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November 18, 2003

**Via Hand Delivery**

Mr. Thomas Dorman  
Executive Director  
Public Service Commission  
211 Sower Boulevard  
Frankfort, Kentucky 40601

RE: Kentucky American Water - Deferrals

Dear Tom:

Please consider this request of Kentucky American Water for the Staff of the Commission to review the conclusions set forth in your letter of October 15, 2003, and one of my the requests contained in my letter of September 24, 2003.

**SECURITY COSTS.** Your letter stated the Staff conclusion that approval to establish an account to accrue the deferral of security costs incurred after September 11, 2001, would constitute a violation of Condition 2 of Appendix A of the Commission's Order in Case No. 2002-00317. That condition is:

"At no time prior to May 30, 2007, will KAWC 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."

My letter of September 24, 2003, requesting approval for the establishment of an account to accrue expenses incurred after September 11, 2001, for enhanced security measures was not a request for "recovery of costs" as prohibited by Condition No. 2. Prior to the applications for approval of the Change of Control of Kentucky American Water (Cases No. 2002-00018 and 2002-00317), Kentucky American Water filed an "Asset Protection Charge Tariff" establishing a procedure for the recovery of post-September 11, 2001, enhanced security measures. The requested procedure would have allowed a quarterly adjustment in Kentucky American Water's

Mr. Tom Dorman  
November 18, 2003  
Page 2

rates to recover its enhanced security costs. As a part of the approval of the requested change of control, the Commission found that changes in operating practices would likely produce changes in cost of service.<sup>1</sup> The Commission specifically found that, in view of anticipated changes in operating practices, maintenance of Kentucky American Water's rates was in the public interest until March 16, 2004, or one year following the date of the closing of the merger, whichever occurred later. The maintenance of Kentucky American Water's rates then in effect required the withdrawal of the Asset Protection Charge Tariff or its denial. Having found that the public interest would be served by the maintenance of the existing structure, the Commission found "that the introduction of any new rate mechanism regarding security costs at this time is inappropriate and that KAWC's proposal for such mechanism, which is currently under view in Case No. 2001-00440, should be withdrawn until KAWC's integration with Thames is complete."<sup>2</sup>

The purpose of the Commission's Condition 2 was to freeze the rates of Kentucky American Water until March 16, 2004, or one year after the closing. The requested approval for the establishment of a deferred asset will not affect the existing rates of Kentucky American Water at all. The propriety of the inclusion of any of the post-September 11, 2001 enhanced securities costs can be fully addressed and examined in Kentucky American Water's next general rate case.

The matter of the treatment of post-September 11, 2001 enhanced security costs has been examined by the Missouri Public Service Commission in Case No. WO-2002-273. Missouri-American Water Company filed an application for an Accounting Authority Order for its post-September 11, 2001 enhanced security costs. By way of explanation the Missouri Commission stated:

"An AAO is an order of the Commission authorizing an accounting treatment for a transaction or group of transactions other than that prescribed by the Uniform System of Accounts. It is an accounting mechanism that is generally used to permit deferral of costs from one period to another. The items deferred are booked as a regulatory asset rather than as an expense, thus improving the financial picture of the utility in question during the deferral period. During a subsequent rate case, the Commission determines what portion, if any, of the deferred amounts will be recovered in rates." (Citations omitted, emphasis added.)<sup>3</sup>

<sup>1</sup> Case No. 2002-00018, Order, May 30, 2002, p. 17.

<sup>2</sup> *Id.* at 18.

<sup>3</sup> Missouri Public Service Commission, Case No. WO-2002-273, Report and Order, December 20, 2002, page 3.

Mr. Tom Dorman  
November 18, 2003  
Page 3

In approving the request, the Commission carefully pointed out that its actions did not change rates.

“By seeking an AAO, Missouri-American seeks to preserve the possibility—not the certainty—of recovering some of the expenditures made to upgrade security from the very ratepayers protected thereby. It is true that the management of Missouri-American chose to make the expenditures under consideration in this case; it was not required to do so by any governmental agency or Act of God. However, that point is simply one of the circumstances that the Commission must consider, as is the fact that the decision was made in the light of the events of 9-11 and the various governmental responses to those events. For these reasons, the Commission concludes that an AAO is reasonable under all of the circumstances and should be granted.”<sup>4</sup>

In like fashion, the Idaho Public Utilities Commission made it clear that its authorization of a deferral does not change rates and does not constitute any abdication of the Commission’s right to judge the amount of the deferral that should be subsequently recovered. In Case No. UWI-W-01-2, United Water Idaho Inc. requested the deferral of some electric power costs it was going to incur as a result of a rate increase from its electrical supplier. The Commission concluded:

“The Commission finds it reasonable to authorize such a deferral. The Company also proposes to apply a carrying charge on the unamortized deferral balances at a rate equal to the customer’s deposit rate. The Commission finds it reasonable to reserve judgment on the recovery of the amount deferred as well as the appropriateness of any carrying charge until actual recovery is requested.”<sup>5</sup>

The Pennsylvania Public Utility Commission has also approved Pennsylvania-American Water’s request for deferred accounting treatment for a post-September 11, 2001 incremental security costs.<sup>6</sup> The Pennsylvania Commission concluded:

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<sup>4</sup> *Id.*, p. 30.

<sup>5</sup> Order, July 31, 2001, p. 3.

<sup>6</sup> Pennsylvania Public Utility Commission, Case R-00027983, Opinion and Order entered July 24, 2003, currently on appeal.

Mr. Tom Dorman  
November 18, 2003  
Page 4

“However, we will adopt the ALJ’s recommendation that we grant the Petition at Docket No. R-00027983 with respect to deferred accounting treatment for the company’s claimed incremental security costs incurred between September 11, 2001 and the resolution of the company’s upcoming general base rate case. We note that the Company has attempted to enhance security at its intrastate facilities in an effort to safeguard the quality and reliability of its water operations. However, approval of deferred accounting treatment is not an assurance of future rate recovery of the claims incremental security costs. It is incumbent upon the Company to demonstrate its right of rate recovery of the claimed incremental security costs, or portions thereof, in its pending general base rate case through the submission of additional evidence; . . .”<sup>7</sup>

On March 5, 2001, West Virginia-American Water Company filed an application with the Public Service Commission of West Virginia for an increase in its rates. During the pendency of that case, and after September 11, 2001, West Virginia-American Water Company requested the Commission’s consideration of the allowance of enhanced security costs. The Commission declined to include the enhanced security costs in the pending rate case but did authorize the deferral for consideration in the next rate case.

“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 costs. Furthermore, the Commission is also acutely aware of the need not to publicize steps being taken by the company to insure the safety of the public water supply. However, the Commission is not prepared at this time to grant rate recover to the company in the form of a surcharge or rider to the rates contained in the current ongoing rate case. Instead, since the Commission will consider the initial amount, carrying costs and timing of recovery of all security related costs 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 costs of additional security. The Commission directs this deferral in recognition of the fact that we shall provide the Company with the opportunity to recover its deferred costs in future rates. Accordingly, the Company may request recovery of these deferred costs when it files its next rate case. This will give the Commission and interested parties an

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<sup>7</sup> *Id.*, pp. 8-9.

Mr. Tom Dorman  
November 18, 2003  
Page 5

opportunity to review the reasonableness and prudence of the Company's actions, the actual level of plant additions and operating costs incurred and the extent to which deferred costs are unusual or extraordinary as compared to normal, historic operations. The Commission will allow recovery of reasonable deferred costs in future rate cases after our review of the actual level of unusual or extraordinary security costs, the prudence of the costs and the appropriate timing for such recovery, but only to the extent that the Commission finds the costs are reasonable, necessary and prudent."<sup>8</sup>

In West Virginia-American Water Company's next rate case, Case No. 03-0353-W-42T, currently pending before the West Virginia Public Service Commission, James W. Ellars, Chief Utilities Manager in the Commission's Engineering Division reviewed the deferred security costs and made his recommendation in his prepared direct testimony:

"Based on the Company's records that were made available for review, it is my opinion that the deferred expenses of \$5,015,224 incurred by the Company since September 11, 2001, are prudent, reasonable and necessary to insure the security of the Company's facilities."<sup>9</sup>

Kentucky American Water respectfully asks the Staff to reconsider its position because (1) the approval of the deferral will not violate any Commission condition prohibiting changes in rates and (2) the approval will not affect the Commission's authority to determine the reasonableness and prudence of enhanced security costs in the next general rate case.

If the members of the Staff involved in the determination which I ask be reconsidered need any additional information, please let me know.

Very truly yours,

STOLL, KEENON & PARK, LLP

By Lindsey Ingram, Jr.  
Lindsey Ingram, Jr.

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<sup>8</sup> West Virginia Public Service Commission, Case No. 01-0326-W-42T, Order, December 21, 2001, p. 12.

<sup>9</sup> Direct testimony of James W. Ellars, p. 7.