

**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)

**DIRECT TESTIMONY OF
JAMES E. SALSER**

April 30, 2004

**KENTUCKY AMERICAN WATER
CASE NO. 2004-00103
DIRECT TESTIMONY
JAMES E. SALSER**

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- 1. Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**
- A. My name is James E. Salser and my business is 169 Ohio Avenue, Murraysville, West Virginia, 26164.
- 2. Q. BY WHOM ARE YOU EMPLOYED?**
- A. I am self-employed as a consultant providing consulting services in the areas of rate, acquisitions and economic analyses.
- 3. Q. PLEASE OUTLINE YOUR BUSINESS EXPEERIENCE IN THE AREA OF RATES AND REVENUES.**
- A. I have a Bachelors Degree in Business administration from West Virginia State College. Since 1966 I have held numerous positions in the American Water System in the areas of rates and revenues, ranging from a staff accounting position with the American Water Works Service Company (“Service Company”) in Richmond, Indiana, through my service as Director of Rates at Service Company regional offices. I have testified on financial, ratemaking and accounting issues before the public utility commissions in approximately 16 states. A summary of my education and business experience is attached as Appendix A to this testimony.
- 4. Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?**
- A. My testimony will address, (i) the working cash component to rate base, (ii) federal income tax, and (iii) calculation of the forecasted levels of revenues incorporated in the company’s accounting exhibit.

RATE BASE - WORKING CAPITAL

1
2 **5. Q. MR. SALSER, REFERRING TO WORKING CAPITAL**
3 **ALLOWANCE SHOWN ON SCHEDULE B-5, PAGE 2 OF 2,**
4 **WHAT IS WORKING CAPITAL AND WHAT METHOD DID THE**
5 **COMPANY USE IN CALCULATING ITS WORKING CAPITAL**
6 **ALLOWANCE IN THE CASE?**

7 **A.** Working capital is a rate base element that recognizes the amount of
8 investor supplied funds that are used to fund the day to day operation of
9 the Company and to recognize the delay in the recovery of certain
10 expenses from the ratepayers. For the purpose of filing this case, the
11 Company has prepared a new lead/lag study that utilizes the methodology
12 in its last study performed in 1996.

13
14 **6. Q. WOULD YOU PLEASE DESCRIBE THE LEAD/LAG STUDY**
15 **METHOD IN CALCULATING THE WORKING CAPITAL**
16 **ALLOWANCE?**

17 **A.** This method measures the net time lag between the date customers receive
18 service from the Company and the date they pay for those services
19 (revenue lag), and the lag between the date the Company receives goods
20 and services and the date they pay for those goods and services (expense
21 lag). If applied correctly, a lead/lag study is a useful tool in calculating a
22 working capital allowance.

23
24 **7. Q. BASED ON THE LEAD/LAG STUDY, WHAT IS THE LEVEL OF**
25 **WORKING CAPITAL ALLOWANCE THAT THE COMPANY IS**
26 **PROPOSING IN THIS CASE?**

27 **A.** The Company is proposing a working capital allowance of \$ 2,495,000.

28 .
29
30 **8. Q. PLEASE DESCRIBE WHAT IS ON SCHEDULE B-5.2, PAGE 4 OF**
31 **6 OF EXHIBIT 37.**

1 A. This schedule summarizes the Company's lead/lag study. The actual study
2 was based on analyzing data for the twelve months ending December 2003
3 for the expenses and 91 days ending January 15, 2002 for revenues. The
4 lead/lag days were then applied to the forecasted test period present rates
5 operating results. The basic principle of the study, as shown on this
6 schedule, was to multiply the daily cost of operations by the net interval
7 between the time the customer delays payment of services rendered
8 (revenue lag) and the time the Company delays payment of its operating
9 expenses (expense lag).

10
11 9. Q. **MR. SALSER, HAS THE COMPANY CALCULATED ITS
12 WORKING CAPITAL USING THE LEAD/LAG STUDY METHOD
13 BASED ON PRIOR COMMISSION ORDERS.**

14 A. Yes. The Lead/Lag Study methodology used by the Company was
15 recognized by the Commission in Case No. 97-034.

16
17 **Rate Base - Other Working Capital**

18 10. Q. **WHAT IS THE NEXT RATE BASE ELEMENT?**

19 A. The next rate base element as shown on Schedule B-1, page 2 of 2 is the
20 other working capital. The element of other working capital allowance
21 which is comprised of chemicals and plant materials was developed by
22 calculating a 24-month average balance for the period ending February
23 2002.

24
25
26 **INCOME TAXES:**

27 11. Q. **PLEASE EXPLAIN THE COMPANY'S FORECASTED LEVEL OF
28 INCOME TAXES?**

29 A. The Company has forecasted a level of Income Taxes for the test year in
30 the amount of \$ 2,487,148 at present rates. This is broken down into
31 two components:

1
2 Current provision for federal and state income taxes of \$ 1,982,244 and \$
3 \$ 503,942 as shown on pages 1 of 2 of Schedules E-1.3 and E-1.4.
4

5 Deferred federal and state income taxes of \$ (209,357) and \$ (9,681) are
6 shown on page 2 of 2 of schedules E-1.3 and E-1.4.
7

8 The calculations of the Company's current provision for both federal and
9 state income taxes is based on the statutory rates of 35% for federal and
10 8.25% for state. A small surtax credit of \$ 4,876 is incorporated in the
11 state income tax calculation to recognize a graduated level of tax rates up
12 to the top rate of 8.25%. To arrive at the total current provision,
13 forecasted expenses at present rates were deducted from operating
14 revenues to arrive at income before income taxes. This was done for both
15 the federal and state tax calculations. From this number statutory add
16 backs and deductions were made to arrive at the taxable income. These
17 statutory adjustments are shown on pages 1 of 2 of Schedule E-1.3 and E-
18 1.4 and are labeled as reconciling items. The first is interest expense.
19 This was calculated by multiplying rate base by the weighted cost of debt
20 for the forecasted test year. The next two items are an add back for book
21 depreciation and then a deduct for tax depreciation. The next item is the
22 add back for non-deductible meals. IRS regulations only permit a
23 deduction of 50% for meals. The deduction of \$ 256,108 for taxable
24 AFUDC represents the difference between the forecasted level of book
25 and tax AFUDC being calculated for the forecasted test year. The add
26 back for Deferred Debits, Deferred Maintenance, Property Losses and
27 Community Education costs relate to the amortization of these items.
28 There is a corresponding offset in deferred taxes to the increase in the
29 current tax provision calculation. The add back for the amortization of the
30 UPAA is similar to the treatment of book depreciation in that the tax
31 deduction on the UPAA is included in the tax depreciation figure. The

1 add back for the amortization of the regulatory asset associated with the
2 equity gross-up of AFUDC is reflected here. The last adjustment is an add
3 back for the receipt of Taxable CIAC associated with the Company's
4 proposed tariff for Tapping Fees. The Tapping Fees are considered to be
5 Connection Fees under current IRS regulations and will be included in
6 current taxable income. Upon adjusting income before income taxes by
7 the statutory adjustments, the statutory income tax rates for federal and
8 state are multiplied times the taxable income to arrive at the current
9 provision for both federal and state purposes. The same calculation is then
10 performed at Proposed Rates as a result of the Company's proposed
11 increase in revenues.
12

13 **12. Q. MR. SALSER, PLEASE DISCUSS THE FORECASTED LEVEL OF**
14 **DEFERRED INCOME TAX EXPENSE.**

15 **A.** As shown on page 2 of 2 of Schedule E-1.3, the forecasted level of
16 Deferred Federal Income Taxes is \$ (209,357). As shown on page 2 of 2
17 of Schedule E-1.4, the forecasted level of Deferred State Income Taxes is
18 \$ (9,681).
19

20 The forecasted deferred taxes relate to UPIS, Deferred Maintenance,
21 Deferred Debits, Property Losses, amortization of the regulatory assets
22 and liabilities and the amortization of Investment Tax Credits. The
23 deferred taxes properly recognize the temporary timing difference between
24 book and tax basis elements.
25

26 **13. Q. MR. SALSER IS THE CALCULATION OF DEFERRED INCOME**
27 **TAXES THE SAME METHOD USED IN THE COMPANY'S LAST**
28 **RATE CASE?**

29 **A.** Yes. The company has continue to used SFAS 109 in recording deferred
30 income taxes on deferred tax liabilities and asset.
31

1 **16. Q. HOW DID THE COMPANY CALCULATE THE DEFERRED TAX**
2 **LIABILITY THAT IS SHOWN ON SCHEDULE B-6, PAGE 2 OF 2**
3 **THAT IS A RATE BASE DEDUCTION?**

4 **A.** The deferred tax liabilities for Deferred Debits, Deferred Maintenance and
5 Property Losses are calculated by applying the statutory federal and state
6 income tax rates to the 13-month average balance included in rate base.
7 This represents the proper method of calculating the deferred tax liability
8 using SFAS 109.

9
10 The amount shown on Schedule B-6, page 2 of 2 for Deferred Taxes
11 related to UPIS is a little more complex because it entails analyzing and
12 determining the net change in a number of balance sheet accounts both for
13 book and tax basis. This analysis includes UPIS, accumulated
14 depreciation reserve, regulatory assets and regulatory liabilities, Customer
15 Advances and CIAC.

16
17 The starting point for this analysis is the actual balance on the books of the
18 Company at January 2004. The Company prepares a schedule each month
19 that shows the components of the deferred taxes related to UPIS. They are
20 Net UPIS, Deferred Taxes related to Regulatory Assets and Liabilities,
21 Customer Advances, CIAC and ITC. This deferred tax liability then needs
22 to be reduced by the regulatory asset/liability associated with the AFUDC
23 equity gross-up, Plant Flow Through, Excess Deferred Taxes and the ITC
24 Gross-up.

25
26 **17. Q. WHY DOES THE DEFERRED TAX BALANCE HAVE TO BE**
27 **REDUCED BY THE REGULATORY ASSETS AND LIABILITIES?**

28 **A.** SFAS 109 prohibits net-of-tax accounting and reporting and requires
29 recognition of deferred tax assets and liabilities and also requires an
30 adjustment of a deferred tax liability or asset for an enacted change in tax
31 laws or rates.

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Therefore, to the extent that one of the above situations occur, a regulatory asset or liability is created and is offset by a corresponding amount to the deferred tax liability account. In the case of tax depreciation that was flowed through on the books of the Company prior to 1964, a regulatory asset was created and was offset by a deferred tax liability.

18. Q. PLEASE CONTINUE.

A. Once we had our starting point, all accounts reflected in the calculations of deferred taxes associated with UPIS was forecasted through to the end of the forecasted test period. This was done for both book and tax basis accounts and incorporated all temporary timing differences. The net change in these accounts by month were calculated. The statutory tax rates were applied to these net changes between book and tax basis property to calculate each individual month's deferred tax expense or benefit. The deferred tax expense or benefit was then added to the previous month's deferred tax liability to build the forecasted 13-month average amount for deferred taxes associated with UPIS which was used to reduce rate base. The balance for the regulatory assets and liabilities were also adjusted by their current amortization and the continued recording of the gross-up and amortization of the equity portion of AFUDC.

This calculation also produced the deferred tax expense associated with UPIS which is shown on Schedule E-1.3 and E-1.4, page 2 of 2 for both federal and state.

REVENUES

19. Q. WHAT IS THE BASE PERIOD USED FOR THIS CASE?

A. The base period used in this case is the twelve months ending July 31, 2004. This information was derived utilizing actual billing determinates or

1 bill analysis for the six months ended January 31, 2004 and the
2 Company's budgeted billing throughout the six months ended July 31,
3 2004.

4
5 **20. Q. WHAT IS THE FORECASTED PERIOD FOR THIS FILING?**

6 **A.** The forecast period for this filing is the twelve months ended November
7 30, 2005. This period reflects the first year that the approved rates in this
8 case will be in effect.

9
10 **21. Q. HOW DID KENTUCKY AMERICAN WATER ("KAW") ARRIVE**
11 **AT THE LEVEL OF REVENUES REFLECTED AT PRESENT**
12 **RATES IN THE FORECASTED PERIOD?**

13 **A.** Schedule M of Kentucky American Water's filing contains the bill
14 analysis utilized by it to arrive at the level of revenues that are expected
15 for the base year and anticipated to experience during the forecast period.
16 As in prior cases, I have adjusted our base year billing determinates for
17 changes that are known and measurable and that will occur before or
18 during the forecast period. I will address each customer class separately.

19
20 **Residential**

21 As stated previously, a bill analysis based upon the twelve months ended
22 July 31, 2004 was utilized as a basis to project forward. We decrease to
23 this projection 943 customers to reflect the actual number of customers at
24 January 2004. In addition, we added another 3,023 customers for normal
25 growth through the end of the forecast period. As in the previous case, the
26 consumption in this class is based upon a study that was prepared by Dr.
27 Edward Spitznagel. Dr. Spitznagel is recommending a weather
28 normalized level of sales of 165.56 gallons per customer per day for the
29 forecast period. This level of sales was applied to the level of customer
30 bills that were reflected in our forecasted period to arrive at gross sales.

1 Current tariffs were then applied to the associated billings and
2 consumption to arrive at revenues.

3
4 **Commercial**

5 As with the residential class, a bill analysis based upon the twelve months
6 ended July 31, 2004 was utilized as a basis to project forward. We added
7 from this projection 94 customers to reflect the actual number of
8 customers at January, 2004. In addition, we added another 148 customers
9 from normal growth through the end of the forecast period. Dr. Spitznagel
10 is recommending a weather normalization level of sales of 1,384.01
11 gallons per customer per day for the forecast period. This level of sales
12 was applied to the level of customer bills that were reflected in our
13 forecast to arrive at gross sales. Current tariffs were then applied to the
14 associated billings and consumption to arrive at revenues.

15
16 **Industrial**

17 The Company used a bill analysis based upon the twelve months ending
18 July 31, 2004. Using the most current billing information available, the
19 Company believes that there would be no significant changes in the
20 consumption for these customers during the forecast period. Current tariffs
21 were then applied to the associated billings and consumption to arrive at
22 revenues.

23
24 **Other Public Authority**

25 As with the residential and commercial classifications, a bill analysis
26 based upon the twelve months ended July 31, 2004 was utilized as a basis
27 to project forward. The base period customers were carry over to the
28 forecast period.

29 **Sale For Resale**

30 The Company has included two additional sale for resale customers to the
31 forecast period. The two customers are Peak Mill and East Clark County.

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Fire Service

Fire service billing determinates at January 31, 2004 were utilized for the base period and were used for the forecast period.

Miscellaneous Sales

Kentucky American Water has used the most current twelve month period in developing it's forecasted data.

22. Q. DID KENTUCKY AMERICAN WATER PROPOSE ANY CHANGE FOR REVENUES CLASSIFIED AS OTHER REVENUES?

A. No, the Company hasn't proposed any change in revenue level for this classification.

23. Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.