs are shown in Kentucky American Water's response to the Public Service Commission's Third Data Request, Item 31.

The last Delta question is whether or not the purchase will result in overall benefits in the financial and service aspects of the utility's operations. Again, the compelling answer is yes. The customers in the Tri-Village and Elk Lake areas now have the benefit of American's Call Center, production expertise and planning. As a regional water supplier Kentucky American Water has a legal mandate and a social responsibility to assist in the effort to provide a dependable, potable water supply as far as economics will allow. The requested acquisition adjustments are reasonable and should be approved as was the same request for the acquisition of the assets of the Boonesboro Water Association in Case No. 2000-120.

C. CONSTRUCTION WORK IN PROGRESS

Kentucky American Water has requested the inclusion in rate base of \$6,124,953 of construction work in progress.²⁸ \$5,960, 428 is attributable to the Central Division and \$164,525 to the Tri-Village area. Revising the request for "construction slippage"

²⁸ Filing Exhibit No. 37, Schedule B-1, p. 2.

produces \$5,529,656 of construction Kentucky American Water will make during the forecasted test year on a 13-month average basis.²⁹

The Attorney General has objected to the inclusion of CWIP in rate base, arguing that it violates the regulatory principal of intergenerational equity. The argument is fallacious simply because the rates in a forecasted test year are based upon the costs in the forecasted test year and the rates are set to provide a return during that 12-month period. Additionally, the Attorney General argues that the company is achieving a significant benefit through the use of a forecasted test year and should not be afforded this additional benefit.

Construction work in progress has been allowed in Kentucky American Water's rate base in every case it has filed using a forecasted test year.³⁰ Given the historical precedent the personal feelings of the Attorney General's witness are non-persuasive. Kentucky American Water's filing contains an offsetting adjustment of AFUDC above the line for ratemaking purposes. The inclusion of CWIP in rate base with AFUDC above the line properly matches invested capital and rate base during the forecasted test year. No investor can be expected to make an investment exceeding \$6,000,000 in a forecasted test period without receiving an appropriate return during that same period. That is the fundamental principle of cost based ratemaking. The elimination of the CWIP from rate base would result in the anomalous situation of the capital structure exceeding rate base without an appropriate reduction in the short-term debt component of the capital

²⁹ PSC Data Request No. 2, Item 115 attachment.

³⁰ \$1,970,366 was allowed in Case No. 92-452 by Order dated November 19, 1993, at p. 22. \$2,802,902 was allowed in Case No. 95-554 by Order dated September 11, 1996, at p. 25. \$3,831,347 was allowed in Case No. 97-034 in p. 29 of the final Order in that case. \$4,963,029 was allowed in Case No. 2000-120 by Order dated November 27, 2000, at p. 33.

structure because short-term debt is used to finance construction. Removal of any short-term debt in the capital structure during the forecasted test year simply makes the overall cost of capital higher.

D. CASH WORKING CAPITAL

Kentucky American Water proposed working capital of \$2,433,000 for the Central Division, \$56,000 for the Tri-Village area, and \$6,000 for the Elk Lake area.³¹ The Attorney General has proposed an adjustment to the company's presentation. Two items included in the Attorney General's proposed adjustment are inappropriate and inconsistent with this Commission's history.

One of the changes proposed by the Attorney General is a significant change in the lag days for the service company bill from 1.3 days to a proposed 12 days. The argument is that Kentucky American Water's lag reflects payment in advance of the midpoint of the service period resulting in prepayment of charges that are essentially driven by personnel costs. As pointed out in the rebuttal testimony of James E. Salser, the basic assumption upon which this proposed adjustment is based is simply not true. The service company bill, always reflected at its costs, include a number of expenses that it incurs that are not personnel related. Examples are space rent, office equipment and computer rental, software maintenance, leased telephone lines and the payment of group insurance. The alleged correlation between personnel costs at the service company and personnel cost of Kentucky American Water simply does not exist and the proposed adjustment should be disallowed.

³¹ Filing Exhibit No. 37, Schedule B-5.2, p. 4.

Additionally the Attorney General has proposed the elimination of depreciation expense from the cash working capital claim. The argument is made that depreciation expense is not a cash outflow by the company and only items for which actual out-of-pocket cash expenditures should be included. Again, this is not a new argument put forth by the Attorney General. The same argument was made in Case No. 92-452 wherein the Commission characterized the argument made by the Attorney General and the LFUCG as recommending “exclusion of any expenses not requiring a cash payment.”³²

There can be no better response than that enunciated by the Commission in that case:

“The AG/LFUCG are correct that depreciation, amortization and deferred taxes are non-cash items, but non-cash items can produce a need for cash working capital. Depreciation expense does not require a cash payment, although cash was expended at the time the property was acquired, and the recorded depreciation is used to offset the investment in property even though it is yet to be received from the customer through rates. [Citation omitted.] The same applies to amortization and deferred taxes.

Theoretically, net earnings are earned when customer service is provided, and become the property of the stockholders. This requires that a cash working capital requirement should be recognized for the lag and receipt of operating income. [Citation omitted.]³³

The inappropriate elimination of depreciation expense reduces Kentucky American Water’s claim by \$691,025 and for the service company lag the reduction is \$142,000, for a total inappropriate rate base adjustment of \$833,025. The Attorney General’s adjustment should therefore be \$870,176 from the original proposal of

³² Case No. 92-452, Order dated November 19, 1993, p. 19.

³³ Case No. 92-452, Order dated November 19, 1993, pp. 19-20.

Kentucky American Water resulting in a cash working capital requirement of \$1,624,824 added to rate base.

E. DEFERRED DEBITS

(1) **Security Costs.** Kentucky American Water has proposed the inclusion in rate base of a deferred debit for security costs having an average balance in the forecasted test year of \$2,665,378.³⁴ Kentucky American Water has proposed a 10-year recovery of expenditures in the original amount of \$2,805,661.79. A return of and on this required expenditure is necessary and appropriate.

The post 9-11 era is new to America because we now constantly face the threat of future terrorist attacks. The announced intention of terrorists to target America's critical infrastructure system cannot be ignored. Among all the utility infrastructure systems the treatment and distribution of potable water has the most impact upon health and welfare. Water consumers have a right to expect, and the Public Service Commission has a right to demand, that Kentucky American Water has made its service as safe and reliable as possible. The Commission's regulations require a water purveyor to make "all reasonable efforts to prevent interruptions of service. . . ."³⁵

The direct testimonies of Mr. Bruce Larson and Dr. Kenneth Rubin detail the evolution of the protective measures employed by Kentucky American Water, and their attendant costs, from September 12, 2001 to the date of the filing of this case. The evolution of the protection of the system was necessary because prior to 9-11 utility security was focused on natural disasters, vandalism, and potential contamination. Overt

³⁴ Work Paper 1-12, p. 3.

³⁵ 807 KAR 5:066, Section 4(1).

terrorism, designed to instill fear and kill or harm innocent people, was not the primary focus. The immediate response was clear—armed law enforcement personnel with arrest powers were required to protect the integrity of the assets. Representatives of Kentucky American Water talked to the then Governor about providing National Guard assistance or state police to protect the integrity of the source of supply to no avail.³⁶ It is difficult to understand why the state government was not interested in protecting its property (Kentucky American Water’s main source of supply) and it is understandable that Kentucky American Water was not enamored of the response. Kentucky American Water naturally turned to the local government and utilized off-duty LFUCG policemen to protect the primary source and both treatment plants. This period of “active” protection extended until the company was comfortable with the “passive” protection measures it had been able to implement.

The initial protection afforded by off-duty LFUCG policemen was at a very advantageous cost to Kentucky American Water. The charges were for the actual hourly rate for the off-duty policemen and the time involved by the coordinator at the police department. All benefits payable to policemen for the LFUCG were not charged to Kentucky American Water and obviously represent a considerable cost to the government. This fiscal arrangement continued until the local government decided that it could no longer afford to continue on that basis. Simply charging for the basic hourly rate for the off-duty policemen ignored the other costs to the LFUCG commensurate with higher wages for the individual policemen. On or about April 1, 2002, a little more than five months after 9-11, the LFUCG informed Kentucky American Water that it could no

³⁶ Transcript of Evidence, Vol. I, Mr. Richard C. Svindland, p. 44.

longer absorb the cost it was incurring. Being absolutely convinced that the presence of uniformed, armed policemen in well-marked vehicles was necessary, Kentucky American Water contracted privately for the continued surveillance of its facilities through Alliance Staffing. The interjection of a third party in lieu of the government understandably had three financial consequences: (i) Kentucky American Water now was going to have to pay the “full cost” of policemen and not just their basic hourly off-duty rate, (ii) the third party would have costs it would need to recover, and (iii) the third party would be entitled to a reasonable profit.

As the evolution of protection continued, in approximately the middle of August, 2003, Kentucky American Water determined that it was prudent to use guards supplied by a guard service, Murray Guards. This evolution was possible only because Kentucky American Water had been able to make capital investments during the timeframe to appropriately protect its assets and to monitor in a more comprehensive fashion the quality of potable water.

Phase One (direct contract with the LFUCG) per hour cost was \$26.91.³⁷ Phase Two (third party contracting) cost rose to \$51.00 per hour. The increase is easily understandable. If a third party is paying the basic off-duty hourly rate of \$26.91 on average, 55% of that basic hourly cost is a reasonable approximation of the costs of benefits.³⁸ Adding \$14.80 (55% of \$26.91) as the new cost to be required undertaken by Kentucky American Water results in a basic hourly cost with benefits of \$41.71. Adding a reasonable cost for the insurance acquired by Alliance Staffing, its internal costs, and a

³⁷ Direct Testimony, Dr. Kenneth I. Rubin, p. 15, line 17.

³⁸ Kentucky-American’s cost of benefits is 54.45%. See Exhibit No. 2, page 1, to Direct Testimony of Mr. Coleman D. Bush for the calculations of the activation fee.

reasonable profit easily gets the costs to \$51.00 per hour. Up until the transition to Murray Guards, Kentucky American Water had no reasonable choice other than contracting directly with the LFUCG as long as it could and then through a third party for the provision of the same service.

Kentucky American Water produced Dr. Kenneth I. Rubin to do basically two things, evaluate the reasonableness of the quality of the response to 9-11 and the reasonableness of the costs. His conclusions are clear—“...off-duty police guards represent a reasonable, immediate security shield since they provide potential deterrents, detection, delay and response capabilities.”³⁹ Dr. Rubin also reviewed the other security costs incurred by Kentucky American Water and found them to be reasonable.⁴⁰

It is entirely appropriate to measure Kentucky American Water’s deferral request by security costs incurred by other water companies. Dr. Rubin did that in Schedule 7 to his direct testimony. He drew three conclusions from his comparison:

- (1) The “best fit line” for the 16 water utilities data suggests that Kentucky American Water would have spent \$9.75 per capita for security costs. The actual expenditure was \$10.72 per capita.
- (2) The average among all 16 companies was \$11.83 per capita. Kentucky American Water’s expenditure of \$10.72 per capital is significantly less.
- (3) Since it is fundamental that water utilities achieve economies with size, Dr. Rubin reviewed the expenditures by quartile. Kentucky American Water’s expenditure put it in the third quartile by size wherein the average expenditure was \$9.37 per capita. Kentucky American Water’s expenditure of \$10.72 per capita is certainly within reason.

³⁹ Direct Testimony, Dr. Kenneth I. Rubin, p. 15.

⁴⁰ Id., p. 16.

Kentucky American Water's expenditures for security costs prior to the filing of this case were reasonable in amount and absolutely necessary. Recovery of and on the expenditures should be allowed.

The earliest pronouncement on utility recovery of security costs was that promulgated by the Federal Energy Regulatory Commission on September 14, 2001. In Docket No. PL01-6-000 the Commissioners wrote:

“The Commission is aware that there may be uncertainty about companies' ability to recover the expenses necessary to further safeguard our energy infrastructure, especially if they are operating under frozen or indexed rates. In order to alleviate this uncertainty, the Commission wants to assure the companies we regulate that we will approve applications to recover prudently incurred cost necessary to further safeguard the reliability and security of our energy supply infrastructure in response to the heightened state of alert. The companies may propose a separate rate recovery mechanism, such as a surcharge to currently existing rates or some other cost recovery method.”

On November 28, 2001, Kentucky American Water filed with the Public Service Commission its Asset Protection Charge Tariff designed to recover on a monthly basis the total costs incurred since the last general rate case for the protection of assets. This request was subsequently assigned Case No. 2001-00440. Without any decision having been made in Case No. 2001-00440, on May 30, 2002, the Commission entered an Order in Case No. 2002-00018, commonly referred to as the Change of Control of Kentucky American Water, containing Condition 2 subsequently accepted by the applicants. That condition is:

“KAW will, within 10 days of the date of this Order, withdraw its proposed Asset Protection Charge Tariff that is currently the subject of review in Case No. 2001-00440 [footnote omitted] and will not for 5 years from the date of

this Order apply to the Commission for recovery of costs associated with the protection of water utility assets **except through adjustments in its general rates for water service.**” (Emphasis added.)

In conformity with its acceptance of this condition, on June 10, 2002, Kentucky American Water withdrew its Asset Protection Tariff.

The condition is clear and there can be no reasonable interpretation other than Kentucky American Water could, as it has done herein, seek recovery of cost associated with the protection of water utility assets as an adjustment in its general rates for water service. Had the Commission intended that Kentucky American Water could not seek recovery of its security costs for five years after May 30, 2002, the highlighted phrase as an exception thereto would not have been added to the condition.

By its Order dated November 27, 2000, in Case No. 2000-120, the Commission directed Kentucky American Water to “formally apply for Commission approval before accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense in previous rate case proceedings. The Commission will consider each expense independently and with particular regard to materiality.”

In conformity therewith on September 6, 2001 and September 24, 2003, Kentucky American Water, by formal letter, requested the Commission’s approval for the establishment of regulatory assets to accrue acquisitions, preliminary service and design, tank painting, sludge removal, customer service consolidation (Call Center), financial service consolidation (Shared Services) and security costs.⁴¹ By letter dated October 15,

⁴¹ Initially Kentucky American Water sought the accrual of its condemnation costs which was subsequently withdrawn.

2003, the staff of the Public Service Commission addressed the two requests contained in the letter of September 24, 2003 (security cost and condemnation cost) and denied them. The other requests were not addressed. The request for accruing security cost was denied with a strained interpretation of Condition 2 of the Order in Case No. 2002-00018. The request for accrual of condemnation cost was denied and not appealed by Kentucky American Water. In response to the invitation extended in the letter of October 15, 2003, denying the accrual of security costs, Kentucky American Water asked by letter dated November 18, 2003, for the staff's reconsideration of that position.

That letter is attached to Kentucky American Water's application, subsequently assigned Case No. 2003-00478, and is Exhibit D attached thereto. The request for approval of a deferral at that time was not a request for "recovery of costs" as prohibited by Condition 2 within five years, except in an application for a general increase in rates. In support of its position that the approval of deferrals of security costs was not a request for recovery of costs, Kentucky American Water cited pronouncements of the Missouri Public Service Commission, the Idaho Public Utilities Commission, the Pennsylvania Public Utility Commission, and the West Virginia Public Service Commission. All of the cited commissions approved the deferral of security costs on the books of the respective companies. The approval allows the affected company to book the expenditure as a regulatory asset rather than an expense which improves the financial picture of the affected company during the deferral period.

The application of Kentucky American Water in Case No. 2003-00478 was not decided by the Commission and by Order herein on June 7, 2004, was consolidated into this case.

In conformity with the directive in its last rate case Kentucky American Water has indeed applied to the Commission for approval of accruing the expenses requested herein as regulatory assets.

The Iowa Utilities Board on February 21, 2002, by Order approving an Amended Settlement Agreement in Docket No. RPU-01-4, approved increased water rates for Iowa-American Water Company including “additional security costs deemed necessary to protect water supplies subsequent to the September 11, 2001, terrorist attacks in New York City and Washington, D.C.” The timing of the Amended Settlement Agreement is notable because the initial increase of Iowa-American Water Company was filed on April 17, 2001, and the initial Settlement Agreement was approved on August 20, 2001. The Amended Settlement Agreement, providing for the recovery of security costs, was approved six months later.

On January 16, 2004, the Pennsylvania Public Utility Commission considered the security recovery requests of Pennsylvania-American Water Company. The company claimed deferred costs to be amortized over five years and an ongoing annual cost. Several intervenors argued that the allowance of deferred security costs would constitute impermissible retroactive ratemaking. In approving the request for deferred security costs the commission said:

“An exception to the rule governing retroactive ratemaking is that the expenses are extraordinary and non-recurring. [Citations omitted.] The ALJ found the cost to be extraordinary, but he did not conclude that the costs were non-recurring. However, in our view, those costs do not constitute retroactive ratemaking because circumstances arose from an extraordinary and non-recurring event, namely, the terrorist attacks of September 11, 2001 . . .

We are convinced that the deferred costs do not connote retroactive ratemaking and that the costs were reasonable and prudently incurred.”⁴²

In Case No. 01-0326-W-42T, the West Virginia Public Service Commission directed West Virginia-American Water Company to defer its security costs in an order approving a settlement with date of December 21, 2001. After the case had been filed West Virginia-American requested rate treatment for additional security costs subsequent to September 11, 2001. The commission reasoned:

“The commission is concerned about the very real possibility of harm to the State’s utility infrastructure in light of the events of September 11, 2001. To this end, the commission sees the need for heightened security. The commission is also aware that heightened security may well lead to higher cost . . . the commission will consider the initial amount, carrying cost and timing of recovery of all security related cost that are unusual or extraordinary (as compared to costs that represent normal, historic operations) in the Company’s next rate case, we shall direct the Company to defer the actual cost of additional security.”⁴³

The Indiana Utility Regulatory Commission recently approved the request of Indiana-American Water Company for the inclusion of deferred security costs and ongoing annual expenses. The deferred security costs were amortized over a five-year period and in doing so the commission rejected the contention of the Indiana Office of Utility Consumer Counselor that the allowance of deferred security costs would constitute retroactive ratemaking.

“We first address the retroactive ratemaking issue raised by the Public. Security measures benefit the ratepayers at the

⁴² Opinion and Order, Pennsylvania Public Utility Commission, Case No. R-00038304, January 16, 2004, pp. 47-48.

⁴³ Case No. 01-0326-W-42-T, Public Service Company of West Virginia, Order dated December 21, 2001, p. 11.

time they were expensed and going forward. The Commission hereby clarifies that the amortization of the deferred security expenses over a five (5) year period is authorized consistent with our December 30, 2003 Order in Cause No. 42029.”⁴⁴

The security expenses of Kentucky American Water were reasonable in amount, prudently incurred, extraordinary, and non-recurring and a return of and on the amount is appropriate and necessary.

(2) **Shared Services and Customer Call Center**. Kentucky American Water has requested the deferral of \$529,630 for Shared Services Center and \$542,835 for the Customer Call Center as the average balance for the forecasted test period to be amortized over a 10-year period.⁴⁵

The Attorney General’s objection to these requested deferrals is that the Commission has not granted deferral accounting treatment and therefore the inclusion in rates would constitute retroactive ratemaking.

Kentucky American Water has complied with the Commission’s directive and has sought the approval for the accounting of these requested accruals. These and other accruals are the questions in Case No. 2003-00478 which has been consolidated with this rate case by motion of the Attorney General and the Commission’s Order dated June 7, 2004. There is no requirement or directive to Kentucky American Water that the Commission will allow deferrals in ratemaking only if they have previously been approved by the Commission. The only directive is that Kentucky American Water should apply for deferrals which it has done.

⁴⁴ Cause No. 42520, Indiana Utility Regulatory Commission, Order dated November 18, 2004, p. 120.

⁴⁵ Work Paper 1-12, p. 3.

Again, the Attorney General has objected to the inclusion of a deferral in ratemaking arguing that it constitutes retroactive ratemaking. The argument is made without any supporting authority. The concept has been dealt with recently by the Pennsylvania Commission and the Indiana Commission in granting deferrals of security costs. It is interesting to note that the Attorney General does not object to the inclusion of deferrals for ratemaking purposes in this case that have previously been approved by the Commission.

It is difficult to understand why any objection would be made to the inclusion of these deferrals for ratemaking when the establishment of the Shared Services Center and the Customer Call Center has resulted in a net savings to Kentucky American Water.⁴⁶ Exhibit MAM 5 to the direct testimony of Mr. Michael A. Miller was prepared for the forecasted test year showing the cost to Kentucky American Water for the enhanced and improved Southeast Region, the National Shared Services Center and the National Customer Call Center (\$1,634,746) and the forecasted test year amortization of the deferred costs as of the beginning of the forecasted test year (\$57,141 for the Call Center and \$55,751 for the Shared Services Center). Offsetting these costs in the forecasted test year are the labor and overhead cost savings as a result of the establishment of the Call Center shown on page 2 of the exhibit in the amount of \$533,690, other customer accounting expense savings to Kentucky American Water in the amount of \$264,245 shown on page 3, labor and overhead cost savings from the relocation of accounting functions in the amount of \$1,039,794 shown on page 4 and other savings from the accounting and financial expense eliminations in the amount of

⁴⁶ Direct Testimony, Mr. Michael A. Miller, Exhibit No. MAM-5, p. 1.

\$29,285 shown on page 5. The net savings is \$119,377 which obviously has been imbedded in this rate case. Since the customers have received a substantial benefit it would be manifestly unfair not to allow Kentucky American Water to recover the costs incurred in generating the benefit.

III. FORECASTED TEST YEAR REVENUES

A. RESIDENTIAL CONSUMPTION

Updated Exhibit 37, Schedule M-3.1 C, page 1, shows \$24,870,193 of anticipated residential revenue in the Central Division based upon 1,154,162 residential customer bills. For the Tri-Village area \$1,008,180 in residential revenue is anticipated from 19,823 residential customer bills and \$114,120 from 3,254 residential bills in the Elk Lake area.

The revenue was based upon the study by Dr. Edward L. Spitznagel, Jr. determining that month, drought index and years were predictive of residential customer consumption and looking at Kentucky American Water's data for seven years and one month he projected 165.42 gallons per day for residential consumption in the forecasted test year assuming normal weather.

Dr. Spitznagel has observed that the decrease in residential consumption appears to be 3.29 gallons per customer per day from 1997, assuming normal weather. He also has observed that 84% of this decrease appears to be caused by water-conserving appliances.⁴⁷ This continuing decrease in customer consumption must be observed in forecasting revenues.

⁴⁷ PSC Data Request No. 2, Item 49.

Without any effort to statistically correlate consumption with normal weather, the Attorney General recommends the use of 174.68 gallons per day per residential customer. This is an increase of 5.6% above the consumption predicted by Dr. Spitznagel. The basis for the Attorney General's guess is the averaging of two numbers—residential consumption during the period December 2000 through November 2001 and Dr. Spitznagel's projection for the forecasted test year. No rational basis for this mathematical exercise is presented other than historical residential consumption has been greater than it is projected to be in the forecasted test year. The Attorney General's witness agreed that "conservation is occurring and more efficient fixtures are being introduced."⁴⁸ The revenue impact of the Attorney General's exercise is extraordinary--\$1,095,293.⁴⁹

Not only is there an absence of a rational basis for the Attorney General's position but Dr. Spitznagel's projection is reasonable in view of historical consumption. Attached to the rebuttal testimony of James Salser as Exhibit JES-1 is historical consumption of the residential class for Kentucky American Water for six different time periods. In calendar year 2003 the residential consumption for Kentucky American Water's customers was 164.92 gallons per day, less than that projected by Dr. Spitznagel for the forecasted test year. The data in Mr. Salser's exhibit clearly shows that residential consumption for Kentucky American Water has been decreasing. To believe that forecasted residential consumption will increase almost 10 gallons a day from 2003 or 15 gallons a day from the base period strains credibility beyond the breaking point.

⁴⁸ Direct Testimony, Ms. Andrea C. Crane, p. 37.

⁴⁹ Direct Testimony, Ms. Andrea C. Crane, Schedule ACC-15, line 9.

B. COMMERCIAL CONSUMPTION

Base year updated information, Exhibit No. 37, Schedule M-3.1 C, T and E, pages 2 of each, shows \$13,047,621 of anticipated forecasted test year revenue for the commercial class of customers in the Central Division from 101,227 bills, \$38,298 in the Tri-Village area from 557 bills, and no commercial revenue in the Elk Lake area. The revenue was predicted using Dr. Spitznagel's commercial consumption of 1385.52 gallons per customer per day. As was done with residential consumption, the Attorney General's witness averaged Dr. Spitznagel's projected consumption and the company's last case which covered the period of time December 2000 to November 2001. There is no logic or mathematical basis for this process. As Dr. Spitznagel has pointed out, the decrease in commercial customer consumption appears to be 22.05 gallons per customer per day, assuming average weather. He observes that 79% of this decrease appears to be due to the introduction (new and replacement) of water-conserving appliances.⁵⁰

The arbitrary change by the Attorney General has an incremental revenue impact of \$753,187.⁵¹ There is no logical basis for this suggestion particularly when one considers that it is higher than the commercial consumption during calendar year 2002, 2003 and the base period.

C. RESIDENTIAL CUSTOMERS

Kentucky American Water has estimated the number of residential customers during the forecasted year to be 99,845 in the Central Division, 1,880 in the Tri-Village area and

⁵⁰ PSC Data Request No. 2, Item 49.

⁵¹ Direct Testimony, Ms. Andrea C. Crane, Schedule ACC-17, line 9.

344 in the Elk Lake area for a total of 101,969.⁵² This estimate is on the “high” side of reasonable when consideration is given to the fact that as of the end of October, 2004, Kentucky American Water had 99,299 residential customers⁵³ and it historically has added 2,500 customers annually.⁵⁴ The most currently available data, together with historical trends, suggests 101,799 (99,299 plus 2,500) residential customers for the forecasted year, 170 less than actually proposed. The Attorney General’s guess of 102,625 residential customers for the forecasted year is not based on any rational approach and should be rejected.

D. COMMERCIAL CUSTOMERS

Like he has done with residential customers, the Attorney General has over-estimated the number of commercial customers Kentucky American Water will have in the forecasted test year. The data sent to the Commission by letter of November 22, 2004, shows 8,178 commercial customers as of the end of October, 2004. Kentucky American Water believes that there will be 8,289 commercial customers in the forecasted year.⁵⁵ The Attorney General has guessed, without any basis in fact, that Kentucky American Water will have 8,482 commercial customers in the forecasted year, 193 more than are reasonable to predict. The difference is material and the quantity suggested by the Attorney General should not be adopted for rate making purposes.

⁵² Rebuttal Testimony, Mr. James E. Salser, Exhibit JES-1, page 1.

⁵³ Kentucky American Water’s statements and data filed with the Commission by letter of November 22, 2004.

⁵⁴ Rebuttal Testimony, Mr. James E. Salser, page 5.

⁵⁵ Rebuttal Testimony, Mr. James E. Salser, Exhibit JES-1, page 2.

IV. EXPENSES

A. SALARY AND WAGE ADJUSTMENTS

The Attorney General proposes two adjustments, one to remove three employees from the complement in the forecasted test year and another to remove 90% of Kentucky American Water's president and his assistant's compensation.

Neither proposal is reasonable. Implicit in this suggestion is the idea that the quantity of work to be done can be accomplished by less than a full complement of employees. That is true if, and only if, the less than full complement of employees work overtime to accomplish the required quantity of work or temporary employees are added to the payroll. The forecasted test year includes 14,899 hours of overtime, 69% of the 2004 overtime hours annualized from September 2004 of 21,740. The annualized 2004 estimate is a realistic number considering that 19,532.75 overtime hours were actually paid for in 2003. Additionally, for the first nine months of 2004, Kentucky American Water incurred \$120,060 in temporary labor expense but only \$90,872 has been included in the forecasted test year. The reduction of overtime hours and temporary labor expense in the forecasted test year implicitly assumes that the three vacancies will be filled consistently throughout the forecasted test year. It is much more efficient for the company to hire employees than to pay wages at 1-1/2 times the normal rate.

The Attorney General's proposal to eliminate 90% of the compensation for Kentucky American Water's president and executive secretary is based upon a misunderstanding of the direct testimony of Mr. Chris Jarrett. In his testimony at the hearing⁵⁶ Mr. Jarrett apologized for the "less than elaborate enough response" and

⁵⁶ Transcript of Evidence, Vol. III, p. 195.

explained that the then president of Kentucky American Water had been asked to do more than was appropriate. Mr. Jarrett recommended to the Executive Committee of the board that the preparation, meetings and attendance at rate hearings could not be added to the workload of Mr. Mundy and that he, Mr. Jarrett, would participate in the rate proceeding as the chief executive officer of the company. Any time that the president of Kentucky American Water has spent defending it in the condemnation action by the LFUCG has been in addition to the normal duties and responsibilities of that office. The workload has only increased as a result of the condemnation action and certainly there is no justification for a reduction in the expenses of the office because of an increased workload. Additionally, the publicity attendant to the most recent LFUCG council elections suggest the possibility of the new council terminating the condemnation action, which would make the otherwise illogical recommendation moot.

B. INCENTIVE COMPENSATION PLANS

Kentucky American Water proposed the inclusion of \$229,146 in the forecasted test year for incentive compensation.⁵⁷ These payments are spread out among 40 people in the Central Division, Elk Lake area and Tri-Village area.⁵⁸

The Attorney General has recommended that 60% of the annual incentive plan be allocated to the shareholders and a reduction to a three-year historical average for the setting of rates. The Attorney General recommends that the long-term incentive plan be totally disallowed for ratemaking purposes.

⁵⁷ Work Paper 3-1, p. 1.

⁵⁸ PSC Data Request No. 2, Item 52.

Averaging the benefits provided historically in the annual incentive compensation plan for use in a forecasted test year is nothing more than an arbitrary mathematical exercise designed to inappropriately reduce expenses.

The proposal to reduce 60% of the cost of the annual incentive plan because 60% of the potential award is based upon financial components assumes that the financial health of the company is in the best interest only of the shareholders. Nothing could be further from the truth. The financial viability of Kentucky American Water is as much an interest of the ratepayers as it is the shareholders. Without a viable financial entity to attract capital, meet unanticipated expenditures such as security costs and provide a basis for ongoing rehabilitation of infrastructure, customer service will deteriorate. Financial viability is necessary to allow the company to obtain debt at a reasonable cost.

The observations made by Schumaker & Company in its comprehensive management and operations audit of Kentucky American Water in 1991 remain true.

“Compensation packages should be competitive in order to *attract* and *retain* qualified individuals. The compensation must be sufficient to retain individuals who hold key positions in Kentucky-American at a time in their careers where they can be seriously courted by other companies. It is generally important to companies to maximize their investment in those individuals and maintain continuity in the leadership of their organizations . . . For a bonus program to work for Kentucky-American, it must be inclusive. The executives at American Water Works Service Company, the Southern Region office, and Kentucky-American should all be eligible.

While it may appear that the installation of a bonus program would result in significant cost to Kentucky-American, those must be balanced by the recruitment, hiring, and training cost associated with the replacement of a senior level employee. The amount of the increased cost would depend upon the type of bonuses and level of

availability. Some of the initial costs can be offset by reduced merit increases tied to base salary.⁵⁹

LG&E Energy is a Kentucky company shown as having executive and middle management participation in annual incentive plans shown in the Towers Perrin memorandum dated August 3, 2004, attached to Kentucky American Water's response to the Public Service Commissions Third Data Request, Item 36. The data base utilized by Towers Perrin shows that 99% of the companies surveyed maintain annual incentive plans for executives and 95% for middle management and professional participants. Kentucky American Water is not out of step with the maintenance of its plans, it is competitive with other regulated industries and the proposed expense should be included in the forecasted test year.

C. OTHER POST-EMPLOYMENT BENEFITS

The Attorney General has proposed a reduction in Kentucky American Water's OPEB expense of \$51,381. The explanation for this adjustment is the denial of Kentucky American Water's increase in its forecasted test year OPEB costs of 9% over the 2004 OPEB costs.

Towers Perrin determined Kentucky American Water's 2004 OPEB costs to be \$904,227 in its report attached to the response to Attorney General Data Request No. 1, Item 75. With the common knowledge that health care costs are increasing annually and dramatically, particularly for the age group covered by post-retirement benefits, Kentucky American Water increased the Towers Perrin cost estimate to the forecasted test year by 9%. This estimate of the increase in health care costs is reasonable according

⁵⁹ Schumaker & Company Management Audit of Kentucky-American Water Company, June, 1991, pp. 312-313.

to a recent article in the *Wall Street Journal*. “Meanwhile health-care costs are surging and are likely to go up by 8% or 9% per year over the next five years, according to Glenn Melnick, a professor of health-care at the University of Southern California.”⁶⁰

As support for the arbitrary adjustment proposed by the Attorney General, OPEB expenses from 1999 to 2003 were reviewed. There is variability in the historical analysis with a decrease from 1999 to 2000, an increase from 2000 to 2001, a slight decrease from 2001 to 2002, and a rather dramatic increase from 2002 to 2003. From 1999 to 2003 Kentucky American Water reduced its employee count by approximately 20 positions as a result of efficiencies achieved through regionalization and the establishment of the Call Center and Shared Services Center. The OPEB cost increase during this time frame would have been much greater had there not been a rather significant employee reduction. The jaundiced view taken by the Attorney General’s witness of the historical OPEB costs simply will not sustain, on any rational basis, his proposed adjustment. Kentucky American Water’s proposed increase from the 2004 level is reasonable, consistent with historical trends and should be approved.

D. WASTE DISPOSAL COSTS

As a part of the Attorney General’s proposed adjustment to Kentucky American Water’s waste disposal costs, the recommendation was made to change the recovery period to three years. The proposed change in timeframe should not be accepted.

As explained in the rebuttal testimony of Linda C. Bridwell, there are two items included in the waste disposal cost at the Richmond Road Station. Ongoing annual sedimentation removal costs are included along with a need for the removal of solids

⁶⁰ *Wall Street Journal*, December 27, 2004, p. 1.

from Lake Ellerslie which is adjacent to the Richmond Road Station. It is clearly anticipated, as Ms. Bridwell opines, that it will be necessary to annually remove solids from Lake Ellerslie.

E. MAINTENANCE EXPENSE

The Attorney General recommends an adjustment to the ongoing routine annual maintenance cost of Kentucky American Water. Kentucky American Water projects routine annual maintenance costs of \$972,706 in the forecasted test year. The Attorney General's witness averages costs from 2001, 2002 and 2003 and uses that adjustment, plus the estimated annual maintenance in the Tri-Village area for the forecasted test year. This consistent practice by the Attorney General of adjusting forecasted test year expenditures based upon averaging some historical period (not even the most recent historical period) is simply not appropriate and will not stand scrutiny.

The Attorney General's proposed maintenance expense for the forecasted test year is \$761,229, or over 15% less than that expended in 2001. As Ms. Bridwell testified in her rebuttal testimony, "as anyone knows who has worked in the operations of a utility, maintenance is the life blood of operations. Preventative maintenance is critical to reducing emergency costs and, more important, it is critical to preventing instances where our customers lose service. This is particularly true in the water production areas."⁶¹ The arbitrary reduction of Kentucky American Water's proposed ongoing maintenance expense is neither rational nor justified and exposes Kentucky American Water customers to unnecessary risks and should be denied.

⁶¹ Rebuttal Testimony, Ms. Linda C. Bridwell, p. 3.

F. REGULATORY EXPENSE

Kentucky American Water has proposed a three-year recovery of total rate case costs of \$622,049. Based upon a review of five previous cases, the Attorney General proposes an adjustment of \$70,000.

What the Attorney General's witness fails to realize in proposing this arbitrary adjustment is that Kentucky American Water's costs are higher in this case than in any previous case because of the time from the last case, the "new" issues present in this case and the more extensive discovery than has existed in any previous case.

Kentucky American Water's last rate case was concluded in 2000. All costs have gone up since that time, including expert witnesses, consultants and attorneys. Kentucky American Water anticipated issues in this case about security costs, Shared Services and the Call Center but there has been an extensive amount of discovery in unanticipated expenses involving the proposed income tax adjustment and the use of a hypothetical capital structure. As explained in the rebuttal testimony of Mr. Michael A. Miller, at page 41, Kentucky American Water will expend more than it estimated for this case and to adjust downward its initial estimate would not be appropriate, fair or reasonable.

G. BUSINESS DEVELOPMENT COST

Arguing that "The provision of regulated water service in a franchised service territory is not a competitive situation . . ." the Attorney General's accounting witness proposes to eliminate Kentucky American Water's proposed \$117,525 of expenses for business development in the forecasted test year.

First of all, the only area in which Kentucky American Water operates pursuant to a franchise is Fayette County, Kentucky. The remainder of its service area is located in

counties in the Commonwealth of Kentucky which are not permitted to require franchises from public utilities.

Secondly, the proposed adjustment is inconsistent with this Commission's previous regulation of Kentucky American Water. In Case No. 2000-120 Kentucky American Water was granted the full expenses of its business development employee. As a regional supplier of water and the most logical entity for the consolidation of water purveyors, Kentucky American Water not only is pursuing legislative mandates and Commission encouragements, but is attempting to obtain efficiencies through expansions. Existing customers benefit from acquisitions. These proposed costs are prudent, reasonable and have been allowed in the past.

H. CONSOLIDATED TAX ADJUSTMENT

For the first time in the history of the regulation of Kentucky American Water in the Commonwealth of Kentucky a witness for the Attorney General has proposed a consolidated federal income tax adjustment based upon a methodology described as "the effective tax rate methodology." Ms. Crane explains this methodology as allocating tax losses based on each individual company's percentage share of positive taxable income. She has used three years, 2000, 2001 and 2002, to reduce Kentucky American Water's federal income tax expense.

This unprecedented and unique approach required Kentucky American Water to obtain the opinion of Mr. James I. Warren, an attorney who specializes in the taxation of and tax issues related to public utilities. His rebuttal testimony makes it clear that the extraction of tax benefits from an entity that participates in the filing of a consolidated tax

return (a company that has an operating loss) and transferring that tax benefit to another entity in the “family” is a cross-subsidy.

The premise for the Attorney General’s proposal seems to be that a tax loss benefit generated by one member of the group should be shared by other members of the group. This is simply not logical and this Commission has never sanctioned nor imposed a federal income tax adjustment for any jurisdictional company.

As previously approved by this Commission, Thames Water Aqua US Holdings, Inc. is the corporate entity utilized to file the consolidated federal tax return which includes Kentucky American Water. There are obvious savings to Kentucky American Water’s customers from the costs attendant to filing a federal income tax return by participating in the consolidated tax return. However, as Mr. Miller testified at the hearing in this matter⁶² every year Kentucky American Water sends a check equal to 35% of its taxable income to the entity filing the consolidated tax return for the system and never gets back any refund. The advantage of a consolidated return is only to the entity that incurs an operating loss as the tax benefit attributable to that operating loss is given to that entity by the consolidated tax filer instead of postponing that tax benefit to loss carry-forward years.

As Mr. Warren points out in his rebuttal testimony⁶³ the imposition of a consolidated tax adjustment will preclude Kentucky American Water from earning its allowed rate of return because it is an imputed, not an actual, benefit. The only way to reflect the adjustment is to reduce revenues with absolutely no offsetting benefit. If all

⁶² Transcript of Evidence, Vol. III, p. 167.

⁶³ Rebuttal Testimony, Mr. James R. Warren, p. 16.

other revenue and expense items remain the same, diminished revenues mean nothing more nor less than a diminished return from that authorized.

The proposed adjustment is nothing like the state income tax adjustment proposed by Union Light, Heat and Power Company (ULH&P) in Case 2001-00092. Therein ULH&P itself proposed to use its effective Kentucky consolidated income tax rate which had the effect of increasing the federal tax liability by less than the reduction from the Kentucky statutory rate, a net savings to the utility. The Kentucky consolidated return of ULH&P was filed with companies under the Cinergy umbrella and the net taxable Kentucky income tax was calculated and apportioned to Kentucky on a weighted property, payroll and receipts factor. Companies were included in the Kentucky return that would not have filed a Kentucky return except that they were members of the Cinergy group. That is simply not the case with a federal consolidated return. All companies under the Thames Water Aqua US Holdings, Inc. umbrella are required to file a federal income tax return and they have elected to do that in a consolidated form. The sole determinates of tax liability for federal purposes are income and expenses; there is no prorating of property, payroll and receipts.

In the Order in Case 2001-00092, dated January 31, 2002, the Commission expressed doubt about the proposal when it said: “This is the first proceeding in which the Commission has considered the use of the effective, rather than the stated, Kentucky tax rate. The Commission has some concerns about using this approach....”⁶⁴

⁶⁴ Page 59 of the Order.

The proposed adjustment raises serious extra-territorial jurisdictional issues, is not consistent with previous regulation ⁶⁵, is not cost based, and automatically precludes any reasonable opportunity to earn the authorized rate of return and should be denied.

V. LOW INCOME DISCOUNT TARIFF

Kentucky American Water has proposed a 25% discount in the meter charge in the Central Division and in the initial blocks in the Tri-Village and Elk Lake areas. The discount would apply to any customer who is certified by the Community Action Council as having family income below the defined poverty level. The annual estimated cost to Kentucky American Water of the low income discount has been estimated at \$30,000.⁶⁶

The Attorney General's witness, Mr. Scott J. Rubin, does not recommend adoption of the proposed low income discount tariff because he has been "advised by counsel that it is not lawful for KAWC to adopt a special rate for a customer because of the customer's income."⁶⁷

Kentucky American Water does not believe that the proposed tariff is unlawful. Kentucky Revised Statute 278.030(3) provides that it may use "suitable and reasonable classifications" of its service, patrons and rates and may take into account "the nature of the use, the quality used, the quantity used, the time when used, the purpose of which used, and any other reasonable consideration." Kentucky Revised Statute 278.170(1) only prohibits the utilization of "any unreasonable preference or advantage" and the

⁶⁵ Any significant departure from previous regulation should be carefully considered in the context of an administrative case where all of the affected utilities have an opportunity to comment and the Commission can consider the potential effect on all of the entities under its jurisdiction.

⁶⁶ Direct Testimony, Mr. Michael A. Miller, p. 65.

⁶⁷ Direct Testimony, Mr. Scott J. Rubin, p. 9.

General Assembly has authorized the Commission to determine “any question of fact” in the determination of the reasonableness of a preference. The classification is reasonable, there is precedent in Kentucky and Kentucky American Water has historically contributed to the cost of the program.

There are two basic reasons justifying the low income discount tariff. First, Kentucky American Water is an integral part of its service territory and has a social conscience. Permanently discontinuing water service to the neediest customers is not an acceptable option because potable water is a necessity of life. Secondly, the assumed reduction in credit problems is a pragmatic and economic justification for the tariff. As the American Water Works Association Manual of Water Supply Practices, commonly known as the M1 Manual, says:

“When customers have trouble paying utility bills, the cost to the utility is manifested in increased arrearages, late payments, disconnection notices and service terminations. The associated increased collection costs and bad debt write-offs increase all of the customers’ bills.”

Kentucky American Water has, since 1999, had a “Water For Life Fund.” Since that time it has contributed \$36,047 to the Community Action Council to assist low income customers with the payment of water bills.⁶⁸

There is ample precedent in the Commonwealth of Kentucky for the establishment of the low income discount tariff. Columbia Gas of Kentucky, Inc. has a tariff imposing a \$0.0672 charge per 1,000 cubic feet for its Energy Assistance Program

⁶⁸ Transcript of Hearing, Vol. III, p. 24.

available to general service and small volume gas transportation service rate customers for November through March of each year who meet eligibility of requirements.⁶⁹

Louisville Gas & Electric Company and Kentucky Utilities Company both have Home Energy Assistance Programs recently approved by this Commission in Cases No. 2003-00433 and 00434 funded by a \$.10 surcharge per residential meter.

VI. ACCOUNT ACTIVATION FEE

Kentucky American Water has proposed an account activation fee of \$24.00⁷⁰ which is similar in principle to a reconnection charge for restoring service to an account that has been disconnected for nonpayment of a bill. However, this charge will apply exclusively to the initiation of new service or for a reconnection of existing services previously turned off or disconnected.

Again, the Attorney General's witness, Mr. Scott J. Rubin, does not support the proposed charge because he believes that it would fall most heavily on the low income customers. In support of this proposition he cites Federal Census Bureau statistics showing that households with lower incomes tend to move more often than households with higher incomes. While true, these statistics do not support the proposition set forth by the Attorney General because lower income families traditionally rent property and water service is usually in the name of the owner of the property. Additionally, as income increases families tend to increase the standard of living by moving into larger and more expensive homes.

⁶⁹ Columbia Gas of Kentucky, Inc. Tariff, Third Revised Sheet No. 51b.

⁷⁰ Calculated in Work Paper 2-4, p. 1.

The Attorney General's witness really seems to be saying that the cost of the provision of potable water service is regressive in nature. Kentucky American Water has attempted to ameliorate any regressive nature of water charges with extensive conservation programs and the low income discount it has proposed in this case.

There are specific, identifiable costs incurred by those customers who would be subject to the account activation fee. The services are "inside" and "outside." Each item is adequately described in Kentucky American Water's response to the Attorney General's First Data Request, Item 8. The tariff is estimated to generate \$672,000 per year⁷¹ and the allocation of this specific, identifiable cost to those causing it is consistent with the most elementary principle of ratemaking.

VII. EMERGENCY PRICING TARIFF

Kentucky American Water has proposed an emergency pricing tariff designed to reduce consumption during a recurrence of the drought of record.

On May 16, 2001, the Commission wrote a letter to all jurisdictional water utilities urging them to develop a water shortage response plan and specifically pointing out that "if water usage needs to be curtailed for an extended period of time, it may be necessary to include a penalty provision for customers who choose not to curtail their usage."⁷² Kentucky American Water's emergency pricing tariff puts its customers into three categories and deals with each category separately.

Residential base consumption is defined as the previous November through April consumption. Upon activation of the emergency pricing tariff residential consumption

⁷¹ Direct Testimony, Mr. Michael A. Miller, p. 65.

⁷² Letter of Thomas M. Dorman, Executive Director of the Public Service Commission, dated May 16, 2001, shown in Work Paper 2-5, beginning at p. 1.

above the base level but less than 25% above the base level would be priced at five times the tariff rate and consumption 25% above the base level would be priced at ten times the tariff rate. If residential consumption is more than 50% above the base rate for two successive meter readings, personal communication would be instituted between the company and the consumer. Three successive readings of consumption more than 50% above the base rate would result in the possibility of termination of service based upon 48 hours notice.

Commercial customers base consumption volume is defined as the previous 12 months consumption. Consumption above the base volume but less than 15% above that volume would be priced at five times the tariff rate and consumption greater than 15% above the base volume would be priced at 10% of the tariff rate. Consumption greater than 50% above the base rate would be dealt with the same way as residential consumption.

Industrial customers would be treated the same way as commercial customers except the base consumption period would be the previous May through October.

Other public authority and sale for resale customers would be treated the same way as commercial customers except the base period is the preceding 12 months.

The purpose of the tariff is to reduce consumption to 35,000,000 gallons per day during the drought and to maintain Kentucky American Water's financial integrity. The list of the Attorney General's objections to the imposition of this tariff ran from the absence of no billing system available and presumed lack of personnel for meter reading.

The rebuttal testimony of Coleman Bush, page 9, demonstrates that the cost to set up the billing system will be \$165,600. No one expects Kentucky American Water to set up a billing system for a tariff until it achieves Commission approval.

Kentucky American Water's response to the Public Service Commission's Third Data Request, Item 54, clearly shows that additional personnel would be required and the cost thereof to implement the program for meter reading.

The selection of base periods and the potential imposition of penalty provisions are designed to limit residential consumption to interior use equivalent to the previous winter (November through April), the commercial customers to the previous year, the industrial customers to the previous summer usage (May through October), and the other public authority and sale for resale customers to the previous 12 months. If customers limit their consumption to the defined base periods, the projected result will be pumpage of less than 35,000,000 gallons per day. The results are shown in Exhibit A attached hereto which is Kentucky American Water's projected consumption during the forecasted test year as shown in Work Paper 2-1, p. 8 of 25, adjusted for daily consumption per customer classification per base period.

The emergency pricing tariff is an integral part of Kentucky American Water's demand management plan and because it is abundantly clear that the source of supply problem is not going to be solved in the immediate future it should be approved by this Commission.

VIII. HYPOTHETICAL CAPITAL STRUCTURE

Kentucky American Water has proposed a 13-month average capital structure for the forecasted test year consisting of 3.719% short-term debt, 51.376% long-term debt,

3.78% preferred stock and 41.125% common equity.⁷³ This capital structure has been formulated with a careful consideration of the capital demands that will be placed upon it in the forecasted test year and the most efficient and cost-effective way to meet those capital demands. Kentucky American Water traditionally finances construction through short-term borrowings and when appropriate, considering costs, converts short-term borrowings to long-term debt. Included in the forecasted test year is a refinancing of the company's 6.79% long-term debt which matures September 1, 2005. The methodology of determining the capital structure for the forecasted test year comports with Commission regulations and is consistent with the approach taken in all of the previous forecasted test year cases of Kentucky American Water.

The Attorney General's cost of capital witness, Dr. J. Randall Woolridge, has proposed using a hypothetical capital structure for Kentucky American Water which is the average of the quarterly capitalization ratios in 2001, 2002 and 2003.

This hypothetical capital structure proposed by the Attorney General totally ignores the financing of \$14,000,000 of long-term debt in March, 2004, the refinancing of the \$5.5 million, 6.79% debt that matures in September, 2005, and retained earnings that have been generated in 2004 and will be generated through November, 2005. It does not reflect the current capital structure or the capital structure to be utilized during the forecasted test year and rates based thereupon will clearly be confiscatory.

The Attorney General's proposal is blatantly inconsistent and cannot be reconciled with this Commission's previous determination of a capital structure for Kentucky American Water in a forecasted test year. In Case No. 2000-120 the

⁷³ Filing Exhibit No. 37, Schedule J-1.1.

Commission approved Kentucky American Water's proposed 13-month average of the forecasted test year capital structure and said:

“In this case Kentucky-American filed a forecasted capital structure that is designed to meet capital requirements for the forecasted test year. The Commission recognizes that Kentucky-American's capital requirements continually change. When setting rates for a forecasted period, the most current information should be utilized to properly match rates with the cost of service. Since the application was filed, changes to Kentucky-American's projected capital structure have been noted. These changes should be reflected in the rates approved in this case.”⁷⁴

Interestingly, Dr. Woolridge does not contest Kentucky American Water's calculation of its 13-month average capital structure for the forecasted test year. He simply proposes a hypothetical capital structure which has never in fact existed with Kentucky American Water and which is not reflective of the capital needs in the forecasted test year.

IX. COST OF EQUITY

Kentucky American Water's expert witness, Dr. James H. Vander Weide, calculated Kentucky American Water's forecasted test year cost of capital in three separate ways. He used the discounted cash flow method, the ex ante risk premium method, and the ex post risk premium method. These methods produced a cost of capital of 10.7%, 11.4% and 11.4%. Dr. Vander Weide recommended a fair rate of return on common equity of 11.2%.

In sharp contrast is the Attorney General's witness, Dr. J. Randall Woolridge, who recommends a return on equity of 8.75% percent.

⁷⁴ Case No. 2000-120, Order dated November 27, 2000, p. 54.

Dr. Vander Weide used a quarterly discounted cash flow model for estimating the cost of equity because all companies in his proxy group pay dividends quarterly. The market price that investors are willing to pay for the stock in the proxy group reflects the expected quarterly receipt of dividends. Dr. Roger A. Morin agrees.

“But because dividends are normally paid quarterly, the investor’s required return should be assessed with a DCF model that recognizes quarterly payments.”⁷⁵

The discounted cash flow model requires an estimate of future growth. Dr. Vande Weide used analyst’s estimate of future earnings per share reported by I/B/E/S and Value Line. In sharp contrast the Attorney General’s expert witness utilized historical dividend rates. Again, Dr. Vande Weide’s approach is confirmed by Dr. Morin:

“In any event, the use of the DCF model prospectively assumes constant growth in both earnings and dividends. Moreover, there is an abundance of empirical research that shows validity and superiority of earnings forecasts to estimate the cost of capital Published studies in the academic literature demonstrate that growth forecasts made by security analysts represent an appropriate source of DCF growth rates, are reasonable indicators of investor expectations, and are more accurate than forecasts based on historical growth Thus, both empirical research and common sense indicate that investors rely primarily on analysts’ growth rate forecasts rather than historical growth rates alone.”

In applying the incorrect discounted cash flow model, Dr. Woolridge used two proxy groups, five small water companies and four large water companies. His segregation of the companies reported in C. A. Turner’s monthly reports was based upon a division of annual revenues of \$100,000,000 with the requirement that the sale of water needed to contribute 80% to the revenue stream. After examining the two proxy groups

⁷⁵ Regulatory Finance, p. 183.

he concluded that the small water company group was most appropriate to use. The small water company group is hardly comparable—the average common equity ratio is 45.8% contrasted with the proposed 41.125% common equity for Kentucky American Water in the 13-month averaging of the capital structure for the forecasted test year. Of equal importance is the fact that only two of the five small water companies selected by Dr. Woolridge are followed by Value Line. The utilization of these small, thinly traded and not widely followed proxies means that investors' expected growth rates for the companies are simply not available.

For exactly these reasons the Florida Public Service Commission concluded it was appropriate to use an index of natural gas distribution utilities in the application of a DCF and CAPM models to determine a leveraged authorized range of return for common equity of water and wastewater utilities.⁷⁶

In updating the adopted approaches on June 10, 2004, the Florida Public Service Commission determined that the range of return on common equity for water and wastewater utilities in the state of Florida should be 9.10% for companies with 100% equity and 11.4% for companies with 40% equity.⁷⁷ The leveraged formula adopted by the Florida Public Utilities Commission was 7.57% plus 1.533 divided by the equity ratio. For Kentucky American Water, were it in Florida, the authorized return on common equity would be 11.3%.⁷⁸

Dr. Woolridge also utilized the Capital Asset Pricing Model to arrive at a projected cost of capital of 6.97% using the small water companies as proxies and 7.01%

⁷⁶ Order No. PSC-01-2514-FOF-WS, Docket No. 010006-WS, December 24, 2001.

⁷⁷ Order No. PSC-04-0587-PAA-WS, Docket No. 040006-WS, June 10, 2004.

⁷⁸ 7.57% plus 1.533/.41125 equals 11.3%.

using the large water companies as proxies. For his risk-free rate of interest, Dr. Woolridge used the yield to maturity of 10-year United States treasury notes. For his estimate of company-specific risks (Beta), he used the average Value Line Betas for his proxy companies. For his estimate of the expected return on the market portfolio he used 3.8%.⁷⁹ This flawed use of the CAPM cannot be accepted. Investment in the common stock of a public utility is a long-term expectation. The yield to maturity on long-term treasury bonds should have been used instead of that on 10-year treasury notes. As Dr. Vande Weide pointed out in his rebuttal testimony, at pp. 12-13, the Derig and Orr Study did not endorse a 4% risk premium used by Dr. Woolridge. Lastly, the 3.8% market risk premium allegedly built upon the Ibbotson-Chen Study is inappropriate because (1) Dr. Woolridge estimated a lower rate of inflation than done in that study, (2) he failed to recognize that the arithmetic mean risk premium should be utilized rather than the geometric mean risk premium to forecast future equity returns, and (3) Ibbotson Associates recommends a risk premium equal to 7.2% over the yield to maturity on 20-year treasury bonds. Utilizing the appropriate values in the CAPM, Dr. Woolridge would have obtained an equity cost for Kentucky American Water of 13.5%.⁸⁰

Dr. Woolridge's recommendation for the cost of capital of 8.75% in the forecasted test year cannot pass a test of reasonableness for the following reasons:

(1) The latest award for any of the water companies utilized by Dr. Woolridge in the C. A. Turner monthly reports is that for Artesian Water Resources. The allowed return on equity was 10.5% by Order dated April, 2003.

⁷⁹ Dr. Woolridge used the average of 4% ex ante expected equity risk premiums from the Derig and Orr Study and an ex ante expected equity risk premium using Ibbotson and Chen's "building blocks methodology."

⁸⁰ Rebuttal Testimony, Dr. James H. Vander Weide, p. 14.

(2) If Kentucky American Water were located in Florida, the rate of return per Order No. PSC-04-0587-PAA-WS would be 11.3%.

(3) In June, 2004, this Commission awarded Kentucky Utilities Company and Louisville Gas & Electric Company 10.5% return on equity. Of particular interest is the recommendation of the Attorney General's cost of capital witness in those cases, 10% to 10.25% return on equity without the presence of the Earnings Sharing Mechanism. In both cases, the percentage of common equity (KU at 51.58% and LG&E at 48.6%) would suggest that Kentucky American Water at 41.125% for the forecasted test year is riskier. The relative risk can also be measured by the amount of investment required to produce a dollar of revenue. Based on the December 31, 2005 data for Kentucky American Water, it takes \$3.05 invested to return a dollar of revenue.⁸¹ It only takes \$2.07 of investment to produce a dollar of revenue for Louisville Gas & Electric Company and \$1.97 of investment to return a dollar of revenue for Kentucky Utilities Company.⁸²

(4) The *Public Utilities Fortnightly* edition of November, 2004, surveyed all of the equity awards from October 1, 2003 through September 15, 2004. Not one single reported return (none were water companies) are close to the Attorney General's recommended 8.75%. The lowest reported return was 9.6% for Rochester Gas & Electric Corp., the highest is 12.7% for Wisconsin Electric Power and the average of the 52 reported companies was 10.67.

⁸¹ Rate base of \$158,034,342 with projected '05 revenues of \$51,778,000.

⁸² From the June 30, 2004 Orders, KU's rate base was \$1,400,591,637 and its annual revenues were \$710,376,288. LG&E's rate base was \$1,506,088,444 with associated revenues of \$726,815,085.

(5) The current average return on equity of Kentucky American Water's sister companies is 10.29% with the range from 9.75% to 11.00%.⁸³ The average of the returns on equity for those six companies that had a return on equity authorized in 2004 is 10.18%. It is extremely doubtful that any of its sister companies face a capital expenditure to remedy a source of supply problem like that faced by Kentucky American Water.

X. CONCLUSION

Kentucky American Water last had a rate increase on November 27, 2000—more than four years ago. Since that time it has made a continuing commitment to its service area, has provided significant assistance to other purveyors in the Commonwealth and has delivered quality water that met or exceeded all regulatory standards. Since November 27, 2000, the ratepayers have been the beneficiaries of rates that have become lower than reasonable for a long time and now the financial condition of Kentucky American Water must be restored by an increase in rates that is fair, just and reasonable.

Respectfully submitted,

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⁸³ Rebuttal Testimony, Mr. Michael M. Miller, Exhibit MAM-3.