

**COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION**

IN THE MATTER OF:)
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)
ADJUSTMENT OF THE RATES OF) **CASE NO. 2004-00103**
KENTUCKY-AMERICAN WATER COMPANY)
)
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)

**REBUTTAL TESTIMONY
OF
MICHAEL A. MILLER
ON BEHALF OF
KENTUCKY-AMERICAN WATER COMPANY**

October 8, 2004

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KENTUCKY-AMERICAN WATER COMPANY
PSC CASE NO. 2004-00103
REBUTTAL TESTIMONY OF MICHAEL A. MILLER

1. Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

A. Michael A. Miller, 1600 Pennsylvania Avenue, Charleston, West Virginia.

2. Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?

A. Yes.

3. Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I will address several recommendations discussed in the direct testimony of AG witnesses Crane and Woolridge:

1. Capital Structure
2. Return on Equity
3. Forecasted Test Year
4. Rate Base
5. Revenues
6. Payroll and incentive pay
7. OPEBs
8. Amortization of Deferred Costs
9. Rate Case Expense
10. Business Development Costs
11. Federal Income Taxes
12. Interest Synchronization
13. Low Income Tariff

1 **GENERAL**

2
3 4. Q. DO YOU HAVE ANY GENERAL COMMENTS ON THE POSITIONS
4 TAKEN BY THE AG WITNESSES CRANE AND WOOLRIDGE?

5 A. Yes. Ms. Crane and Dr. Woolridge have suggested that the Commission deviate
6 from the manner in which the Company has been regulated since the inception of
7 the forecasted test-period regulation in the early 1990's. As permitted under
8 Administrative regulation 807 KAR 5:001 and as authorized by KRS 278.192 and
9 278.310, the Company has filed each case since 1993 using a fully forecasted test-
10 year. The Company will cover the alleged deviations in the rebuttal testimony of
11 its witnesses as they address the various areas of the cost of service. Some of the
12 key deviations from the historical methodology are treatment of capital structure,
13 revenues, maintenance, rate base, and various O&M expenses. The most
14 noticeable feature of the AG's recommendations is that there is little, if any,
15 support to deviate from long established regulatory policy of the Kentucky
16 Commission other than to indicate that different methods are used in other
17 regulatory jurisdictions. There is no credible argument against the Company's
18 use of Commission approved methods of determining a reasonable cost of service
19 from a forecasted test-year filing. The Company believes its filing meets the
20 requirements of the Commission and will point out where the suggested
21 deviations are offered in an obvious attempt to unjustly and unreasonably
22 understate a fair and reasonable cost of service.

23
24
25 **CAPITAL STRUCTURE**

26
27 5. Q. HAVE YOU REVIEWED THE TESTIMONY CONCERNING CAPITAL
28 STRUCTURE FILED BY DR. WOOLRIDGE?

29 A. Yes.
30

1 6. Q. WHAT CAPITAL STRUCTURE METHODOLOGY HAS BEEN UTILIZED
2 BY DR. WOOLRIDGE IN ARRIVING AT HIS RECOMMENDATION FOR
3 THE COST OF CAPITAL?

4 A. Dr. Woolridge calculates his recommended capital structure by averaging the
5 capital structures at the end of each quarter for the twelve quarterly periods from
6 January 2001 through December 2003.

7

8 7. Q. DOES DR. WOOLRIDGE'S METHODOLOGY CONFORM TO THE
9 GUIDELINES PRESCRIBED IN ADMINISTRATIVE REGULATION 807
10 5:001, SECTION 10(C)?

11 A. No, it does not. Dr. Woolridge is simply relying on historical information and
12 makes no attempt to dispute the 13-month average capital structure for the
13 forecasted test-year proposed by the Company. Dr. Woolridge provides no
14 support for his position other than to indicate that the Company's capital
15 component elements between 2001 and 2003 are different than those proposed by
16 the Company in the case.

17

18 8. Q. DR. WOOLRIDGE ADDRESSES HIS POSITION ON THE USE OF AN
19 HISTORICAL THREE-YEAR AVERAGE CAPITAL STRUCTURE IN
20 RESPONSE TO DATA REQUEST PSC-I-35. WOULD YOU COMMENT ON
21 THIS RESPONSE?

22 A. Dr. Woolridge's response does not address compliance with the relevant
23 administrative regulation. He simply indicates that a "known and measurable"
24 financing on March 1, 2004 distorts his hindsight view of what the capital
25 structure components were over the last three years. While I agree with him that
26 the Company did place a permanent financing in March 2004, that certainly is no
27 reason to ignore the financial impacts on the forecasted period for which rates are
28 being established in this case. In fact, to do so would distort the capital structure
29 that exists now and the one that will be in place during the forecasted period. The
30 AG's proposed capital structure ignores events that have already happened and
31 certainly is not in compliance with the Commission's regulations regarding a

1 forecasted test-year rate filing. The AG's proposed capital structure should be
2 viewed for what it is, an attempt to artificially deflate the proper cost of capital
3 through the inappropriate use of historical data.
4

5 9. Q. FOR WHAT PURPOSE DOES THE COMPANY UTILIZE SHORT-TERM
6 DEBT?

7 A. The Company utilizes short-term debt to bridge its cash requirements between
8 permanent financings. The Company has had two maturities of LT Debt issues
9 since its 2000 rate case. The Company utilized short-term debt to refinance these
10 issues until it determined the optimum time to replace those issues with LT Debt.
11 As explained in my direct testimony, the Company has paid close attention to the
12 bond markets and placed its LT Debt through American Water Capital Corp.
13 (AWCC) at the time it could obtain the best possible rates. Through these efforts
14 the Company has been able to lower its weighted cost of LT Debt to 6.33% as
15 filed in this case from the 7.69% approved in case 2000-120. The savings from
16 the refinancing activities are fully embedded in the Company's cost of service in
17 this filing. It is inappropriate to attempt to artificially lower the weighted cost of
18 LT Debt currently in place by imputing short-term debt levels that no longer exist.
19

20 10. Q. WHAT PROBLEMS WOULD DR. WOOLRIDGE'S RECOMMENDED
21 CAPITAL STRUCTURE CREATE IF IT WERE TO BE APPROVED?

22 A. The recommended capital structure is simply not representative of the
23 components of capital that will be in place during the time rates from this case are
24 to be effective, the forecasted test-year period. If the capital structure approved in
25 this case is not representative of the capital structure that will be in place during
26 2005, it does not produce the proper weighted cost of capital, will be confiscatory,
27 and it will not provide the Company a reasonable opportunity to achieve its
28 authorized return on equity.
29

30 11. Q. PLEASE DESCRIBE THE LATEST ACTUAL CAPITAL STRUCTURE OF
31 THE COMPANY,

1 A. I have prepared a schedule that includes the Company's capital structure included
2 in the filing, the Company's actual capital structure at August 30, 2004 and the
3 capital structure proposed by the AG. That schedule is attached to this testimony
4 as Rebuttal Exhibit MAM-1. The Company's Capital structure at August 30,
5 2004 (as indicated in column 10 of the Exhibit) is comprised of 53.94% LT Debt,
6 0.82% ST Debt, 3.96% Preferred Stock, and 41.28% Common Equity. The
7 capital structure at August 30, 2004 compares very favorably to the capital
8 structure proposed by the Company based on the 13-month average for the
9 forecasted test-year (shown in column 2). Dr. Woolridge's proposed capital
10 structure is also shown in column 2 on Rebuttal Exhibit MAM-1 under the
11 subtitle AG and is comprised of 46.41% LT Debt, 7.78% ST Debt, 4.60%
12 Preferred Stock, and 41.21% Common Equity. As can easily be determined in
13 this review, the capital structure proposed by the AG severely understates the
14 level of long-term debt that the Company has in place currently and also
15 overstates the level of short-term debt. It is not reflective of the current capital
16 structure or the average capital structure for the forecasted test-period; therefore,
17 if approved, rates based thereon will meet the well defined term of confiscatory as
18 they would be set on capital components other than those known to be in
19 existence during the time rates from this case will be effective.

20
21 12. Q. WHAT CHANGES IN THE CAPITAL STRUCTURE ARE IGNORED IN THE
22 USE OF A THREE-YEAR HISTORICAL AVERAGE OF THE CAPITAL
23 STRUCTURE?

24 A. It ignores the known Long-term Debt financing of \$14.0 million issued in March
25 2004; the refinancing of the \$5.5 million, 6.79% bond that matures in September
26 2005; and the additional retained earnings that have been generated through
27 August 2004 and will be generated through November 2005. The proposed
28 capital structure, generated by looking through the rearview mirror (historical), is
29 just not representative of the known and measurable capital components currently
30 in place or to be generated during the forecasted test period.

31

1 13. Q. CAN YOU QUANTIFY THE UNDERSTATEMENT OF THE COST OF
2 CAPITAL PRODUCED BY THE PROPOSED CAPITAL STRUCTURE?

3 A. Yes, as shown in column 6 of Rebuttal Exhibit MAM-1, I have input the AG's
4 recommended cost of equity into the Company's proposed capital structure in
5 order to arrive at the cost of capital deviation related solely to the capital structure
6 (please note that the use of the AG's cost of equity is for illustration purposes
7 only and the Company in no way agrees with that cost of equity). Utilization of
8 the AG's cost of equity components in the Company's capital structure produces a
9 weighted cost of capital of 7.24% or **13 basis points** more than in the AG's
10 proposed capital structure. . By improperly using an historical capital structure
11 the AG has understated the cost of capital by \$215,000 as shown at the bottom of
12 column 6 on Rebuttal Exhibit MAM-1.

13
14 14. Q. DID THE COMMISSION ADDRESS THE AREA OF CAPITAL STRUCTURE
15 IN ITS ORDER IN THE COMPANY'S LAST RATE CASE?

16 A. Yes. In Case 2000-120 the Commission used of the Company's proposed 13-
17 month average forecasted test-year capital structure. On page 54 the Order says,
18 "In this case Kentucky-American filed a forecasted capital structure that is
19 designed to meet capital requirements for the forecasted test year. The
20 Commission recognizes that Kentucky-American's capital requirements
21 continually change. When setting rates for a forecasted period, the most current
22 information should be utilized to properly match rates with the cost-of-service.
23 Since the application was filed, changes to Kentucky-American's projected
24 capital structure have been noted. These changes should be reflected in the rates
25 approved in this case. Therefore, to determine the weighted cost of capital, the
26 Commission utilized the 13-month average balance of short-term and long-term
27 debt of \$3,843,000 and \$72,751,207 at cost rates of 6.9 and 7.69 percent,
28 respectively, as determined by Kentucky-American."
29

1 15. Q. HAS THE COMPANY CALCULATED ITS CAPITAL STRUCTURE AND
2 WEIGHTED COST OF CAPITAL CONSISTENT WITH THE ORDER IN
3 CASE 2000-120?

4 A. Yes. The AG has simply ignored the clear language in the Order from case 2000-
5 120 and the Administrative Regulation 807 KAR 5:001, Section 10(C). The AG
6 has provided no meaningful evidence to support a change from the previous Order
7 or the long established Commission policy and practice regarding the
8 determination of the proper capital structure. The Company has provided a
9 capital structure based on the 13-month average of the forecasted test-year
10 consistent with the Administrative Regulation 807 KAR 5:001 and the Order in
11 Case 2000-120 that was determined using known and measurable changes and
12 will properly match the cost of service approved in this case, and therefore the
13 Company's approach to capital structure should be approved in this case.
14
15

16 **RETURN ON EQUITY**
17

18 16. Q. HAVE YOU REVIEWED THE TESTIMONY OF DR. WOOLRIDGE
19 REGARDING RETURN ON EQUITY?

20 A. Yes.
21

22 17. Q. DO YOU HAVE ANY GENERAL COMMENTS ABOUT THAT
23 TESTIMONY?

24 A. Yes. As I read his testimony it is his opinion and belief that his analysis fully
25 captures investor expectations and produces an ROE of 8.75%. Although he
26 primarily relies on his DCF calculations, his application of the CAPM produces
27 an ROE that is only 21 to 26 basis points above the projected 30-year A-rated
28 utility bond rates for 2005, and his recommendation for ROE of 8.75% is only
29 199 basis points above those bond rates. The Company does not believe the risk
30 premiums just described are in line with the risk premium between 30-year A-
31 rated utility bonds and the ROE's granted other water companies of similar risk in

1 regulatory jurisdictions where American Water subsidiaries have received orders.
2 The 8.75% ROE is manifestly inadequate. The end result of the AG's
3 calculations produces a result that is significantly below ROEs in almost all other
4 U.S. regulatory jurisdictions. I will address the ROEs awarded in other states and
5 Dr. Vander Weide will address the shortcomings of the determination of an 8.75%
6 ROE using the DCF and CAPM calculations.
7

8 18. Q. WHAT IS THE DIFFERENCE IN REVENUE REQUIREMENT AT 8.75% ROE
9 AND THE 11.20% RECOMMENDED BY MR. VANDER WEIDE?

10 A. The differences between the Company and the AG in the areas of capital structure
11 and cost of equity equate to a revenue requirement difference of \$3.063 million.
12 This difference demonstrates how important the ROE issue is in this case.
13

14 19. Q. WHY SHOULD THE COMMISSION CONSIDER THE A-RATED UTILITY
15 BONDS TO ASSESS THE BASIS POINTS SPREAD (RISK PREMIUM) FOR
16 THE COMPANY'S ROE IN THIS CASE?

17 A. The utility business is a long-term business. Utility plant investments are
18 recovered over many years, with useful depreciation lives for water mains, for
19 instance, of upwards of 70 years. Many water lines and treatment plants remain
20 in service for over 100 years. It is also a ratemaking and financial community
21 axiom that there is greater risk associated with the ownership of the equity in a
22 company than with the ownership of the debt of a company, based on the simple
23 fact that the shareholders stand "last in line" in the event of dissolution.
24 Consequently, a comparison of current rates for long-term bonds in relation to
25 authorized ROEs provides a viable and meaningful calculation of the extent of
26 that additional risk. A-rated utility bonds provide the best reflection of the risk
27 associated with equity because the interest rates on those bonds reflect the cost at
28 which the utility could obtain that long-term debt in the market at any given time.
29

30 20. Q. WHAT HAS OCCURRED TO INTEREST RATES OVER THE LAST FOUR
31 YEARS?

1 A. Since the effective date of the rates approved in the Company's last rate case
2 (November 2000), the fed funds rate has moved down over that period from 6.5%
3 to a low of 1.00% (the current rate is 1.50% based on the Federal Reserve action
4 of June 30, 2004 and another 25 basis points in on August 10 to 1.5%). A
5 significant decline in the 13-week T-bill rate has occurred over the same four-year
6 period. Unlike the fed funds rate and the 13-week T-bill rates (which are **not**
7 market driven), the market driven 10- and 30-year T-Bonds have declined only
8 modestly in comparison to the substantial decline in the fed funds rate. The T-
9 bond rates appeared to hit bottom during second quarter of 2003 and rebounded
10 during the third quarter of 2003. The latest projections from Value Line
11 Investment Survey (August 27, 2004) indicate a significant increase in both 10-
12 year and 30-year T-bonds for 2005. In fact, 10-year T-bonds are forecasted to be
13 5.3% in 2005 or 123 basis points over the 10-year T-bonds of September 24,
14 2004. The 30-year T-bonds are forecasted to be 6.0% for 2005 or 113 basis
15 points over the 30-year T-bond rate of September 24, 2004. The current trends
16 indicate increases in interest rates for all T-bonds and T-bills and the trend of
17 increasing interest rates is expected to continue into 2005, the time that rates from
18 this case will be effective.

19 The relationship of A-rated bonds and T-Bonds provides a good measure of
20 investor expectations over the longer term, and 30-year A-rated bonds provide the
21 best index for a comparison of the relative risk for equity and debt.

22
23 21. Q. YOU PROVIDED AN EXHIBIT ATTACHED TO YOUR DIRECT
24 TESTIMONY THAT RECAPED VARIOUS INTEREST RATES OVER THE
25 LAST YEAR AND PROJECTED FOR 2005. DO YOU HAVE UPDATED
26 INFORMATION IN THIS AREA?

27 A. Yes. I am attaching a schedule, titled Rebuttal Exhibit MAM-2, which includes
28 the weekly interest rates from the Value Line publication for the four quarters
29 ending with the latest publication of September 24, 2004. I have also included a
30 calculation of 30-year A-rated utility bonds for 2005 based on the latest two and
31 four quarter spreads between A-rated bonds and 30-year T-bonds added to the

1 Value Line projection for 30-year T-bonds in 2005. That calculation produces a
2 30-year bond rate of 6.76% which is the same result indicated in my direct
3 testimony. This information is used to provide support for the interest rate
4 utilized on the refinancing of the \$5.5 million bond that will mature in September
5 2005. This information will also be used in the following rebuttal regarding ROE.
6

7 22. Q. YOU INDICATED EARLIER THAT YOU DISAGREE WITH THE ROE
8 RECOMMENDATIONS OF THE AG WITNESSES. WHY?

9 A. The recently authorized ROEs for other American Water operating subsidiaries,
10 when compared to the Value Line interest rate for A-rated utility bonds at the time
11 of the Order, demonstrates just how unreasonable the AG's ROE recommendation
12 is. This comparison is a simple method the Commission can use to assess the risk
13 between A-rated utility bonds and equity recognized by Commissions in other
14 jurisdictions in determining a fair and reasonable rate of return on equity, and to
15 assess the fairness and reasonableness of the recommended ranges of ROE in this
16 case.
17

18 23. Q. WHAT ARE THE ROEs CALCULATED USING THIS APPROACH?

19 A. On Rebuttal Exhibit MAM-3, I applied the projected 2005 30-year A-rated utility
20 bond rate of 6.76% (as determined at the bottom of Rebuttal Exhibit MAM-2) and
21 then added the average spread (risk premium) of the American Water subsidiaries
22 authorized return on equity to produce an ROE of 10.84%. This is within the
23 range provided by Dr. Vander Weide.
24

25 24. Q. WHY SHOULD THE COMMISSION REVIEW THE LEVEL OF ROE
26 AUTHORIZED BY OTHER REGULATORY JURISDICTIONS?

27 A. The Company does not obtain its equity capital in the open market, but obtains
28 that equity from American Water. Each of the rate of return witnesses recognizes
29 this fact and utilizes a proxy group of publicly-traded water companies to
30 determine a market expectation of ROE. There is an incredibly wide range of
31 recommendations from the cost of capital witnesses for the Company and the AG

1 in this case. If the Company (as would any company) is to be able to obtain
2 capital when needed to maintain facilities and improve service it must have the
3 opportunity to achieve an ROE that is equal to companies with similar risk. I
4 believe it is appropriate, if not essential, that the Commission review all available
5 data on ROE, including the level of ROE that other regulatory commissions are
6 recognizing as fair and reasonable based on the most current data. All of these
7 subsidiaries obtain their equity capital from the same parent, all obtain their debt
8 from AWCC, all have similar capital structures, and all face similar financial and
9 business risks. These returns can, at the very least, provide a frame of reference
10 and comparison in the Commissions determination for a fair and reasonable return
11 on equity in this case. Given the extremely wide range of results in the
12 recommendations in this case, it is both reasonable and essential that the
13 Commission look at all available data, including other commission decisions, to
14 test the fairness and reasonableness of the ROE recommendations in this case.
15

16 25. Q. YOU INCLUDED THE RECOMMENDED ROE OF THE AG IN THIS CASE
17 ON THIS SCHEDULE. HOW DO THOSE RECOMMENDATIONS
18 COMPARE?

19 A. I included those ROEs to show how low they are. The recommended 8.75% ROE
20 of the AG to the calculated 2005 A-rated utility bonds produces a spread of only
21 199 basis points, far below that recognized in any other jurisdiction in which
22 American Water operates. The Company believes an ROE spread to current A-
23 rated utility bond projections this far below other regulatory jurisdictions is
24 unreasonable and out of touch with market expectations.
25

26 26. Q. IS THE COMPANY ASKING THE COMMISSION TO USE THE METHOD
27 JUST DESCRIBED TO DETERMINE THE ROE?

28 A. No. The Company is only asking that Commission consider the information in
29 determining the reasonableness of the ROE it establishes in this case and the
30 unreasonableness of the AG's recommended ROE. The Company believes that a
31 comparison of other Commission established risk premiums between ROE and

1 the A-rated utility bonds at the time the ROE was established, when compared to
2 the current bond market expectations, provides a valuable point of reference for
3 the Commission. This is particularly true when the comparative companies
4 compete for same equity capital, obtain their capital from the same source, and
5 have very similar business and financial risk.
6
7

8 **FORECASTED TEST YEAR**
9

10 27. Q. YOU MENTIONED EARLIER IN YOUR REBUTTAL TESTIMONY THAT
11 THE AG WITNESSES HAVE DEVIATED FROM THE REQUIREMENTS OF
12 THE FORECASTED TEST YEAR FILING. WHAT DID MS. CRANE SAY
13 ABOUT THE USE OF A FORECASTED TEST YEAR?

14 A. While Ms. Crane acknowledges that Kentucky law permits the filing of a
15 forecasted test-year, she clearly indicates that she does not prefer that process.
16 She indicates on page 8 of her testimony that, “the use of forecast data does make
17 it more difficult for regulators to assess the reasonableness of a utility’s claim.”
18 She also indicates that the use of CWIP and recovery of deferred extraordinary
19 costs are internally inconsistent with the use of a future test year. She asserts that
20 the use of a forecasted test year provides a tremendous benefit to the Company
21 and she says that she has not hesitated to make adjustments to forecasted methods
22 and previously approved practices of the Commission if they meet her criteria.
23

24 28. Q. WHAT IS YOUR RESPONSE TO MS. CRANE’S ATTITUDE ON THE USE
25 OF A FORECASTED TEST-YEAR METHODOLOGY TO DETERMINE A
26 COST OF SERVICE?

27 A. While Ms. Crane is entitled to her opinion, I do not believe the Commission
28 should be swayed by the fact she does not care for the forecasted test-year. The
29 Commission has regulated the Company using the forecasted test-year filing since
30 the early 1990’s, the Company has filed this case in conformance with the policies
31 and practices of the Commission established by Kentucky law, rules and

1 regulation of the Commission, and past Commission Orders. The Company does
2 not believe that the Commission has had trouble in arriving at a fair and
3 reasonable cost of service in prior cases and believes the Commission will do so
4 in this case.

5
6 29. Q. WOULD YOU COMMENT ON MS. CRANE'S ASSERTION THAT THE
7 COMPANY'S FILING MATERIAL IS CONFUSING, CONFLICTING AND
8 POORLY ORGANIZED MAKING REGULATORY REVIEW DIFFICULT?

9 A. Yes. In reviewing her testimony I did not see where Ms. Crane had appeared in
10 Kentucky previously and this could have led to her confusion. However, the
11 Company filed this case in the exact format of its previous rate cases and believes
12 its filing meets the requirements of the Commission for a forecasted test-year
13 filing. It is obvious to me that Ms. Crane was able to find the data she required
14 from the filing documents and the hundreds of data requests issued by the parties
15 in this case to put forth the AG's position.

16
17 30. Q. WOULD YOU SPEAK TO MS. CRANE'S COMMENTS THAT THE USE OF
18 CWIP AND DEFERRED ASSETS ARE INCONSISTENT WITH A
19 FORECASTED TEST-YEAR?

20 A. This Commission has appropriately recognized CWIP in the forecasted test-year
21 (along with a corresponding offset for AFUDC) in the Company's past filings
22 which I will cover in detail later in this testimony. The use of a forecasted test-
23 year has absolutely nothing to do with the Commission's consideration for the
24 ratemaking treatment on several deferred assets requested by the Company in this
25 case. This is a major issue in this case with a revenue requirement difference of
26 nearly \$800,000. The Commission should not be misled that a forecasted test-
27 year would somehow preclude proper rate making treatment for these legitimate
28 costs. This area will also be addressed in detail later in the testimony.

29

1 31. Q. PLEASE COMMENT ON THE ASSERTION THAT THE COMPANY
2 RECIEVES A TREMENDOUS BENEFIT IN FILING A FORECASTED TEST
3 YEAR?

4 A. This comment is simply not accurate. The very essence of regulation of utilities
5 is to replace the market factors not present in the environment because of its
6 monopolistic nature. Regulation of utilities in the U.S. is founded on the premise
7 that regulation sets the price of the service at the Company's cost of service which
8 includes a fair and reasonable return on its invested capital for the period that
9 rates are being established, and a reasonable opportunity for the Company to
10 achieve the authorized return on that investment. The method of determining fair
11 and reasonable rates takes many different forms in the various state regulatory
12 jurisdictions. Some states utilize fully forecasted test years and others use
13 historical test years. There are literally hundreds of variations regarding cost of
14 service elements. However, I know of no state that does not permit known and
15 measurable adjustments to historical test-years in order to determine the proper
16 cost of service during the time rates will be effective. Other states require a
17 historical test-year but permit post-test year rate base additions for committed
18 construction and other states also permit CWIP. The Company believes that a
19 fully forecasted test-year filing has the best potential for the establishment of fair
20 and reasonable rates and has worked well for the Company, its customers, and the
21 Commission. It is incorrect to imply the Company receives some kind of
22 inappropriate windfall or benefit from the use of the forecasted test-year filing as
23 permitted by Kentucky law and Commission rules.

24
25 32. Q. HAS THE COMPANY REGULARLY OVERACHIEVED THE AUTHORIZED
26 ROE?

27 A. No. I provided a schedule attached to my direct testimony as Exhibit MAM-1,
28 that shows the achieved versus authorized ROE for 2000-2005. The Company
29 has not achieved its authorized ROE in any year from 2000-2003 and will not do
30 so in 2004. In 2001, the year following the Company's last rate filing, the
31 Company's achieved ROE was 39 basis points under its authorized ROE. The

1 forecasted test-year has not provided the Company a windfall. The forecasted
2 test-year filings of the Company have provided the Company a reasonable
3 opportunity to achieve its authorized ROE and contributed to the avoidance of
4 costly annual rate filings as described in the response to PSCDR2-#67.
5
6

7 **RATE BASE**
8

9 33. Q. WHAT RATE BASE IS BEING RECOMMENDED BY MS. CRANE?

10 A. The AG is recommending a rate base of \$149,515,650. This compares to the rate
11 base request of the Company in its updated Exhibit 37-schedule B of
12 \$159,875,659 or a difference of \$10,360,009. The Company provided a
13 reconciliation of invested capital to rate base as Exhibit 9 to its filing. That
14 exhibit indicates the Company will have capital invested in the Company of
15 \$160,813,991 based on the 13-month average capital structure determined in the
16 forecasted test-year. The Exhibit 9 also indicates that the Company has not been
17 permitted rate base treatment for the KRS Residuals facility, Community
18 Education costs, Y2K costs, and the Bluegrass Water Project per previous
19 Commission Orders totaling \$2,129,821. The Company readily agrees it is not
20 entitled to rate base treatment for those four items and has not requested such.
21 The Company does ask the Commission to consider the impact of the remaining
22 \$9.2 million difference in invested capital and the AG rate base which is at issue
23 in this case. The Company simply can not be expected to absorb the carrying cost
24 of \$9.2 million of capital and have any expectation of an opportunity to achieve
25 whatever ROE the Commission establishes in this case. The annual revenue
26 requirement difference on the unrecovered invested capital (rate base) of \$9.2
27 million not included in the AG's rate base recommendation is approximately \$1.1
28 million. If the AG's recommendation for rate base were approved, on the first
29 day the rates from this case are effective the Company would have to overcome
30 an erosion of its earnings of 99 basis points in order to achieve it authorized ROE.
31 The Company has not historically been regulated in such a manner and is

1 confident that the Commission will not impose such a harsh and inappropriate
2 recommendation in this case.

3 **Utility Plant Acquisition Adjustments**

4
5 34. Q. PLEASE DESCRIBE THE ADJUSTMENTS MADE BY THE AG TO THE
6 COMPANY'S FILING FOR UTILITY PLANT ACQUISITION
7 ADJUSTMENTS?

8 A. Ms. Crane eliminates the entire \$314,433 for the acquisition adjustments related
9 to the acquisition of the Tri-Village and Elk Lake systems suggesting opposition
10 to UPAA under any circumstances. While she does not eliminate the previously
11 approved UPAA for Boonesboro, she gives considerable attention to pointing out
12 that she believes the Commission was incorrect or incomplete in its analysis
13 approving that UPAA in the Company's last case under the guidelines established
14 in the Delta Natural Gas Case No. 9059.

15
16 35. Q. WHAT EVIDENCE DOES SHE PROVIDE THAT THE COMPANY HAS NOT
17 MET THE GUIDELINES ESTABLISHED IN THE DELTA GAS CASE?

18 A. Very little. She relies on her belief that UPAA should never be recoverable in
19 rates and also relies on the response of the Company to PSCDR3-#30. In that
20 response the Company provided copies of all internal documents and
21 correspondence it had related to the two acquisitions. From the hundreds of pages
22 of documents contained in this response, Ms. Crane summarizes the contents as
23 indicating the Company viewed these acquisitions as only business development
24 opportunities. Ms. Crane appears to oppose any efforts to expand the company's
25 customer base (but I will cover this later in rebuttal on management fees),
26 ignoring the Company's testimony that it has been encouraged to address the
27 troubled water systems in Kentucky by the Commission, the Division of Water,
28 and the Kentucky Infrastructure Authority.

29
30 36. Q. WAS THERE OTHER TESTIMONY AND RESPONSES TO DATA
31 REQUESTS PROVIDED BY THE COMPANY THAT ADDRESS WHETHER

1 THESE ACQUISITION ADJUSTMENTS MEET THE CRITERIA
2 ESTABLISHED IN THE DELTA GAS CASE?

3 A. Yes, Mr. Bush in his direct testimony covered the allocation of pre-acquisition
4 costs for corporate management and hourly workers that are now being charged to
5 the Northern Division customers and have lowered the cost of service to the
6 existing and future customers of the Company's Central Division. Mr. Bush also
7 covered on pages 20-22 of his direct testimony the service issues experienced in
8 these two systems, including a serious THM problem. The benefits to both the
9 Central Division and Northern Division customers were covered in the response
10 to PSCDR2 #82. I am attaching that response to this testimony as Rebuttal
11 Exhibit MAM-4 because it recaps the Company's position regarding meeting the
12 tests for rate recovery established in Delta Natural Gas. Ms. Crane provides no
13 rebuttal to the testimony of the Company regarding these acquisition adjustments,
14 but instead attempts to provide a "smoke screen" to mask her belief that UPAA
15 should not be recognized under any circumstances. The Company believes it has
16 provided testimony on this subject that has not been rebutted by Ms. Crane that
17 demonstrates these acquisition adjustments, as did the Boonesboro acquisition
18 adjustment, meet the tests established in the Delta Natural Case and should be
19 afforded rate base recovery in this case.

20
21 37. Q. ON PAGE 18 OF HER TESTIMONY MS. CRANE INDICATES THAT THE
22 FORMER OWNER OF TRI-VILLAGE ACHIEVED A WINDFALL IN THE
23 SALE OF THE SYSTEM THROUGH DEPRECIATION. IS THIS CORRECT?

24 A. No. Being a public system, Tri-Village did not recover the depreciation recorded
25 on CIACs in rates, but instead recovered the cash outlay for the principal
26 repayment on its bonds. But for book purposes Tri-village recorded depreciation
27 expense on gross utility plant just like many public systems I have encountered.
28 Ms. Crane simply makes an incorrect assumption in her testimony on this point.

29
30 **Construction Work In Progress**

31

1 38. Q. DOES MS. CRANE INCLUDE THE CWIP INCLUDED AS RATE BASE IN
2 THE COMPANY'S FILING?

3 A. No. She excludes the CWIP saying that it is not used and useful and may never
4 serve customers, CWIP should never be a rate base item, and the inclusion of
5 CWIP is inappropriate in a forecasted test year filing.
6

7 39. Q. HOW HAS THE COMMISSION HISTORICALLY TREATED CWIP IN THE
8 COMPANY'S RATE FILINGS?

9 A. In the exact manner as proposed by the Company in its filing, with the CWIP
10 included in rate base and an offsetting adjustment to AFUDC above the line for
11 rate making purposes. As explained in the responses to questions 28 and 29
12 above, Commissions use various methods in their regulatory practices to arrive at
13 a just and reasonable cost of service on which to base rates. Just because Ms.
14 Crane has not seen CWIP in rate base in other states does not make her right and
15 certainly is not justification for the Commission to change its long-established
16 rate making methodology.
17

18 40. Q. HAS THE COMPANY ACHIEVED SOME WINDFALL IN ITS EARNINGS
19 FROM THE MANNER IN WHICH THE COMMISSION HAS TREATED
20 RATE BASE?

21 A. No. As indicated in my direct testimony and previously in this rebuttal testimony,
22 the Company has not overachieved its authorized ROE. The Commission's
23 historical treatment of CWIP with above the line AFUDC properly matches the
24 invested capital and rate base during the forecasted test-year for which rates in
25 this case will be established.
26

27 41. Q. DOES MS. CRANE'S ADJUSTMENT CONSIDER ALL ASPECTS OF THE
28 RATEMAKING PROCESS?

29 A. No. The Commission recognizes the components of the capital structure in its
30 rate setting process which is used to finance the CWIP during the forecasted test
31 year. This is evidenced by looking at the capital structure in the Company's filing

1 as shown on Rebuttal Exhibit MAM-1. The Company's capital structure on that
2 Exhibit is approximately \$6.0 higher than at August 2004. The additional capital
3 is being obtained to finance the CWIP in 2005. The vast majority of that capital
4 comes in the form of ST Debt which serves to lower the overall cost of capital
5 proposed by the Company. It would therefore be proper to eliminate a substantial
6 portion of ST Debt from the Company's capital structure if Ms. Crane's
7 elimination of CWIP were accepted since that is the capital being utilized to
8 finance the CWIP included for 2005. If there is to be a proper matching of the
9 rate base and the actual invested capital ST DEBT would need to be eliminated
10 from the forecasted period. This adjustment would increase the weighted cost of
11 capital. However, that would be contrary to the inappropriate attempt by the AG
12 witness to impute an inflated level of ST Debt through his use of a three-year
13 historical average capital structure as described in the testimony on capital
14 structure given previously in this rebuttal.

15
16 42. Q. WHAT IS THE IMPACT OF THE AG'S PROPOSED ELIMINATION OF
17 CWIP AND ASSOCIATED ABOVE THE LINE AFUDC?

18 A. The AG was asked to provide this data in response to question 37 in the Staff's
19 first set of interrogatories to the AG, however, Ms. Crane did not provide the
20 requested comparison to the two methods. I have calculated the net impact to be a
21 reduction in the Company's proposed revenue requirement of \$132,890. The
22 adjustment to CWIP proposed by the AG does not meet the established practice of
23 the Commission in past cases, the AG has provided no credible evidence on
24 which the Commission should make such a change, and ignores the required
25 offsetting adjustment required to properly match the invested capital (capital
26 structure) to the rate base proposed by the AG. The Commission should reject
27 this unsupported proposal by the AG witness to inappropriately change the rate
28 base methodology used by the Commission to establish rate base, and the just and
29 reasonable rates in past cases.

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Cash Working Capital

43. Q. WILL YOU BE ADDRESSING THE ADJUSTMENT TO CASH WORKING CAPITAL PROPOSED BY THE AG?

A. No. Mr. Salser will be addressing that element of rate base.

Deferred Debits

44. Q. IN YOUR DIRECT TESTIMONY YOU INDICATED THE COMPANY WAS SEEKING RATE BASE RECOGNITION FOR FIVE DEFERED EXPENSES THAT HAD BEEN RECORDED SINCE THE COMPANY’S 2000 RATE CASE. WHAT POSITION DID THE AG WITNESS TAKE ON THESE DEFERRALS?

A. Ms. Crane eliminated each of those items from her rate base recommendation reducing rate base by \$4.571 million.

45. Q. WHAT IS MS. CRANE’S BASIS FOR ELIMINATING THIS SIGNIFICANT AMOUNT FROM RATE BASE?

A. Ms. Crane indicates that the Company is provided a significant advantage by being able to file its case based on a forecasted test period, and that in her opinion the recognition of prudently incurred expense in this manner (regarding security, significant expenses required to protect the well-being and health of the Company’s customers and employees) would constitute retroactive rate reimbursement of expenses. She also indicates the Company has not been granted approval for the deferrals therefore recognizing them for ratemaking purposes in this case would be inappropriate.

46. Q. YOU OBVIOUSLY DON’T AGREE WITH MS. CRANE. PLEASE EXPLAIN WHY?

1 A. The Company has not been provided a windfall in rates based on forecasted test-
2 year regulation as indicated by Ms. Crane. This was covered earlier in the
3 response to question 29 and 30 above and will I will not repeat those arguments
4 here. As stated earlier, Ms. Crane's assertion that the use of a forecasted test year
5 prohibits recognition of regulatory assets for rate setting purposes is **wrong** and
6 can not be supported in this case by U.S. GAAP or regulatory principles and
7 practices which I will explain in the following testimony. She is also incorrect in
8 her assertion that the deferrals requested for rate treatment in this case should be
9 disallowed because to date the Commission has not approved or denied the
10 requested deferrals. I will also cover this area in the following testimony.

11
12 47. Q. YOU INDICATE IN THE RESPONSE TO QUESTION 46 THAT MS.
13 CRANE'S ASSERTION OF RETROACTIVE RATEMAKING IS NOT
14 SUPPORTED IN THIS CASE. WOULD YOU PLEASE EXPLAIN YOUR
15 POSITION?

16 A. Yes. The Company's last rate case (case 2000-120) was decided in November
17 2000. The forecasted test-year in that case was the 12 months ended November
18 2001. The Company could not have been expected to be able to fully quantify the
19 impacts of the Customer Care Center (CCC) and Shared Services Center (SSC)
20 transitions at that time because the analyses of whether those transitions were
21 prudent and would benefit the customers were just beginning at that time, and no
22 final decision had been reached on whether to proceed with those initiatives. The
23 Company could certainly not have known at that time that the events of
24 September 11, 2001 would occur necessitating the need to entirely rethink the
25 security of the Company's facilities against potential terrorist attacks. In addition,
26 the Company did not know the change of control of the Company's parent,
27 American Water, would take place including a specific condition in the Kentucky
28 Commission Order approving the transaction that precluded the Company from
29 seeking a change in rates prior to March 17, 2004. The use of a forecasted test-
30 year alone cannot be interpreted to permanently preclude recovery of prudently
31 incurred expenses from rate recovery. The Company believes the circumstances

1 just described merit the consideration in this case of the deferred expenses related
2 to the transition costs to the CCC and SSC, and the security expenses required to
3 protect the customers and employees post September 11, 2001. Given those
4 circumstances the rate treatment requested does not constitute retroactive rate
5 making.

6
7 48. Q. ARE THERE OTHER REASONS THAT THE CLAIM OF RETROACTIVE
8 RATEMAKING IN THIS INSTANCE IS NOT CORRECT?

9 A. Yes. A forecasted test-year regulation is not intended to set rates indefinitely, but
10 is one method (a method permitted by Kentucky law) that Commissions use to
11 determine just and reasonable rates in the period those rates will be effective. In
12 case 2000-120 that period was for the year ended November 2001. The
13 establishment of deferred assets for future recognition in rates is addressed in U.S.
14 GAAP under FAS 71. FAS 71 recognizes that due to timing of regulatory
15 approval there can be revenue and expenses incurred in a current accounting
16 period that will not be recognized in rates established by regulation until a future
17 period. FAS 71 does not address the manner in which the Commission regulates
18 the Company (i.e., historical test-year or forecasted test-year), it only addresses
19 the timing of the expense and the future rate recovery. To meet the requirements
20 of FAS 71 the Company must believe that future rate recovery is likely before
21 deferral can be recorded. As treasurer/comptroller of the Company, I have
22 indicated to the Company's auditors that future rate recovery is likely given the
23 circumstances described in my direct testimony and this rebuttal testimony. I
24 believe the deferred transition costs for the CCC, SSC, and security will be
25 recognized in future rates and I still believe that will occur given the positions of
26 the parties in this case. It is illogical and unreasonable to suggest that the use of a
27 forecasted test-period in case 2000-120, the twelve months ended November
28 2001, should preclude the Company from gaining recognition of the CCC and
29 SSC transition cost or deferred security in this case. The use of a forecasted test-
30 year in this case has no relationship or has no bearing on the rate treatment for
31 deferred debits requested by the Company in this case.

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49. Q. IS MS. CRANE CORRECT THAT RATE RECOGNITION FOR THE DEFERRED CUSTOMER CARE AND SHARED SERVICES CENTERS SHOULD NOT BE CONSIDERED IN THIS CASE BECAUSE THE COMMISSION HAS NOT ACTED ON THE COMPANY'S REQUEST FOR ACCOUNTING DEFERRAL?

A. No. The Company was required to seek Commission approval for any additional deferrals in the Order in case 2000-120. As indicated in my direct testimony, on September 6, 2001 the Company filed with Mr. Tom Dorman at the Commission a letter requesting Commission approval for accounting deferral on a number of expenses, including the CCC and the SSC. This letter was attached to my direct testimony as Exhibit MAM-6. The Company specifically indicated that it would defer the CCC and SSC transition expenses until the Company moved those functions to the new centers, and would amortize the transition cost equal to the cost savings generated until the unamortized transition cost could be considered in the next rate case. As of the filing of this testimony the Commission has not acted on that request. The Company believes the fact that the Commission has not taken action on these requests to date should not preclude the Company from seeking rate recognition for the unamortized portion of the transition cost in this case. The Company is seeking a 10 year recovery of the unamortized transition cost as outlined in direct testimony exhibit MAM-5.

50. Q. DOES THE COMPANY TREATMENT OF TRANSITION COST UP TO THIS POINT IN ANY WAY PROVIDE A WINDFALL TO THE COMPANY AS SUGGESTED BY MS. CRANE OR VIOLATE THE PROVISIONS OF FAS 71?

A. No. There have been cost savings from the transition to the CCC and SSC as outlined in direct Exhibit MAM-5. Once those savings began to accrue to the Company, the Company began amortizing the transition costs equal to the projected savings. The impact of this accounting treatment does not permit the Company to retain the benefit of those savings as suggested by Ms. Crane. In

1 addition, the manner in which the Company has recorded this transaction is
2 exactly as prescribed by FAS 71.

3 51. Q. ARE THERE OTHER REASONS THE TRANSITION COSTS FOR THE CCC
4 AND SCC SHOULD BE RECOGNIZED IN THIS CASE?

5 A. Yes. The entire savings of \$232,266 identified on Direct Exhibit MAM-5 is
6 embedded in the Company's filing in this case thereby those benefits flow directly
7 to the customers in this case. If Ms. Crane's position were accepted, the
8 customers would receive \$232,268 of savings but the Company would receive no
9 return of and on the investment required to generate those savings. The Company
10 does not believe this constitutes just and reasonable cost of service determination.
11 It would not be fair ratemaking to pass the savings to the customers but deny the
12 return of and on the very investment required to generate those savings,
13 particularly when that investment was made to provide the customers improved
14 service at a lower cost. If the Commission would elect to not recognize the
15 transition cost then the Company should be permitted to retain the savings until
16 the investment is written off since that would be the only way the Company could
17 generate a return of that investment.

18
19 52. Q. WHAT IS THE COMPANY'S POSITION ON THE AG'S
20 RECOMMENDATION TO ELIMINATE RATE RECOVERY FOR DEFERRED
21 ADDITIONAL SECURITY COSTS?

22 A. Ms. Crane eliminates this item from rate base solely on the basis that the
23 Commission has not at this point approved the deferral. She provides no rebuttal
24 to the Company's extensive testimony in this case about the prudence of this
25 expenditure or the necessity to expend these funds to maintain the health and
26 safety of the customers and employees given the extraordinary circumstances
27 after September 11, 2001. I don't want to repeat the extensive direct testimony
28 provided on this subject but will recap the events regarding the deferral of
29 security costs to-date. As outlined in detail in my direct testimony, after the
30 Company accepted the conditions included in the Order in case 2002-00018, the
31 Company withdrew its filing in case 2001-440 requesting a surcharge for its

1 additional security expenses. Based on the language of the Order in case 2002-
2 00018, which indicated the Company could only pursue rate recovery of its
3 additional security cost in a general rate filing, the Company believed it was free
4 to defer those costs for consideration in its next rate case. The Company filed a
5 letter on September 24, 2003 requesting accounting deferral for those security
6 expenses. On October 15, 2003 the Commission issued a letter indicating the
7 request was denied. On November 18, 2003 the Company requested
8 reconsideration on this matter, contending that it was only requesting accounting
9 deferral (not rate recovery) of the expenses so that they could be considered in the
10 next general rate filing which it believed was consistent with the language in case
11 2002-00018. On November 21, 2003 the Commission issued a letter indicating
12 they were reconsidering this matter. There has been no further action as of the
13 date of this testimony. The Company believes the result of the process to this
14 point places us at the position which the Company has advocated, that is that the
15 matter should be addressed in this general rate filing. The AG witness has
16 provided no evidence disputing the necessity and prudence of this expenditure
17 and only relies on her misplaced notion that since the Commission has not
18 approved (nor has the Commission denied the deferral) the deferral of security
19 expense, rate recovery should be denied in this case. The Company respectfully
20 suggests that the position of the AG be denied in this instance.

21
22 53. Q. WHY SHOULD THE COMMISSION APPROVE RATE RECOVERY OF THE
23 DEFERRED SECURITY EXPENSE?

24 A. The Company took the steps that were required to protect the very health and
25 safety of the customers its serves regarding the heightened potential for terrorist
26 attacks on critical U.S. infrastructure. One can only imagine what the impact
27 would be if the hundreds of thousands of customers of the Company suddenly did
28 not have access to a safe water supply. Needless to say that would be disastrous
29 to our customers and the economic conditions of the service area. The Company
30 took appropriate and prudent action to make every effort to see that did not
31 happen. Given the extraordinary circumstances surrounding the area of additional

1 security the Company should be provided a return of and on this investment over
2 an appropriate period of time because it was absolutely necessary to take these
3 measures to protect the health and safety of our customers.
4

5 54. Q. MS. CRANE INDICATES THAT THE COMPANY HAS INCLUDED THE
6 UPAA FOR TRI-VILLAGE AND ELK LAKE TWICE IN ITS FILING. IS SHE
7 CORRECT?

8 A. Yes. The Company mistakenly included the UPAA only for Tri-Village and Elk
9 Lake in both the UPAA section of its filing and in the deferred debits section of
10 its filing. I apologize to the Commission and parties for this error and it should
11 have been caught by me when preparing my direct testimony because I provided
12 direct testimony on this matter in both areas of the filing. The Commission
13 should eliminate rate base of \$314,433 included as an additional deferred debit.
14 However, the Company does believe the UPAA of \$314,433 should not be
15 eliminated as suggested by Ms. Crane and rebutted by the Company earlier in this
16 testimony.
17

18 55. Q. PLEASE RECAP THE ITEMS THAT THE COMPANY IS REBUTTING ON
19 THE AG'S RATE BASE RECOMMENDATIONS?

20 A. Attached to this testimony is a schedule, titled Rebuttal Exhibit MAM-5, that
21 recaps the items being rebutted regarding the AG's recommendation on rate base
22 and rate base related items. As indicated on the schedule the Company believes
23 the AG has inappropriately reduced rate base by \$11.010 million, \$9.501 million
24 net of deferred taxes. The AG's proposal regarding CWIP and cash working
25 capital has been made contrary to Kentucky law and regulations of the PSC, and
26 the proposal regarding UPAA has been done without any credible evidence
27 rebutting the Company's evidence concerning the tests established in the Delta
28 Natural Gas case. Finally, the elimination of the rate recovery of the deferred
29 debits for the CCC, SSC and security do not conform to sound regulatory
30 practices, US GAAP and the regulation practices of the other regulatory
31 jurisdictions who have acted upon those items for other American Water

1 subsidiaries. Rebuttal Exhibit MAM-5 also indicates the amortization of the three
2 deferred debits inappropriately eliminated by the AG recommendations for O&M
3 expenses. The Company is confident that the Commission will not be misled by
4 the AG's unsupported positions on these important issues.
5

6
7 **REVENUES**
8

9 56. Q. THE AG's WITNESS, MS. CRANE, MAKES A SUBSTANTIAL
10 ADJUSTMENT TO THE GOING LEVEL REVENUES PROPOSED BY THE
11 COMPANY IN THIS CASE. WOULD YOU ADDRESS THAT ISSUE?

12 A. Yes. Both Mr. Salser and Dr. Spitznagel address the going-level revenues in their
13 direct testimony and will also provide rebuttal testimony concerning the
14 recommendations and criticisms by Mr. Crane. I will also cover this area from
15 the perspective of the potentially damaging impact Ms. Crane's recommendation
16 could have on the Company. I will also address the reason that Ms. Crane's
17 recommendations regarding going-level revenues are incorrect.
18

19 57. Q. WHAT IS THE IMPACT OF THE RECOMMENDATIONS OF MS. CRANE
20 REGARDING GOING-LEVEL REVENUES?

21 A. She increases residential, commercial and fire protection going-level revenues by
22 \$1.962 million, effectively lowering the rate increase requested by the Company
23 by a like amount. The Company believes its going-level revenues determined for
24 the forecasted period (adjusted for consumption trends and weather normalization
25 by Dr. Spitznagel as they have been in at least the last three Company rate cases)
26 are representative of the sales levels that will occur in 2005, the time rates from
27 this case will be effective. If Ms. Crane's recommendations were recognized and
28 she is wrong as the Company believes she is, the Company will experience an
29 erosion of 179 basis points from its ability to achieve the cost of equity approved
30 in this case. The Company's forecasted test-year sales levels in past cases have
31 been prepared in the same exact manner that they have in this case (base period

1 sales adjusted to reflect customer growth and normalized for weather and usage
2 trends by Dr. Spitznagel). Those forecasts from prior cases have proven to be
3 accurate and as explained earlier in this rebuttal testimony the Company has
4 consistently not achieved its authorized ROE. The Company respectfully requests
5 that the Commission give this area careful consideration because if the sales
6 levels on which rates in this case are established incorrectly it will have a
7 significant negative impact on the Company.
8

9 58. Q. WHY ARE MS. CRANE'S SALES LEVEL PROJECTIONS INCORRECT?

10 A. Ms. Crane bases her increased going-level sales and customer numbers from
11 information included in the six months of actual and six month of budgeted base
12 period information included in the Company's filing. There is an error in the base
13 period information in the original filing that has contributed to Ms. Crane's
14 incorrect recommendations.
15

16 59. Q. WHAT WAS THE ERROR IN THE SALES AND CUSTOMERS USED IN
17 THE 6+6 BASE PERIOD FILING?

18 A. In December 2003 the Company closed accounting for billed revenue on
19 December 11 in order to accommodate an orderly and early accounting close for
20 the year. The Company calculated the unbilled revenue from December 12
21 through December 31 in order to reflect the correct revenue for the 2003 calendar
22 year. In preparing its base period information the Company adjusted the
23 December 2003 sales levels to account for the sales between December 12 and
24 December 31. Unfortunately those same sales were included in the January 2004
25 budgeted sales creating a situation where the sales and bills from December 12 to
26 December 31 were doubled in the base period filing. Ms. Crane has arrived at
27 incorrect assumptions because she has also doubled up those sales and customers
28 in her calculations. The Company did not make this same error in its forecasted
29 information in its filing. The Company regrets that this situation has occurred and
30 any inconvenience it has caused the Commission and Ms. Crane, but it is a
31 situation that must be addressed correctly in this case if the Company is to have

1 any hope of receiving fair and just rates in this case and any opportunity to
2 achieve the ROE granted in this case.

3
4 60. Q. DID THE COMPANY CORRECT THE BASE PERIOD SALES LEVELS
5 WHEN IT FILED ITS UPDATE TO THE CASE TO REFLECT THAT
6 ACUTAL DATA THROUGH JULY 2004?

7 A. Yes. Attached to this rebuttal testimony is Schedule I-4 (page 1 of 1) which
8 reflects the corrected actual base period sales and customer levels. I have
9 identified this schedule as Rebuttal Exhibit MAM-6.

10
11 61. Q. WHAT DOES THE REVISED SCHEDULE INDICATE?

12 A. The schedule indicates that for the base period the average annual usage for
13 residential and commercial customers are 58,144 and 490,283 gallons,
14 respectively. The actual average usages in the base period are very close to the
15 usages arrived at in the forecasted period once Dr. Spitznagel's detailed statistical
16 analysis is applied to normalize the sales levels for weather and usage trends. The
17 Company believes its sales levels included in its forecasted period filing are
18 reflective of the sales levels that would occur in a normal year and should be used
19 for determining the proper rates in this case just as they have been in past cases.

20
21 62. Q. MS. CRANE ALSO INDICATES THAT THE SALES LEVELS INCLUDED IN
22 THE FORECASTED PERIOD ARE NOT REFLECTIVE OF THOSE
23 INCLUDED IN THE COMPANY'S STRATEGIC PLAN FOR 2004 AND 2005.
24 IS SHE CORRECT?

25 A. Yes, she is correct. The Strategic Business Plan to which Ms. Crane refers was
26 prepared in March 2003 and simply is not reflective of the current water sales
27 levels. The Company is not meeting those sales levels it believed it would meet
28 when in prepared that Plan in 2003. The Company's financial performance is
29 being hindered by those lower sales in 2004, and those lower sales are one of the
30 major reasons the Company has filed this rate case.

31

1 63. Q. MS. CRANE INDICATES THAT WATER CONSERVING PLUMBING
2 FIXTURES DO HAVE AN IMPACT ON THE DECLINING WATER USAGE
3 PER CUSTOMER. IS SHE CORRECT AND ARE THERE OTHER DRIVERS
4 FOR LOWER USAGE PER CUSTOMER?

5 A. She is correct in mentioning that low flow plumbing fixtures in new home
6 construction is leading to lower average usage. The low flow devices are the only
7 ones being sold today, and as they replace older homes plumbing fixtures, average
8 usage is impacted. This is not a trend limited to just the Company, but is being
9 seen across the country. In addition, Ms. Crane may or may not be aware that the
10 Company, as required by Commission Order, has had an aggressive customer
11 information program to promote water conservation. The Company believes this
12 customer information program is also having a significant impact on the lower
13 average usage per customer. All of the conservation impacts and weather
14 normalization are taken into account in the Company's forecasted test-year water
15 sales included in this filing. Again the Company believes given all the factors
16 described in this rebuttal testimony support the concept that the rates in this case
17 should be established on the Company's forecasted sales levels.

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20 **SALARIES AND WAGES**

21

22 64. Q. THE AG WITNESS ELIMINATES THREE VACANCIES THAT THE
23 COMPANY HAD AT THE TIME OF THE RESPONSE TO PSCDR2-#52. DO
24 YOU AGREE WITH THIS ADJUSTMENT?

25 A. No. The Company is currently filling these positions and expects to have them
26 filled by the time of the hearing on November 8.

27

28 65. Q. WHAT REASONING DOES MS. CRANE USE TO JUSTIFY HER
29 ADJUSTMENT?

30 A. She indicates that it is normal for utilities to have vacancies and the Company has
31 had vacancies in 64 of the last 66 months.

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66. Q. IF THE COMPANY HAS HAD REGULAR VACANCIES WHY IS HER ADJUSTMENT NOT APPROPRIATE?

A. When the Company has vacancies it must use overtime and temporary employees to fill the void. Mr. Bush will cover this in his testimony. The Company included a compliment of 133 employees in its forecasted test-year filing, but eliminated over 5,700 hours of overtime experienced from the 2003 and 2004 actual overtime hours to compensate for its request for this compliment of employees, as well as eliminating temporary labor used in 2004 to compensate for vacancies. It would be appropriate to incorporate the vacancies into the rate filing only if the overtime hours and temporary labor charges used to compensate for the vacancies is restored to the forecasted test-year. It is not appropriate to impute the vacancies and utilize the lower overtime and temporary labor as is being suggested by Ms. Crane.

67. Q. EVEN IF THE VACANCIES WERE INCORPORATED, DID MS. CRANE CALCULATE THE PROPER ADJUSTMENT?

A. No. Ms. Crane used an average cost per employee without any recognition as to the actual cost of those employees included in the forecasted test-year or the capitalized payroll amounts.

68. Q. WHAT IS THE O&M COST INCLUDED FOR THE THREE VACANCIES INCLUDED IN THE FORECASTED TEST-YEAR?

A. The O&M labor and overhead costs included in the forecasted test-year compared to Ms. Crane's adjustment are shown in the following schedule.

<u>Position</u>	<u>Total Salary</u>	<u>Salary Capitalized</u>	<u>O&M Salary</u>
Crew Leader	34,481	3,724	30,757
Meter Reader (inc.OT)	52,186	234	51,952
Engineer	<u>60,000</u>	<u>60,000</u>	<u>0</u>

1	Totals	146,667	63958	82,909
2	Overhead Rate			<u>154.45%</u>
3	Labor Cost plus overheads			128,052
4	AG Adjustment			<u>193,796</u>
5	Overstatement of AG Adjustment			65,744

6

7 69. Q. THE AG WITNESS HAS RECOMMENDED THAT 90% OF THE SALARY
8 OF THE PRESIDENT AND THE EXECUTIVE SECRETARY OF THE
9 COMPANY BE ELIMINATED FROM RATE RECOVERY. PLEASE
10 COMMENT ON THIS ADJUSTMENT?

11 A. The LFUCG in this case issued numerous data requests in this case which in the
12 opinion of the Company had absolutely nothing to do with the establishment of
13 just and reasonable rates in this case, but instead were issued in an attempt to
14 promote their condemnation proceeding. The AG witness Ms. Crane has latched
15 on to this theme in her recommendation to eliminate 90% of the salary and payroll
16 overheads of the President and the Executive Secretary indicating that since they
17 spend time on the condemnation effort their salaries should not be recovered in
18 rates. This adjustment is not appropriate, nor is not founded on proper regulatory
19 principles.

20

21 70. Q. DID THE COMPANY INCLUDE ANY EXTERNAL COST IT HAS
22 EXPENDED FOR THE CONDEMNATION ISSUE IN THE RATES
23 REQUESTED IN THIS CASE?

24 A. Absolutely not. The Company did not include one penny of the additional cost it
25 has had to expend to protect its existence and its service to its customers.

26

27 71. Q. THE COMPANY INDICATED THAT THE PRESIDENT AT THE TIME OF
28 THE FILING THE CASE WOULD NOT FILE TESTIMONY. PLEASE
29 EXPLAIN?

30 A. That is correct. The Company indicated that due to the extra efforts required by
31 the condemnation effort, Mr. Mundy (the President at that time) would not

1 provide testimony and that is the reason that Mr. Jarrett would testify. The
2 Company indicated that Mr. Mundy had been directed by the Board to dedicate
3 his effort to the condemnation. Given his responsibility to continue to run day to
4 day operations and manage the tasks associated with a contentious condemnation
5 effort it was decided that given the expected level of additional work associated
6 with the upcoming rate case filing Mr. Mundy would not have the time to
7 participate in the rate case. Given the decision for the current President not to
8 provide testimony in the rate case the Company believed it necessary to provide
9 an explanation as to why Mr. Jarrett would appear in this case.
10

11 72. Q. DID THE COMPANY CLARIFY ITS POSITION ON THIS DECISION IN
12 RESPONSE TO NUMEROUS DATA REQUESTS?

13 A. Yes. The LFUCG asked repeated questions in discovery attempting to establish
14 that certain employees did nothing but work on the condemnation. The Company
15 responded consistently that the LFUCG was not accurate. The Company clarified
16 that the President's job description had not changed; the President was still
17 responsible for the day to day operations of the Company and was still
18 responsible for all aspects of government and customer relations in addition to the
19 additional workload imposed on the Company by the condemnation effort of the
20 LFUCG. The Company clearly addressed this topic in the responses to
21 LFUCGDR1-#52, and LFUCGDR2-questions # 26, 27, 29, 30, 31, 32, 33, 35, 36,
22 and 37. Ms. Crane has now become the advocate for the position put forth by the
23 LFUCG that the Company should now absorb the cost of its employees who for
24 no other reason than what the Company believes is an ill-conceived effort by the
25 LFUCG to attempt to acquire the Company through a contentious and costly
26 condemnation effort.
27

28 73. Q. WOULD YOU PROVIDE A SUMMARY OF THE COMPANY'S POSITION
29 ON THIS ISSUE?

30 A. Yes. I believe the best summary is found in the Company's response to
31 LFUCGDR2-#37. That response says, "The Company sees no reason to track

1 internal time related to the condemnation effort. The Company has essentially the
2 same level of management employees today as it had before the condemnation
3 proceeding was initiated by the LFUCG and if the condemnation proceeding were
4 to end tomorrow the Company would still need essentially the same level of
5 management employees. In other words the Company has absorbed the
6 extraordinary level of additional work associated with the condemnation effort of
7 the LFUCG by having its management employees work longer hours and week
8 ends with no additional pay. Since the Company would need the same level of
9 management employees as it has today to run its operations and there is no
10 additional internal costs to the Company related to the condemnation effort it is
11 absolutely appropriate and justified that it recover its internal labor and labor
12 related expenses from the rate payers.”

13
14 74. Q. YOU SAID EARLIER THAT THE POSITION OF THE AG TO ELIMINATE
15 90% OF THE PRESIDENT AND EXECUTIVE SECRETARY’S SALARY
16 WAS NOT FOUNDED ON PROPER REGULATORY PRINCIPLES. PLEASE
17 EXPLAIN?

18 A. As explained in the previous answer the Company’s management employees have
19 been required to absorb the additional work associated with the condemnation
20 effort. This has been done with no additional cost to the Company or the rate
21 payers because all additional costs related to the condemnation (external costs)
22 have been eliminated from the forecasted test-year filing. The elimination of the
23 salaries proposed by the AG would not reflect the known and measurable on-
24 going costs of the Company that are required to continue providing the excellent
25 water service for which the Company is known. It would not be appropriate to set
26 rates in this case absent those management salaries that are critical to the service
27 provided by the Company. That would not be consistent with proper regulatory
28 principles.

29
30 **INCENTIVE PLAN COSTS**

1 75. Q. WHAT ADJUSTMENTS TO THE COMPANY'S FILING DID THE AG MAKE
2 RELATED TO INCENTIVE PLAN COSTS?

3 A. The AG witness used a three-year average to determine the Annual Incentive Plan
4 (AIP) costs and then further reduced the request to reflect only 40% of the three-
5 year average costs. She eliminated the entire Long-term Incentive Plan costs
6 requested by the Company.
7

8 76. Q. WHAT IS THE COMPANY'S POSITION ON MS. CRANE'S
9 RECOMMENDATION TO USE A THREE-YEAR AVERAGE TO
10 DETERMINE THE AIP COST?

11 A. Given the potential for annual fluctuation in the AIP cost, depending on the extent
12 the Company and each individual meets the goals established for payment of the
13 AIP, the use of a three-year average would be reasonable. When the ability to
14 predict costs due to annual fluctuations may be difficult, the use of historical
15 averages in the rate making process is appropriate for consideration. The
16 Company will accept the AG's recommendation that the AIP cost be set at
17 \$145,899 in this case.
18

19 77. Q. DOES THE COMPANY AGREE WITH THE AG'S RECOMMENDATION TO
20 LIMIT THE AIP COST TO THE NON-FINANCIAL PORTION OF THE
21 PAYMENT?

22 A. No. Ms. Crane is incorrect in her reasoning in this area where she indicates only
23 the shareholders benefit from the strong financial performance of the Company
24 and the rate payers receive no benefit. The Company directly responded to this
25 assertion in response to PSCDR3-#61. That question was - "State why it is
26 reasonable to include for rate-making purposes the portion of the incentive pay
27 reward attributable to Kentucky-American's financial performance when the
28 benefits of such reward accrue only to Kentucky-American's shareholders?" The
29 response says, "KAWC does not agree with the statement contained in the
30 question. The AIP and LIP are structured to incorporate a culture in management
31 to continually strive to seek out efficiencies and cost saving measures whenever

1 possible. It is not true in the regulated environment in which KAWC operates
2 that only the shareholders benefit when strong financial performance is obtained.
3 As the Company continues to operate more productively and efficiently the
4 savings from those efforts enhance shareholder return until other factors (such as,
5 capital investment, inflation, etc.) drive the need to increase rates. Once new rates
6 are approved those savings then are flowed directly to the customers. Efficiency
7 and productivity gains, and associated cost savings, promoted by the incentive
8 plans will directly benefit the customers in that they help offset increased costs in
9 other areas of the business and can help prolong the need to raise rates, and once a
10 rate increase is necessary it will be less than what the need to increase rates would
11 have been if the efficiency and productivity gains, and associated cost savings had
12 not been made. The customers are the ultimate beneficiaries of the financial
13 benefits that accrue from the strong financial performance of the Company as are
14 the stockholders on the interim period between rate cases.”

15
16 As stated in the discussion and rebuttal on the CCC and the SSC it would be
17 inappropriate to pass the savings generated to the rate payers from cost savings
18 initiatives but deny the Company recovery of the costs that contribute to
19 generations of those savings. If this theory of regulation were routinely imposed
20 on Companies it would be a disincentive for any regulated company to pursue
21 efficiency and productivity gains if the cost to generate those savings were not
22 recovered by the Company. The Company does not believe that is the message
23 that the Commission wishes to send to the utility companies operating in the
24 Commonwealth.

25
26 78. Q. ARE THERE OTHER JUSTIFICATIONS FOR THE RATE RECOVERY OF
27 INCENTIVE TYPE COMPENSATION?

28 A. Yes. Incentive pay plans should not be viewed as some form of entitlement in
29 utility operations; they should be viewed as an integral part of the overall
30 compensation package. It is the norm in most utility compensation packages. As
31 described in the response to PSCDR3-#61, incentive pay plans are common in

1 most companies and many utility companies. One of the goals of the incentive
2 plans is to provide a competitive overall compensation package in order to attract
3 and retain employees possessing the high qualifications and technical skills
4 required to manage and operate a major utility. The customers benefit in the form
5 of enhanced service and lower cost when the Company is able to attract, motivate
6 and retain employees with high qualifications and management skills.

7
8 79. Q. YOU SAY THAT THE PRESENCE OF INCENTIVE PLANS IS PREVALENT
9 IN THE UTILITY INDUSTRY. WHAT SUPPORT DO YOU HAVE FOR
10 THIS?

11 A. The Company addressed this subject in the response to PSCDR3-#36. I am
12 attaching that response as Rebuttal Exhibit MAM-7. I must note that copies of
13 incentive plans of other utilities are not easily accessible to the Company and
14 many companies would not share those plans for public knowledge. The
15 Company was able to obtain from one of its consultants, Towers Perrin, a copy of
16 a recap of the information they had obtained in a survey they performed of
17 various regulated entities. Attached to the response is a letter issued to the
18 Company recapping the survey results regarding the prevalence of incentive plans
19 in the utilities responding to the survey. The letter indicates that 99% of the
20 utilities responding had incentive pay plans for their executives and 95% of the
21 utilities had incentive pay plans for their middle management and professional
22 employees. The Company believes this data strongly supports the Company's
23 position that if it is to attract and retain highly qualified and capable employees
24 the AIP is an important aspect of its overall compensation plan.

25
26 80. Q. WHAT POSITION DOES THE AG TAKE REGARDING THE LONG-TERM
27 INCENTIVE PLAN?

28 A. The LIP is eliminated entirely.

29
30 81. Q. WHAT JUSTIFICATION IS GIVEN?

1 A. One justification given is that Ms. Crane mistakenly indicates it is the President of
2 Kentucky-American who recommends his or her own pay under the LIP to the
3 Board of Directors. If this were true she would probably be correct. However,
4 Ms. Crane is mistaken on this point.
5

6 82. Q. PLEASE DESCRIBE WHY SHE IS WRONG?

7 A. The LIP was established by the Board of Directors of American Water, not
8 Kentucky American. It is the President of American Water who establishes
9 eligibility for the plan, not the President of Kentucky American. The President of
10 Kentucky American does not determine his or her own eligibility or award under
11 the plan. The Company believes it is critical to attract and retain highly qualified
12 executives in order to maintain the quality of service expected by the customers
13 and employees of the Company. The Company believes the LIP is critical to the
14 overall compensation package required to attract the type of executives required
15 to manage the major utilities in the American Water system because it is
16 competing for those types of individuals with other major utilities and other
17 business who likely have similar compensation incentive packages. The
18 Company believes the customers are the ultimate beneficiaries of the innovative
19 and diligent work of its executives and the stability provided by attracting and
20 retaining those highly qualified executives.
21
22

23 **OTHER POST EMPLOYMENT BENEFITS**
24

25 83. Q. DID THE AG MAKE AN ADJUSTMENT TO THE COMPANY'S PROPOSED
26 OPEB EXPENSE?

27 A. Yes, Ms. Crane eliminated the 9% increase in OPEB expenses over the 2004
28 actuarial level reducing the Company's request by \$51,738. She supports this
29 adjustment by indicating that increased medical costs do not necessarily mean that
30 OPEB expenses will increase, and OPEB expenses are also impacted by return on
31 assets, number and ages of employees, pay increases and other factors.

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84. Q. DOES THE COMPANY AGREE?

A. No. She is correct that OPEB costs are impacted by the factors she mentions. However, the Company's employee level is stable from 2004 to 2005, which eliminates that factor from decreasing costs. The Company will provide a pay increase in 2005 as it has historically done each year and the increase in medical costs is solid given the trends in the medical area. She indicates that OPEBs have gone up and down in the various years between 1999 and 2003, but she gives no consideration to the fact that the Company has reduced its employee count during this period by approximately 20 positions due to movement of positions to the SE Region, the Call Center and the Shared Services Center. The average annual OPEB cost has increased 7.7% between 1999 and 2003 and this increase would have been much greater on a per employee basis if Ms. Crane had taken the reduction in employees into account. Ms. Crane attempts to indicate the 9% increase in OPEB costs for 2005 is unreasonable, but like in many areas of her testimony she only portrays a small portion of the story and attempts to rely on historical information that is not reflective of current events. The Company believes its proposed increase of 9% for OPEB costs in 2005 is reasonable, supported by the actuarial assumptions, is consistent with historical trends, and should be approved in this case.

AMORTIZATION OF DEFERRED COSTS

85. Q. YOU COVERED IN YOUR REBUTTAL TESTIMONY REGARDING RATE BASE THE DEFERRED DEBITS ELIMINATED BY THE AG. DOES THIS ALSO HAVE AN IMPACT ON THE OPERATING EXPENSES?

A. Yes. In the rebuttal testimony above on rate base I have addressed the areas regarding rate recovery for the Tri-Village and Elk Lake UPAA; and the deferred costs for security, call center transition costs, and shared services center transition costs. The Company believes that it has demonstrated that the AG's position is

1 not appropriate and I will not repeat those positions here. The rate recovery of
2 those items should also include an amortization of the costs. Rebuttal Exhibit
3 MAM-5 identifies the amortizations of these four items is \$401,827, and the
4 amortizations of those four items should also be included in the approved rates in
5 this case for all the numerous reasons covered earlier in this rebuttal testimony.
6
7

8 **RATE CASE EXPENSE**
9

10 86. Q. WHAT LEVEL OF RATE CASE EXPENSE DID THE COMPANY INCLUDE
11 IN ITS FILING?

12 A. The Company included \$622,409, requesting a three-year amortization of the cost
13 for rate recovery.
14

15 87. Q. DID THE AG ADJUST THE COMPANY'S REQUEST?

16 A. Yes. Ms. Crane eliminated \$70,000 of the Company's request, citing that in her
17 opinion there was a duplication of cost related to the service company and the
18 hiring of outside consultants and indicating the cost of the current case was more
19 than had been experienced in prior cases.
20

21 88. Q. HAS THE COST OF THIS CASE BEEN HIGHER THAN PREVIOUS CASES?

22 A. Yes, but that has absolutely nothing to do with the cost of this case. The
23 Company provided the reasons for the cost of this case in response to PSCDR2-
24 #65. As indicated in the response to that request, this case has been more
25 involved than previous cases and a great many new issues are present in this case
26 because it has been over four years since the last general rate case. The
27 Company indicated that this case involved rate recovery issues for the call center,
28 shared services, security and the rate issues surrounding the Northern Division
29 that have not been present in previous cases. There has also been an
30 extraordinary amount of discovery in this case, including subparts there were over
31 1000 responses to discovery. A good deal of the discovery was related to the

1 LFUCG's desire to bring condemnation issues into this proceeding although they
2 have nothing to do with the establishment of just and reasonable rates in this case.
3 Regardless the Company did its best to provide responses to the massive
4 discovery requests. Given the level of new issues in this case the Company has
5 had to bring more external witnesses than in past cases.
6

7 89. Q. WILL THE COMPANY SPEND THE \$622,409 ESTIMATED TO PROCESS
8 THIS CASE?

9 A. Yes. As of September 2004 the Company has expended \$708,062 and expects to
10 spend approximately \$50,000 more through the hearing. The recommendation of
11 Ms. Crane to reduce the estimate is not supported by the actual cost or the other
12 justifications mentioned in her testimony. In addition, the issues in this case are
13 driving the cost of this case compared to previous cases, and the rate case cost
14 from the Company's past cases should have no bearing on the rate case cost
15 recognized for rate recovery in this case.
16

17 90. Q. MS. CRANE SUGGESTS THAT THERE IS A DUPLICATION OF COSTS
18 FROM THE SERVICE COMPANY AND THE OUTSIDE CONSULTANTS
19 INVOLVED WITH THIS CASE. IS SHE CORRECT?

20 A. No. The SE Region Service Company rate department is currently comprised of
21 four analysts and me. This year Ed Oxley left the Company to return to the WV
22 Commission after over 15 years service and Roy Ferrell retired after over 35 years
23 service. This year the Company has completed its Virginia rate case in June, filed
24 the WV rate case in March (the hearing was just completed September 13), filed
25 the Kentucky rate case in April, and filed a Tennessee rate case in September.
26 Given this heavy workload the Company had little choice but to utilize outside
27 consultants. The cost of accounting consulting in this case is not duplicative of
28 the service company cost in this case as suggested by Ms. Crane, but is a function
29 of the workload of our department. She provides no support for this position
30 other than her opinion which may have been influenced by her work on rate cases
31 from other American Water subsidiaries. Regarding her contention that lead/lag

1 studies have historically been prepared by Service Company employees, again she
2 is not accurate. Since Ed Grubb's transfer to Missouri, the SE Region has not
3 performed lead/lag studies in-house, but has hired consultants for this issue in
4 each state where it has filed a rate case since 2002.

5
6 91. Q. PLEASE SUMMARIZE THE COMPANY'S POSITION ON RATE CASE
7 EXPENSE?

8 A. The cost of this case is higher than in past cases as the Company knew it would
9 be. The number of new issues in this case is the driver of the cost, along with
10 extensive discovery by the parties. Ms. Crane supplies no facts to support her
11 recommendations other than historical costs of prior cases, and her unsupported
12 contention of duplicative efforts. This is not sufficient justification for the
13 Commission to eliminate the cost already expended to process this case.

14
15
16 **BUSINESS DEVELOPMENT COSTS**

17
18 92. Q. DID THE AG WITNESS MAKE ADJUSTMENTS TO MANAGEMENT FEES
19 TO ELIMINATE BUSINESS DEVELOPMENT COSTS?

20 A. Yes. She has eliminated \$117,525 of management fee costs associated with
21 business development. Ms. Crane suggests regulated water companies have
22 essentially a captive audience for service and therefore there is little need to
23 undertake business development opportunities. She goes so far as to say that
24 business development is almost oxymoronic for a regulated water utility.

25
26 93. Q. DO YOU AGREE WITH MS. CRANE?

27 A. Obviously I do not. I covered in detail the benefits that the acquisitions of the
28 Tri-Village and Elk Lake acquisitions have had on the customers of the Central
29 Division and will not repeat them here. In the direct testimony of Mr. Bush he
30 described the allocations of both corporate management costs and hourly costs to
31 both the regulated acquisitions and the contract operations managed by the

1 Company which have directly benefited the Central Division customers. She also
2 ignores that the Company has been encouraged by various Kentucky
3 governmental bodies, including the Commission, to expand its system when it
4 makes sense to do so. Obviously, the Commission, the Department of Water and
5 Kentucky Infrastructure Authority do not share Ms. Crane's clouded view that
6 expansion of service is "oxymoronic" and provides no benefits to the existing
7 customers.
8

9 94. Q. IS SHE CORRECT THAT ONLY THE SHAREHOLDERS BENEFIT FROM
10 GROWTH THROUGH ACQUISITION OR CONTRACT OPERATIONS?

11 A. No. The testimony of Mr. Bush and this rebuttal demonstrate that the existing
12 customers benefit in the growth from acquisitions. Ms. Crane appears to be an
13 experienced regulatory consultant and I am sure she knows that the benefit from
14 any efficiency gains, cost saving measures and growth only remain with the
15 Company until other factors require rates to be adjusted. In each rate case any
16 benefits from these activities then flow to the customers. While I am sure Ms.
17 Crane knows the rate making process she attempts to incorrectly portray that
18 business development provides no benefits to existing customers.
19

20 95. Q. HAS THE COMPANY RECOVERED BUSINESS DEVELOPMENT IN PRIOR
21 CASES?

22 A. Yes. In the 2000 rate case the Company had a business development employee
23 on its payroll (David Baker) and his salary was included in the cost of service in
24 that case. Shortly after that case Mr. Baker was promoted and transferred to
25 Illinois. The SE Region Office had business development employees and
26 Kentucky business development activities were incorporated into their positions.
27 The reasons were simple; the Company believed it could accomplish those results
28 at a lower cost by sharing the business development costs with the four other
29 states in the SE Region. After Mr. Bush completed his important work in
30 developing the Call Center operation and transitions he too filled one of those
31 business development positions in the SE Region Office, concentrating primarily

1 on Kentucky and Tennessee. Contrary to the suggestions of Ms. Crane the
2 Company can not develop new territories without some resources dedicated to
3 that activity. The Company believes it has demonstrated that business
4 development does benefit its customers, had been recognized in prior rate cases,
5 and there has been no credible evidence provided by Ms. Crane to support not
6 continuing to recover those costs in this rate case.

7
8
9 **FEDERAL INCOME TAXES**

10
11 96. Q. WHAT ADJUSTMENTS TO FEDERAL INCOME TAXES HAS THE AG
12 RECOMMENDED?

13 A. Other than the normal adjustments to income taxes resulting from changes in the
14 operating income impact from the AG's recommendations in this case, Ms. Crane
15 is proposing that a consolidated tax savings be used for the Company.

16
17 97. Q. IS THIS A METHOD PREVIOUSLY USED BY THE COMMISSION TO
18 DETERMINE THE FEDERAL INCOME TAXES OF THE COMPANY?

19 A. No. The Company has always been regulated as a stand alone entity for federal
20 tax purposes and to my knowledge such a concept as proposed by Ms. Crane has
21 not been utilized to establish rates for any regulated utility in Kentucky.

22
23 98. Q. SHOULD THE COMMISSION ADDRESS SUCH A MAJOR CHANGE IN
24 POLICY IN THIS CASE?

25 A. No. This would constitute a major change in the Commission's policy regarding
26 income taxes and would have far reaching implications to every major utility in
27 the Commonwealth. While the Company strongly disagrees with the concept put
28 forth by Ms. Crane, if the Commission has any interest in pursuing the subject,
29 the most appropriate way to address the consequences would be in a generic
30 proceeding where all utilities could participate.. The Company has contacted Mr.

1 James Warren, a tax attorney and CPA who has extensive experience in this and
2 other tax matters to provide rebuttal testimony on this issue.

3
4 99. Q. WHY IS A CONSOLIDATED TAX SAVINGS APPROACH NOT
5 APPROPRIATE FOR ESTABLISHING THE COMPANY'S RATES IN THIS
6 CASE?

7 A. The Company is required to expend cash at the statutory federal tax rate for the
8 federal tax liability generated from the taxable income of the Company. Ms.
9 Crane is suggesting that a lower tax rate be used than the statutory rate on which
10 Kentucky American must pay. This would create a situation whereby the
11 Company would not recover in rates an expense it is required to pay whether it is
12 a stand alone taxpayer or part of a consolidated return. This situation would erode
13 the Company's ability to achieve its authorized ROE, a permanent erosion of 29
14 basis points if Ms. Crane's adjustment were accepted that could never be
15 recovered by the Company.

16
17 100. Q. ARE THEIR OTHER REASONS THAT THIS RECOMMENDATION
18 SHOULD NOT ADDRESSED IN THIS CASE?

19 A. Yes. The Company can not take advantage of tax losses experienced by other
20 member companies as suggested by Ms. Crane. There is no windfall tax benefit
21 to the Company either. The Company pays its federal income taxes at the same
22 statutory rate as it would as a stand alone company as long as it has taxable
23 income. The only benefit to the Company in being a part of a consolidated
24 federal income tax return is that if it were to ever have a taxable loss it could get
25 an immediate refund for the tax loss. Under a stand alone tax return, the
26 Company would be able to recoup the tax loss by use of the net operating loss tax
27 provision against a previous or future income tax year. The Company has
28 historically generated taxable income therefore the Company's participation in
29 any tax losses of the consolidated group are strictly passive, meaning the
30 Company has no risk in the expenses or tax strategies that generate those tax
31 losses, nor does it recover in rates one penny of the expenses associated with

1 those tax losses. What is suggested by Ms. Crane is that the customers of
2 Company should receive a non-existent tax benefit to the Company. What she is
3 suggesting is that the Commission should confiscate the tax benefit of other
4 companies, a tax benefit which Kentucky American had no part in generating.
5 Her position would create a cross subsidy to the Company to which its ratepayers
6 are not entitled. She recognizes the problems with this cross subsidy issue
7 regarding tax losses generated by regulated companies and suggests that regulated
8 company tax losses should be excluded from her calculation since those regulated
9 companies are expected to generate taxable income in the future. However, she is
10 perfectly willing to create this same subsidy regarding non-regulated companies
11 in the consolidated group even though they too are expected to generate taxable
12 income in the future. The use of a consolidated tax savings for regulated utilities
13 is not appropriate and should be dismissed by the Commission.
14

15 101. Q. MS. CRANE INDICATES A SMALL NUMBER OF STATE REGULATORY
16 COMMISSIONS USE CTS? WOULD YOU COMMENT ON THIS?

17 A. Yes. She indicates that WV, PA and NJ use CTS and I believe she is correct. I
18 believe that only one other state uses CTS, that being Texas. Mr. Warren will
19 cover this area in detail, but each of the states mentioned by Ms. Crane applies the
20 CTS differently and less restrictively than the method suggested. In addition, the
21 three states mentioned by Ms. Crane established their position on CTS over 30
22 years ago. That leaves 46 state regulatory jurisdictions that do not use CTS.
23 While Ms. Crane has worked in WV, PA, and NJ their positions on CTS were
24 established long before her arrival, and her involvement in cases in those states is
25 surely not sufficient evidence to support this Commission's adoption of such a
26 potentially far reaching, and in the Company's opinion, damaging policy in this
27 case.

28 **INTEREST SYNCHRONIZATION**

29
30 102. Q. DESCRIBE THE AG'S ADJUSTMENT IN THIS AREA?

1 A. The AG has synchronized the interest based on the AG's position on rate base,
2 capital structure, and weighted cost of capital. The Company has rebutted all of
3 these issues and the interest synchronization would need to be adjusted to
4 conform to the Commission's final determination in these areas.
5

6 **LOW INCOME TARIFF**
7

8 103. Q. THE LOW INCOME TARIFF IS ADDRESSED BY AG WITNESS MR.
9 RUBIN. WHAT IS HIS POSITION?

10 A. While Mr. Rubin appears to support assistance for low income customers, as does
11 Mr. Burch from the Community Action Council, he recommends not approving
12 the Company's proposed Low Income Tariff on legal advice that the tariff is not
13 lawful. I can not make the determination if it is lawful and will leave that for the
14 lawyers to brief and the Commission to decide. I do know that the same type of
15 tariff has been approved in Pennsylvania and is being considered in a number of
16 other states. I also know that Commissions approve tariffs all the time that are
17 outside the normal, strict application of class cost of service studies. There are
18 special tariffs for incentive economic development and sale for resale customers
19 that are approved on the premise of cost based rate making, but are outside the
20 results produced in a class cost of service study. There are also tariffs generated
21 in other jurisdictions to address special situations and extenuating circumstances
22 and are determined to be cost based given the overall benefit to the customers.
23 Commissions make these determinations in various jurisdictions all the time. I
24 will leave it to the Commission to determine the merits of this tariff and its
25 legality. If the Commission should approve the tariff, the Company requests that
26 the \$30,000 dollar expense be included in the cost of service. That cost as
27 indicated in my direct testimony was estimated to cost 2.5 cents per customer per
28 month and seems a small price to pay in order to help those fellow residents who
29 have the most difficulty in paying for an essential service, the provision of potable
30 water.
31

1 104. Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

2 A. Yes.

3