**KENTUCKY-AMERICAN WATER COMPANY**
**CASE NO. 2004-00103**
**LEXINGTON-FAYETTE URBAN COUNTY GOVERNMENTS**
**THIRD REQUEST FOR INFORMATION**
**ITEMS 1-9**

Witness Responsible:

Coleman Bush

1. Please refer to pages 7 though 11 of the rebuttal testimony of Coleman Bush pertaining to the proposed Emergency Pricing Tariff ("EPT"), as well as the exhibits thereto.

   (a) Has KAWC conducted any meetings regarding the EPT with outside participants such as those listed on page 7 since June 2000? If so please list all such meetings, including the participants and dates. If not, please explain in detail why no additional meetings regarding this tariff were held.

   (b) Is KAWC recommending either the revocation of, or amendment of, Lexington-Fayette Urban County Government Ordinance No. 221-2000 (now codified as Section 11-9 of the Code of Ordinances, Lexington-Fayette Urban County Government, "Water shortage response") (the "ordinance")? If so please provide in detail all such recommendations and the justification therefore.

   (c) Please explain in detail how the customers of KAWC will be made aware of the EPT prior to its actual implementation and the corresponding increase in their rates. To the extent that such notification relies on the process contained in the ordinance, please explain what additional steps, if any, would be taken for notifying customers outside Fayette County.

   (d) How will any additional revenues collected under the EPT be utilized by KAWC? Does KAWC propose to retain all such revenues?

   (e) Regarding the proposed residential rate, does the November-April "base period" commence on November 1 and end on April 30? If not, please provide the actual proposed time frame.

   (f) Please explain in detail the rationale utilized to come up with different base periods for each customer classification.

Witness Responsible:

Coleman Bush

(g) Is KAWC willing to consider filing the EPT as a separate matter before the Commission and/or having it considered as part of Commission Case No. 2001-117? Please explain your answer in detail.

Response:

(a) No. The Company felt that it had general agreement (I am unable to say that it was consensus) on the major points of the tariff among all parties involved in the meetings up to and including June 2000. While preparing the tariff for submission, the Company reviewed its files from past external and internal meetings and also conducted a search of the Internet for related information, but found nothing that conflicted with what it believed to be the general agreement for a tariff design reached during the earlier external meetings.

(b) No.

(c) In the event of a drought emergency, while we cannot depend on the media to spread the message, I believe it is a foregone conclusion that the Herald-Leader and other area newspapers will carry a story or stories regarding the drought emergency including the steps that the Company will have to take during the emergency, including the implementation of the Emergency Pricing Tariff. For example, in the past, during drought conditions, the Herald-Leader kept our customers informed daily of key information related to drought metrics. The radio and TV media will no doubt find this a story of interest as well.

While it has not been developed, in the event of a drought emergency, the Company would conduct an intense education campaign designed to keep customers informed not only of the implementation of the Emergency Pricing Tariff, but of the entire

Witness Responsible:

Coleman Bush

Demand Management Plan and of each step as it is implemented. Because of the serious implementation issues related to this tariff, it is being proposed for implementation only as a final step to preserve human health and safety – at the Water Rationing Phase of the Demand Management Plan. The phase preceding the Water Rationing Phase, the Water Shortage Emergency Phase, specifies that all customers will be notified of their current actual usage and base usage amounts in preparation for the implementation of the Emergency Pricing Tariff if it should become necessary. At this point, we will be asking customers to reduce demand far beyond what is comfortable. This communication with our customers will be accomplished via our billing system through bill messages or bill inserts along with a general education campaign through print, TV and radio media.

(d) It remains to be seen if there will be any additional revenues in total. Or, if there are additional revenues in total, whether they will even be adequate to cover the additional expenses that result from the drought emergency such as increased customer education costs and increased meter reading costs as explained in my responses to previous requests for information. I cannot speak for the Commission, but I have proposed that the final order approving the Emergency Pricing Tariff be accompanied by a formal "true-up" process whereby all parties would have input into a final handling for rate purposes of drought related revenues and expenses. The objectives of the process should be to treat all customers fairly and consistently and to allow the Company to maintain its financial integrity according to the measurements prescribed in the general rate order.

(e) The determination of the base period for residential customers is based on the Lexington-Fayette Urban County Government's practice for sewer billing as contained in its Code of Ordinances:

Witness Responsible:

Coleman Bush

*Sec. 16-58. Charges based on water consumption.*

*It is hereby determined that the most accurate and feasible method of ascertaining and measuring the use of the facilities and services of the sanitary sewer system, and of requiring compensation for such use, is by basing sanitary sewer service rates and charges upon the quantity of water supplied to the premises of the respective users, as shown by periodic meter readings of the party supplying water service; and the urban county government's rates and charges for such use and service are established on such basis. It being realized that all such water supplied may not be discharged into the sanitary sewer system, for those users, as defined in schedule A of Code of Ordinances section 16-59, the urban county government will utilize low water usage months, determined to be the calendar months of November, December, January, February, March and April, for purposes of calculating an average for use in the remaining months of the year if such averaging will result in a bill based on a lower consumption than the actual consumption during those remaining months. A zero-month reading, that is, a month in which no water is consumed, will not be used in computing averages. Those new customers who do not have an established use history of three (3) or more months of low water usage will be billed at a rate of ninety (90) percent of actual usage until the low water usage months begin.*

(f) Our selection of the criteria for determining the base period for each classification was a result of what the Company felt was the general agreement reached during our external meetings. In particular, the industrial class relies heavily on summer cooling, in many cases a large contributor to increased summer demand. One of the overarching goals of the Emergency Pricing Tariff is, as long as basic human health and safety needs are met, to preserve business. Many of our customers and especially our industrial customers, because water us such a big part of their operating costs,

Witness Responsible:

have already enacted measures to reduce water consumption and accordingly might not have much room to decrease demand in the event of a drought if they want to remain in business. However, and we felt we had general agreement on this point with the parties in our external meetings, the customers in the industrial class were certainly willing to do everything they could, short of closing their doors, to reduce their water demand. Of course, if the situation became so dire, they were willing to close their doors to preserve human health and safety. For this class, we felt a reasonable compromise was to use the May – October period as a base, a time of higher average demand, but a time that contains enough periods with low temperatures and ample rainfall that would cause the resultant average to produce a base much lower than actual demand during a drought with its associated dry conditions and high temperatures.

For the other classes, which have more diversity than the industrial class, the Company felt that the use of an annual average would result in a base significantly lower than what would actually be demanded during a drought, but with enough of the summer demand in it to allow some cushion for demands necessary to preserve business and necessary government functions.

The Demand Management Plan contains the provision that these base levels can be adjusted downward if demand reduction levels are not met.

(g) The Company is willing to take any reasonable steps toward the creation of an effective Demand Management Plan, but as considerable time and expense have already gone into the creation of what the Company feels is a sound resolution to the problem and as we should not let another summer arrive without this tool in our

Witness Responsible:

Coleman Bush

Demand Management Plan, it sees no reason that the Emergency Pricing Tariff as filed should not be approved in this case.

Witness Responsible:

Michael A. Miller

2. Please refer to page 5 of the rebuttal testimony of Michael Miller, referencing "additional retained earnings" generated through August 2004. In KAWC updated filing Schedule 37B (page 45 of 45), KAWC reports that at the end of 2003 it had retained earnings of $26,090,081. At the end of the base period KAWC reports retained earnings of $22,993,100 (an 11.87% decrease over year end 2003 retained earnings).
   (a) Please explain the reason for this apparent decline in retained earnings between year end 2003 and the end of the base period.
   (b) Is the balance of retained earnings for the forecasted test year on the updated Schedule 37B the balance for the beginning of, or the end of, the forecasted period?
   (c) Please list and explain in detail all assumptions used in calculating the forecasted period retained earnings balance of $26,030,002.

Response:

(a) Schedule B-8 contained an error. The Company's capital structure components were correctly included in the Schedule J included in the filing and utilized to establish the Company's revenue requirement in this case. Attached is a revised schedule B-8 that reflects the correct information. As shown on the attached revised schedule B-8, page 2 of 2 there has been no decline in retained earnings. For electronic version, refer to KAW_R_LFCDR3#2_attachment_110304.pdf.

(b) As shown on the attached revised schedule B-8, page 2 of 2 the balance at November 30, 2005 is $30.048 million. The Capital structure used by the Company in determining the revenue requirement in this case is attached to the Direct Testimony of Michael A. Miller as Exhibit MAM-2 as was based on the 13-month average for the forecasted test-year period.

Witness Responsible:

Michael A. Miller

(c) As indicated in the responses to parts a and b above the balance of $26.030 is not correct. The retained earnings used to arrive at the forecasted test-year amounts were determined by taking the forecasted earnings for each month less quarterly dividend payments to determine the change in retained earnings balance.

Witness Responsible:

Michael A. Miller

3. Please refer to pages 8 through 10 of the rebuttal testimony of Michael Miller, and Rebuttal Exhibit MAM-3. Are the rate of returns granted in the West Virginia and/or Arizona rate orders in effect, or have they been stayed?
   (a) If either the West Virginia or Arizona rate orders have been stayed, please state when the order was stayed, under whose authority it was stayed, and provide a copy of the order or other document(s) that granted the stay on the rate of return findings.
   (b) Please provide the return on equity finding established by the respective regulatory body in Arizona and West Virginia in the last rate case in these jurisdictions.

Response:

Neither order has been stayed but both have been accepted for appeal.

(a) See response to 3 above.

(b) WV – 7%, currently accepted for appeal by the West Virginia Supreme Court of Appeals after oral argument by the Company and other parties. Briefs and Reply briefs have been filed in the Appeal Case and oral arguments on the merits will be scheduled in the near future.

AZ – 9%, currently under appeal to the Arizona Court of Appeals.

Witness Responsible:

Michael A. Miller

4. Please refer to page 22 of the rebuttal testimony of Michael Miller. Please provide all **facts** relied upon by Mr. Miller in advising KAWC's auditors that "future rate recovery is likely" for the deferred assets for which recovery is sought in this case. Please provide copies of all documents that Mr. Miller or KAWC provided to its auditors to support this statement.

   (a) Did Mr. Miller share the contents of the October 15, 2003 letter from Executive Director of the Public Service Commission, Thomas Dorman, to legal counsel for KAWC wherein the director indicated that with respect to KAWC's attempt to establish regulatory assets to accrue post September 11, 2001 enhanced security costs the Commission's Staff "finds that authorization to establish a regulatory asset to accrue such costs would be a violation of that condition [Condition 2 of the Commission's May 30, 2002 Order in Case No. 2002-00018] and should not be allowed" with KAWC's auditors?

   (b) Was the advice by Miller discussed with, or provided to, the auditors prior to the acceptance by KAWC of the merger conditions in PSC Case No. 2002-00018? When was this advice given to the auditors? Please produce a copy of all documents provided by Miller or KAWC to the auditors.

   (c) If the basis for this statement by Miller is in any way related to information provided by the Commission or its staff, please fully disclose such information and the content of any discussion, conversation, memorandum, letter, or document (along with copies of the same) including but not limited to the content, date, and persons involved.

Response:

Attached are the documents supplied to the Company's external auditors. For electronic version, refer to KAW_R_LFCDR3#4_attachment_110304.pdf. Please see the rebuttal testimony of Michael A. Miller beginning on page 20 (question 44) and ending on page 27

Witness Responsible:

(question 55) which the Company believes fully describes the Company's position about rate recovery. Mr. Miller regarding additional security costs relied on the facts and understanding of information contained in the Order in case 2002-00317 and fully described in the letter to Mr. Thomas Dorman dated November 18, 2003 which is attached to the Direct Testimony of Mr. Miller as Exhibit MAM-8. Mr. Miller also relied on FAS 71 to determine his position on the call center and shared service center transition costs, which indicates the proper treatment for deferral of expenses in regulated enterprises. As indicated in Mr. Miller's rebuttal testimony, FAS 71 permits write-off of deferred costs to the extent of savings generated.

(a) No. As indicated at numerous locations in the direct and rebuttal testimony of Mr. Miller and on Exhibit 8 to his direct testimony the Company does not believe deferral of enhanced security is in violation of Condition 2 of the Order in Case 2002-00018. The Company has also not provided a copy of the letter from Mr. Dorman dated November 21, 2003 (the last correspondence issued to the Company on this subject) which indicates the Staff is continuing to review the Company's request for deferral.

(b) See the documents attached to this response. As indicated in those documents the advice to the auditors was provided before and after the Order in case number 2002-00018.

(c) The Company has provided all correspondence on this subject in the response to this data request or in the exhibits attached to Mr. Miller's testimony. See the rebuttal testimony on deferred assets of Mr. Miller beginning on page 20 that fully describes the basis for Mr. Miller and the Company's position about rate recovery requested in this case for the deferred costs of the Company established since the Company's previous general rate case.

Witness Responsible:

Michael A. Miller

5. Please refer to pages 14, 15, and 21 of the rebuttal testimony of Michael Miller, regarding KAWC's use of the future test year and his assertions that it has worked well without serving as a windfall to the company.

(a) Please provide copies of any study, analysis, or information in KAWC's possession that supports its contention that the future test year has "worked well" for its customers. More specifically, please provide any information that demonstrates whether KAWC's rates would be higher or lower if it used an historic test period.

(b) Please provide copies of any study, analysis, or information in KAWC's possession that demonstrates that a windfall to KAWC has not occurred as result of using a future test year.

(c) Please find attached hereto as LFUCG Exhibit No. 1 a copy of a comparative analysis recently published by the Bluegrass Area Development District that includes water and sewer rates charged by the respective utilities in this district, including KAWC. Does KAWC believe that the use of a future test year impacts its relative placement among the utilities? If not, please list and describe the factors that KAWC believes would account for the discrepancy in rates among these utilities.

Response:

(a) The Company has prepared no study on this subject that would determine the rates using an historical test-year. Kentucky code and Kentucky Public Service Commission rules permit the filing of a forecasted test-year, therefore the Company sees no reason to undertake the substantial effort and cost to prepare such a study. The Company's understanding of the purpose of regulation is to set the rates of the Company at such level that will permit the Company an opportunity to achieve its authorized ROE during the time those rates are in effect. Whether a forecasted or

Witness Responsible:

Michael A. Miller

historical test-year (adjusted for known and measurable changes) is used does not change the purpose of setting the appropriate rates for the rate year (2005) in this case. Mr. Miller addressed the forecasted test-year methodology permitted by Kentucky code at length in his rebuttal testimony. Mr. Miller's position on the issue is based on his direct testimony Exhibit MAM-1 which indicates even in the rate year approved in its previous rate case (2001) the Company did not over achieve its authorized ROE, therefore there was no windfall. In addition, as indicated in the response to several data requests and the rebuttal testimony the use of a forecasted test-year has contributed to the avoidance of expensive annual rate filings, which benefits the customers over the long-term.

(b) Please see response to 5(a) above.

(c) The Company does not believe the use of a forecasted test-year has any impact nor does the Company believe a generic rate comparison provides any meaningful information concerning the establishment of just and reasonable cost based rates of the Company in this case.

For any comparison of rates to be meaningful, a multitude of factors must be fully reviewed and analyzed. As quoted from the 2000 Raftelis Rate Survey, "the determinates of utility rates are varied and complex and do not necessarily reflect the true cost of service. Drawing conclusions from rate comparisons should be done only after evaluating several community characteristics----." The following list does not encompass all the factors that must be analyzed, but is intended to provide an example of the factors that can and do cause differences in rates. The exhibit referenced in this question gives no indication any of these factors have been considered.

Witness Responsible:

Michael A. Miller

- Geography
- Level of Service
- Age of system-remaining life of assets
- Tax subsidation by public entities
- Type and quality of source of supply
- Customer density

Witness Responsible:

Michael A. Miller.

6. Please refer to pages 24 and 25 of the rebuttal testimony of Michael Miller. If KAWC believed that it would be allowed to recover deferred security costs from the Commission why did it wait until apparently September 24, 2003 to seek permission to accrue these assets?

   (a) During the pendency of Commission Case No.'s 2002-00018 or 2002-00317, did KAWC indicate to the Commission or any other party that it intended to accrue security costs for recovery? If so, please provide a detailed explanation that include the content of any communication, the dates, and the persons or parties involved, as well as copies of any supporting documentation.

Response:

The Company did not wait until September 24, 2003 to seek permission. See letter from Hebert A. Miller, Vice President and Corporate Counsel for the Company, to Mr. Thomas Dorman dated July 2, 2002. The Company's actions leading to the letter attached as Exhibit MAM-7 are explained in the direct testimony of Michael A. Miller on page 26.

(a) The Company did not know the position of the Commission on this topic until the receipt of the Order in case 2002-00018, and based on the language of condition 2 attached to that order believed it could defer the security cost for consideration in its next general rate filing. Please see Exhibit MAM-8 attached to the direct testimony of Michael A. Miller.

Witness Responsible:

Michael A. Miller

7. Please refer to pages 27 and 28 of the rebuttal testimony of Michael Miller, regarding his claim that the corrected sales levels are "representative of the sales levels that will occur in 2005."

   (a) The "current strategic business plan" provided by KAWC in Supplemental Response to Attorney General Request for Information No. 176, and in response to the Commission's August 11, 2004 order, contains projected contribution to operating result of $290,510, and projected value contribution of $86,460 for 2005 from the acquisition of Owenton Water. Please define "contribution to operating result" and "value contribution" as used in this schedule.

   (b) Are these projected contributions included in the revised sales and revenues? If not, please explain in detail why not, and also provide a current forecast of sales and revenues for Owenton for the forecast period.

   (c) Please refer to page 61 of 69 of KAWC's "current strategic business plan", where it states that a key assumption of the project plan for Owenton is a "rate increase in year 2". What is the projected amount of this increase?

Response:

(a) Operating result is Earnings before interest and taxes. Value contribution is determined by operating result return on net operating assets compared to the internal weighted cost of capital hurdle rate.

(b) No. The Company has yet filed for nor been granted approval by the Commission to acquire the Owenton assets. At this time the Company does not know that the proposed transaction will be approved. If it were approved in 2005 those revenues would have no impact in this case. Owenton tariffs will be

Witness Responsible:

Michael A. Miller

maintained separately, and the Company is currently preparing a tariff application to file with the Owenton purchase agreement. The sales levels are the same as indicated in the Supplemental response to AG Request for Information No. 176. The final revenue number has not been completed at this time.

(c) As stated in part b above the Company is currently preparing a tariff application to be filed with the purchase agreement.

Witness Responsible:

Michael A. Miller

8. Please refer to page 29 of the rebuttal testimony of Michael Miller, regarding his claim that the "current strategic business plan" (provided by KAWC in Supplemental Response to Attorney General Request for Information No. 176, and in response to the Commission's August 11, 2004 order) is not reflective of current conditions. In light of this claim, has KAWC prepared a new or updated "strategic business plan"? If so, please provide a copy of the same. If not, please explain in detail.
   (a) The "current strategic business plan" indicates that KAWC intends to avoid future rate cases through 2008. Is this still the intent of KAWC, or has this been modified in any way? If it has been modified, please explain in detail how, and provide copies of all supporting documents that detail, discuss, or outline such modifications.
   (b) Please explain, how, in the future, the benefits from acquisitions by KAWC will "flow to customers" (as indicated by Michael Miller on page 43 of his rebuttal testimony) if KAWC exceeds the rate of return sought in this case and does not have to file a new rate case.

Response:

The Company is currently in the process of preparing its updated plan. At this time the plan is not complete.

(a) There is no change to this plan based on the preliminary planning of the Company. There are factors that could change this schedule. One factor is the assumption of an adequate rate increase in the current case. Another factor that could potentially impact this plan is if a source of supply solution is finalized.

(b) During the interim periods between rate cases any benefits from an acquisition or productivity/efficiency projects offset such items as inflationary cost increases, medical and pension cost increases and capital improvement costs potentially

Witness Responsible:

Michael A. Miller

delaying a future rate increase to the existing customers benefit. If the Company is over achieving it's authorized ROE (which it has historically not done) the Commission is always free to call the Company before the Commission on a show cause order. Given past history the Company believes this possibility is remote.

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Witness Responsible:

Michael A. Miller

9. Please refer to pages 40 and 41 of the rebuttal testimony of Michael Miller. Please provide copies of all invoices for rate case expenses to date that have not previously been provided.

Response:

See attached copies of invoices for rate case expenses. For the electronic version, please refer to KAW_R_LFCDR3#9_attachment_110304.pdf.