

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:)
ADJUSTMENT OF THE RATES OF) Case No. 2004-00103
KENTUCKY-AMERICAN WATER COMPANY)

BRIEF

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TABLE OF CONTENTS

I. INTRODUCTION	1
1.1 Procedural Overview	1
1.2 Operational Overview	2
II. RATE BASE	3
2.1 Utility Plant-In-Service	3
2.2 Utility Plant Acquisition Adjustment	4
2.3 Construction Work in Progress ("CWIP")	5
2.4 Cash Working Capital	6
2.5 Contributions in Aid of Construction ("CIAC")	8
2.6 Customer Advances	8
2.7 Deferred Debits	9
2.8 Deferred Income Tax Reserve	11
III. OPERATING INCOME	12
3.1 Revenue	12
3.1.1 Residential Operating Revenue	12
3.1.2 Commercial Operating Revenue	13
3.1.3 Public and Private Fire Revenue	15
3.1.4 Allowance for Funds Used During Construction	15
3.2 Expenses	15
3.2.1 Salaries and Wages	16
3.2.2 Incentive Plans	18
3.2.3 Other Post Employment Benefit Costs	19
3.2.4 Deferred Charges	20
3.2.5 Waste Disposal Costs	20
3.2.6 Maintenance Costs	21
3.2.7 Rate Case Costs	21
3.2.8 Rental Expense	23
3.2.9 Social Club Dues	23
3.2.10 Institutional Advertising	23
3.2.11 Business Development Costs	24
3.2.12 Low Income Discount	24
3.2.13 Property Taxes	24
3.2.14 Acquisition Amortization	25
3.2.15 Depreciation Expense	25
3.2.16 Consolidated Income Taxes	25
3.2.17 Interest Synchronization	27
3.3 Additional Issues	28
3.3.1 Normalization of Costs	28
3.3.2 Allocation Issues and Non-regulated Activity	28

IV. RATE OF RETURN	32
4.1 Overview	32
4.2 Capital Structure	32
4.3 Short-term Debt	33
4.4 Long-term Debt	33
4.5 Preferred Stock	33
4.6 Return on Common Equity	34
4.6.1 The Appropriate Return on Common Equity Recommendation for Kentucky- American is 8.75%.	34
4.6.2 Kentucky-American's Analysis is Not Reliable.	38
V. RATE DESIGN	40
5.1 Overview	40
5.2 Emergency Pricing Tariff	40
5.3 Low Income Discount	41
5.4 Economic Development Tariff	44
5.5 Activation Fee	44
5.6 Northern Division	45
5.7 Central Division	45

I. INTRODUCTION

1.1 Procedural Overview

On 26 March 2004 the Kentucky-American Water Company filed notice of its intent to file an application for an increase in its rates. On 30 April 2004 Kentucky-American filed its application for an increase in rates effective on and after 30 May 2004. The application seeks an annual increase in rates in the amount of \$7,297,443, an approximate 16.82% increase. The application is supported by a forward-looking test period that is the twelve months ending 30 November 2005. It also seeks approval of several tariff provisions.

Finding that further proceedings were necessary to investigate the reasonableness of the proposal, the Kentucky Public Service Commission, pursuant to KRS 278.190(2), suspended the proposed rates for six months up to and including 29 November 2004.¹

On 20 April 2004 the Attorney General of the Commonwealth of Kentucky, through his Office of Rate Intervention, filed a Motion to Intervene in the proceedings. On 7 June 2004 the Commission entered an Order granting the Attorney General's request for intervention. The Commission also granted motions for intervention made by the Lexington-Fayette Urban County

¹Order, 28 May 2004.

Government, the Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc., and Bluegrass FLOW, Inc.

The Attorney General has reviewed the application and the materials submitted in support of the application, participated in discovery, submitted expert testimony and surrebuttal testimony, and participated in the evidentiary hearing for this application. The Attorney General now tenders his brief which addresses rate base, revenues and expenses, capital structure, rate of return, and rate design. The discussion in this brief focuses upon primary adjustments to individual items. Secondary adjustments to other items, such as taxes and depreciation, resulting from changes to primary adjustments are, except where noted, assumed.

1.2 Operational Overview

Kentucky-American's regulated water business remains stable. Its use of a forward-looking test period in tandem with an ability to weather-normalize its residential and commercial sales forecast provides the company with an effective means to minimize risk. Capital cost rates for U.S. corporations are currently at their lowest levels in more than 40 years. The Company's cost rate of its debt and equity will remain low. While the evidence does suggest the need for an adjustment in rates, Kentucky-American's application overstates its rate base and understates its operating income level. The evidence supports an annual increase in rates of \$111,933.

II. RATE BASE

2.1 Utility Plant-In-Service

Kentucky-American's application proposes a jurisdictional net rate base of \$158,958,817.² KAWC calculated a 13-month average of its utility plant-in-service balances for the twelve months ending 30 November 2005 in order to develop its rate base amount.

In past Kentucky-American cases in which a forward-looking test period was used, the Company's projections have been an unreliable indicator for determining plant-in-service amounts. This is due to the fact that there has been a significant variance between the historic level of actual capital expenditures compared to budgeted capital expenditures. The variance remains significant. Accordingly, the Commission should continue to utilize an adjustment process to the Company's forecast by application of a "slippage" factor which reduces the utility plant-in-service claim from \$287,861,620 to \$287,853,455.³

To the extent that the Company's plant-in-service balances will be less than the Company's forecast, Kentucky-American's depreciation expense requires adjustment.

² Filing Requirements, Vol. 2 of 2, Exhibit 37 A, page 1 of 4; later corrected to \$160,747,520, Corrected Exhibit 37A, page 1 of 4.

³KAWC Response to PSC 2-115.

2.2 Utility Plant Acquisition Adjustment

Kentucky-American, in furtherance of its corporate goal of the enhancement of shareholder value through growth, continues to aggressively pursue the acquisition of water systems.⁴ One result of this growth strategy is that there is frequently a variance between the purchase price for the utility and the acquired utility's net book value. The consequence is an acquisition adjustment amount.

In the present case, Kentucky-American includes three acquisition adjustments in its filings that relate to premiums paid for the acquisition of (1) the Boonesboro Water Association, (2) the Tri-Village System, and (3) the Elk Lake System. The Boonesboro adjustment was approved by this Commission in Case No. 2000-00120. The Attorney General does not challenge that adjustment.

The company now, however, seeks recovery for the Tri-Village and Elk Lake acquisition adjustments. The Commission should deny these adjustments due to the fact that the company has failed to meet the *Delta* test criteria.⁵

⁴*In the Matter of: The Verified Joint Application of Boonesboro Water Association, Inc., and Kentucky-American Water Company for Approval of the Transfer of the Ownership of the Assets of Boonesboro Water Association, Inc. To Kentucky-American Water Company*, Case No. 97-00320, pre-filed Testimonies - Mundy, page 5; 22 September 1997 hearing TE, pages 26, 27.

⁵See, *In the Matter of: An Adjustment of Rates of Delta Natural Gas Company, Inc.*, Case No. 9059, Order, 11 September 1995, page 3.

First, the *Delta* test is a protective measure to protect the ratepayers in a situation in which the acquiring utility pays a purchase price in excess of the actual value of the assets acquired. Second, it is clear that the acquisitions were business development opportunities wholly consistent with furthering the interest of Kentucky-American's shareholder.

The acquisitions did not result in an overall benefit to Kentucky-American. Other than the small benefit of the economics of adding additional customers, the Company does not identify any specific cost savings for KAWC resulting from the purchase of either the Tri-Village or Elk Lake systems.⁶ The company's ratepayers should not be called upon to pay higher rates attributable to the premium paid for Tri-Village and Elk Lake. Moreover, the acquisitions were done in furtherance of Kentucky-American's shareholder's interest. Consequently, the shareholders rather than the ratepayers should be responsible for the consequence of the premium price.

2.3 Construction Work in Progress ("CWIP")

Kentucky-American's rate base per its application includes \$6,124,953 of Construction Work in Progress (or "CWIP"). With the application of a slippage factor, the rate base amount is \$5,529,656.

The Commission should eliminate CWIP from Kentucky-American's rate base. There are several reasons for elimination. First, CWIP represents facilities

⁶TE Vol. II of V, page 116; and see TE Vol. II of V, pages 150 through 154.

that are not used or useful in Kentucky-American's provision of regulated water service. Thus, the use of CWIP forces the ratepayers to pay for plant that may never provide them with benefit. Additionally, the use of CWIP places the risk of project construction on the ratepayers rather than the shareholders.

There is an alternative methodology. Permitting the accrual of an Allowance for Funds Used During Construction ("AFUDC") for projects not yet in service properly matches the benefits from in-service facilities to the ratepayers receiving service from those facilities. Also, it transfers the risks associated with plant not yet in-service to the shareholders. Further, the use of this alternative is an accepted regulatory practice in other jurisdictions.⁷

Another factor that supports the elimination of the use of CWIP by Kentucky-American is the fact that the company uses a forward-looking test period to set rates. Thus, the Company will already be fully compensated for its investment utilized in the provision of regulated water service. The use of CWIP with a forecasted test period extends the time horizon beyond the end of the forward-looking test period.

2.4 Cash Working Capital

The company's cash working capital requirement stems from the difference in timing between the outflows of cash for expenses and the inflow of revenues from the company's customers. A lead/lag study is a methodology to

⁷Crane, Pre-filed Direct Testimony, page 20.

assess a company's actual cash flows, and Kentucky-American supplied one for this case. The study, however, merits several adjustments.⁸

In Case No. 2000-00120, the lag for chemical expense was 30.49 days. In this case, it is only 6.65 days. This reflects a procurement and payment practice that is not normal. Moreover, there is no explanation for this practice. This decrease does not appear reasonable. Thus, the Commission should use the lag of 30.49 days accepted in the last case.

The Service Company lag should be increased from the negative 1.34 days, which reflects prepayment of charges, to a positive 12 days. The Service Company charges are primarily driven by personnel costs.⁹ The basis for the Attorney General's recommendation of a 12 day lag is the fact that the Service Company charges should be no shorter than the lag for internal KAWC personnel costs.

The company's lag amounts for Other Post Employment Benefits, insurance other than group, waste disposal costs, state income taxes, interest expense, and preferred dividends were supported by a lead/lag study for a sister company.¹⁰ The sister company's study results for other items differ from those used by Kentucky-American for this filing. The sister company's results

⁸Crane, Pre-filed Direct Testimony, pages 22 through 28.

⁹TE Vol. II of V, pages 106, 107, and page 175.

¹⁰KAWC response to OAG 2-29.

are simply not reliable as applied to Kentucky-American. The best evidence of the lags for these items is the support in the company's workpapers.

Depreciation expense should be eliminated from Kentucky-American's cash working capital claim. Depreciation does not result in an actual out-of-pocket cash expenditure. It is a non-cash expense; therefore, it does not represent investor-supplied capital to meet the day-to-day expenses of operations that result from a timing difference between the actual outflow of cash to pay an expense and the subsequent inflow of revenue. The Attorney General acknowledges that this Commission has allowed depreciation as a component of cash working capital; however, he asks that the Commission reconsider its position.

2.5 Contributions in Aid of Construction ("CIAC")

Kentucky-American's filing overstates its level of Contributions in Aid of Construction. The CIAC claim should be revised to correct the errors in the initial filing and to reflect the impact of a slippage adjustment.

2.6 Customer Advances

The slippage adjustment also impacts the company's claim for customer advances. Accordingly, an adjustment to the pro forma level of customer advances for the forward-looking test period is in order.

2.7 Deferred Debits

Kentucky-American includes over \$6.7 million of deferred debits in its rate base claim. Approximately \$1.1 million of these deferred debits relate to deferrals that have previously been approved by the Commission. The Attorney General does not recommend any adjustments to the previously approved deferrals. He does recommend denial for Kentucky-American's proposals for the remaining deferral requests concerning security costs, Shared Service Center costs, Customer Call Center costs, rate case costs, and the acquisition costs for Tri-Village and Elk Lake systems.

In Case No. 2000-00120, the Commission discussed the fact that the use of deferrals is contrary to a forecasted test year methodology, it may constitute retroactive ratemaking, and it may constitute single-issue ratemaking.¹¹ Indeed, the Commission expressed its concern with "Kentucky-American's present practice of deferring expenses as regulatory assets."¹² It ordered Kentucky-American to "formally apply for Commission approval before accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense in the previous rate case proceedings."¹³

¹¹*In the Matter of: Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2000-00120, Order, 27 November 2000, pages 21 and 22.

¹²Case No. 2000-00120, Order, 27 November 2000, page 23.

¹³Case No. 2000-00120, Order, 27 November 2000, pages 23 and 24.

In sum, the main problem is that Kentucky-American isolates expenses from a prior period without any corresponding consideration of other factors from that prior period and then places the items in a forwarding-looking test period. As noted by this Commission in Case No. 2000-00120, the KAWC's use of deferrals is contrary to a forward-looking test period.

Kentucky-American has a statutory right to file an application for a rate increase.¹⁴ It also has a statutory right to elect between the use of either an historical test period or a forward-looking test period.¹⁵ Kentucky-American has no right, however, to mix and match theories and to seek retroactive reimbursement for costs that are incurred between its rate cases.

With regard to the Tri-Village and Elk Lake acquisitions, the company has included the unamortized balances associated with the acquisitions in its deferred debits as well as a separate acquisition adjustment for each. The adjustments should be removed from rate base.

The Commission should continue to exclude the unamortized balance associated with rate case costs from rate base. Nonetheless, if the Commission adopts the Attorney General's recommendation to normalize this cost, there will be no unamortized balance relating to rate case costs.

¹⁴KRS 278.180.

¹⁵KRS 278.192.

2.8 Deferred Income Tax Reserve

Kentucky-American's application includes deferred income tax that results from differences between the tax treatment for certain costs and the corresponding ratemaking treatment for these costs. The application includes claims for deferred income taxes related to the company's utility plant-in-service projection and its claim for deferred debits.

The application of a slippage adjustment to the company's utility plant-in-service requires a corresponding reduction to the deferred taxes relating to the plant that is projected to be delayed. Also, consistent with the recommendation to eliminate certain deferred debits from rate base, there should be an elimination of the tax benefits for these deferrals.

III. OPERATING INCOME

3.1 Revenue

3.1.1 Residential Operating Revenue

Kentucky-American's forecast for residential revenue is the sum of a gallons per customer per day consumption projection multiplied by the number of residential customers. The application understates both the consumption amount as well as the number of customers.

Kentucky-American's residential revenue is based, in part, upon a weather normalized residential consumption amount of 165.42 gallons per day per customer (or 60,378 gallons per year). This is an amount significantly below the weather normalized per customer consumption projections for the prior three Kentucky-American cases that include weather normalized projections.

The application understates residential consumption. Evidence of this understatement is contained in Kentucky-American's application¹⁶ as well as its Strategic Business Plan¹⁷ both of which project a 66,000 gallons per customer per year residential consumption amount for 2004 and 2005.

The Commission should adjust Kentucky-American's residential sales projection upward to 174.68 gallons per day per customer (or 63,758 gallons

¹⁶Filing Requirements Vol. 2 of 2, Exhibit No. 37, Schedule I-4, page 1 of 1.

¹⁷ KAWC response to OAG 1-176, page 27 of 69.

annually). The upward adjustment is the average of the residential utilization amount used in Case No. 2000-00120 and Dr. Spitznagel's consumption result for this case. It reflects a decrease in consumption due to greater efficiency, but, more importantly, it better comports with recent experience and the company's own evidence.

For the last several years, Kentucky-American has experienced steady growth in the number of its residential customers. From 1999 to 2003, the residential customer base grew by an average of 2,793 customers per year. Frankly, there is no evidence that this trend will not continue. In fact, the company's own Strategic Business Plan reflects steady growth through, at least, the end of Year 2008.¹⁸

Despite this trend of growth, Kentucky-American uses an unduly low residential customer count for setting rates. Its residential customer count is contrary to Kentucky-American's recent experience as well as its other internal projections. Accordingly, the Attorney General recommends an appropriate adjustment to increase the number of residential customers for setting rates.

3.1.2 Commercial Operating Revenue

Kentucky-American's forecast for commercial revenue is the sum of a gallons per customer per day consumption projection multiplied by the number

¹⁸KAWC response to OAG 1-176, page 27 of 69.

of commercial customers. As with residential revenue, the application understates both the consumption amount as well as the number of customers.

Kentucky-American's commercial revenue is based, in part, upon a weather normalized commercial consumption amount of only 1,385.52 gallons per day per customer (or 505,715 gallons per year). This is an amount significantly below the weather normalized per customer commercial consumption projections for the prior three Kentucky-American cases that include weather normalized projections. It is also contrary to other evidence in its own application¹⁹ and significantly below the company's Strategic Business Plan projections of 1,449.31 gallons per customer per day for 2004 and 2005²⁰.

The Commission should adjust Kentucky-American's commercial sales projection upward to 1,469.48 gallons per day per customer (or 536,360 gallons annually). The upward adjustment is the average of the commercial utilization amount used in Case No. 2000-00120 and Dr. Spitznagel's consumption result for this case. It comports with recent experience and the company's own evidence.

Kentucky-American's commercial customer count has been growing, and there is no evidence that the growth will subside. Yet again, Kentucky-American understates its customer count for setting rates. Accordingly, the Attorney

¹⁹Filing Requirements Vol. 2 of 2, Exhibit No. 37, Schedule I-4, page 1 of 1.

²⁰ KAWC response to OAG 1-176, page 27 of 69.

General recommends an appropriate adjustment to increase the number of commercial customers for setting rates.

3.1.3 Public and Private Fire Revenue

31 January 2004 billing determinates were used as the basis for the company's projection for public and private fire revenue. The projection should reflect an increase in the number of connections installed through the end of the forward-looking test period.²¹ Accordingly, both public and private fire revenue should be revised to reflect the increase.

3.1.4 Allowance for Funds Used During Construction

Kentucky-American included a revenue amount relating to an Allowance for Funds Used During Construction (AFUDC). It is an above-the-line revenue item. Due to the fact that the Attorney General is recommending the elimination of CWIP from rate base, a corresponding adjustment to place the AFUDC revenue below-the-line is appropriate. If the Commission rejects the Attorney General's recommendation on CWIP, then AFUDC should be moved back to its above-the-line position for determining the revenue requirement.

3.2 Expenses

Expenses, even those having a minimal effect on operating income, must be borne by shareholders unless such expenses are proven to be beneficial to

²¹See KAWC response to LFUCG 1 - 42.

ratepayers in furnishing utility service.²² The mere inclusion of an expense amount in an application is wholly unremarkable and compels nothing regarding the reasonableness and propriety of the expense.²³

3.2.1 Salaries and Wages

The evidence demonstrates that Kentucky-American has overstated its employee level. Like other companies, Kentucky-American has normal turnover in its employees and usually has vacant positions.²⁴ In fact, at the time of the submission of the Attorney General's pre-filed testimony, the company had 3 vacant positions. By the time of the hearing, the number of KAWC employee vacancies had increased to 14.²⁵ As with the slippage adjustment that reflects the fact that Kentucky-American's construction budget tends to vary from its actual experience, a similar adjustment is in order for the employee level and corresponding expenses.

²²*In the Matter of: Notice of Adjustment of Rate of Kentucky-American Water Company*, Case No. 9482, Order, 8 July 1986, page 22; also see *In the Matter of: Adjustment of Rates of Columbia Gas of Kentucky, Inc.* Case No. 10498, Order, 6 October 1989, page 30.

²³KRS 278.190(3); see *In the Matter of: Notice of Adjustment of Rates of Kentucky-American Water Company*, Case No. 8836, Order, 20 December 1983, page 9 ("The burden of proof for the necessity of any change in the approved rates rests entirely with Kentucky-American. It is not necessary ... that this Commission or anyone else prove that the proposed change is inappropriate."); also see *Energy Regulatory Commission v. Kentucky Power*, Ky.App., 605 S.W.2d 46, 50 (1980)(fact that applicant's evidence is uncontroverted, or otherwise unrebutted, unexplained or unimpeached is unremarkable).

²⁴KAWC response to PSC 2 - 52; and KAWC response to PSC 1 - 18.

²⁵TE Vol. II of V, page 119.

Rather than setting rates on a full complement of employees, the Commission should adjust the employee level to reflect the recurring nature of unfilled positions attributable to terminations, transfers, and retirements. Thus, the Attorney General recommends eliminating 3 employee positions from the company's revenue requirement claim. It is important to note that the Attorney General does not recommend the elimination of any particular employee. Instead, he recommends a reduction in the employee total to reflect that fact that this utility does not maintain a full complement of workers. The ratepayers should not be charged for workers who are not with the company. Given that there are presently 14 vacant positions, this is a very conservative adjustment.

There is another reason supporting the adjustment. Kentucky-American continues to participate, incessantly, in corporate reorganizations, realignments, and other forms of corporate shuffling that impact its employee levels. In fact, at the hearing it was conveyed that the company is now utilizing mobile computing in its service territory.²⁶ The introduction of this technology will present, in the near term, a situation in which the local workforce can, and will likely, be reduced.²⁷ Bluntly, the employee level will shrink again in the coming months.

The Commission should also adjust Kentucky-American's application to eliminate from the test period a portion of the cost for Roy Mundy and his

²⁶TE Vol. II of V, pages 230, 231.

²⁷TE Vol. II of V, page 231.

assistant, Patricia L. Ballard, thereby denying rate recovery for this amount.

While the ratepayers may be called upon to fund activities necessary for their benefit, they are not to fund activities that relate to the promotion and protection of the interests of Kentucky-American's shareholders.

The condemnation proceeding is a matter for Kentucky-American's shareholders; therefore, they are the ones who bear responsibility for the cost of Mr. Mundy's "full time and energies" as well as the cost of his assistant in advancing shareholder interest. Hence, the Attorney General recommends the exclusion of 90% of the labor, overhead costs, and payroll taxes claimed by KAWC for Mr. Mundy and his assistant.

3.2.2 Incentive Plans

Central to Kentucky-American's mission are the goals of creating and enhancing shareholder value. The financial criteria of Kentucky-American's Annual Incentive Plan (AIP) is based upon accruing benefits to shareholders rather than ratepayers. The shareholders have a responsibility to bear a reasonable portion of the costs of the AIP. The Attorney General recommends an allocation of 60% of the cost of the AIP. In recognition of the fact that the AIP is not exclusively based upon producing direct benefits to the shareholders, the Attorney General includes 40% of the costs in the company's revenue requirement.

Further, in light of evidence of Kentucky-American's past spending for this program and the cost-cutting measures and employee reductions that have taken place and will continue to occur in the near term, an adjustment should be made to reduce the company's projection for AIP spending. For this case, the Commission should use a three-year average for setting the AIP spending level.

The company also has a Long-term Incentive Plan (LIP). The sole criterial for the award of the LIP is the "achievement of cumulative net income."²⁸ This is a criteria that rewards achievement that benefits shareholders. The entire LIP programs should be excluded from the revenue requirement calculation. It is a matter for shareholder funding.

3.2.3 Other Post Employment Benefit Costs

Kentucky-American developed its Other Post Employment Benefit (OPEB) cost claim on a preliminary 2004 Towers Perrin report that utilizes data collected as of July 2003. Per the report, the company's share of OPEB costs for 2004 is proposed to be \$904,227. Thereafter, the company increased this estimate by 9% to develop costs for 2005. The KAWC projection is unreasonable, and the Commission should reject it.

The determination of annual OPEB costs is dependent upon a variety of factors. Arriving at annual OPEB costs is complex process. It is not as simple as isolating one factor and making a single-issue adjustment, and the evidence in

²⁸KAWC response to OAG 1 - 123, page 11.

this case does not support the conclusion that the level of OPEB expenses follows the same upward trend for health care costs.

An actuarial report provides the best support for an OPEB claim. In this case, it is the most recent documentation from Towers Perrin. According, the Attorney General recommends the use of the \$904,227 projection reduced by the amount capitalized by the company.

3.2.4 Deferred Charges

The Commission should deny Kentucky-American's claim for deferrals associated with security costs, Shared Service Company transition costs, and Customer Care Center transition costs. The company did not receive permission to defer these costs. Also, an express prohibition relating to security costs was established by the Commission during the RWE acquisition approval.²⁹ Thus, it has done indirectly what the Commission directly prohibited by its order in Case No. 2002-00018.

3.2.5 Waste Disposal Costs

The company has waste disposal costs for its Kentucky River Station and for its Richmond Road Station. The company has overstated its on-going waste disposal costs for the Richmond Road Station.³⁰ Additionally, a projected

²⁹*In the Matter of: RWE AG, Thames Water, Apollo Acquisition, American Water Works, and Kentucky-American*, Case No.2002-00018.

³⁰KAWC response to PSC 2 - 9 (d).

cleaning at the Richmond Road Station in the amount of \$70,000 should be recovered over three years rather than being expensed in a single year.

3.2.6 Maintenance Costs

Kentucky-American projects forecast test period maintenance costs in the amount of \$972,706. This is an amount well in excess of the base year figure of \$825,341. The company offers very little in terms of explaining the significant increase in the forecasted period over the base period. The Attorney General recommends using a three-year average of on-going maintenance cost to develop the company's revenue requirement in this case.

3.2.7 Rate Case Costs

Kentucky-American's rate case expense has been the source of Commission concern. In Case No. 8324, the Commission found the legal fees for the preparation and presentation of that case "excessive," and reduced the amount of legal fees submitted, \$60,000, by 50% to \$30,000.³¹ The legal fee claim for this case: \$280,000.

In its subsequent application, Case No. 8571, the Company sought to recover rate case expense in the amount of \$120,000. This Commission found the

³¹*In the Matter of: Notice of Adjustment of Rates of Kentucky-American Water Company, Case No. 8314, Order, 8 February 1982, pages 9, 10.*

amount grossly overstated and reduced it, by approximately one-third, to \$75,566.³² The total rate case claim for this case: \$622,409.

Kentucky-American's rate case spending is troublesome. Even when viewed with an eye toward spending in recent cases, the claim is considerably higher than the actual costs of all 4 of the previous fully-litigated rate cases using a forward-looking test period. It is Kentucky-American's responsibility to demonstrate that it is doing "everything possible" to minimize rate case costs.³³

The company does not appear to be following the Commission's instruction. For example, it hires a former Director of Rates in the American system as a major accounting witness. Yet, it incurs significant Service Company costs. Alternatively, given the extensive resources at the Service Company (which has always been touted as a principal advantage of the American family), it is not clear why an outside consultant was necessary.

It appears that the claim for both Service Company charges and a consultant is redundant. The Attorney General recommends a reduction of overall rate case cost in the amount of \$70,000. This is not a specific adjustment to eliminate Mr. Salser's services or the lead/lag study per se. This is simply an

³²*In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After September 17, 1982*, Case No. 8571, Order, 17 February 1983, pages 13, 14.

³³*In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company*, Case No. 9283, Order, 1 October 1985, pages 29, 30.

adjustment to reduce the overall rate case expense for work that should have been handled by one or the other but not both.

3.2.8 Rental Expense

The company acknowledges that its rental expense claim is overstated.³⁴ An adjustment is in order to reduce Kentucky-American's forward-looking test period expense by the \$58,295 amount.

3.2.9 Social Club Dues

Kentucky-American includes social club dues in the amount of \$5,228 in its application. This expense is for items that have no bearing on the ability of the company to provide reasonable service.

3.2.10 Institutional Advertising

Kentucky-American makes a claim for \$72,415 in institutional advertising. This amount should be disallowed. For advertising, the Commission has given special instructions concerning cost recovery.³⁵ Kentucky-American fails to meet its burden of proof or otherwise satisfy its regulatory requirements for cost recovery. The advertising materials at issue are image building and promotional in nature. Further, it is clear that some of the materials are marketing efforts to expand Kentucky-American's non-regulated water activities or otherwise promote the shareholder agenda of growth. The advertisements are not for the

³⁴KAWC response to OAG 1 - 138.

³⁵807 KAR 5:016.

purpose of providing any material benefit to the ratepayers. It should not be borne by the ratepayers.

3.2.11 Business Development Costs

Kentucky-American includes \$117,525 for business development costs allocated from the Regional Office.³⁶ The burden is upon the company to demonstrate the propriety of these costs, and there has been no demonstration. The business development costs are the responsibility of the shareholders. Hence, the Attorney General recommends their removal.

3.2.12 Low Income Discount

Kentucky-American proposes a Low Income Water Discount tariff. The Attorney General recommends its rejection. The company identified an annual cost amount of \$30,000. It is unclear how the estimated cost is reflected.

Since the Attorney General seeks the rejection of the tariff, he recommends a corresponding adjustment to expenses in the event that the tariff is not accepted. If the company has not included this expense amount in its filing, the recommendation is revised to reflect that fact.

3.2.13 Property Taxes

The Attorney General is recommending an adjustment relating to the historic slippage in Kentucky-American's plant-in-service. The adjustment to reduce plant-in-service requires an adjustment to reduce property tax expense.

³⁶KAWC response to OAG 1 - 17.

3.2.14 Acquisition Amortization

The Attorney General recommends the denial of acquisition adjustments for the Tri-Village and Elk Lake acquisitions. The denial of the adjustments requires a second adjustment to eliminate the amortization expense that corresponds to the acquisition adjustments.

3.2.15 Depreciation Expense

The Attorney General is recommending an adjustment relating to the historic slippage in Kentucky-American's plant-in-service. The adjustment to reduce the level of depreciable plant requires a corresponding adjustment to reduce the related depreciation expense for this plant.

3.2.16 Consolidated Income Taxes

Under Kentucky-American's proposal, Kentucky-American will send money to its parent to pay a tax bill as if Kentucky-American filed its taxes on a stand alone basis. It calculates this payment using its statutory tax rate. In reality, Kentucky-American is part of a consolidated group that files as one taxable entity. The filing of a consolidated return allows the group to take advantage of tax losses experienced by other member companies who file on the same consolidated tax group in determining tax liability.

The ability for Kentucky-American to file as part of a larger consolidated group with all of Thames Water Aqua GmbH's United States businesses was the

reason behind the creation of Thames Water Aqua US Holdings, Inc. (TWUS).³⁷

The filing of a consolidated return provides a benefit.

The ratepayers of Kentucky-American may be properly required to pay for the legitimate expense of the provision of reasonable water service. If Kentucky-American actually filed its taxes on a "stand-alone" basis rather than as part of a consolidated tax group, there would be no issue. However, it does actually file as a part of a consolidated group and the calculation of revenue requirement as if it did not do so results in a windfall to the Company from rates that are higher than necessary because Kentucky-American's effective tax rate is lower than it would otherwise be if it had filed its taxes on a stand-alone basis.

This is an issue that has been addressed by other jurisdictions that have American affiliates including Pennsylvania, New Jersey, and West Virginia which have each adopted a consolidated tax adjustment for rate-making purposes. The adjustment is in order for Kentucky-American.³⁸

The Attorney General recommends a consolidated income tax adjustment based on the effective tax rate methodology. This methodology develops an

³⁷*In the Matter of: The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua US Holdings, Inc., Apollo Acquisition Company, and American Water Works Company, Inc., for Approval of a Change in Control of Kentucky-American Water Company, Case No. 2002-00317, TE 21 November 2002, pages 44 and 45.*

³⁸The Attorney General acknowledges that he bears the burden for this recommended adjustment. See e.g. TE Vol. I of V, pages 14 through 20; AG's Renewed Motion for Surrebuttal, 8 November 2004.

adjustment for prospective federal income tax by allocating tax losses to those companies that generate positive taxable income. Each company is then allocated tax losses based on that company's percentage share of positive taxable income.³⁹ Generally, a three-year average is used to develop the adjustment.

The Attorney General's adjustment uses an effective income tax rate over a multi-year period as a means for projecting Kentucky-American's prospective effective income tax rate. It is truly a best practice that many of American's customers presently enjoy. Kentucky's ratepayers should be able to partake of this benefit. This adjustment process is also justified because Kentucky-American's ratepayers have no responsibility to pay rates based upon a tax rate other than an effective income tax rate that results from the consolidated tax group structure sought by the company and approved by this Commission in Case No. 2002-00317.

3.2.17 Interest Synchronization

The Attorney General recommends an adjustment to pro forma interest expense for income tax purposes. The Attorney General's recommendations result in a lower rate base amount and a lower cost of debt than those in the company's application. There is, consequently, a lower pro forma interest expense for the company under the Attorney General's recommendations and an increase in income tax liability. Thus, the Attorney General's recommendations

³⁹Crane, Pre-filed Direct Testimony, page 74.

result in an interest synchronization adjustment that reflects a higher income tax burden and a decrease to pro forma income at present rates.

3.3 Additional Issues

3.3.1 Normalization of Costs

The normalization of costs is the inclusion of a normal level of prospective costs in rates. The concept of normalization is not new to Kentucky-American. It uses normalized residential and commercial sales projections to establish rates based upon "normal" weather. Normalization is not amortization.

Amortization concerns past costs. Normalization is a prospective process. It provides recovery of future costs; therefore, it is especially appropriate for use in setting rates based upon a forward-looking test period.

Kentucky-American's practice relating to deferred debits with its use of a forward-looking test period is troublesome. The Commission should give serious consideration to moving the company away from the practice of seeking to amortize costs such as periodic waste disposal costs and rate case costs toward a practice of normalizing these types of expenses.

3.3.2 Allocation Issues and Non-regulated Activity

Kentucky-American is no longer simply a provider of regulated water service. In addition to the provision of regulated water service, the company, since its acquisition of the assets of the Boonesboro Water Association, has been a

provider of sewerage service.⁴⁰ Additionally, Kentucky-American now has a healthy appetite for the provision of non-regulated services.⁴¹ To date, the provision of non-regulated water service has been a money loser for Kentucky-American.⁴²

Kentucky-American is devoting its resource to these endeavors with an eye to “leverage” the regulated water service for the development of its non-regulated business.⁴³ While the company claims that it has removed the non-regulated operating results from the test year,⁴⁴ a closer look at this claim is warranted. For example, its institutional advertising benefits the marketing of its non-regulated service, but Kentucky-American did not allocate any of this advertising expense for the base period or the forecasted period to non-regulated operations.⁴⁵ Clearly, not all costs are being allocated to non-regulated activity.

⁴⁰TE Vol. II of V, page 81.

⁴¹KAWC response to OAG 1 - 176 (Business Plan 2004 -2008); see also TE Vol. II of V, pages 81, 82.

⁴²TE Vol. I of V, pages 119, 120.

⁴³KAWC response to OAG 1 - 176 (Business Plan 2004-2008)(“cross-selling” of non-regulated services).

⁴⁴TE Vol. I of V, page167.

⁴⁵KAWC response to OAG 1 - 160.

Additionally, Kentucky-American provides leak detection services for the benefit of several municipal utilities and books this activity above-the-line.⁴⁶ The activity is not provided under the terms of any approved tariff⁴⁷ and there is no indication that it is service that is any way subject to the regulation of this Commission.⁴⁸ It is non-regulated activity performed for the purpose of building Kentucky-American's non-regulated business.

More importantly, it is activity that uses the resources of Kentucky-American's regulated water operations to grow the non-regulated business and further its business development activities. Further, evidence concerning the scant revenue that Kentucky-American receives for leak detection indicates that the company only charges for the costs of mileage and labor.⁴⁹ There is no recovery of overhead for this non-regulated activity. Thus, the company's ratepayers are left watching the Kentucky-American regulated resources being given away by the company.

Kentucky-American is permitted to develop its non-regulated business. That is not a point for debate. Instead, the issue is who should pay for the development of Kentucky-American's non-regulated business. In light of the

⁴⁶KAWC response to OAG 1 - 168 and KAWC response to OAG 2 - 19.

⁴⁷KAWC response to OAG 2 - 19 (c).

⁴⁸TE Vol. I of V, pages 119, 120.

⁴⁹KAWC response to OAG 2 - 19 (e).

fact that all spending is the responsibility of the shareholders unless proven beneficial to the ratepayers as well as the fact that Kentucky-American bears the burden to justify this increase, the Commission should, as a starting point and in addition to the Attorney General's previous recommendations, give consideration to eliminating cost recovery through rates for any employee who provides service or has duties other than regulated water service. To the extent that the company, which has the burden, can demonstrate a reasonable basis to allocate some level of the costs for these employees to KAWC's regulated water business, the corresponding expense would be recoverable.

IV. RATE OF RETURN

4.1 Overview

The Kentucky-American Water Company's regulated water business is quite sound, and it will remain stable. Capital costs for U. S. corporations are at their lowest rates in several decades. The overall fair rate of return for Kentucky-American is 7.11%.

4.2 Capital Structure

Kentucky-American consistently uses short-term debt as a source of capital.⁵⁰ A review of Kentucky-American's short-term debt as a percentage of its capitalization for each quarter of Year 2001 through the end of Year 2003 shows a capital structure with, on average, 7.78% of capitalization in short-term debt. Thus, the company's 3.719% capitalization amount for the short-term debt for the forward-looking test period appears to be understated.

Kentucky-American points to its compliance with 807 KAR Section 10 as an impregnable shield for its capital structure. The company's duty under the administrative regulations applicable to an application for a general adjustment in rates calls for capitalization and net investment rate base to be on a thirteen month average for the forecasted period.

⁵⁰See KAWC response to OAG 1 - 152.

It is a filing requirement for the company. As with all other information that the company submits in its application, it is subject to an examination for reasonableness. It is likewise subject to adjustment if it fails to provide a reasonable basis for setting rates. In that recent history demonstrates a capital structure with, on average, a greater percentage of short-term debt than what the Kentucky-American proposes, an adjustment to the company's capital structure is in order to provide a reasonable projection for the capital structure for the forward-looking test period.

4.3 Short-term Debt

The Attorney General adopts Kentucky-American's Short-Term Debt cost rate of 2.7%.⁵¹

4.4 Long-term Debt

The Attorney General adopts Kentucky-American's Long-Term Debt cost rate of 6.34%.⁵²

4.5 Preferred Stock

The Attorney General adopts Kentucky-American's Preferred Stock cost rate of 7.72%.⁵³

⁵¹See Update Exhibit 37 (Base Period Information), Schedule J, page 2 of 4.

⁵²See Update Exhibit 37 (Base Period Information), Schedule J, page 3 of 4.

⁵³See Updated Exhibit 37 (Base Period Information), Schedule J, page 4 of 4.

4.6 Return on Common Equity

4.6.1 The Appropriate Return on Common Equity Recommendation for Kentucky-American is 8.75%.

The Kentucky-American Water Company, in its role of providing regulated water service, is a stable company, and it will enjoy steady water customer growth for, at minimum, the next several years. It has a ready source of capital. Further, it has the right to seek rate relief, use a forward-looking test period for its rate request, and weather normalize its sales for projecting consumption in the forecasted test period. In terms of competition, there are no national competitors that will be players in Kentucky's regulated market.⁵⁴ In sum, it is a stable company with the market to itself.

Capital costs for U.S. corporations are currently at their lowest levels in more than four decades.⁵⁵ Thus, the base level of interest rates, as indicated by the rate for Ten-year Treasury bonds is around 4%, and the last time that it was this low was in 1964.⁵⁶ The expected market risk premium is low, between 2.5% and 3.8%.⁵⁷ The expected return for Kentucky-American is, consequently, low.

In developing a fair rate of return for Kentucky-American, Dr. Woolridge evaluated the return requirements of investors for the common stock of two

⁵⁴TE Vol. V of V, page 16.

⁵⁵TE Vol. II of V, pages 173, 174.

⁵⁶TE Vol. II of V, page 173.

⁵⁷TE Vol. II of V, page 173.

groups of publicly-held water service companies, a Small Water Company (SWC) Group and a Large Water Company (LWC) Group. A Discounted Case Flow (DCF) analysis was performed for each group.

The DCF Model discounts the value of all future dividends and cash flows the investor expects to receive.⁵⁸ Thus, it requires a dividend yield and a growth rate to arrive at an equity cost rate. The dividend yields for the proxy groups are 3.30% for the Small Water Company (SWC) Group and 3.40% for the Large Water Company (LWC) Group.⁵⁹ These yields are adjusted by $\frac{1}{2}$ the expected growth in order to reflect growth for the coming year.⁶⁰ This produces adjusted dividend yield amounts of 3.39% and 3.49% respectively.

The expected growth rates for the analysis are 5.5% for the SWC Group and 5.25% for the LWC Group.⁶¹ Adding the adjusted dividend yields to the expected growth rates produces a DCF equity cost rate of 8.89% for the SWC Group and 8.74% for the LWC Group.⁶² This analysis is the basis for the Attorney General's recommendation of an equity cost rate of 8.75%.

⁵⁸Woolridge, Pre-filed Direct Testimony, page 16; TE Vol. II of V, page 152.

⁵⁹Woolridge, Pre-filed Direct Testimony, page 21.

⁶⁰ $3.39\% = 3.30\% \times (1 + (\frac{1}{2} \times 5.5\%))$; $3.49\% = (1 + (\frac{1}{2} \times 5.25\%))$; see also Woolridge, Pre-filed Direct Testimony, page 22; TE Vol. II of V, pages 179 to 181.

⁶¹Woolridge, Pre-filed Direct Testimony, page 26.

⁶²Woolridge, Pre-filed Direct Testimony, page 26; Exhibit _(JRW-7), page 1 of 5.

The Capital Asset Pricing Model (CAPM) estimates capital costs by, in general terms, applying a risk premium to a risk-free rate.⁶³ The yield on Ten-year Treasury Bonds is the benchmark long-term Treasury rate for use as a risk-free rate in the CAPM analysis, and, in light of the recent range for this mark, a rate of 4.5% is appropriate for the risk free rate.⁶⁴

For the CAPM, a beta must be determined. Beta is a measure of the systematic risk of a stock.⁶⁵ Essentially, it measures how the stock price moves with the market, and a stock with the same price movement as the market has a beta of 1.⁶⁶ Regulated utilities, including water utilities such as Kentucky-American, are less risky than the market and, thus, have betas less than 1.0.⁶⁷ The beta for the SWC Group is 0.65 and 0.66 for the LWC Group.⁶⁸

Finally, it is necessary to determine a risk premium. There are different approaches for making this determination. Each approach has its problems. Nonetheless, given the current market environment and the projections for the

⁶³The CAPM formula depiction is, in sum, $Ke = Rf + b(Rm - Rf)$ where Ke is the investor's required rate of return, Rf is the risk-free rate, Rm is the expected market rate of return, and b is beta. See, for development, Woolridge, Pre-filed Direct Testimony, pages 27 and 28.

⁶⁴Woolridge, Pre-filed Direct Testimony, pages 28 and 29.

⁶⁵Woolridge, Pre-filed Direct Testimony, page 29.

⁶⁶Woolridge, Pre-filed Direct Testimony, page 29.

⁶⁷Woolridge, Pre-filed Direct Testimony, pages 29 and 30.

⁶⁸Woolridge, Pre-filed Direct Testimony, page 31.

near term, an expected market return of 8.1% is appropriate.⁶⁹ Consequently, an equity risk premium of 3.6% (or 8.1% - 4.5%) is supported by a “building blocks methodology” derivation⁷⁰ while a 4.0% range is supported by a 2003 risk premium study by Derrig and Orr.⁷¹ An average of these two projections is used to arrive at a risk premium of 3.8%.

Thus, putting it all together, the CAPM estimate for the SWC Group is 6.97% (or 4.5, the risk-free rate, times .65, beta, times 3.8, the market risk premium). The CAPM estimate for the LWC Group is 7.02% (or 4.5 times .66 times 3.8).⁷²

There appears to be some concern from the company regarding the fact that the equity cost recommendation is “only” 8.75%. While both state and federal law require non-confiscatory rates, neither KRS Chapter 278 nor the Takings Clause of the Fifth Amendment establish a specific numerical floor below which a rate of return may not be set. Hence, while the recommendation is lower than past awards, that result is unremarkable given the corresponding historically low levels for capital costs and the low expected return premiums.⁷³

⁶⁹Woolridge, Pre-filed Direct Testimony, pages 32 through 44 (page 42 for composition).

⁷⁰Woolridge, Pre-filed Direct Testimony, page 44.

⁷¹Woolridge, Pre-filed Direct Testimony, pages 35 and 36.

⁷²Woolridge, Pre-filed Direct Testimony, page 46.

⁷³TE Vol. II of V, pages 172 to 175.

Moreover, in Year 2003 there was a significant change in tax law which reduces the tax rates on dividend income and capital gains. This change lowers the pre-tax return required by investors.⁷⁴ The fact is that the equity cost rate to allow Kentucky-American to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investor is lower today than in the last several years.

4.6.2 Kentucky-American's Analysis is Not Reliable.

Dr. Vander Weide lists certain "major" factors, including weather fluctuations and customer growth, that affect business risk in the water utility industry.⁷⁵ It is clear that Dr. Vander Weide was unaware that Kentucky-American has a right to use weather normalized sales in projecting its forward-looking test period⁷⁶ and that he does not have any specific knowledge of Kentucky-American's plans for growth.⁷⁷ These are two of the bedrock elements of his discussion of business risk. In that this proceeding concerns Kentucky-American and its cost of common equity, this lack of knowledge represents a dire fundamental problem.

⁷⁴Woolridge, Pre-filed Direct Testimony, page 47; TE Vol. II of V, pages 175 and 176.

⁷⁵Exhibit 10, Direct Testimony, Vander Weide, pages 9 to 11.

⁷⁶TE Vol. V of V, page 14.

⁷⁷TE Vol. V of V, pages 14 and 15.

Further, with regard to factors such as supply uncertainty and capital expenditures, in preparing his direct testimony he did not speak with the then-President Roy Mundy or the then-Director of Engineering, Linda Bridwell, the person responsible for supervising the implementation of the investment plan and construction schedule and who has been the lead on the company's continuing efforts to meet its source of supply challenges.⁷⁸ While his testimony contains some general points about utilities, an understanding of Kentucky-American is not manifest.

Dr. Vander Weide prepared his testimony from the point of view of an investor.⁷⁹ As he concedes, in the process of making investment decisions, investors will seek to obtain relevant information concerning their investment decisions,⁸⁰ and the investors also know the regulatory risks associated with investing in public utilities.⁸¹ Yet, the analysis that he provides fails to take into account, in plain terms, some of the most essential evidence concerning Kentucky-American that a reasonable investor would seek. It is not reliable.⁸²

⁷⁸TE Vol. V of V, page 13.

⁷⁹TE Vol. V of V, page 19.

⁸⁰TE Vol. V of V, page 17.

⁸¹TE Vol. V of V, page 17.

⁸²Other problems with his testimony, including some that approach the magnitude of the problem highlighted in this brief (e.g. the KAWC flotation adjustment), are adequately addressed in the Attorney General's Pre-filed Direct Testimony, Woolridge, pages 49 to 73 and incorporated by reference.

V. RATE DESIGN

5.1 Overview

Kentucky-American's application includes a proposals for an Emergency Pricing Tariff, a Low Income Water Discount tariff, and the approval of an activation fee. The company also expends time and resource for identifying an Economic Development Tariff that it does not propose.

5.2 Emergency Pricing Tariff

Kentucky-American's application includes a request for approval of an Emergency Pricing Tariff. The company itself provides a salient assessment of the proposal. "It will not survive in its present form under the necessary public scrutiny that will be part of this case."⁸³

Water budgets are relatively new to the water industry. Kentucky-American uses a water budget in an Emergency Pricing Tariff as a drought response measure. There are a variety of problems with the tariff provision. Chief among the problems is the lack of an identification of the total costs of such a program in comparison to the total benefit that would be received from implementing the tariff.⁸⁴ Simply enough, the proposal has not been shown to be a cost-effective method to reduce demand during an emergency.

⁸³Rebuttal Testimony, C. Bush, page 7.

⁸⁴TE Vol. III of V, page 222, 223.

Additionally, there are other structural problems with the tariff. The company now concedes that its assumption concerning the role of the LFUCG's Water Conservation Appeals Board was in error, and there is no Emergency Pricing Tariff appeals process in place.⁸⁵ Consequently, the avenue for a customer to advance a challenge concerning the fairness of a water budget is unclear. Moreover, over-collection/under-collection scenarios represent significant regulatory consequences and risks, and the company's plan does not appear to meaningfully address these items. The Commission should not approve the Emergency Pricing Tariff.

5.3 Low Income Discount

Kentucky-American proposes a Low Income Water Discount tariff. Under the tariff, eligible residential customers will receive a discount of 25% on their service charge.⁸⁶ The tariff seeks reduced rate service for these customers. Any such program, no matter how laudable, must be lawful. This one is not.

Kentucky-American, which has the burden of proof on this issue, had the opportunity to demonstrate the lawfulness of the proposal in its application. While explaining the mechanics of the program in the application, KAWC did not identify a legal basis upon which this Commission could approve the tariff.⁸⁷

⁸⁵Rebuttal Testimony, Bush, page 9.

⁸⁶Filing Requirements, Vol. 1 of 2, Exhibit 2, page 8 of 12; but see TE Vol. III of V, pages 130 to 133, the amount and nature of the discount varies by division.

⁸⁷Exhibit 10, Direct Testimony, M. Miller, pages 65 - 67.

In the Attorney General's First Request for Information, the company was asked to "identify the statutory basis under the current regulatory framework in Kentucky authorizing the implementation of the low income tariff" discussed in the application.⁸⁸ Kentucky-American objected to providing the information.⁸⁹ The company, in response to a Commission Staff request and in conceding the lack of any "express" statutory authority, identified KRS 278.030(3) as the basis.⁹⁰

The tariff seeks to assign the responsibility of paying for costs attributable to one group of customers to a second group of customers. It is, from any point of view, a program to provide reduced rate service. The starting point for the analysis is KRS 278.170, and this Section contains clear and unambiguous instructions from the General Assembly regarding "free or reduced rate service."⁹¹ There are a few very specific instances in which the Commission may authorize a discount. The low income discount proposed by the Company, no matter how laudable, is not one of them.

The General Assembly has clearly given consideration to the provision of free or reduced rate service for charitable purposes. While free or reduced rate service is permissible to, among others, charitable and eleemosynary institutions

⁸⁸KAWC response to OAG 1 - 173.

⁸⁹KAWC response to OAG 1 - 173.

⁹⁰KAWC response to PSC 2 - 28.

⁹¹KRS 278.170(2).

and to persons engaged in charitable and eleemosynary work, there is no statutory authority to provide direct reduced rate service as per the Kentucky-American tariff proposal.⁹²

KRS 278.030(3) does not carry the day for the tariff. KRS 278.030 presents the hurdle that a utility must clear to maintain separate classifications. It does not, however, address the issue of free or reduced rate service for any customer class. The issue of free or reduced rates is, instead, addressed by KRS 278.170.

During the evidentiary hearing, the company made reference to home energy assistance programs.⁹³ Absent from Kentucky-American's inquiry was the fact that the General Assembly has given statutory authorization (KRS 278.285) for the Columbia Gas, Louisville Gas and Electric, and Kentucky Utilities home energy assistance programs. For Low Income Water Discount programs, it does not provide statutory authority.

When the General Assembly wants to authorize free or reduced rates, it does so in plain and unambiguous terms. It has yet to provide statutory authority for the approval and implementation of what Kentucky-American seeks through its Low Income Water Discount. The proposal is unlawful.

⁹²Also, to be clear, while Subsection 2 permits free or reduced rate service for the purpose of providing relief in case of "flood, epidemic, pestilence, or other calamity," the plain language of this portion addresses emergency situations from temporal catastrophic events. This portion of the Subsection does not lend itself to authorizing a long-term program that is meant to address a non-catastrophic circumstance.

⁹³TE Vol. III of V, pages 216 to 218.

5.4 Economic Development Tariff

Kentucky-American expended effort and resource to fashion an Economic Development Tariff that is not within the scope of the items for which it seeks approval. The wild-goose chase nature of the proposal aside, this pseudo-proposal is unlawful.

Again, as with the low income discount proposal, the Company points to the development of a pathway for free or reduced rate service that does not have a basis in KRS 278.170 - the statute for authorizing such service. There is no statutory authority for the phantom tariff.⁹⁴ The General Assembly may someday, in determining the public policy of the Commonwealth, enact a statute to authorize such a tariff. Until such time, an Economic Development Tariff such as the one with vestige in this case is unlawful.

5.5 Activation Fee

Kentucky-American proposes an activation fee. It appears to be the case that the Commission has previously authorized activation fees for other water utilities, and the Commission may properly take administrative notice of the facts and circumstances of these prior authorizations.

It may be the case that an activation fee can serve as an unnecessary bar for a customer who seeks service; however, it also appears to be the case that such a fee can have a legitimate use for the assignment and recovery of cost. For

⁹⁴See KAWC response to OAG 1 - 174.

Kentucky-American's proposal, the actual impact is not clear. The responsibility of demonstrating the reasonableness of this fee proposal is the company's alone. It simply has not provided an adequate evidentiary basis for an approval.

5.6 Northern Division

The Attorney General recommends that there be no change in the Northern Division rates in this case. Kentucky-American should defer any changes in the Northern Division rates until it performs a cost of service study that includes the Northern Division.

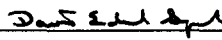
5.7 Central Division

If the Commission approves the activation fee, it should use the additional revenue from the fee to reduce or eliminate any increase in the 5/8-inch customer charge. KAWC does not challenge this proposal. If the overall level of rate increase is less than \$672,000 that would be generated by the activation fee, then all Central Division charges should be reduced by an equal percentage.

If the overall level of rate increase is greater than \$672,000, the additional revenue requirement should be collected by increasing the Central Division meter, consumption, and fire service charges by the same percentage, with the exception of the 5/8-inch meter charge if the activation fee is approved.

Submission of Filing in Paper Medium

Per Instructions 3 and 13 of the Commission's 27 May 2004 Order, Counsel submits for filing, by hand delivery to Beth O'Donnell, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601, the original and one copy in paper medium of the document. 5 January 2005 is the date for the filing in paper medium.


Assistant Attorney General

Certificate of Service

Per Instructions 4, 8 (d), and 12 of the May 27th Order, Counsel certifies service of a true and correct photocopy of the document by mailing the photocopies, first class postage prepaid, to the other parties of record on 5 January 2005.

The following are the other parties of record: David Jeffrey Barberie, Leslye M. Bowman, Lexington-Fayette Urban County Government, Department of Law, 200 East Main Street, Lexington, Kentucky 40507; Coleman D. Bush, Kentucky-American Water Company, 2300 Richmond Road, Lexington, Kentucky 40502; Joe F. Childers, 201 West Short Street, Suite 310, Lexington, Kentucky 40507; Roy L. Ferrell, West Virginia American Water Company, 1600 Pennsylvania Avenue, Charleston, West Virginia 25302; Lindsey W. Ingram III, Stoll, Keenon & Park, LLP, 300 West Vine Street, Suite 2100, Lexington, Kentucky 40507-1801; Lindsey W. Ingram, Jr., Stoll, Keenon & Park, LLP, 300 West Vine

Street, Suite 2100, Lexington, Kentucky 40507-1801; Michael A. Miller, West Virginia American Water Company, 1600 Pennsylvania Avenue, Charleston, West Virginia, 25302; Jon Parker, 201 W. Short Street, Suite 310, Lexington, Kentucky 40507; Bluegrass FLOW, Inc., c/o Foster Ockerman, Jr., 200 N. Upper Street, Lexington, Kentucky 40507; and Roy W. Mundy II, Kentucky-American Water Company 2300 Richmond Road, Lexington, Kentucky 40502.


Assistant Attorney General

Certification Regarding Electronic Filing

Counsel certifies that he has (per Instructions 3 and 8 (b) of the May 27th Order) submitted one copy of the document in electronic medium. Pursuant to Instructions 8 (a) and 8 (c) of the May 27th Order, he certifies that the electronic version of the filing is a true and accurate copy of the document filed in paper medium and that he has, by electronic mail, notified the Commission and the other parties that the electronic version of the filing has been transmitted to the Commission. (See attached) 5 January 2005 is the date of filing in electronic medium.


Assistant Attorney General