

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

Adjustment of Rates of Kentucky-)
American Water Company)

Case No. 2004-00103

ATTORNEY GENERAL'S
RENEWED MOTION FOR SURREBUTTAL

The Commission, through a 27 October 2004 Order, denied the Attorney General's previous motion seeking the opportunity to present surrebuttal. The Order does expressly provide that the Attorney General may renew his motion for surrebuttal "if he can clearly state the facts that entitle him to present such testimony and specifically identify those matters that such testimony would address."¹ The Attorney General moves for surrebuttal regarding his consolidated income tax adjustment. In support, he notes the following.

Kentucky-American's application does not include a consolidated income tax adjustment. The Attorney General proposes such an adjustment.² Therefore, per the Commission, in advancing a proposal that the Company did not address in its application, the OAG has a burden of proof to meet on this issue. Kentucky-American does not accept the OAG's proposal, and it has provided

¹ 27 October 2004, Order, page 3.

² Crane, Pre-filed Direct Testimony, pages 73 and 74.

evidence (namely the rebuttal testimony of James Warren) in opposition to the adjustment. These facts satisfy the requirements for entitlement to surrebuttal.³

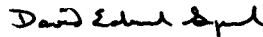
The OAG's consolidated income tax adjustment is a proposal for which the Attorney General has a burden and Kentucky-American provides opposition. Hence, the "good cause" requirement applicable to surrebuttal requests concerning "new matters" raised in rebuttal is not applicable.⁴

Per the instructions in the Commission's October 27th Order, the Attorney General tenders (with this motion) the proffered surrebuttal.

WHEREFORE, the Attorney General moves for the Commission to allow his witnesses to present surrebuttal on his consolidated income tax adjustment.

Respectfully submitted,

GREGORY D. STUMBO
ATTORNEY GENERAL


Dennis G. Howard II
David Edward Spenard
Assistant Attorneys General

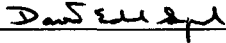
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601-8204
502-696-5453 (FAX) 502-573-8315

³ 27 October 2004, page 2 (identification of "any proposal or issue on which he bears the burden of proof and that Kentucky-American has addressed in the rebuttal testimony of its witnesses.")

⁴ "This Commission has previously held that a party seeking to introduce surrebuttal testimony must, **unless it bears the burden of proof**, demonstrate good cause for such testimony." (emphasis added, citation omitted). Order, 27 October 2004, page 2. The "good cause" requirement is not applicable.

Submission of Filing in Paper Medium

Per Instructions 3 and 13 of the Commission's 27 May 2004 Order, Counsel submits for filing, by hand delivery to Beth O'Donnell, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601, the original and one copy in paper medium of the document. 8 November 2004 is the date for the filing in paper medium.


Assistant Attorney General

Certificate of Service

Per Instructions 4, 8 (d), and 12 of the May 27th Order, Counsel certifies service of a true and correct photocopy of the document by mailing the photocopies, first class postage prepaid, to the other parties of record on 5 November 2004.

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

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


Assistant Attorney General

Certification Regarding Electronic Filing

Counsel certifies that he has (per Instructions 3 and 8 (b) of the May 27th Order) submitted one copy of the document in electronic medium. Pursuant to Instructions 8 (a) and 8 (c) of the May 27th Order, he certifies that the electronic version of the filing is a true and accurate copy of the document filed in paper medium and that he has, by electronic mail, notified the Commission and the other parties that the electronic version of the filing has been transmitted to the Commission. (See attached) 5 November 2004 is the date of filing in electronic medium.


Assistant Attorney General

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]

SURREBUTTAL 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

November 5, 2004

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

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

4
5 **Q. Did you previously file Direct Testimony in this case?**

6 A. Yes, on August 27, 2004, I filed Direct Testimony on behalf of the Office of Rate
7 Intervention of the Attorney General for the Commonwealth of Kentucky. In that
8 testimony, I recommended a revenue requirement increase of \$111,933 for the
9 Kentucky-American Water Company (“KAWC” or “Company”).

10
11 **Q. What is the purpose of your Surrebuttal Testimony?**

12 A. The purpose of my Surrebuttal Testimony is to address new arguments raised in
13 the Rebuttal Testimony of Mr. Warren regarding consolidated income taxes. Mr.
14 Warren not only presents arguments that have no bearing on the ratemaking issues
15 before this Commission, but he also seems to misunderstand my testimony on the
16 issue of consolidated income taxes.

17
18 **Q. Please address Mr. Warren’s argument on page 10 of his Rebuttal Testimony
19 that the Commission should reject consolidated income tax adjustments
20 because KAWC was not “responsible” for generating the tax losses.**

21 A. Mr. Warren opposes the use of consolidated income tax adjustments, arguing that
22 the Commission should consider “which member is most responsible for

1 producing the tax benefit or incurring the tax cost.”¹ While Mr. Warren examines
2 responsibility, he fails to examine the resulting impact of these tax losses on
3 KAWC.

4 When a consolidated income tax return is filed, the Internal Revenue
5 Service (“IRS”) does not examine which party is responsible for various gains and
6 losses. It examines the consolidated group as one taxable entity. As a result, the
7 effective tax rate to KAWC is lower than it would otherwise be if the Company
8 filed an income tax return on a stand-alone basis. Moreover, these tax losses
9 used by the consolidated group members, including KAWC, are no longer
10 available to be used by the entity that originally generated them. Therefore, by
11 adopting a consolidated income tax adjustment, the Commission is not denying
12 the “responsible party” any tax benefit that they might otherwise enjoy.

13
14 **Q. Please comment on Mr. Warren’s statement on page 11 of his Rebuttal**
15 **Testimony that KAWC is a passive participant and therefore it reaps a**
16 **“windfall” benefit from these tax losses.**

17 **A.** Whether or not KAWC is a passive participant is immaterial. The fact that the
18 Company files as part of a consolidated income tax group means that its effective
19 tax rate is lower than it would otherwise be. The Commission should utilize this
20 actual effective tax rate regardless of the reasons why this rate is lower than it
21 would otherwise be had the Company filed its taxes on a stand-alone basis. The
22 Company incurs many costs, some of which are totally beyond its control. In
23 determining the appropriate ratemaking treatment the Commission examines the

¹ Testimony of Mr. Warren, page 10, lines 11-14.

1 impact of the cost on KAWC. The same methodology should be used when
2 examining cost savings.

3 In addition, the decision to file a consolidated income tax return, and to
4 offset taxable gains with taxable losses, is a decision directly under the control of
5 KAWC's owner. In fact, after this Commission had approved the proposed
6 merger of Thames Water Aqua Holdings GmbH ("Thames") by RWE
7 Aktiengesellschaft ("RWE"), the parties modified the merger transaction and
8 refiled for Commission approval of the modified transaction. As stated in the
9 Order approving the merger, one of the reasons for the modification to the
10 transaction was "to permit the filing of a consolidated United States tax return for
11 these holding."² Moreover, in that case, the parties stated that there were two
12 reasons to modify the proposed transaction,

13 First, it would reduce administrative expenses by eliminating the need to
14 file multiple tax returns in the United States. Second, it may permit some
15 tax savings by allowing the payment of taxes calculated on the net profits
16 of all entities within the consolidated group. Thames could recognize for
17 tax purposes losses of some U.S. affiliates that otherwise might not have
18 been recognized.³
19

20 Thus, the issue of consolidated income tax savings was important enough for the
21 parties to modify the original merger transaction, but now KAWC does not want
22 to flow any of those savings through to ratepayers.

23
24 **Q. Please comment on Mr. Warren's statement on page 13 of his Rebuttal**
25 **Testimony that it is common for a consolidated tax group to compensate its**
26 **members for utilized benefits.**

² Order in Case No. 2002-00317, page 7.

1 A. This is a fancy way to say that KAWC should collect its income taxes from
2 ratepayers at the statutory rate so that it can pay its affiliate the difference between
3 taxes at the statutory rate and taxes at the effective tax rate. Under this
4 methodology, the tax savings are paid to affiliates, rather than returned to
5 ratepayers. I disagree strongly with Mr. Warren's conclusion that ratepayers
6 should pay higher taxes through their utility rates so that the tax loss companies
7 can be compensated in this manner. Mr. Warren opposes cross-subsidies, as
8 discussed on page 13 of his Rebuttal Testimony, but his methodology results in a
9 direct subsidy of unprofitable affiliates by regulated ratepayers.

10
11 **Q. Please respond to Mr. Warren's statement on page 14 of his Rebuttal**
12 **Testimony that consolidated income taxes confiscate the tax benefits of**
13 **expenditures made by other companies.**

14 A. Mr. Warren's statement is incorrect. If a company files a consolidated income tax
15 return, it foregoes the ability to use tax loss carryforwards to offset taxable
16 income in future years. Therefore, consolidated income taxes do not result in any
17 confiscation of tax benefits because these benefits do not exist to a tax loss
18 company if that company files its tax return as part of a consolidated income tax
19 group.

20
21 **Q. Finally, please respond to Mr. Warren's criticism throughout his Rebuttal**
22 **Testimony regarding your use of "actual taxes paid".**

³ Id., page 8.

1 A. Mr. Warren apparently fails to understand my recommendation with regard to
2 “actual taxes paid.” My revenue requirement does not utilize “actual taxes paid.”
3 Rather, my adjustment is uses the average effective income tax rate over a multi-
4 year period as a proxy for the future. Ratemaking is prospective and my
5 recommended income tax adjustment is also prospective. One reviews prior tax
6 losses and gains in order to develop an estimate for the utility’s prospective
7 effective income tax rate, not to determine the actual income taxes that should be
8 included in a utility’s revenue requirement.

9 Mr. Warren also criticizes me for not including tax losses from regulated
10 utilities in my analysis. Since the inclusion of these tax losses would make my
11 adjustment even bigger, I am not sure why Mr. Warren is so concerned with my
12 recommendation to exclude these losses. However, the rationale for excluding
13 such losses is that utilities are not expected to loss money prospectively. If
14 utilities believe that they are going to lose money prospectively, then there is a
15 process for filing for rate relief. Therefore, prior tax losses of regulated entities
16 are not included in my analysis because such losses are not expected to reoccur in
17 the future.

18

19 **Q. Can you summarize your response to Mr. Warren’s Rebuttal Testimony?**

20 A. Yes, Mr. Warren’s testimony ignores the economic reality that the filing of a
21 consolidated income tax adjustment produces benefits that should be flowed-
22 through to ratepayers. Ratepayers should not be burdened with higher utility rates
23 so that subsidies can be given to affiliates with tax losses. This issue was

1 important enough for Thames and RWE to modify its acquisition transaction to
2 take advantage of consolidated income tax benefits. Finally, consolidated income
3 tax adjustments are prospective and should be based on prospective operating
4 conditions. For all these reasons, it is appropriate for the Commission to adopt a
5 consolidated income tax adjustment in this case.

6

7 **Q. Does this conclude your Surrebuttal Testimony?**

8 A. Yes, it does.

9

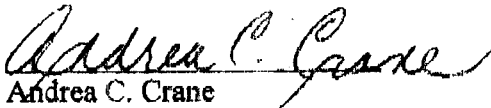
In Re the Matter of:

ADJUSTMENT OF THE RATES
OF THE KENTUCKY-AMERICAN
WATER COMPANY

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CASE NO. 2004-00103

Comes the affiant, Andrea C. Crane, and being duly sworn states that the foregoing testimony and attached schedules were prepared by her and are, to the best of her information and belief, true and correct.


Andrea C. Crane

State/Commonwealth of: Connecticut
County of: Fairfield

Subscribed and sworn to before me by the affiant, Andrea C. Crane, this 5th day of November, 2004.


Marjorie M. Levin, Notary Public

MARJORIE M. LEVIN
NOTARY PUBLIC
MY COMMISSION EXPIRES DEC. 31, 2006

