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	]	

DIRECT TESTIMONY OF

ANDREA C. CRANE

RE: REVENUE REQUIREMENTS

ON BEHALF OF

THE OFFICE OF RATE INTERVENTION OF THE ATTORNEY GENERAL
FOR THE COMMONWEALTH OF KENTUCKY

August 27, 2004

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1 **I. STATEMENT OF QUALIFICATIONS**

2 **Q. Please state your name and business address.**

3 A. My name is Andrea C. Crane and my business address is 1 North Main Street, PO Box 810,
4 Georgetown, Connecticut 06829.

5

6 **Q. By whom are you employed and in what capacity?**

7 A. I am Vice President of The Columbia Group, Inc., a financial consulting firm that specializes
8 in utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and
9 undertake various studies relating to utility rates and regulatory policy. I have held several
10 positions of increasing responsibility since I joined The Columbia Group, Inc., in January
11 1989.

12

13 **Q. Please summarize your professional experience in the utility industry.**

14 A. Prior to my association with The Columbia Group, Inc., I held the position of Economic
15 Policy and Analysis Staff Manager for GTE Service Corporation, from December 1987 to
16 January 1989. From June 1982 to September 1987, I was employed by various Bell Atlantic
17 (now Verizon) subsidiaries. While at Bell Atlantic, I held assignments in the Product
18 Management, Treasury, and Regulatory Departments.

19

20 **Q. Have you previously testified in regulatory proceedings?**

21 A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 170

1 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii,
2 Kansas, Maryland, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, Rhode
3 Island, South Carolina, Vermont, West Virginia, and the District of Columbia. These
4 proceedings involved water, wastewater, gas, electric, telephone, solid waste, cable
5 television, and navigation utilities. A list of dockets in which I have filed testimony is
6 included in Appendix A.
7
8 **Q. What is your educational background?**
9 A. I received a Masters degree in Business Administration, with a concentration in Finance,
10 from Temple University in Philadelphia, Pennsylvania. My undergraduate degree is a B.A.
11 in Chemistry from Temple University.
12
13 **II. PURPOSE OF TESTIMONY**
14 **Q. What is the purpose of your testimony?**
15 A. On April 30, 2004, Kentucky-American Water Company ("KAWC" or "Company") filed a
16 Petition requesting a rate increase of $7,297,443 or approximately a 16.82% increase in its
17 rates for water service. The Columbia Group, Inc., was engaged by the Office of Rate
18 Intervention of the Office of Attorney General ("Attorney General") to review the
19 Company's Petition and to provide recommendations to the Public Service Commission
20 ("PSC" or "Commission") regarding the Company's revenue requirement and cost of capital
21 claims. I am providing testimony on revenue requirement issues. Dr. J.Randall Woolridge,

Vice President of the Columbia Group, Inc., is filing testimony on cost of capital issues, including capital structure and return on equity. In addition, the Attorney General has engaged Scott Rubin to provide testimony on rate design and class cost allocation issues.

III. SUMMARY OF CONCLUSIONS

Q. What are your conclusions concerning the Company's revenue requirement and its need for rate relief?

A. Based on my analysis of the Company's filing and other documentation in this case, and on Dr. Woolridge's cost of capital recommendation, my conclusions are as follows:

1. The Company has an overall cost of capital of 7.11% (see Schedule ACC-2).
2. The Company has a forecast test period pro forma rate base of $149,515,650 (see Schedule ACC-3).[1]
3. The Company has forecast test period pro forma operating income at present rates of $10,562,554 (see Schedule ACC-14).
4. KAWC has a forecast test period pro forma revenue requirement deficiency of $111,933 (see Schedule ACC-1). This is in contrast to the Company's claimed deficiency of $7,297,443.

1 Schedules ACC-1, ACC-42, and ACC-43 are summary schedules; Schedule ACC-2 is a cost of capital schedule; Schedules ACC-3 to ACC-13 are rate base schedules; and ACC-14 to ACC-41 are operating income schedules.

1 **IV. COST OF CAPITAL**

2 **Q. What cost of capital did you utilize to develop your revenue requirement claim?**

3 A. I have utilized the overall cost of capital proposed by Attorney General witness J. Randall

4 Woodridge. This includes the following capital structure and cost of capital components:

5

	Capitalization Ratio	Cost Rate	Weighted Cost
Short-term Debt	7.78%	2.70%	0.21%
Long-term Debt	46.41%	6.33%	2.94%
Preferred Stock	4.60%	7.72%	0.36%
Common Equity	41.21%	8.75%	3.61%
Total			7.11%

6

7 Dr. Woolridge's recommendation results in a cost of capital claim that is 114 basis points

8 lower than the Company's overall claimed cost of capital of 8.25%.

9

10 **V. BASE PERIOD AND TEST PERIOD**

11 **Q. What base period and test period did the Company utilize to develop its claim in this**

12 **proceeding?**

13 A. The Company selected the base period ending July 31, 2004. As filed, the base period data

14 reflects six months of actual results and six months of forecasted data. KAWC has filed its

15 case based on a forecast test period ending November 30, 2005.

Q. Does the use of a forecast test period create specific concerns about the data presented in the Company's filing?

A. Yes, it does. While I understand that the state law[2] permits the use of a forward-looking test period, the use of forecast data does make it more difficult for regulators to assess the reasonableness of a utility's claim. Moreover, the use of a fully forecast test period combined with a partially forecast base period means that regulators are attempting to evaluate projected data relative to a baseline that also contains at least partially projected data. Although I understand that the Company will eventually update its base period with actual data prior to the hearings in this case, the actual data has not yet been provided and therefore it was not available to use in the preparation of this testimony. This further complicates the regulatory review.

If a utility files for a rate increase using a projected test period, then the utility should be required to fully justify its claims with detailed supporting documentation. Utilities filing a forecast test period should provide documentation that is sufficient to allow regulators to assess those claims relative to known actual results. Any changes should be explained and justified by the utility. In this case, the Company has filed a significant volume of material. Unfortunately, much of this material is confusing, conflicting, and poorly organized, making regulatory review difficult, as will be addressed in more detail below. Moreover, the use of a forecast test period significantly increases rate case expenses because the Company's case is more complex, requiring both the Company and regulators to expend more resources for

review than would be the case if an historic test period had been utilized.

Q. Are there other concerns about the use of a forecast test period?

A. Yes, the ability to use a forecast test period is of tremendous benefit to the utility. The use of forecast data allows the utility to reflect in rates future increases in investment and increases in operating expenses that may not be recoverable if an historic test period is used. However, given the use of a projected test period, there is no reason to permit a utility to make additional adjustments to include such items as construction work in progress or deferrals of various expenditures in rate base. Permitting a utility to utilize a future test year and then also permitting CWIP in rate base allows the utility to recover in rates not only plant that is not currently in-service but also plant that will not be in-service until after the end of forecast test period. Permitting the Company to include forecast test period operating expenses and then also permitting them to defer costs for later collection is internally inconsistent and eliminates much of the utility's incentive to make accurate forecast test period projections. This results in the worst of all possible worlds, using speculative projections to set rates and then providing for reimbursement ratemaking after the fact when those projections are inaccurate or fail to capture certain expenditures. Furthermore, the significant use of deferrals is unusual even in states that use an historic test year, let alone a projected test period.

Q. What do you recommend?

2 KRS 278.192.

1 A. In this case, I have utilized the forecast test period proposed in the Company's filing.
2 However, I have not hesitated to make adjustments in situations were the Company failed to
3 provide sufficient data to justify those projections. I have also made adjustments that are
4 theoretically consistent with the use of a forecast test period, such as adjustments to
5 eliminate CWIP and various deferrals from rate base. Finally, I am recommending
6 prospective changes with regard to the manner in which certain maintenance costs and other
7 operating costs are handled. All of these recommendations are discussed in further detail
8 later in this testimony.
9
10
11 **VI. RATE BASE**
12 **A. Utility Plant-in-Service**
13 **Q. How did the Company determine its utility plant-in-service claim in this case?**
14 A. As described by KAWC witness Michael Miller beginning on page 38 of his testimony,
15 KAWC began with its actual plant-in-service balance at January 2004, the mid-point of the
16 base year. The Company then forecasted capital expenditures by month. The Company
17 forecasted capital expenditures for both its routine investment projects, designated
18 investment projects 80 through 97, as well as for special investment projects ("IP") that are
19 non-recurring. KAWC forecasted its expenditures by month, based on the expected cash
20 flow of each project. KAWC assumed that when the project was complete, all capital
21 expenditures would be placed into service.

1 KAWC also forecasted plant retirements by month. These retirements were deducted
2 from the monthly utility plant-in-service balances each month. KAWC then calculated a 13-
3 month average of its utility plant-in-service balances for the twelve months ending
4 November 30, 2005, to develop its rate base claim.
5 .
6 **Q. Are you recommending any adjustment to the utility plant-in-service additions being**
7 **claimed by KAWC?**
8 A. Yes, I am recommending one adjustment. Specifically, I am recommending a reduction to
9 utility plant-in-service to reflect the actual experience of KAWC with regard to meeting its
10 projections of capital expenditures. A review of the Company's historic actual plant-in-
11 service additions relative to its budgeted construction indicates that the Company
12 traditionally has had difficulty completing all of its projected additions on schedule,
13 particularly with regard to the special construction projects. While the Company has
14 completed 105.43% of its routine construction projects on-time over the past ten years,
15 during that period it has only completed 86.12% of its special budgeted construction
16 projects. At the time of its last base rate case, the Company had completed only 97.23% of
17 its budgeted routine construction and 74.87% of its special construction projects over the
18 preceding ten-year period. Thus, while the Company is improving its ability to forecast
19 construction projects, its forecasts as stated should not be used to set rates without an
20 adjustment for slippage of construction projects that has historically occurred.
21 The Company provided information in response to Data Requests PSC 2-115 and

1 PSC 3-44 showing what its rate base claim would be if the historic level of actual capital
2 expenditures to budgeted capital expenditures had been utilized. This is known as the
3 slippage factor. At Schedule ACC-4, I have made an adjustment to reflect a revised utility
4 plant-in-service claim based on this historic slippage factor.
5
6 **Q. Do you have any other comments regarding the Company's utility plant-in-service**
7 **claim?**
8 A. Yes, I do. The completion percentages shown above do not fully capture the magnitude of
9 the slippage problems experienced by KAWC, as demonstrated from a review of the
10 response to PSC 2-116. This response shows the number of projects completed each year, as
11 well as the number of projects completed that were on-schedule, behind schedule, and ahead
12 of schedule. This response illustrates that the Company is notoriously poor in estimating the
13 timing for construction projects, as shown below:

Year	Total No. of IPs Completed	IPs Completed Ahead of Schedule	IPs Completed On Schedule	IPs Completed Behind Schedule
1994	6	1	2	3
1995	6	1	2	3
1996	14	4	4	6
1997	9	0	3	6
1998	7	3	1	3
1999	9	0	0	9
2000	7	3	1	3
2001	7	0	1	6
2002	7	0	2	5
2003	4	1	0	3

Thus, out of a total of 76 investment projects, 61% were completed behind schedule and, in the last three years, 77% were completed by behind schedule. This poor completion record is even more disturbing given that the Company uses a forward-looking test period.

B. Utility Plant Acquisition Adjustment

Q. Please describe the utility plant acquisition adjustments included by the Company in its

1 **filing.**

2 A. KAWC has included three utility plant acquisition adjustments in its filing, as follows:

Boonesboro Water Association	$ 77,271
Tri-Village System	$208,310
Elk Lake System	$106,123

7 KAWC has utilized a ten-year amortization period for the Boonesboro Water Association
8 acquisition and a forty-year amortization period for the Tri-Village and Elk Lake
9 acquisitions. The Booneboro Water Association acquisition adjustment was approved by the
10 Commission in the Company's last base rate case. KAWC is seeking Commission approval
11 for the Tri-Village and Elk Lake acquisition adjustments as part of this case.

12

13 **Q. Do you recommend that the proposed acquisition adjustments be accepted by the**
14 **Commission?**

15 A. No, I recommend that the acquisition adjustments be denied. Acquisition of utility property
16 should be recorded in rate base at the lower of original cost value or the purchase price.
17 Moreover, original cost is defined as the cost at the time that the property first entered utility
18 service. The use of original cost at the time that the property first enters utility service
19 prevents companies from buying and selling assets at inflated prices in order to inflate a
20 company's rate base and shareholder earnings. Conversely, in the event that the purchase
21 price is lower than net original cost value, the purchase price should be used. If a utility

1 buys assets at a price that is lower than net original cost, but books those assets to rate base
2 at the purchase price, shareholders will earn a return on investment that they in fact never
3 made in the utility.
4
5 **Q. Hasn't the Commission already approved the acquisition adjustment of the Booneboro**
6 **Water Association system?**
7 A. Yes, it did approve that acquisition and therefore I am not recommending any adjustment to
8 the Company's claim associated with Booneboro. While I do not agree with the inclusion of
9 an acquisition adjustment in rate base, I recognize that the Booneboro Water Association
10 acquisition adjustment has already been litigated by this Commission, and I do not believe
11 that there is any benefit to attempting to re-litigate that issue here. However, it should be
12 noted that the Commission originally rejected the Booneboro acquisition adjustment in its
13 last case. In fact, in that case, the Commission reiterated its stated position that "the net
14 original cost of plant devoted to utility use is the fair value for rate-making purposes, unless
15 the utility can prove, with conclusive evidence, that the overall operations and financial
16 condition of the utility have benefited from acquisitions at prices in excess of net book
17 value."[3] The Commission went on to state that "the utility seeking the adjustment bears the
18 burden to justify its purchase decision based 'on economic and quality of service criteria.'"[4]
19 The criteria referred to in the Commission's order were outlined in the Delta Natural Gas
20 Company proceeding, Case No. 9059. At that time, the Commission defined the criteria as:

3 Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc. (Ky. PSC Sept. 11, 1985), page 3.
4 Order in Case No. 2000-120, (Ky. PSC Nov. 27, 2000), page 6.

> the purchase price was established upon arms-length negotiations, the initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall cost and rates of the existing and new customers, operational economies can be achieved through the acquisition, the purchase price of utility and non-utility property can be clearly identified, **and the purchase will result in overall benefits in the financial and service aspects of the utility's operations**. (emphasis added)

In its decision in the last case, the Commission initially found that "...Kentucky-American has failed to prove the established criteria for an acquisition adjustment."[5] Accordingly, the Commission rejected the Company's proposed acquisition adjustment. The Company requested a rehearing on this issue, and the Commission reversed itself and found that the Boonsboro Water Association acquisition did meet the criteria for an acquisition adjustment. While the Commission did explain why it believed that the Company met some of the criteria outlined above, it never explained why it believed that the Boonesboro acquisition resulted "in overall benefits in the financial and service aspects of the utility's operations." Nonetheless, the Commission permitted the acquisition adjustment to be included in rates.

Q. Has the Company demonstrated that the Tri-Village and Elk Lake acquisitions meet the criteria for acquisition adjustments?

A. No, it has not. The documentation provided in response to PSC 3-30 demonstrates that the acquisitions of Tri-Village and Elk Lane were viewed as business development opportunities for KAWC. For example, according to presentations made regarding the Tri-Village acquisition, "KAWC will provide water service to new customers based upon the existing

5 Id., page 7.

1 KWAC tariff. This tariff allows for KAWC to extend mains into areas in which the total of
2 revenues to be received from the new customers for the first 3 years equals or exceeds the
3 amount of expense for the main extension."[6] The Company apparently approached the Tri-
4 Village Water District as early as April 1999, stating that "a business partnership between
5 Tri-Village Water District and KAWC presents many advantages to your customers."[7] In
6 May 1999, there were media articles regarding water quality violations at Tri-Village,
7 however, the conclusion of KAWC was that this issue would be addressed as part of the due
8 diligence review after a contractual agreement was reached, as "it will not be appropriate to
9 discuss this with them"[8] during pre-contract tours of the facility.

10 Discussions with Elk Lake Water Company also began early in 1999. Again, this
11 was viewed as a "business partnership." Elk Lake's decision to investigate selling the
12 system was prompted by the decision of their main water plant operator to move, "causing
13 them to want to go ahead and make the decision about selling or shutting down the plant."[9]
14 A complete review of the voluminous documentation provided in response to PSC 3-30 fails
15 to demonstrate that the acquisition of the Tri-Village and Elk Lake systems resulted an
16 overall benefit in the financial and service aspects of the KAWC operations.

6 Response to PSC 3-30b, page 25.
7 Response to PSC 3-39c, page 8.
8 Response to PSC 3-30c, page 9.
9 Response to PSC 3-30E, page 1.

1 **Q. What do you recommend?**

2 A. The Tri-Village and Elk Lake system acquisitions were business development opportunities
3 pursued by KAWC. There is no reason why regulated ratepayers should be required to pay
4 higher rates because the Tri-Village and Elk Lake systems were purchased at prices that
5 exceeded net book value. Moreover, the gain accruing to the former owner of Tri-Village is
6 perhaps more than is readily apparent, since I understand that the Tri-Village system was
7 permitted to recover depreciation expense on contributed property prior to the sale. Thus,
8 the former owner received recovery of an investment that it, in fact, did not make and in
9 addition it sold the system for a profit. There is no reason why any of this profit should be
10 funded by ratepayers, and I recommend that the acquisition adjustments being proposed for
11 Tri-Village and Elk Lake be denied. My adjustment is shown in Schedule ACC-5.

12

13 **C. <u>Accumulated Depreciation</u>**

14 **Q. What adjustments are you recommending to the Company's claim for accumulated**
15 **depreciation?**

16 A. I am recommending an adjustment consistent with the plant slippage adjustment discussed
17 above. To the extent that the Company's capital expenditures are delayed, KAWC's utility
18 plant-in-service balances will similarly be less than forecast, and less depreciation expense
19 will be taken during the forecast test period. The Company quantified the impact of the
20 slippage adjustment on its claim for accumulated depreciation in the response to PSC 2-115.
21 Therefore, at Schedule ACC-6, I have made an adjustment to reduce the Company's

accumulated depreciation balance to reflect the delay in its capital expenditures based on the slippage factor adjustment discussed earlier.

D. Construction Work in Progress ("CWIP")

Q. Did the Company include construction work in progress in its rate base claim?

A. Yes, KAWC originally included $6,124,953 of CWIP in its rate base claim. This amount was revised to $5,529,656 when the Company provided a revised rate base based on its historic slippage factor.

Q. Are you recommending any adjustment to the Company's claim?

A. Yes, I am recommending that the Company's claim for inclusion of CWIP in rate base be denied. CWIP is not an appropriate rate base element. CWIP does not represent facilities that are used or useful in the provision of utility service. In addition, including this plant in rate base violates the regulatory principle of intergenerational equity by requiring current ratepayers to pay a return on plant that is not providing them with utility service and which may never provide current ratepayers with utility service.

One of the basic principles of utility ratemaking is that shareholders are entitled to a return on, and to a return of, plant that is used and useful in the provision of safe and adequate utility service. By its definition, CWIP does not meet this criteria. The Company should accrue an allowance for funds used during construction ("AFUDC") on projects until such time as the project is completed and placed into service. Since the Company is

1 compensated for its costs in this manner, there is no need to make an exception to good
2 ratemaking principles by allowing CWIP to be included in rate base.
3 The AFUDC methodology has two distinct advantages over permitting CWIP in rate
4 base. First, it properly matches the benefits provided to ratepayers with the costs paid by
5 those ratepayers, while allowing CWIP in rate base forces today's ratepayers to pay for plant
6 that may never provide them with any benefit. Second, allowing CWIP in rate base transfers
7 the risk during project construction from shareholders, where it properly belongs, to
8 ratepayers. The shareholders will be compensated for that risk once the plant enters utility
9 service and the AFUDC is appropriately included in rate base.
10
11 **Q. Why is it particularly important to eliminate CWIP in this case?**
12 A. I believe that it is particularly appropriate to eliminate CWIP in this case because the
13 Company is using a forecast test period to set rates. Permitting the Company to use a
14 forecast test period means that during the first year of new rates, the Company will already
15 be fully compensated for the investment that is used to provide utility service to customers.
16 Permitting CWIP to be included in rate base while using a forecast test period extends the
17 time horizon on which the Company's rates are based even further out into the future.
18
19 **Q. Have you testified in other states in which the Company's affiliates operate?**
20 A. Yes, I have testified in several states where American-Water Works Company has
21 subsidiaries, including Pennsylvania, New Jersey, Maryland, New Mexico, Hawaii, and

West Virginia. In most if not all of these states, CWIP is excluded from a utility's rate base claim. However, the principal reason for the PSC to exclude CWIP in rate base in Kentucky is not because it is the general regulatory practice. The principal reason for excluding CWIP from rate base is because it is the proper ratemaking treatment, particularly when a forecast test period is used.

Q. What do your recommend?

A. I recommend that CWIP be excluded from the Company's rate base claim. My adjustment is shown in Schedule ACC-7.

E. Cash Working Capital

Q. What is cash working capital?

A. Cash working capital is the amount of cash that is required by a utility in order to cover cash outflows between the time that revenues are received from customers and the time that expenses must be paid. For example, assume that a utility bills its customers monthly and that it receives monthly revenues approximately 30 days after the midpoint of the date that service is provided. If the Company pays its employees weekly, it will have a need for cash prior to receiving the monthly revenue stream. If, on the other hand, the Company pays its interest expense quarterly, it will receive these revenues well in advance of needing the funds to pay interest expense.

1 **Q. Do companies always have a positive cash working capital requirement?**

2 A. No, they do not. The actual amount and timing of cash flows dictate whether or not a utility
3 requires a cash working capital allowance. Therefore, one should examine actual cash flows
4 through a lead/lag study in order to accurately measure a utility's need for cash working
5 capital.

6

7 **Q. Did the Company provide a lead /lag study in support of its cash working capital claim?**

8 A. Yes, KAWC did provide a lead/lag study as well as supporting documentation for its claim.

9

10 **Q. Are you recommending any adjustment to the Company's cash working capital claim?**

11 A. Yes, I am recommending several adjustments to the Company's claim. First, I am
12 recommending modifications to the lead-lag days used by the Company for several expenses.
13 Second, I am recommending the elimination of depreciation expense from the Company's
14 cash working capital claim. Third, I have updated the Company's cash working capital
15 claim to reflect the level of expenses that I am recommending in this case.

16

17 **Q. What lag days are you recommending be revised?**

18 A. I am recommending revisions to the Company's lag days for chemicals, service company
19 charges, OPEB, insurance other than group, waste disposal, other expenses, and state income
20 taxes, interest expense, and preferred dividends.

21

1 **Q. What lag days did the Company include in its cash working capital study for chemical**
2 **expense?**
3 A. In this case, the Company has reflected a lag of only 6.65 days. In its last case, KAWC
4 reflected a lag of 30.49 days for its chemical expense. A review of the Company's
5 workpapers shows that KAWC has used a service lag of one day for many of its chemical
6 invoices and has also used a payment lag of a day in many cases. This means that for many
7 of its chemical purchases, KAWC is purchasing chemicals every two days and paying for
8 them upon purchase. This represents a significant change in procurement practices from
9 those in place at the time of the Company's last case. No explanation was offered by the
10 Company for this procurement practice.
11
12 **Q. What is the typical lag for chemical expenses?**
13 A. Utilities typically purchase chemicals on a monthly basis and pay for their chemical costs
14 sometime in the following month. Therefore, the lag of 30.49 days used by the Company in
15 its prior cash working capital study is reasonable and typical of other water utilities. On the
16 other hand, the expense lag used for chemical expense in this case reflects procurement and
17 payment patterns that are not normal and customary.
18
19 **Q. What do you recommend?**
20 A. I recommend that the Commission reject the expense lag proposed by the Company with
21 regard to its chemical expense claim. Instead, I recommend that the Commission adopt a lag

1 of 30.49 days for chemical expense, which is the lag used by KAWC in its last base rate
2 case. My adjustment is shown in Schedule ACC-8.[10]
3
4 **Q. What adjustment are you recommending to the lag days used for Service Company**
5 **charges?**
6 A. I am recommending that the Service Company lag days be increased from the (1.34) days
7 used in the Company's filing to 12.0 days. KAWC's lag reflects payment of service
8 company charges in advance of the midpoint of the service period. Thus, on average,
9 KAWC is prepaying these charges. However, the Service Company charges are largely
10 driven by personnel costs. The Service Company employees are located at the Service
11 Company for organizational efficiency, but the types of services being provided are those
12 that would be provided internally by KAWC in the absence of a centralized Service
13 Company. The Service Company acts as a substitute for each individual company having to
14 hire its own employees. Therefore, there is no justification for requiring prepayment of
15 Service Company charges.
16 I recommend that the Commission use 12.0 days as the lag for Service Company
17 charges because this is the lag for KAWC labor costs. The lag for costs associated with
18 Service Company charges should be no shorter than the lag for internal KAWC personnel

10 All of my cash working capital adjustments are included in my pro forma cash working capital recommendation in Schedule ACC-8.

1 costs. My adjustment, which reflects a lag of 12.0 for Service Company charges, is shown in
2 Schedule ACC-8.
3
4 **Q. Please describe your remaining adjustments to the lag days used by the Company.**
5 A. In its workpapers, KAWC did not provide supporting cash working capital workpapers for
6 the lag days for its Other Post Employment Benefit ("OPEB") expenses, insurance other than
7 group, waste disposal costs, state income taxes, interest expense, or preferred dividends. In
8 response to a request for additional information, KAWC indicated that the lags for these
9 items were being supported based on a lead/lag study conducted for a sister company.[11]
10 When the workpapers for that sister company's lead/lag study were provided, the
11 workpapers contained lags from certain items that differed from those used by KAWC in its
12 filing, as shown below:
13

	KAWC Filing	Response to AG 2-29
OPEB	(0.50) Days	23.13 Days
Insurance Other Than Group	(47.19)	(44.90)
Waste Disposal	25.97	26.90
Income Taxes-SIT	30.13	52.75
Interest-LTD	90.45	119.64
Interest-STD	15.58	14.60
Preferred Dividends	45.49	46.40

14
15 I recommend that the lags supported by the Company's workpapers provided in
16 response to discovery be used to develop KAWC's pro forma cash working capital claim in

11 Response to AG 2-29.

1 this case. No supporting documentation has been provided with regard to the lags claimed
2 by KAWC in its filing for OPEB costs, insurance other than group, waste disposal costs,
3 state income taxes, interest expense, or preferred dividends. The only documentation with
4 regard to expense lags for these costs is the information provided in response to AG 2-29.
5 Therefore, those lags should be used to develop the Company's claim in this case. These
6 lags are incorporated in my cash working capital adjustment shown on Schedule ACC-8.
7
8 **Q. Turning to another issue, what is the basis for your recommendation that depreciation**
9 **expense be eliminated from the Company's cash working capital claim?**
10 A. My recommendation is based on the fact that depreciation expense does not result in cash
11 outflows by the Company and is not an appropriate element of a lead/lag study. The
12 Company does not make cash payments for depreciation expense on a specified date. The
13 purpose of a lead/lag study is to match cash inflows, or revenues, with cash outflows, or
14 expenses. Cash working capital reflects the need for investor-supplied funds to meet the
15 day-to-day expenses of operations that arise from the timing differences between when the
16 Company has to expend money to pay the expenses of operations and when revenues for
17 utility service are received by the Company. Only items for which actual out-of-pocket cash
18 expenditures must be made are included in a cash working capital calculation. The actual
19 amount and timing of cash flows dictate whether or not the Company requires a cash
20 working capital allowance. The purpose of the lead/lag study is to determine the level of
21 investor-supplied funds actually needed, not to compensate the Company for all of its costs.

1 Recovery of all costs, including non-cash costs such as depreciation expense, is provided
2 through an appropriate revenue requirement. Therefore, there is no need to include non-cash
3 expenses in a Company's cash working capital calculation. Only actual cash flows should
4 be considered in determining KAWC's need for a cash working capital allowance. At
5 Schedule ACC-8, I have made an adjustment to eliminate depreciation expense from the
6 Company's cash working capital claim.
7
8 **Q. Hasn't the Commission traditionally permitted depreciation expense to be included in a**
9 **utility's lead/lag study?**
10 A. I understand that in the past, the PSC has permitted the inclusion of cash working capital in a
11 utility's lead/lag study. However, there is no sound theoretical reason for allowing this
12 ratemaking treatment. Accordingly, I am recommending that the Commission reexamine
13 this issue. Pennsylvania and West Virginia are just two examples of jurisdictions where
14 depreciation expense is excluded from a utility's cash working capital study.
15
16 **Q. Are there other categories included in the Company's lead/lag study that other**
17 **regulatory commissions often exclude from a utility's cash working capital allowance?**
18 A. Yes, there are. Such items as amortizations, deferred taxes, and net income are often
19 excluded from a regulated utility's cash working capital claim and I have testified in the past
20 that these items should not be included in cash working capital. However, in this case, I
21 recognize that I am asking the PSC to reconsider an earlier decision regarding the

components to include in cash working capital. Therefore, in order to limit the amount of controversy in this case, I am confining my recommendation to the exclusion of depreciation expense, since depreciation expense has no impact on cash flow and the most apparent non-cash expense included in the Company's claim.

Q. Should all components of the Company's cash working capital claim be updated to reflect the actual revenue requirement found by the Commission to be reasonable?

A. Yes, all components of the cash working capital claim should be updated based on the Commission's findings in this case. At Schedule ACC-8, I have included my adjustment to update the Company's cash working capital claim to reflect the revenue requirement recommendations contained in my testimony. For simplicity, my adjustment was determined by updating the daily cash requirement for the adjustments that I have made to various revenue requirement components. I have not attempted to recalculate the net lag days by updating each individual expense category. However, if each individual expense category was updated to reflect my recommendations, I believe the result would be a further reduction to the Company's cash working capital requirement. Accordingly, the methodology that I have used to update the cash working capital claim is conservative.

F. Contributions in Aid of Construction ("CIAC")

Q. Please describe your adjustment relating to the Company's claim for contributions in aid of construction.

1 A. In response to AG 1-111, KAWC indicated that it had made several errors in its filing with
2 regard to CIAC. The Company stated that the effect of these errors was to overstate CIAC
3 by $2,095,255 in its filing. In its response to PSC 2-115, the Company corrected these
4 errors. In addition, in that response, KAWC provided a revised CIAC amount, that reflects
5 the plant slippage factor discussed earlier as well as the corrected CIAC balance. At
6 Schedule ACC-9, I have made an adjustment to include this revised CIAC claim to a) correct
7 the CIAC errors contained in the Company's initial filing and b) reflect the impact on CIAC
8 of the slippage in capital projects.
9
10 **G. <u>Customer Advances</u>**

11 **Q. What adjustment have you made to the Company's claim for customer advances?**

12 A. Consistent with the plant slippage adjustment, I have updated the Company's claim for
13 customer advances based on the historic level of plant slippage that has occurred over the
14 past ten years. The delays experienced by KAWC in completing its capital projects will
15 impact not only the level of utility plant-in-service and CIAC, but also the pro forma level of
16 customer advances expected to be received during the forecast test period. My adjustment,
17 which is based on information provided by KAWC in response to PSC 2-115, is shown in
18 Schedule ACC-10.

1 **H. Deferred Debits**

2 **Q. Please describe the Company's claim for deferred debits to be included in rate base.**

3 A. KAWC has included over $6.7 million of deferred debits in its rate base claim.
4 Approximately $1.1 million of these deferred debits relate to deferrals that have been
5 approved by the PSC in the past. I am not recommending any adjustment to those deferrals
6 that have been previously addressed.

7 However, the Company has included deferred debits relating to several new
8 expenditures in its claim. Specifically, it has included deferrals relating to security costs,
9 Shared Service Center costs, Customer Call Center costs, rate case costs, and acquisition
10 costs for the Tri-Village and Elk Lake systems. The total amount included in the Company's
11 claim for these deferrals is $4,570,991. KAWC is requesting a ten-year amortization of the
12 security costs, shared services center costs, and customer call center costs. It is requesting a
13 three-year amortization for rate case costs. Finally, it is requesting a forty-year amortization
14 for the acquisition costs associated with Tri-Village and Elk Lake.

15

16 **Q. Are you recommending any adjustment to the Company's claim?**

17 A. Yes, I am recommending that the Company's claim for deferred treatment of these costs be
18 denied. As discussed previously, the Company is provided with a significant advantage by
19 being able to file its case based on a forecast test period. Therefore, KAWC should not also
20 be permitted to request retroactive reimbursement for costs that are incurred between rate
21 cases. Allowing the Company to defer these costs for future recovery is inconsistent with

1 the use of a forward-looking test period.

2 Between rate cases, there are many factors that impact upon a utility's earnings. In
3 some cases, a utility incurs unexpected costs, such as those that KAWC incurred for security
4 from September 11, 2001, through the base year. In other cases, actions are taken by
5 Company management that will impact on the costs incurred by the utility, such as the
6 decisions to reorganize certain functions in the Shared Services Center and Customer Call
7 Center. However, ratemaking is not a reimbursement system, particularly for a utility that is
8 permitted to utilize a forecast test period. In fact, the review of the Company's accounting
9 functions that were moved to the Shared Service Center began in 1999, prior to the last base
10 rate case. The actual transition of certain accounting functions to the Shared Services Center
11 took place in January 2002. The transition to a National Customer Call Center occurred in
12 October 2003. To the extent that savings result from these types of reorganizations, then a
13 utility's shareholders receive the benefits of the savings between rate cases, and rightly so.
14 But it should be a net savings, because shareholders should also be required to absorb any
15 cost increases that occur between rate cases as a result of management's decision to
16 reorganize.

17 Finally, while I am not disputing the Company's contention that the reorganizations
18 have resulted in cost reductions, it is interesting to note that not all customers have
19 apparently benefited from these efforts at consolidation. According to the Strategic Business
20 Plan provided in response to AG 1-176, "The American Water National Call Center is
21 experiencing the pain of a start up. Negative customer experiences have the potential to

1 hinder business development results."[12]

2

3 **Q. Did the Company request deferred accounting treatment for these costs?**

4 A. The Company did request deferred accounting treatment, at least for the Shared Services
5 Center costs and the Customer Call Center transition costs. However, it is my understanding
6 that the PSC has not granted deferred accounting treatment. Therefore, the Company's
7 attempt to recover these costs in prospective rates clearly constitutes retroactive ratemaking
8 and should be denied.

9

10 **Q. Has the Company previously requested approval for recovery of its security costs?**

11 A. Yes, according to the testimony of Mr. Miller at page 25, KAWC previously filed for a
12 "surcharge" to recover increased security costs. As part of the approval of the acquisition of
13 KAWC by RWE, the Company withdrew its request for a surcharge. Moreover, as a
14 condition of the merger, KAWC agreed to seek recovery of costs associated with the
15 protection of water utility assets only in a base rate case. It is the Company's position that
16 that this provision did not prevent it from deferring these costs. It was the position of the
17 PSC Staff that the Order in the merger case did prohibit the establishment of a regulatory
18 asset relating to security costs.[13] I understand that Staff may now be reconsidering its
19 position. In any case, deferred accounting treatment has not been granted for these security

12 Response to AG 1-176, page 14.
13 Testimony of Mr. Miller, page 26.

1 costs, nor has it been granted for the Shared Services Center and Customer Call Center costs
2 being claimed by KAWC. Permitting these costs to be recovered in prospective rates shifts
3 the regulatory risk from shareholders, who are properly compensated for that risk through an
4 appropriate return on equity award, to ratepayers. It also constitutes retroactive ratemaking
5 and should be denied.
6
7 **Q. Are there other reasons for denying the Company's claimed deferrals with regard to**
8 **the Tri-Village and Elk Lake acquisitions?**
9 A. Yes, the Company has double-counted these acquisition adjustments in rate base. Not only
10 has the Company included the unamortized balances associated with these acquisitions in
11 deferred debits, but it has included a separate acquisition adjustment for these two
12 acquisitions. For reasons discussed previously in this testimony, these acquisition
13 adjustments should be eliminated from rate base. They should not even be included once in
14 rate base, and they certainly should not be included twice.
15
16 **Q. Has the PSC previously granted rate base treatment for the unamortized balances**
17 **associated with rate case costs?**
18 A. No, it is my understanding that the PSC has traditionally excluded the unamortized balance
19 associated with rate case costs from rate base. I recommend that they continue to deny rate
20 base treatment for these unamortized balances. In addition, in Section VIII of my
21 testimony, I discuss my recommendation that certain periodic costs be normalized rather

than amortized. If such ratemaking treatment is adopted, there will be no unamortized balances relating to rate case costs on the Company's books.

Q. What is the result of your recommendation?

A. As shown on Schedule ACC-11, my recommendation to eliminate these deferred debits from rate base will reduce the Company's claim by $4,570,991. This reduction will be partially offset by a decrease to the associated deferred tax reserve, discussed below.

I. <u>Deferred Income Tax Reserve</u>

Q. Please discuss your recommended adjustment to the Company's accumulated deferred tax reserve.

A. In its filing, KAWC included deferred income taxes resulting from differences between the tax treatment used for certain costs and the ratemaking treatment for these same costs. KAWC included deferred income taxes associated with both its utility plant-in-service projection and its claim for deferred debits.

Since I am recommending that the Company's utility plant-in-service claim be adjusted to account for historic construction slippage, it is necessary to make a corresponding adjustment to reduce the deferred taxes associated with the plant that is projected to be delayed. Therefore, at Schedule ACC-12, I have made an adjustment to reduce my pro forma deferred income tax reserve consistent with my utility plant-in-service

recommendation.

In addition, I have included an adjustment at Schedule ACC-13, to remove deferred taxes associated with the deferred debits that I have eliminated from rate base. Since I have eliminated various deferred debits from rate base, any tax benefits associated with these deferred debits must also be eliminated from the Company's claim. Thus, in Schedule ACC-13, I have calculated the deferred taxes associated with these deferred debits by applying the composite income tax rate to my recommended adjustment for deferred debits. By adjusting the deferred income tax reserve in this manner, the "benefit" that ratepayers receive by eliminating deferred debits from rate base is reduced by 40.37%, which is the composite income tax rate.

J. Summary of Rate Base Issues

Q. What is the impact of all of your rate base adjustments?

A. My recommended adjustments reduce the Company's rate base claim from $158,958,817 to $149,515,650, as summarized on Schedule ACC-3.

VII. OPERATING INCOME ISSUES

A. Residential Operating Revenue

Q. Are you recommending any adjustments to the Company's pro forma revenue claim?

1 A. Yes, I am recommending adjustments to the Company's claims for residential customers,
2 commercial customers, residential consumption, commercial consumption, public fire
3 protection, private fire protection, and AFUDC.
4
5 **Q. How did the Company develop its claim for pro forma residential consumption in this**
6 **case?**
7 A. As described in the testimony of Dr. Spitznagel, the Company undertook a regression
8 analysis to develop a normalized level of consumption per customer. This regression
9 analysis examined the impact of consumption on such variables as calendar month, calendar
10 year, temperature, drought severity, and other factors. Dr. Spitznagel then developed a
11 regression based on those variables that gave the best statistical fit to seven years of
12 utilization data. As a result of that analysis, Dr. Sptiznagel is recommending a residential
13 consumption of 165.42 gallons per day per customer or 60,378 thousand gallons (Tgs) per
14 year.
15
16 **Q. How does this recommendation compare with the consumption results in other KAWC**
17 **cases?**
18 A. The per customer consumption being recommended in this case, represents a significant
19 departure from the recommendations resulting from predictive models used in other recent
20 KAWC cases. According to the response to PSC 2-49, the last three base rates cases had
21 estimates that were very close to one another, but which vary significantly from the

1 Company's claim in this case, as shown below:

1

Period	Residential Consumption per Customer
Oct 1997 - Sept. 1998	184.82 Gallons per day
Jan 2000 - Dec 2000	184.66
Dec 2000 - Nov. 2001	183.94
Dec 2004 - Nov 2005	165.42

2

3 The Company claims that this reduction is the result of two factors. First, it claims
4 that the decline in consumption per customer is due to the difference between the thirty-year
5 normal used in this case and the thirty-year normals used in previous cases. Second, the
6 Company states that newer water-conserving devices are having a significant impact on
7 water usage, noting that customers have grown 25% since 1996, mostly through new
8 construction that tends to have more efficient fixtures. While I have no doubt that some
9 conservation is occurring and that more efficient fixtures are being introduced, the
10 significant decline in the Company's claimed consumption suggests that consumption results
11 proposed for this case may be understated.

12

13 **Q. Is there another reason why you believe that the Company's consumption claim may be**
14 **understated?**

15 A. Yes, there is. In Exhibit 37, Schedule I, page 4, the Company provided its consumption
16 statistics for the past five years. Following are the average actual residential consumption

1 levels during each of the past five years:[14]

2

3 Residential Consumption Per Customer (Tgs)

1999	70
2000	66
2001	65
2002	66
2003	59
Base	62
Forecast	57

4

5 Moreover, according to this exhibit, the Company is projecting consumption of 66,000
6 gallons per year per residential customer in both 2004 and 2005. Thus, this data conflicts
7 with the Company's claim that residential consumption will be only 165.42 gallons per day
8 or 60,378 gallons per year during the future test period. In its Strategic Business Plan,
9 KAWC also uses 66,000 gallons per customer per year as the assumed pro forma
10 consumption for 2004 and 2005.

14 This data is captioned "Average Revenue Per Customer" but it clearly reflects usage per customer, not revenue per customer. Moreover, although the schedule states that all units are in Ccfs, this data appears to be in Tgs.

1 **Q. What do you recommend?**

2 A I recommend that the Commission utilize pro forma consumption of 174.68 gallons per day
3 per customer for residential customers, or 63,758 gallons annually. I have developed this
4 recommended consumption based on the average of the consumption result from the
5 modeling performed this year by Mr. Spitznagel and the residential utilization presented in
6 KAWC's last case. The Company's claim in this case represents a decrease over 10% from
7 the residential utilization used in the last case. While I acknowledge that fixtures are, on
8 average, becoming more efficient, I do not believe that this explanation is sufficient
9 justification to incorporate a 10% reduction in residential consumption in this case. My
10 recommendation is supported by the fact that the Company's own exhibits and Strategic
11 Business Plan project residential consumption in 2004 and 2005 that is comparable to levels
12 experienced in 2000-2002.
13
14 **Q. How did you quantify your adjustment?**

15 A. As shown in Schedule ACC- 15, I used the Company's pro forma number of customers and
16 my recommended pro forma consumption level of 174.68 gallons per day to determine the
17 total annual pro forma residential sales. I then converted total annual sales from Tgs to Ccfs,
18 to be consistent with the units stated in the Company's tariff. I then determined the
19 incremental sales by subtracting the Company's claim from my pro forma recommended
20 sales. The result is an increase of 653,594 (Ccfs). I priced all of these sales at the current
21 volumetric rate in the Central Division, which is the lowest volumetric rate in the KAWC

1 system, to determine a pro forma level of incremental gross revenue. I then made an
2 adjustment to reflect incremental costs of these additional sales, based on the Company's
3 claims for purchased water, chemical expense, power expense, uncollectibles, and the PSC
4 assessment. My recommendation results in a net revenue increase of $541,591, as shown on
5 Schedule ACC-15.
6
7 **Q. How did the Company determine its pro forma claim for the number of residential**
8 **customers?**
9 A. According to the testimony of Mr. Salser, the Company began with a bill analysis based on
10 actual results for the six months ending January 31, 2004, and the Company's budgeted
11 billings for the last six months of the base period. The number of residential customers was
12 then decreased by 943 to reflect actual customers at January 31, 2004, and was then
13 increased by 3,023 to reflect pro forma growth through the end of the forecast period.
14 According to the response to PSC 2-50, the Company's customer base has grown by
15 approximately 2,500 customers per year for the past several years. KAWC states in that
16 response that they used a 3-year average of historical growth to project growth for the
17 forecasted period.
18
19 **Q. What adjustment are you recommending to the Company's methodology?**
20 A. I am not recommending any adjustments to the Company's methodology. However, the
21 stated methodology appears to be at odds with the actual claim in this case. For example, as

described above, the Company has indicated that its pro forma residential customer claim is based on a net addition of 2,080 (3,023 - 943) customers in the forecast period relative to the base period. However, a review of the workpapers in this case indicates that the Company has actually reduced the number of residential customers from the base period to the forecast period. Following are the total residential customers for each division in the base period and the forecast period, as presented in the Company's workpapers:

	Base Period WP 2-2, pgs. 1, 10, 13	Forecast Period WP 2-1, pgs. 1, 19, 24
Central	100,578	99,745
Tri-Village	1,731	1,867
Elk Lake	316	344
Total	102,625	101,956

Thus, the adjustment included in the Company's filing actually reflects a net decrease in the number of customers from the base period to the forecast period, and not the net increase that the Company has claimed. Moreover, in Exhibit 37 I, page 2, the Company claims a pro forma residential customer count of 103,304 in the forecast period, well below the number of customers being in its filing.

Q. Have residential customers generally increased each year?

1 A. Yes, as shown in Exhibit 37, Schedule I, page 3, there has been a steady trend of increasing
2 residential customers since 1999. From 1999 to 2003, residential customers grew by an
3 average of 2,793 customers per year. According to the Company's Strategic Business Plan,
4 KAWC expects to continue to see growth in customer counts. In its Strategic Business Plan,
5 the Company projects 102,418 residential customers as of the end of 2004 and 104,801 by
6 the end of 2005.
7
8 **Q. How have you developed your recommended pro forma claim for residential**
9 **customers?**
10 A. I have made an adjustment to reflect a forecast period residential customer count of 102,625
11 customers, the same count that the Company is projecting for the base period in its filing.
12 Since I understand that the customer counts are likely to increase from year-to-year, my
13 recommended adjustment is conservative. My adjustment is shown in Schedule ACC-16.
14 In quantifying my adjustment, I have applied my recommended pro forma residential
15 consumption level to the incremental number of customers resulting from my adjustment. I
16 have assumed that all incremental customers are 5/8th meter customers and therefore I have
17 used the lowest fixed charge meter rate to quantify my adjustment. I used rates for the
18 Central Division for both the fixed rate meter charge and for volumetric charges to these
19 incremental customers, since the Central Division rates are currently the lowest among the
20 three divisions. Finally, I reduced the incremental pro forma revenue resulting from my
21 adjustment by incremental costs to determine the impact on the Company's net operating

income.

B. **Commercial Operating Revenues**

Q. Did you make any adjustments to the Company's claim for commercial revenues?

A. Yes, I did. The Company's commercial consumption for the past five years, as shown in Exhibit 37, Schedule I, page 4, was:

Commercial Consumption Per Customer (Tgs)

1999	565
2000	546
2001	537
2002	535
2003	498
Base	525
Forecast	490

Moreover, according to this schedule, the Company is projecting consumption of 529 Tgs per year per commercial customer in both 2004 and 2005. However, in its filing, KAWC assumed normalization consumption of only 1,385.52 gallons per customer per day, or 505,715 gallons annually. Once again, we see that the recommendation in this case differs significantly from the commercial consumption recommendations made in prior KAWC

cases:[15]

Period	Commercial Consumption per Customer
Oct 1997 - Sept. 1998	1,549.69 Gallons per day
Jan 2000 - Dec 2000	1,553.14
Dec 2000 - Nov. 2001	1,553.43
Dec 2004 - Nov 2005	1,385.52

KAWC's Strategic Business Plan projects commercial consumption of 1,449.31 gallons per customer per day in 2004 and 2005, or 529,000 gallons annually.

Q. What do you recommend?

A Similar to my recommendation with regard to residential consumption, I recommend that the Commission utilize pro forma consumption based on the average of the consumption result from the modeling performed this year by Mr. Spitznagel and the commercial utilization presented in KAWC's last case. This will result in a commercial consumption of 1,469.48 gallons per day per customer for commercial customers, or 536,360 gallons annually. This recommendation is shown in Schedule ACC-17.

This adjustment was quantified in a similar manner to my residential consumption adjustment. First, I used the Company's pro forma number of customers and my recommended pro forma consumption level of 1,469.48 gallons per day to determine the

15 Per the response to PSC 2-49.

1 total annual pro forma sales. This resulted in an increase of 485,395 (Ccfs) to the Company's
2 claim. Once again, I priced all of these incremental sales at the current volumetric rate in the
3 Central Division to determine a pro forma level of incremental gross revenue. I then made
4 an adjustment to reflect incremental costs of these additional sales, based on the Company's
5 claims for purchased water, chemical expense, power expense, uncollectibles, and the PSC
6 assessment. My recommendation results in a net revenue increase of $366,293, as shown on
7 Schedule ACC-21.
8
9 **Q. Did you also made an adjustment to the Company's claim for commercial customers?**
10 A. Yes, I did. In spite of the fact that commercial customers have increased from year-to-year,
11 the number of customers reflected in the forecast test period once again reflects a reduction
12 from the base period, as shown below:
13

	Base Period WP 2-2, pgs. 2, 11	Forecast Period WP 2-1, pgs. 2, 20
Central	8,436	8,239
Tri-Village	46	50
Elk Lake	0	0
Total	8,482	8,289

14
15 I have used the Company's base period claim of 8,482 commercial customers to
16 develop pro forma commercial revenues in this case. In quantifying my adjustment, I have

1 applied my recommended pro forma commercial consumption level to the incremental
2 number of customers resulting from my adjustment. I have assumed that all incremental
3 commercial customers are 5/8th meter customers and therefore I have used the lowest fixed
4 charge meter rate to quantify my adjustment. Similar to the methodology used for my
5 residential customer adjustment, I used rates for the Central Division for both the fixed rate
6 meter charge and the volumetric charges to these incremental customers. I also reduced the
7 incremental pro forma revenue resulting from my adjustment by incremental costs to
8 determine the impact on the Company's net operating income. My adjustment is shown in
9 Schedule ACC-18.
10
11 **C. <u>Public and Private Fire Revenue</u>**
12 **Q. Have you made any adjustment to the Company's claim for public and private fire**
13 **revenue?**
14 A. Yes, I have. In developing its claim for public and private fire revenue, KAWC used billing
15 determinants at January 31, 2004. In its response to LFUCG 1-42, KAWC indicated that the
16 "public and private fire connection revenues should have reflected an increase in the number
17 of public fire hydrants and private fire connections install (sic) through the forecast period."
18 In that response, KAWC provided revised public and private fire protection revenues based
19 on the estimated number of billing determinants during the forecast test period. At Schedule
20 ACC-19 , I have made an adjustment to reflect the revised pro forma public hydrant revenue
21 based on these additional billing determinants. A similar adjustment is shown in Schedule

ACC-20 for private fire revenue.

D. Allowance for Funds Used During Construction

Q. How did the Company treat AFUDC in its filing?

A. KAWC included $470,940 in its filing. In response to PSC 2-115, KAWC indicated that its AFUDC claim should be reduced to $417,280 to reflect the impact of slippage of its utility plant-in-service claim. In the filing, AFUDC is treated "above-the-line." Thus, AFUDC is a pro forma revenue that results in a reduction to the rate increase proposed by KAWC.

Q. Are you recommending any adjustment to the Company's claim for AFUDC?

A. Since I am recommending that CWIP be eliminated from rate base, it is necessary to make a corresponding adjustment to eliminate pro forma revenue relating to AFUDC. AFUDC should be treated "below-the-line" for ratemaking purposes, since it would be unfair to a utility to include AFUDC as pro forma revenue but to exclude the associated CWIP from rate base. Therefore, at Schedule ACC- 21, I have made an adjustment to eliminate AFUDC from the Company's pro forma revenue claim, effectively moving AFUDC "below-the-line." If the PSC does not accept my adjustment to eliminate CWIP from rate base, then it is necessary to reverse my AFUDC adjustment and move AFUDC back up "above-the-line," effectively reducing the Company's need for rate relief by the amount of AFUDC.

E. Salaries and Wages

Q. How did the Company determine its salary and wage claim in this case?

A. As described in the testimony of Coleman Bush at page 3, the Company's labor claim is based on a full complement of 133 full-time equivalent employees. The Company included overtime hours based on "actual levels experienced in the past with adjustments made based on judgment and forecasted operational needs."[16] For non-union employees, the Company included wage increases of 3% effective April 2004 and another 3% effective April 2005. For union employees, the Company used the contractual labor rates or, if a contract was subject to negotiation, it used a 3% increase on subsequent anniversary dates. The Company's total salary and wage claim is $6,640,682, approximately 20% of which is capitalized.

Q. Are you recommending any adjustment to the Company's salary and wage claim?

A. Yes, I am recommending adjustments relating to vacant employee positions and the costs for the Office of the President.

Q. Does the Company have any employee vacancies?

A. Yes, in its response to Data Request PSC-2-52, the Company indicated that there are currently three vacant employee positions. The Company reported in that response that all three of these positions are due to "[n]ormal turnover."

Q. Is it normal and customary for a company like KAWC to have unfilled positions at any

1 **given time?**

2 A Yes, it is normal and customary for companies to have unfilled positions at any given time as
3 a result of terminations, transfers, and retirements. Moreover, when setting utility rates, it is
4 important for regulators to recognize that vacant positions are likely to exist in a utility as
5 large as KAWC. If utility rates are set based on a full complement of employees, and if
6 these employee positions remain vacant, then ratepayers will have paid rates that are higher
7 than necessary to the benefit of shareholders. Therefore, I recommend that the Commission
8 consider the likelihood of vacant positions when setting rates in this case.
9

10 **Q. What do you recommend?**

11 A. I recommend that costs for three employee positions be eliminated from the Company's
12 revenue requirement claim, in recognition of employee vacancies. This recommendation
13 provides a good balance between the need to provide flexibility to the Company to decide
14 when additional employees are necessary and the need to protect ratepayers from paying
15 excessive rates. While I have noted that the Company currently has three vacancies, my
16 recommendation is not to disallow these three particular employee positions, but simply to
17 recognize that the Company often has unfilled positions and those costs for unfilled positions
18 should not be included in regulated utility rates.
19

20 **Q. Is your recommendation consistent with the Company's actual experience?**

21 A. Yes, it is. As shown in the response to PSC 1-18, KAWC has had vacant positions in sixty-

16 Testimony of Mr. Bush, page 3, lines 14-15.

four out of the past sixty-six months, providing further support for my recommended adjustment.

Q. How have you quantified your adjustment?

A. In order to quantify my adjustment, I calculated the average salary and wage cost (expense) per employee, including payroll taxes and associated benefits, and then multiplied that average cost by the three positions that I recommend be excluded from the Company's claim. The use of an average cost per employee, rather than the use of specific salaries and wages for specific positions, provides the Company with maximum flexibility to either create new positions and/or to fill vacant positions. My adjustment is shown in Schedule ACC-22. It should be noted that in calculating the average labor costs per employee, I did not include the costs for the Company's incentive program, since that program is the subject of a separate adjustment discussed later in this testimony.

Q. Is there another reason why you believe that your recommended adjustment is reasonable?

A. Yes, there is. KAWC and the other American Water Works companies are in the process of a reorganization. This reorganization involves the realignment of the American Water Works structure from seven regional offices to four regional offices. The reorganization involves new reporting relationships and the termination of some employee positions. The Company has acknowledged that "...most areas of the business are streamlining to reflect the

new regional business structure and eliminating redundant positions to drive costs out of the Business,...".[17] According to the response to PSC 3-24, the reorganization was originally scheduled for completion by July 2004 but the final reorganization is now scheduled for completion in mid-August. KAWC indicated in that response that it "has not projected the results of the reorganization in its forecasted test-year for the final result of that effort is not known at this time. The Company has included the level of employees that it expects to have to carry out the operations of KAWC during the forecasted test year. KAWC does not have the breakdown of cost savings from the reorganization or the transitions costs for severance, moving expenses, and employee evaluations, etc., at this time. After the reorganization is in place, the Company will supply the final estimates of any savings as well as the transition cost required to generate those savings." I am not recommending any adjustment relating to cost savings resulting from this reorganization. However, it is important that the PSC be aware of reorganization activities as it evaluates the recommendations proposed herein.

Q. What adjustment are you recommending to the Office of the President?

A. In its filing, KAWC indicated that Roy W. Mundy, then-President of KAWC, was not available to testify in this case since he had been instructed by the Board of Directors to "devote his full time and energies" to defending the Company in condemnation proceedings that have been instituted by the Lexington-Fayette Urban County Government ("LFUCG").[18]

17 Response to LFUCG 1-19, Attachment 4, page 55.
18 Testimony of Mr. Jarrett, page 5.

However, no adjustment was made to eliminate costs for Mr. Mundy associated with these efforts. Mr. Mundy has since resigned his position, but the Company has not revised its revenue requirement claim associated with salary and benefits for Mr. Mundy.

If Mr. Mundy, or his successor, is devoting his full-time exclusively to defense of the condemnation action, then he is not performing other services typically performed by a utility company president (including testifying in major rate cases). Although the Company contended in discovery responses that KAWC's President is ultimately responsible for the day-to-day operations of KAWC, he is clearly devoting significant resources to the condemnation proceeding, as instructed by the Board of Directors.

The Company's shareholders, not its ratepayers, should be required to finance activities associated with the condemnation proceeding. KAWC appears to recognize this since it has "not requested the inclusion of any expenses incurred by it in defending the takeover effort for external sources for ratemaking purposes in this case."[19] However, apparently it has included internal costs associated with Mr. Mundy and his assistant, Patricia L. Ballard, as well as costs for other Company personnel, in its claim. I recommend that the Company's revenue requirement be adjusted to remove these costs.

Q. Why should these costs be funded by shareholders?

A. LFUCG is the governmental agency elected to represent the majority of ratepayers in the Company's service territory. Therefore, ratepayers are already being represented in this condemnation action by LFUCG. If ratepayers are forced to pay costs associated with the

condemnation in utility rates, they will essentially be paying twice, once to support efforts of LFUCG to bring the action and again to support the efforts of KAWC to fight the action. By fighting this condemnation, KAWC is acting on behalf of its shareholders, and it is the shareholders who should fund all costs associated with the litigation.

Q. How did you quantify your adjustment?

A. According to the response to PSC 3-9-2, the Company "has not tracked individual employee hours worked in the base period on the condemnation action." Consequently, I cannot identify with specificity the costs included in the Company's claim relating to the condemnation. However, at a minimum, based on the direction provided by the Board of Directors, it appears that the KAWC President is working "full time" on the condemnation action. Therefore, I am recommending that 90% of the labor, overhead costs, and payroll taxes claimed by KAWC for Mr. Mundy, and for Mr. Mundy's assistant, be excluded from the Company's revenue requirement claim. Given the likelihood that there are a significant number of other employees involved in the condemnation action, I believe that my adjustment is conservative. My adjustment is shown in Schedule ACC-23.

19 Response to LFUCG 1-57.

1 **F. Incentive Plans**

2 **Q. How much did the Company include its filing associated with incentive payments to**
3 **employees?**

4 A. KAWC included incentive costs of $229,146 in its filing. This included $205,719 of
5 expense for the Annual Incentive Plan ("AIP") and $23,427 for the Long-term Incentive Plan
6 ("LIP").

7

8 **Q. What are the criteria for award of the ("AIP")?**

9 A. According to the testimony of Mr. Miller at page 50, 60% of the AIP is based on the
10 financial aspects of the Company's performance, 25% is based on operational results, and
11 15% is based on individual results. The Company's financial results are evaluated by two
12 measures - value added and free cash flow. Value added reflects the contribution made by a
13 business unit relative to its cost of capital, while free cash flow is defined as the cash flow
14 from operating activities plus capital expenditures.[20]

15

16 **Q. Do you have any concerns about the costs of the AIP included in the Company's**
17 **revenue requirement?**

18 A. Yes, I do. My general concern is that the financial criteria component of the plan is based on
19 benefits that ultimately accrue to shareholders, not ratepayers. To the extent that financial
20 performance meets or exceeds certain guidelines, shareholders benefit through higher
21 earnings. But such financial measures can be directly at odds with ratepayer benefit. For

example, one way of meeting financial benchmarks is to raise utility rates, an action that has a direct and detrimental impact on ratepayers.

Q. Has the Commission indicated that it believes there is some merit in allocating a portion of AIP costs to shareholders?

A. Yes, it has. In its Order in the Company's last base rate case, the Commission indicated that "...based on evidence of this proceeding, the Commission is reconsidering its position on this issue and is hereby placing Kentucky American on notice that, in future rate proceedings, it must demonstrate fully why shareholders should not bear a portion of these costs."[21]

Q. What do you recommend?

A. I recommend that 60% of the costs of the AIP be allocated to the Company's shareholders. My recommendation is based on the fact that 60% of the AIP award is based on financial performance, a criteria that directly benefits shareholders. I understand that the other components of the plan do not depend on the ability of the Company to meet its financial targets and therefore I am including 40% of the AIP costs in my pro forma revenue requirement recommendation. My adjustment is shown in Schedule ACC-24.

Q. Are you recommending any other adjustment to the Company's AIP claim?

A. Yes, I am. The amount of AIP payments included in the forecast test period is high relative

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20 As defined in the Plan provided in response to AG 1-123, page 4.
21 Order in Case No. 2000-120, page 44.

to historic levels, as shown below:[22]

Year	AIP
Forecast	$205,719
2003	78,500
2002	139,700
2001	219,498

The Company has provided no justification for this significant increase, especially when one considers the reorganization that is taking place is designed to reduce employees and cut costs. Therefore, I am recommending that a three-year average of AIP payments be used to set rates in this case. This adjustment would reduce the Company's pro forma expense for the AIP to $145,899. I recommend that 40% of this amount, or $58,360, be recovered from KAWC's ratepayers, as shown on Schedule ACC-24 .

Q. Please describe the LIP?

A. According to the testimony of Mr. Miller at page 52,

> The LIP is administered by the Compensation and Management Committee of the Board of Directors of American Water Works, Inc. Executives and other key employees of the Company who are designated from time to time by the Committee, based on the recommendation by the President of the Company, are eligible for the LIP. Mr. Mundy, President of the Company is the only KAW employee eligible for

22 Response to PSC 2-57 and testimony of Mr. Miller, page 50.

the LIP.

It is interesting to note that the recommendation regarding eligibility comes from the President of the Company and yet it is Mr. Mundy, as President at the time of the filing, who was the only employee eligible for an LIP award. This makes the LIP especially troubling.

Q. What is the criteria for award of the LIP?

A. The sole criteria for award of the LIP is "achievement of cumulative net income."[23]

Q. Should these costs be recovered from ratepayers?

A. No, they should not, for two reasons. First, this award is based purely on net income, an award criteria that benefits shareholders. Second, the only employee eligible for the award is the same employee that recommends eligibility to the Board of Directors. In my view, this constitutes a conflict of interest. For both of these reasons, I recommend that all costs claimed by the Company for the LIP be disallowed. My adjustment is shown in Schedule ACC-24.

Q. Did you make a payroll tax adjustment to reduce payroll taxes consistent with the salary and incentive compensation adjustments discussed above?

A. Yes, I did. The payroll tax impact of my recommended adjustments relating to employee

23 Response to AG 1-123, page 11.

vacancies and the Office of the President are incorporated in the overhead factors used in Schedules ACC-22 and ACC-23 respectively. At Schedule ACC-25, I have made a separate adjustment to eliminate income taxes associated with my incentive compensation adjustment.

G. Other Post Employment Benefit Costs

Q. How did the Company develop its OPEB cost claim?

A. KAWC's claim is based on a preliminary 2004 valuation using data collected as of July 2003. This report, which was prepared by Towers Perrin, was provided as part of the response to AG 1-75. Pursuant to this report, the KAWC share of 2004 OPEB costs was proposed to be $904,227. The Company increased this estimate by 9% to develop 2005 costs. It is my understanding that this 9% increase was made to account for a 9% projected increase in health care costs during 2005. KAWC used 1/12th of the 2004 estimated cost and 11/12th of the estimated 2005 cost to develop its claim for OPEBs in its filing.

Q. Are you recommending any adjustments to the Company's claim?

A. Yes, I am. Simply because the Company projects that health care costs will increase by 9% in 2005, it does not follow that its 2005 OPEB costs will increase by a similar percentage. In fact, its 2005 costs may not increase at all. A company's OPEB cost in any given year is based on many factors, including projected trends in health care costs, return on assets, employment levels, ages of employees, and other factors. Moreover, increases in health

1 care trends that are expected to occur in future years are continuously considered in
2 developing the Company's annual OPEB cost. Future increases in health care costs are
3 therefore already reflected in the annual OPEB cost determined each year by the Company's
4 actuaries. Therefore, applying another 9% increase to reflect an increase in health care costs
5 in 2005 essentially double-counts the impact of these cost increases.

6 In addition, a utility's annual OPEB cost is heavily dependent upon the rate of return
7 on investment used in the calculation as well as on the actual results of any funded
8 investments. A company's annual OPEB cost is also heavily impacted by the assumptions
9 used regarding future discount rates. The factors that influence the annual OPEB costs are
10 varied and complex. Thus, a future year's OPEB cost cannot be accurately estimated by
11 simply increasing a prior year's cost by a future health cost trend.

12

13 **Q. What level of OPEB costs has the Company incurred in each of the past five years?**

14 A. As shown in the response to AG 1-77, the Company's costs have not exhibited a
15 continuously upward trend consistent with increases in health care costs. Rather, costs
16 declined from 1999 to 2000, increased from 2000 to 2001, were level between 2001 and
17 2002, and increased in 2003, as shown below:

Year	OPEB Expense
1999	$512,664
2000	$437,463
2001	$498,823
2002	$493,066
2003	$670,966

In its filing, KAWC has included an OPEB expense claim of $798,734.

Q. What do you recommend?

A. An actuarial report provides the best support for a utility's OPEB claim. Therefore, I recommend that the Commission utilize the latest documentation from Towers Perrin, which indicates a cost allocation to KAWC for 2004 of $904,227. At Schedule ACC-26, I have used this estimate to develop the Company's pro forma expense. I reduced the total cost of $904,227 by the amount capitalized, using the same capitalization ratio as the ratio used by the Company. My recommendation results in a pro forma OPEB expense of $747,353.

H. <u>Deferred Charges</u>

Q. What adjustment are you recommending to the Company's claim for deferred charges?

A. As discussed in the Rate Base section of this testimony, I am recommending that the Company's claim for deferrals associated with security costs, Shared Service Company transition costs, and Customer Care Center transition costs be denied. The Company did not receive permission to defer these costs from the Commission. Moreover, such deferred treatment for security costs appears to be specifically prohibited per the Order in KAWC's merger case. Therefore, at Schedule ACC-27, I have made an adjustment to eliminate the amortization expense associated with these deferred costs from the Company's rates.

I. Waste Disposal Costs

Q. How did the Company develop its claim for waste disposal costs?

A. The Company's claim is based on a two year amortization of total costs of $170,000 relating to cleaning the Kentucky River Station, a total cost of $70,000 relating to a projected cleaning at the Richmond Road Station, and on-going waste disposal costs of $7,000 per month or $84,000 annually for the two stations.

Q. Are you recommending any adjustments to the Company's claim?

A. Yes, I am recommending two adjustments. First, according to the response to PSC 2-99(d), the Company overstated its on-going waste disposal costs for the Richmond Road Station. These costs amount to approximately $2,500 per month instead of the $3,500 per month included in the filing. Therefore, at Schedule ACC-28, I have made an adjustment to reduce the Company's waste disposal costs by $12,000 annually.

In addition, I am recommending that costs for cleaning for the Richmond Road Station be recovered over three years. KAWC included a one year recovery for these costs. However, the station is not cleaned on an annual basis. To the extent that the station is cleaned periodically, but not annually, these costs should be recovered over a multi-year period. If the proposed cleaning is a one-time event, then these costs should be eliminated entirely from the Company's claim on the basis that they are non-recurring. In either case, the Company's proposed ratemaking treatment to recover these costs over one year is inappropriate.

Q. What level of costs for cleaning the Richmond Road Station have you included in your revenue requirement?

A. I have included a three-year recovery period for these costs. The Company indicated in response to PSC 3-39 that the Richmond Road Station was last cleaned in August 2002. Moreover, in its claim, it is projecting that the station will again be cleaned in June 2005. Therefore, it appears that the Company does clean the station periodically, approximately every three years. Accordingly, at Schedule ACC-28, I have reflected a three-year recovery period for these costs.

J. Maintenance Costs

Q. How did the Company develop its claim for maintenance costs?

A. I understand that the Company has traditionally been permitted to defer and amortize certain

1 expenditures relating to maintenance costs. In its filing, KAWC included $388,920 of costs
2 associated with amortization of prior period costs. In addition, the Company included on-
3 going routine annual maintenance expense of $972,706, for a total claim of $1,361,626.
4
5 **Q. Are you recommending any adjustments to the Company's claim?**
6 A. I am not recommending any adjustment to the amortization expenses claimed by KAWC, but
7 I am recommending an adjustment to the on-going routine annual maintenance costs
8 included in the Company's claim. As shown below, these costs have fluctuated over the last
9 three calendar years:
10
11
12
13
14

Year	On-going Maintenance
2001	$897,888
2002	$687,834
2003	$741,798

15
16 The Company is projecting base year costs of $825,341 and forecast test period costs
17 of $972,706. In support of this claim, KAWC stated "[t]his increase represents increase
18 costs associated with the upkeep on Kentucky American Water's utility property that need to
19 be performed that are over and above the base year levels including tank inspections and
20 general maintenance of plant."[24] This is hardly compelling evidence to support the
21 Company's request for a significant increase in these costs. Given the fact that the Company

has not provided adequate support for its forecast test period claim, I recommend that the Commission utilize a three-year average of on-going routine maintenance costs to develop the Company's revenue requirement in this case.

Q. How did you quantify your adjustment?

A. My adjustment is based on the three-year average of on-going routine maintenance costs incurred from 2001-2003. In addition, I included the incremental on-going costs relating to Tri-Village and Elk Lake, per the Company's filing. My adjustment is shown in Schedule ACC-29.

K. Rate Case Costs

Q. Please describe the Company's rate case cost claim.

A. KAWC is requesting a three-year recovery of total rate case costs for the current case of $622,049. These costs are composed of the following:

Service Company	$156,940
Legal	$280,000
Rate of Return Consultant	$ 26,350
Lead/Lag Study	$ 20,000
Consultant - Rate Filing	$ 50,000
Service Co. Consultant	$ 20,000
Security Consultants	$ 15,000
Weather Normalization	$17,119
Other	$37,000
Total	$622,409

24 Testimony of Ms. Valentine, page 10.

1

2 **Q. Are you recommending any adjustment to the Company's claim.**

3 A. Yes, I am recommending an adjustment. The Company did not explain why its expects to
4 incur significant Service Company costs, given that it has also hired a former Director of
5 Rates in the American System as a major accounting witness in this case. Alternatively, it
6 did not indicate why it needed to hire an outside rate case consultant, given the extensive
7 resources available at the Service Company. Accordingly, the Company's claim for both
8 Service Company charges in the amount of $156,940 as well as costs for an outside
9 consultant in the amount of $50,000 appear duplicative. In addition, the Company did not
10 support its claim for a lead/lag study in the amount of $20,000, when such studies are
11 typically performed by a utility in-house. The magnitude of the Company's claim is
12 especially troublesome given that the Company's rate case cost claim is 35% higher than the
13 actual costs incurred in the Company's last base rate case, and considerably higher than the
14 actual costs incurred in any of the last five cases, as shown below:[25]

Case No.	Actual Rate Case Costs
2000-120	$459,817
97-034	$326,414
95-554	$389,982
94-197	$250,434
92-452	$437,125

15

1 The Company did not solicit competitive bids for rate case services in the current
2 case. Given the lack of competitive bids and the extensive use of both outside consultants
3 and Service Company personnel, I am recommending an adjustment to reduce the
4 Company's rate case claim by $70,000. While I have quantified this adjustment based on
5 KAWC's claim for its lead/lag study and its outside rate case consultant, it should be noted
6 that my recommendation does not suggest that Mr. Salser's services were unnecessary or
7 that Mr. Salser did not provide the Company with valuable services. My recommendation is
8 to reduce the Company's overall rate case cost claim by $70,000; I am not recommending a
9 specific adjustment to eliminate either Mr. Salser's costs or the costs for the lead/lag study.
10 My recommendation results in a pro forma rate case cost claim of $552,049, as shown on
11 Schedule ACC-30. My recommendation provides for an increase of 20% over the rate case
12 costs incurred by KAWC in its last base rate case. Therefore, my recommendation still
13 provides ample opportunity for the Company to recover higher rate case costs than those
14 incurred in its last case. I believe that my recommendation is especially reasonable, given
15 the historic level of rate case costs incurred by KAWC.
16
17 **L. <u>Rental Expense</u>**

18 **Q. Please discuss your recommended adjustment with regard to the Company's rental**
19 **expense claim.**

20 A. In response to AG 1-138, the Company indicated that its rental expense claim had been
21 overstated. Specifically, the Company stated that its claim included a) lab equipment that

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25 Per the response to PSC 2-64.

1 will now be purchased instead of leased; b) a copier that is no longer being leased; and c)
2 lease obligations for a copier and postage machine in Tri-Village that will not be incurred.
3 In total, KAWC indicated that its pro forma rental expense was overstated by $58,295.
4 Accordingly, at Schedule ACC-31, I have made an adjustment to reduce the Company's
5 forecast test period rental expense by this amount.
6
7 **M. <u>Social Club Dues</u>**
8 **Q. Did the Company include any social club dues in its revenue requirement claim?**
9 A. Yes, as shown in Exhibit 37, Schedule F-1, page 1, KAWC has included social club dues of
10 $5,228 in its filing. These include dues to Spindletop Hall, the Keeneland Club, the
11 University of Kentucky Faculty Club, the Lafayette Club, and several organizations such as
12 the Rotary Club, Kiwanis, and Audubon Society.
13
14 **Q. Do you believe that it is appropriate to recover social club dues from captive**
15 **ratepayers?**
16 A. No, I do not. Utility rates should include a reasonable level of costs that are necessary for
17 the provision of safe and reliable utility service. Social club dues do not meet this standard
18 and should not be borne by ratepayers. Social club dues are not necessary to the provision of
19 safe and adequate utility service. At Schedule ACC-32, I have made an adjustment to
20 eliminate social club dues from the Company's revenue requirement claim.
21

1 **N. Institutional Advertising**

2 **Q. Please describe the advertising costs included in the Company's claim.**

3 A. KAWC has included total advertising costs of $171,545 in its claim. This includes
4 institutional advertising of $72,415 and conservation advertising of $99,130.

5

6 **Q. Are you recommending any adjustment to the Company's claim?**

7 A. Yes, I am recommending that the $72,415 in institutional advertising be disallowed. The
8 Company's institutional advertising is comprised of newspaper advertising of $6,238; radio
9 advertising of $1,743; direct mail of $3,940; and customer handouts of $60,494. Institutional
10 advertising should not be included in a regulated utility's revenue requirement.[26] The
11 purpose of such advertising is to promote the institution, in this case KAWC, and its
12 shareholders. For example, one of KAWC's print ads begins "[w]e at Kentucky American
13 Water are very proud to accept the Director's Award for continued commitment to water
14 treatment excellence." Another ad states "[w]hen it comes to the future of water quality,
15 you can trust Kentucky American Water to lead the way, as we have for generations."
16 Kentucky American also was a named sponsor of the Lexington Children's Museum's
17 annual "Museum Go Round," which included KAWC signage, reference to KAWC in print
18 and radio ads, and logo give-aways. These marketing opportunities all promote the
19 corporate name of KAWC, and in some cases its parent, RWE Group. The ads are designed
20 to favorably influence customer opinion. These ads constitutes "soft-lobbying" of ratepayers
21 on behalf of the Company. Such ads and other promotions are not necessary to the provision

1 of regulated utility service and should not be paid for by ratepayers. At Schedule ACC-33, I
2 have made an adjustment to eliminate institutional advertising costs from rates. I am not
3 recommending any adjustment to the Company's claim for conservation-related advertising.
4
5 **O. Business Development Costs**
6 **Q, How much has the Company included in its filing for business development costs?**
7 A. As shown in the response to AG 1-17, the Company has included $117,525 for business
8 development costs allocated from the Regional Office.
9
10 **Q. Should business development costs be included in the revenue requirement of a**
11 **regulated utility?**
12 A. No, they should not. The provision of regulated water service in a franchised service
13 territory is not a competitive situation requiring "business development." In fact, "business
14 development" is almost oxymoronic for a regulated water utility. The Commission should
15 ask KAWC to explain exactly what business is being developed. Is it the competitive
16 services business of KAWC, which involves providing contractual services on an
17 unregulated basis to other water systems? Is it the provision of merchandising and jobbing
18 functions, which are booked below-the-line? Is it the acquisition of other utility systems,
19 which will increase the rate base on which shareholders will be have the opportunity to earn
20 a return? In each case, any marketing or "business development" costs should be booked to
21 entities other than KAWC. Since regulated water companies have essentially a captive

26 807 KAR 5:016.

1 audience for service, there is little need for a regulated water utility to undertake business
2 development opportunities.
3
4 **Q. What do you recommend?**
5 A. I recommend that the business development costs included in the Company's claim be
6 disallowed. Regulated ratepayers should not be paying for "business development"
7 opportunities pursued by a regulated water utility. Accordingly, at Schedule ACC-34 , I
8 have made an adjustment to eliminate these costs from the Company's claim.
9
10 **P. <u>Low Income Discount</u>**
11 **Q. Please describe the low income discount proposed in the Company's claim.**
12 A. As discussed in the testimony of Mr. Miller at page 65, KAWC is proposing a low income
13 discount of 25% of the service charges for households that meet certain criteria. KAWC
14 estimates that the low income discount will result in an annual cost to the Company of
15 $30,000. As discussed in the testimony of Attorney General witness Scott Rubin, the
16 Attorney General is not supporting the Company's proposal at this time.
17
18 **Q. How did the Company reflect the cost associated with the low income discount in its**
19 **filing?**
20 A. I am not sure where the $30,000 estimated cost is reflected. It does not appear that the
21 Company included any revenue reduction associated with this lost revenue in its pro forma

1 revenue claim. Nor does the Company have a specific expense adjustment relating to its low
2 income proposal. Therefore, I am assuming that the $30,000 expense is included in another
3 adjustment in the Company's filing. Since the Attorney General is not supporting this
4 discount at this time, it is necessary to eliminate the costs associated with the discount from
5 the Company's claim. At Schedule ACC-35 , I have made an adjustment to reduce KAWC's
6 operating expenses by $30,000 to reflect the Attorney General's recommendation that the
7 low income discount not be implemented at this time. If the Company has not included this
8 $30,000 expense anywhere in its filing, I will revise my recommendation accordingly.
9
10 **Q. <u>Property Taxes</u>**
11 **Q. What adjustment are you recommending to the Company's claim for property taxes?**
12 A. I am recommending one adjustment relating to the historic slippage factor used for KAWC's
13 utility plant-in-service. Since I am recommending an adjustment to reflect a delay in the
14 Company's construction expenditures, it is also necessary to make an adjustment to reflect
15 reduced property tax expense. Since the Company will have less plant-in-service than the
16 amounts claimed in its filing, its property tax liability will also be less than the property tax
17 claimed by KAWC.
18
19 **Q. How did you quantify your adjustment?**
20 A. KAWC provided information in response to PSC 2-115 that indicated its property tax
21 expense would be reduced by approximately $1,900 if the plant slippage factor was applied

1 to its utility plant-in-service claim. I used the information provided in this response to
2 quantify my adjustment, which is shown in Schedule ACC-36.
3
4 **R. Acquisition Amortization**
5 **Q. Please describe your adjustment relating to the Company's claim for amortization**
6 **expense associated with its Tri-Village and Elk Lake acquisitions.**
7 A. The Company's claim includes amortization expense associated with the acquisition
8 adjustment that it is proposing for the Tri-Village and Elk Lake acquisitions. Since I am
9 recommending that the Company's claims for these acquisition adjustments be denied, as
10 discussed in the Rate Base section of this testimony, it is necessary to make a corresponding
11 adjustment to eliminate the amortization expense associated with the acquisition adjustment.
12 My adjustment to eliminate this acquisition amortization expense is shown in Schedule
13 ACC- 37.
14
15 **S. Depreciation Expense**
16 **Q. Are you recommending any adjustment to the Company's depreciation expense claim?**
17 A. Yes, I am recommending an adjustment to revise the Company's depreciation expense claim
18 consistent with my recommended utility plant-in-service adjustments. Since I am
19 recommending that certain components of depreciable plant be eliminated from the
20 Company's rate base, based on the historic slippage factor, it is necessary to make a
21 corresponding adjustment to eliminate the annual depreciation expense on this plant. I have

1 quantified my adjustment in Schedule ACC-38 , based on information provided by KAWC
2 in response to PSC 2-115.
3
4 **T. Consolidated Income Taxes**

5 **Q. Did KAWC include a consolidated income tax adjustment in its filing?**

6 A. No, it did not. KAWC calculated its forecast test period income tax expense on a "stand-
7 alone" basis. The Company's filing ignored the fact that KAWC does not file its federal
8 income taxes on a stand-alone basis, but rather files as part of a consolidated income tax
9 group. By filing a consolidated return, KAWC can take advantage of tax losses experienced
10 by other member companies. The tax loss benefits generated by one group member can be
11 shared by the other consolidated group members, resulting in a reduction in the effective
12 federal income tax rate of the Company. These tax savings should be flowed through to the
13 benefit of Kentucky ratepayers.
14

15 **Q. Why should these tax benefits be flowed through to the Company's ratepayers?**

16 A. These tax benefits should be flowed through to ratepayers because these benefits reflect the
17 actual taxes paid. Establishing a revenue requirement based on a stand-alone federal income
18 tax methodology would overstate the Company's expense, result in a windfall to the
19 Company from rates that are higher than necessary.
20

21 **Q. Has this issue been addressed by other regulatory commissions in states where**

1 **American Water Works companies operate?**

2 A. Yes, at a minimum, this issue has been addressed previously, in Pennsylvania, New Jersey,
3 and West Virginia. These states have all adopted consolidated income tax adjustments for
4 ratemaking purposes.

5

6 **Q. Have you reflected the consolidated income tax adjustment in your revenue**
7 **requirement calculation?**

8 A. Yes, I have. I have included a consolidated income tax adjustment based on the effective tax
9 rate methodology. This methodology develops a prospective federal income tax adjustment
10 by allocating tax losses to those companies that generate positive taxable income. Each
11 company is allocated tax losses based on that company's percentage share of positive taxable
12 income. Generally, a three-year average is used to determine the prospective adjustment.
13 Moreover, since the adjustment is prospective, tax losses generated by regulated entities are
14 not allocated, since such tax losses are not expected to reoccur in the future. My adjustment
15 is shown in Schedule ACC-39 .

16

17 **U. Interest Synchronization**

18 **Q. Have you adjusted the pro forma interest expense for income tax purposes?**

19 A. Yes, I have made this adjustment at Schedule ACC-40. It is consistent (synchronized) with
20 my recommended rate base, and with Dr. Woolridge's capital structure and cost of capital
21 recommendations. The Attorney General's recommendations result in a lower rate base and

1 a lower cost of debt than the rate base and cost of debt included in the Company's filing. The
2 Attorney General's recommendations, therefore, result in lower pro forma interest expense
3 for the Company. This lower interest expense, which is an income tax deduction for state
4 and federal tax purposes, will result in an increase to the Company's income tax liability
5 under the Attorney General's recommendations. Therefore, the Attorney General's
6 recommendations result in an interest synchronization adjustment that reflects a higher
7 income tax burden for the Company, and a decrease to pro forma income at present rates.
8
9
10 **V. <u>Operating Income Summary</u>**
11 **Q. What composite income tax rate did you use?**
12 A. My adjustments are based on a composite income tax rate of 40.37%, as shown on Schedule
13 ACC-41. This reflects a state income tax rate of 8.25% and a federal income tax rate of
14 35%.
15
16 **Q. What is the net effect of the operating income adjustments that you are recommending**
17 **in this case?**
18 A. My recommended operating income adjustments result in a pro forma operating income at
19 present rates of $10,562,554, instead of the $8,792,281 included in the KAWC's claim.
20

1 **VIII. OTHER ISSUES**

2 **Q. Are there any other issues that you would like to address at this time?**

3 A. Yes, there are two other issues that I would like to address: normalizing periodic costs and
4 the allocation of costs among various entities.

5

6 **A. Normalization of Costs**

7 **Q. What is normalization?**

8 A. Normalization is the inclusion of a normal level of a prospective costs in rates. For
9 example, most utilities "normalize" their sales to reflect normal weather conditions.
10 Normalization can also be used for operating expenses that occur periodically, but not
11 necessarily annually. Normalization is appropriate for costs that occur annually but fluctuate
12 significantly from year-to-year, as well as for costs that are reoccurring, but which occur
13 periodically rather than annually.

14

15 **Q. How does normalization differ from amortization?**

16 A. While normalization is the inclusion of a normal level of prospective costs in rates,
17 amortization is the recovery of a previously incurred cost. Amortization is, by definition,
18 retroactive ratemaking, since it permits the utility to recover a previously incurred cost in
19 prospective rates.

20 To provide an example, if a regulatory commission normalizes rate case costs, it will
21 determine an appropriate cost for a base rate case and permit the utility to recover that cost

1 over some period, based on the frequency with which the commission believes the company
2 will file future rate cases. Thus, if it determines that a reasonable cost is $200,000 and that
3 the utility files a rate case on average every 4 years, it will permit the utility to include
4 $50,000 a year in rates. There is no amortization of costs using this scenario. If the
5 company comes in for another rate case in two years, instead of four, the commission will
6 once again determine the appropriate rate case costs to include in rates and the normalization
7 period. If, on the other hand, the company does not file a base rate case for another six
8 years, then the company continues to collect the $50,000 for an additional two years. The
9 point is that normalization seeks to provide for recovery of <u>future</u> costs while amortization
10 provides for recovery of <u>past</u> costs.
11
12 **Q. Are there costs in this case that should be normalized, rather than amortized?**
13 A. Yes, I would contend that most of the costs that the Company has included in deferred
14 maintenance, as well as periodic waste disposal costs and rate case costs, should be
15 normalized, not amortized. Normalization is especially appropriate when a forecast test
16 period is being used, as is the case here. As discussed earlier, it is theoretically inconsistent
17 to permit a utility to use a forecast test period -- and then also permit the utility to amortize
18 certain costs. Thus, I am recommending that the Commission adopt a policy of normalizing
19 maintenance costs and rate case costs. While this recommendation does not result in any
20 specific cost adjustment in this case, in the future it would result in the termination of
21 amortized balances associated with maintenance costs being included in rate base. I believe

1 there are significant advances to opening the dialogue regarding normalization vs.
2 amortization now, since the parties may be in a better position to assess the reasonableness
3 of the normalization methodology without the emotional arguments that may ensue if
4 adoption of the new methodology were to result in a cost disallowance.
5
6 **B. Allocation Issues**

7 **Q. Does KAWC engage in any affiliated and/or unregulated transactions requiring cost**
8 **allocations to be made?**

9 A. Yes, it does. KAWC receives a variety of services from affiliated entities, including the
10 Shared Services Company, the Customer Care Center, and the Southwest Regional office.
11 In addition, KAWC performs certain unregulated services, some of which are booked
12 "above-the-line" and some of which are booked "below-the-line". The Company has not,
13 however, provided a comprehensive report detailing affiliated and unregulated transactions.
14 While some information has been furnished in response to discovery requests, there does not
15 appear to be an on-going reporting requirement for affiliated transactions.
16

17 **Q. Should affiliated interest transactions be subject to greater regulatory scrutiny than**
18 **transactions between non-affiliated parties?**

19 A. Yes, they should. Transactions between non-affiliated parties are conducted at "arm's
20 length." They are generally the result of a negotiation or bidding process, or they reflect
21 prices that are available to the public. With non-affiliated transactions, each party has an

incentive to make the best possible arrangement, and neither party has an incentive to subsidize the other. Such safeguards are not present with affiliated interest transactions.

Cost allocation among regulated and non-regulated services of KAWC is especially important to ensure that regulated water ratepayers are not subsidizing other activities. It is necessary to ensure that the revenues being received from unregulated services are at least sufficient to recover the associated costs. Moreover, it is important to ensure that all costs, and not just incremental costs, are being allocated to unregulated activities.

Similarly, it is important to examine costs that are allocated to KAWC from other entities, including the Shared Services Center and the Customer Care Center. Costs from affiliated entities should be allocated in a manner that appropriately reflects cost causation. The first step in establishing an appropriate cost allocation system is to obtain a clear understanding of the corporate and divisional relationships and the magnitude of the costs associated with providing various services.

Q. What reporting requirements do you recommend be established?

A. I recommend the preparation of simple summary reports that will assist regulators in reviewing the costs allocated from, and to, affiliate and non-regulated operations. Such reports should show, by department name, the total costs incurred by each entity, the amount allocated to KAWC, and the basis for the allocation. Similar information should be provided for unregulated services performed by KAWC. One of the problems in reviewing the Company's filing is that much of the data on affiliated charges is presented based on expense

codes, making review difficult. Therefore, the PSC should require the Company to file documentation annually regarding its affiliate and non-regulated transactions in a manner that is concise and informative. My objective is not to make more work for the Company; it is to facilitate the review of affiliated and non-regulated charges in the future. Moreover, such reports would also help KAWC management to know exactly which departments and entities are providing affiliated services, and at what cost, and to better assess the need for such services.

IX. REVENUE REQUIREMENT SUMMARY

Q. What is the result of the recommendations contained in this testimony?

A. My adjustments result in a revenue requirement deficiency at present rates of $111,933, as summarized on Schedule ACC-1. This recommendation reflects revenue requirement adjustments of $7,185,510 to the Company's requested revenue requirement increase of $7,297,443.

Q. Have you quantified the revenue requirement impact of each of your recommendations?

A. Yes, at Schedule ACC-42, I have quantified the revenue requirement impact of the rate of return, rate base, revenue and expense recommendations contained in this testimony.

1 **Q. Have you developed a pro forma income statement?**

2 A. Yes, Schedule ACC-43 contains a pro forma income statement, showing utility operating
3 income under several scenarios, including the Company's claimed operating income at
4 present rates, my recommended operating income at present rates, and operating income
5 under my proposed rate increase. My recommendations will result in an overall return on
6 rate base of 7.11%.

7

8 **Q. Does this conclude your testimony?**

9 A. Yes, it does.

10

11