

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:)
)
NOTICE OF ADJUSTMENT OF THE RATES OF) **CASE NO. 2004-00103**
KENTUCKY-AMERICAN WATER COMPANY)
EFFECTIVE ON AND AFTER MAY 30, 2004)

REPLY OF KENTUCKY-AMERICAN WATER COMPANY
TO ATTORNEY GENERAL'S BRIEF

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 11, 2005; that the Public Service Commission and other parties participating by electronic means have been notified of such electronic transmission; that, on January 11, 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 11, 2005, one (1) copy in paper medium will be served upon the following via U.S. Mail:

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OPERATIONAL OVERVIEW

The Attorney General characterizes Kentucky American Water’s business as “stable” and asserts that its use of a forward test period for ratemaking together with weather normalization of residential and commercial sales “minimize(s) risks.”¹

Kentucky American Water has financial risks the Attorney General conveniently ignores. The capital intensive nature of the water business compared to other utilities, the increasing cost of regulatory requirements for water quality, the level of its common equity and the projected cost to solve the source of supply problem are risk factors that must be considered by the Commission. The enormity of Kentucky American Water’s construction budget, particularly if one considers the resolution of the source of supply, is a significant risk. As Dr. Roger A. Morin says:

“Construction Risk. Construction risk is an important component of financial risk. If a company has a large construction budget in relation to its size, that company

¹ Attorney General’s Brief, p. 2.

requires substantial external financing in the immediate future. It is imperative that the company has access to needed capital funds on reasonable terms and conditions. A regulated utility is even more susceptible to construction risk than an unregulated company. An unregulated company has more discretion and latitude in scheduling and deferring capital projects. A utility, because of its mandated obligation to serve, does not possess the same flexibility. The problem is compounded for a regulated company that must secure funds from capital markets in order to fund new construction commitments, irrespective of capital market conditions, interest rates conditions, and quality consciousness of market participants.”²

UTILITY PLANT ACQUISITION ADJUSTMENTS

In arguing that Kentucky American Water’s requested acquisition adjustments for the Tri-Village system and the Elk Lake system should be denied, there is a complete failure to justify the requests in terms of the Delta Natural Gas Case No. 9059 requirements. Kentucky American Water justified the requested adjustments through extensive discovery and analysis in this case and the fundamental fact remains that each system needed the professionalism of Kentucky American Water. The Tri-Village board was unwilling to sell its assets unless it could retire its debt, and Kentucky American Water has requested that the acquisition adjustments apply only to the customers in the Tri-Village and Elk Lake areas rather than the whole body of ratepayers as suggested by the Attorney General. However, Kentucky American Water has no objection to the Commission proceeding with single price tariffing for all of its customers in a more expeditious manner than suggested by Kentucky American Water herein.

² Regulatory Finance, pp. 42-43.

**CONSTRUCTION WORK IN PROGRESS AND
HYPOTHETICAL CAPITAL STRUCTURE**

Kentucky American Water joins these two subjects together because the Attorney General's suggestion for each of them violates the most fundamental principle of ratemaking in a forecasted test year—the utility should be awarded rates utilizing the capital structure to be used in the forecasted test year for the provision of water service.

Kentucky American Water has carefully and with considerable thought produced the 13-month average capital structure it will use in the forecasted test year considering a debt refinancing which has occurred since the last rate case, a debt refinancing to occur before the end of the forecasted test year, and the impact of retained earnings. The only reasonable capital structure upon which to base rates is the one that must be used to fund the construction planned during the forecast test year and rates should be granted allowing the planned construction and the capital necessary to support it.

DEFERRED DEBITS

Kentucky American Water has addressed the propriety, reasonableness and necessity of the inclusion of its requested deferred debits but feels compelled to comment upon the Attorney General's recommendations that the deferred debits for the Service Center and Call Center should be denied.

The Attorney General has chosen to completely ignore Kentucky American Water's compliance with Statement of Financial Accounting Standards No. 71 in that it has "written off" the Shared Services and Call Center costs until savings have been achieved for its customers and now that savings are achieved on an annual basis the costs must be likewise included. To do otherwise would be to allocate the savings to the customers without a recognition of the cost to achieve those savings.

RESIDENTIAL AND COMMERCIAL REVENUE

Among other non-persuasive arguments the Attorney General suggests that Dr. Edward Spitznagel's correlation of forecasted test year revenue and commercial sales to normal weather should be ignored because Kentucky American Water's Strategic Business Plan projected a different level of consumption. The Attorney General conveniently forgets or ignores the fact that Kentucky American Water's Strategic Business Plan was formulated in July, 2003, long before it had acquired Dr. Spitznagel's sophisticated analysis.

CONSOLIDATED FEDERAL INCOME TAX ADJUSTMENT

Kentucky American Water set forth its position on the Attorney General's proposal for a federal income tax adjustment in its Brief. However, it is necessary to accurately describe the proposed adjustment as the description contained in the Attorney General's Brief is not accurate.

The fundamental inaccuracy of the Attorney General's suggestion is contained in this sentence:

"The filing of a consolidated return allows the group to take advantage of tax losses experienced by other member companies who file on the same consolidated tax group in determining tax liability."³

This statement is simply incorrect when applied to the process that involves Kentucky American Water. The only advantage achieved in the filing of a consolidated tax return is that a participant with an operating loss currently receives the benefit of that loss instead of a tax loss carry forward. The Attorney General has never taken exception, and could not, with the fact that Kentucky American Water pays the federal statutory tax

³ Attorney General's Brief, p. 25.

rate on its operating income and receives absolutely no monetary benefit from its participation in the consolidated return other than the reduced cost of the preparation of the return.

To carry its logic forward the Attorney General is forced to make two other serious misstatements—(1) Kentucky American Water has a “windfall” from the consolidated return, and (2) Kentucky American Water’s effective tax rate is lower as a result of the consolidated tax return. Neither are true. Kentucky American Water receives no windfall; it pays the federal statutory tax rate on its taxable income, and receives no monetary benefit or any other kind of benefit. There simply is no “windfall.” Lastly, the “effective tax rate” is the product of a mathematical calculation and has no existence in reality. If Kentucky American Water paid a tax rate on its taxable income other than the federal statutory rate, it will be entitled to include only that rate in its cost of service; however, its effective tax rate is the federal statutory rate paid by it.

RETURN ON COMMON EQUITY

In continuing to insist that 8.75 is a reasonable return on common equity, the Attorney General fails to “benchmark” the reasonableness of that recommendation. The failure is understandable; it cannot be benchmarked as anything other than unreasonable. The Attorney General acknowledges that the recommendation is lower than past awards.⁴ As Kentucky American Water pointed out in its Brief, the recommendation is significantly lower than the Attorney General’s recommendation for the return on equity in the rate cases of Kentucky Utilities Company and Louisville Gas & Electric Company. Additionally, the Attorney General seems to be confused about the proper application of

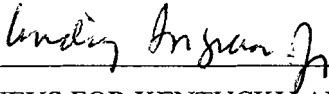
⁴ Attorney General’s Brief, p. 37.

the “Capital Asset Pricing Model.”⁵ It is described as “. . . the risk-free rate, times .65, beta, times 3.8, the market risk premium.” The classic statement of the formula is the risk-free rate plus (not times) the beta, times the market risk premium (which is more accurately described as the overall market return minus the risk-free rate).

Kentucky American Water requests that it be awarded fair, just and reasonable rates as set forth in its Brief herein within a statutorily acceptable timeframe.

Respectfully submitted,

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⁵ Attorney General’s Brief, p. 37.