COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF KENTUCKY- AMERICAN WATER COMPANY	))	CASE NO. 2004-00103

LEXINGTON-FAYETTE
URBAN COUNTY GOVERNMENT'S BRIEF

Comes now the Lexington-Fayette Urban County Government (the "LFUCG"), by counsel, in accordance with the procedural schedule as amended, and submits this Brief in support of its positions in this action.

I. STATEMENT OF THE CASE

This case involves an application for adjustment of rates filed by Kentucky-American Water Company ("Kentucky-American", or the "company") on April 30, 2004, which was shortly after the first date the company could have filed for such relief without violating the Commission's previous orders from Case No. 2002-00018 and Case No 2002-00317 (the "merger cases").

The initial procedural schedule was pushed back *sua sponte* by the Commission, resulting in a separate public comment period taking place in Lexington, Kentucky on the evening of November 4, 2004, with the substantive proceeding commencing November 8, 2004 and concluding on November 23, 2004. The Attorney General, the LFUCG, the Community Action Council, and Bluegrass FLOW, Inc. ("FLOW"), were all granted intervenor status by the Commission. A significant amount of discovery took place, some of which was

the direct result of Kentucky-American refusing to provide responses to areas of questioning deemed relevant by the Commission[1], and at least part of which, by Kentucky-American's own admission, was caused by the testimony it filed in support of the application.[2]

Kentucky-American ultimately requested a 16.82 percent increase in revenue in its application.[3] The testimony of the witnesses for the Attorney General supports a minimal increase. By order of the Commission at the hearing, the parties were allowed until January 4, 2005 to file initial briefs in support of their respective positions, with reply briefs due by no later than January 11, 2005.

II. KENTUCKY-AMERICAN SHOULD BE AFFORDED THE SMALLEST RATE INCREASE SUPPORTED BY THE RECORD

Based upon the record in this case, Kentucky-American is not entitled to a rate increase of the magnitude for which it has applied. Therefore, to the extent that the evidence and arguments of the Attorney General do not conflict with those made herein, the LFUCG adopts them in support of this position. More specifically, the LFUCG adopts the Return on Equity suggested by the Attorney

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[1] See e.g., Commission's Order of September 1, 2004 granting FLOW intervention, page 2, f.n. 1.

[2] See Transcript of Evidence, Volume III, Chris Jarrett, p. 195, line 19 through p. 196, line 1 "I want to apologize to this Commission and those intervenors. That was a less than elaborate enough response, and I gather that by the number of times we had data requests pertaining to it."

[3] On November 30, 2004, with the statutory period preventing such action under KRS 278.192 having passed, the company exercised its option to impose the increase prior to the Commission's final ruling. See Notice of November 30, 2004.

General, as well as the overall rate increase Kentucky-American should be awarded.[4]

Regardless of the amount of any increase ultimately awarded Kentucky-American, the Commission should expressly order the company to return any amounts above that award that have been collected since December 1, 2004, with interest retroactive to December 1, 2004.

III. THE RECORD SUPPORTS NO INCREASE, OR AT MOST, A MODEST INCREASE, TO THE PUBLIC FIRE HYDRANT CLASS

Kentucky-American utilized the Cost of Service Study (the "Study") from its last rate case (Case No. 2000-00120) based on the reasoning that there was no change in its operations that was significant enough to require either conducting a new study or updating it. (See Response to Question No. 8, LFUCG's First Request for Information). As result, there is no cost justification in the record for deviating from the Study.

The Study indicates that public fire protection should be responsible for 4.0 percent of Kentucky-American's total sales revenues. (See Exhibit 36, Schedule A, to the Application, page 6 of 40). However, at the time of the Study, the company served only the current Central Division. Therefore, the largest proportional amount that the LFUCG should bear for public fire hydrants is at most 4.0 percent of sales revenues in the Central Division. As Kentucky-

[4] The Attorney General recommends a return on equity of 8.75 percent while the company recommends an 11.2 percent increase. RWE AG subsidiaries in West Virginia (7 percent) and Arizona (9 percent) have been granted returns, still in effect, that very much support the Attorney General's position. See, Response to Question No. 3, LFUCG's Third Request for Information.

American has also reported zero revenues from public fire protection for the Northern Division, it is clear that neither revenues nor costs from that division should be assigned to public fire protection.[5]

Moreover, Kentucky-American has deviated from the Study, and instead requested that all customer classifications within the Central Division be raised equally. The actual increase assigned to fire protection was originally stated to be $276,043, or 15.32 percent. (See Exhibit 37M to the Application, page 2 of 54). However, because Kentucky-American failed to update the number of public fire hydrants in its forecasted test year, at the request of the LFUCG it re-filed Exhibit 37M (revised Exhibit 37, Schedule M-3c). This revised exhibit indicates that the actual increase to public fire protection will be $289,677 (or 15.32 percent over a similarly increased revenue at present rates), and that the proposed revenues for this class will in fact return more revenue than stated in the application. (See Attachment to Response to Question No. 24, LFUCG's Second Request for Information, page 2 of 18).

Assuming that that the revised Schedule 37M-3c is accurate, the proposed rates ultimately require public fire protection to pay approximately 4.55 percent of the Central Division sales revenues[6], which results in an overcharge for public

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[5] The company has admitted that some costs attributable to these divisions are being charged to the Central Division. See, Response to Question No. 84, LFUCG's First Requests for Information.

[6] Public fire revenues for the forecast period under proposed rates equal $2,180,867. Sales revenues equal $47,941,422 ($47,276,142, plus $665,280 in "Activation Fees", which the company proposes to use to recover revenues previously recovered under customer or usage charges). $2,180,867 [total public fire revenues] divided by $47,941,422 [total sales revenue] equals 4.55 percent. Information used in these calculations is from the Attachment to Response to Question No. 24, LFUCG's Second Requests for Information, page 2 of 18.

fire hydrants of $263,200 during the forecast period[7], as the 4.0 percent allocation justified by the Study only results in a total revenue requirement for public fire protection of $1,917,657[8], or an increase of just $26,477[9].

This unjustified and grossly excessive proposed increase is particularly significant to the LFUCG, as it pays for 94.5 percent of public fire hydrants. (See Response to Question No. 14, Hearing Data Requests). An unjustified allocation of $248,724[10] of additional annual revenue requirements imposed upon a single customer (the LFUCG) for the company's simplistic and unjustified "across the board" methodology is unreasonable and arbitrary.[11]

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[7] $289,677 [company proposed increase] less $26,477 [actual additional revenue required by the Study] equals $263,200 [proposed overcharge].

[8] $47,941,422 [total sales revenue] multiplied by 4 percent [allocation supported by the Study] equals $1,917,657 [revenue requirement for public fire protection].

[9] $1,917,657 [revenue requirement for public fire protection] less $1,891,190 [forecasted revenue under present rates] equals $26,477 [actual additional revenue required].

[10] $263,200 [proposed overcharge] multiplied by 94.5% [percentage of hydrants owned by the LFUCG] equals $248,724 [unjustified allocation to LFUCG].

[11] Although there is no justification for their inclusion, assuming *arguendo*, that the Northern Division's revenues are included in this analysis the overcharge to the LFUCG is still almost $200,000. Total forecasted sales revenues are $49,231,254, when Tri-Village ($1,157,218, from Exhibit 37-M3, page 20 of 54) and Elk Lake ($132,614, from Exhibit 37M-3, page 38 of 54) are included. An assignment of 4.0 percent of these revenues to public fire protection equals $1,969,250. The company's proposed assignment of $2,180,867 is 4.43 percent of the total, for an over-assignment of $211,617 ($2,180,867 less $1,969,250 = $211,617). This results in an unwarranted cost to the LFUCG of $199,631 ($211,617 x .945). One final point – the Commission staff also asked the company to estimate the increase to each class if Tri-Village and Elk Lake were included in the Central Division's rates. Kentucky-American responded that rates for each service classification (including public fire) would be increased by 15.849 percent under the same mindless "across the board" increase methodology. See Response to Question No. 12(b), Commission's Third Request for Information. This would result in an even greater subsidization by the public fire customer class.

The company's filing also demonstrates that even in the base period the LFUCG paid far more than its fair share of revenue requirements, as public fire protection actually paid 4.18 percent of Kentucky-American's sales revenues.[12] However, instead of correcting this disparity with an updated cost of service study, the company proposes to make it far worse.

There is no rational basis or evidence in the record to support requiring the public fire protection class to pay more than 4.0 percent of Kentucky-American's required sales revenues (as finally determined by the Commission in this case). Any other result would lead to subsidization of other customers at a significant cost to the LFUCG.

Furthermore, even the 4.0 percent figure is excessive, as Kentucky-American makes no allowance for the other uses of public fire hydrants that benefit the other ratepayer classifications. For example, Kentucky-American acknowledges that hydrants are necessary to flush its system, and are used for this purpose. (See Responses to Question No.'s 33 and 34, LFUCG's First Request for Information). Although this use of hydrants clearly benefits all ratepayers by improving the quality of their water, no costs associated with hydrants are assigned to any other ratepayers.

Kentucky-American also freely admits that the public as a whole has an interest in having public fire protection readily available. (See, Response to Question No. 27, LFUCG's First Request for Information). Thus, it would be

[12] See Attachment to Response to Question No. 24, LFUCG's Second Request for Information, page 1 of 18. $1,802,175 divided by $43,080,144 equals 4.18 percent.

reasonable for the Commission to further reduce the burden on the LFUCG and other public hydrant owners by assigning a reasonable portion of the public fire hydrant costs to other customer classes in order to reflect the fact that the entire system benefits from having public fire protection.

In sum, there is no cost support in the record for assigning more than 4.0 percent of the appropriate water sales revenues to public fire protection, and further, there is no support for devising a fire hydrant rate that recovers more revenues than are properly assigned to fire protection. The appropriate revenue for public fire protection in this case is determined by multiplying the total sales revenue awarded by the Commission by no more than 4.0 percent, and then further reducing this amount by the reasonable amount of the benefit that such hydrants provide to the other customers and the system as a whole. This amount would then be divided by the number of public fire hydrants to determine the rate to be charged. The LFUCG respectfully requests that the Commission adopt this approach to determining the appropriate rate for public fire hydrants, and thereby end the continuing subsidization of other customers (which will reach almost a quarter of a million dollars annually under the company's proposed rates) by the LFUCG.

IV. THE COMMISSION SHOULD ESTABLISH A REASONABLE TARIFF RATE FOR PUBLICLY OWNED FIRE HYDRANTS

The LFUCG is committed to providing excellent fire protection to its constituents. It does not object to paying its fair share for fire service. However, it should not be required to continue to subsidize other customers through

excessive hydrant charges, or to pass along any additional costs through tax increases. (See Response to Question No. 21, LFUCG's Second Request for Information).

A major part of the cost of fire hydrants is Kentucky-American's required return, and the taxes on the capital investment in the hydrants themselves. The company indicated that 43 percent of the public fire hydrant rate is related to its return and taxes. (See Response to Question 35(d), LFUCG's First Request for Information). When queried as to whether it would consider a proposal that would allow the LFUCG to own at least a portion of the hydrants it pays for, the company instead presented a number of options that would continue to allow it to charge the return and taxes -- while shifting costs to other ratepayers. (See Response to Question No. 1, LFUCG's Second Request for Information).

To the extent the LFUCG might in the future own hydrants, the inclusion and resultant cost of Kentucky-American's equity return, as well as the taxes on such a return, should be avoided entirely (as to those hydrants) if an appropriate tariff is implemented. The LFUCG is not aware of any requirement that it has to take its public fire protection through company-owned hydrants; nor would any such requirement be reasonable.

While the LFUCG appreciates Kentucky-American's professed willingness to discuss different options with respect to the future ownership of public fire hydrants, neither the LFUCG nor other customers should be forced to bear the additional costs of company-owned hydrants just because Kentucky-American

prefers it this way. The LFUCG is in the process of investigating the cost and feasibility of purchasing hydrants to provide fire protection in Fayette County, and therefore respectfully requests that the Commission establish a reasonable rate for the provision of water service by Kentucky-American for such hydrants. That rate should equal the current public fire protection charge, less the return and taxes on the cost of the hydrant itself.

V. THE COMMISSION SHOULD DENY KENTUCKY-AMERICAN'S REQUEST TO ACCRUE ASSETS

Kentucky-American has proposed that it be permitted to accrue certain costs that it incurred between this case and its last rate case, and that it be permitted to treat such accruals as regulatory assets upon which it would earn a return. The proposed accruals are for security costs, customer service center costs, financial service consolidation, acquisitions, preliminary service and design, tank painting and sludge removal. (See Application of December 12, 2003, Case No. 2003-00478 (consolidated with this case)(also attached as Exhibit No. 6 to the pre-filed testimony of Michael Miller)). For the reasons provided below, the LFUCG opposes the accrual and recovery of any of these previously incurred costs, and the Commission should not allow for their recovery.

A. Kentucky-American Violated the Requirements of the Commission's Orders from Case No. 2000-00120

In Case No. 2000-00120, the Commission stated its concern regarding Kentucky-American's practice of deferring expenses as regulatory assets, particularly in light of the company's decision to continue to use the forecasted

test year method in its rate filings. (See Case No. 2000-00120, Order of November 27, 2000 at pp. 23-24). Further, the Commission specifically instructed Kentucky-American on how to proceed should it wish to do so. "KAWC ***shall formally apply for commission approval before*** accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense in previous rate proceedings." (Id. (emphasis added)). This requirement was also formalized in ordering Paragraph 6, which states that "***Prior*** to accruing an expense as a regulatory asset, Kentucky-American shall ***formally apply*** to the Commission for approval of such accrual." (Id. at page 72 (emphasis added)).

Incredibly, after consistently failing to follow this simple requirement, and despite the fact it is bound by the principles of *res judicata* and equitable estoppel[13] to do so (given its failure to appeal any of the orders from the previous rate case) the company now claims that it has been unfairly singled out for such a requirement, and that the requirement is unnecessary and burdensome. (See Application of Kentucky-American, Case No. 2003-00478, paragraph number 3).

Of at least equal, if not greater, concern, is Kentucky-American's representation that the delivery of a number of *ex parte* letters to the former Executive Director of the Commission regarding its desire to accrue certain assets suffices as a ***formal application***. (See Transcript of Evidence, Volume

[13] For an example of the Commission's application of these principles, see the various orders from Case No. 2002-00317.

III, Michael Miller, page 104, lines 17 through 21). Kentucky-American is a sophisticated party represented by a law firm that has been involved in actions before this Commission for years, and it is charged with knowledge of the Commission's regulations. Therefore, the company cannot credibly ascribe its refusal to follow such regulations to its ignorance of the Commission's regulations.

A specific and longstanding regulation outlines exactly what constitutes a formal application to the Commission. (See 807 KAR 5:001, Sections 8 and 15 setting forth specific requirements for Applications, including a specific format for an application that "***shall*** be followed insofar as practicable." (emphasis added)). The "Dear Tom" letters attached to the company's Application in Case No. 2003-00478 in no way meet the requirements of this regulation, and it is disingenuous to suggest that they should, or that they could have been reasonably thought to do so.

Further, the company's apparent interpretation of this language renders the term "formal" meaningless, and rewards Kentucky-American for the very conduct prohibited -- informal, *ex parte* attempts to seek certain treatment of expenses or costs. In order to comply with the requirements of the order, Kentucky-American should have filed an application substantially similar to the exhibit in the application form provided by 807 KAR 5:001, Section 15, which would have then been docketed and numbered, and which would have allowed interested parties to voice any objections. It ultimately did file a formal

application on December 12, 2003 -- thus evidencing its knowledge of the requirement.

Kentucky-American has waived any right that it might have had to accrue such costs prior to the date (December 12, 2003) it actually complied with the Commission's order, and allowing the company to accrue such costs prior to that date would constitute unlawful retroactive ratemaking. Further, any costs incurred for these items since December 12, 2003 are presumably included in the company's base year, as the base year was almost halfway complete by the time Kentucky-American actually complied with the Commission's regulation and the order.

Because Kentucky-American failed to follow the Commission's clear mandate regarding how to request seeking accounting accruals in a future rate case, it has no lawful basis to recover ***any of the accruals*** requested in this proceeding. Any other decision by the Commission renders its previous order and its regulations meaningless, and encourages the e*x parte* behavior displayed by Kentucky-American leading up to the filing of the application. Therefore, the LFUCG respectfully requests that the Commission deny the company's attempt to have ratepayers bear these costs.

B. The Recovery of Accrued Costs Renders the Merger Conditions Meaningless and Penalizes the Ratepayers for the Merger

In order to secure approval of its acquisition by RWE AG, Kentucky-American and its affiliates agreed to certain conditions regarding the merger, which included a provision that Kentucky-American would not file for rate relief any earlier than March 16, 2004. (See Condition 1 of Order dated May 30, 2002, Commission Case No. 2002-00018). This "stay-out" provision was presumably intended as a benefit to the ratepayers that the Commission found necessary in order for the merger to be approved. If, however, Kentucky-American can now accrue costs incurred prior to the base period ***and*** earn a return on such costs ***and*** charge its ratepayers for its taxes on such a return -- then this provision actually harms, rather than benefits, the ratepayers.

The company's proposal regarding these accruals and their recovery is completely inconsistent with the obvious intent of the stay-out provision, and should be rejected for that reason. If this condition was merely a "feel good" provision to prohibit the immediate filing of a rate case, but now results in the recovery of even more dollars by the company than it would have gotten had it been allowed to immediately file an application, then the condition was illusory and actually penalizes the ratepayers. Kentucky-American's interpretation of this condition is both inaccurate and unconscionable, and completely at odds with the value placed on this condition by both the Commission and the company during the merger case litigation. For this reasons, the LFUCG respectfully requests that

the Commission deny Kentucky-American's proposal with respect to the treatment of accrued assets.

C. Even if the Commission Allows for the Recovery of Other Costs, it Cannot Allow for the Recovery of Security Costs

Assuming *arguendo*, that the Commission fails to require the company to follow the requirements of its own order and regulations, and also decides to render the stay-out merger provision meaningless, Kentucky-American should not lawfully be allowed to obtain favorable treatment regarding its security costs[14], as its proposal to recover them not only raises an additional question regarding its alleged acceptance of the merger conditions, but rewards it for making at least one substantive *ex parte* contact directly related to the pending merger conditions while the initial merger case was still before the Commission for final consideration. As further discussed below, this contact was never revealed to the LFUCG until the eve of the public hearing (despite numerous previous attempts by the parties to obtain the disclosure of such information), and was even suggested by the company at the hearing to be of dubious authenticity.

1. The Allowance of Security Costs Renders Condition No. 2 Meaningless and Harms the Ratepayers

Kentucky-American's proposal to impose a security surcharge in Case No. 2001-0440, which would be used to recover its increased costs of providing security in light of the September 11, 2001 terrorist attacks and their aftermath,

[14] The LFUCG takes no position on the total costs incurred by the company for security purposes, as none of these costs should be recovered from the ratepayers.

was still pending before the Commission during Case No. 2002-00018. In order to dispose of this case as part of Case No. 2002-00018, the Commission proposed (and Kentucky-American accepted) a requirement that the company not attempt to recover its security costs other than as part of a general rate case. (See Condition 2, Order of May 30, 2002, Case No. 2002-00018)

However, unknown to any of the intervenors to Case No. 2002-00018 (the Attorney General, the LFUCG, and FLOW), from the beginning, Kentucky-American interpreted this clear and unambiguous provision regarding the recovery of security costs to mean that the company could (with informal approval of the Commission staff) accrue such security costs for years, and then seek their recovery through a return on a regulatory asset. (See Response to Question No.'s 4 and 6 and attachment number 4 (pp. 10-11) to LFUCG's Third Request for Information). If granted, the effect of these accruals would be the elimination of any real meaning to yet another merger condition, and a "reward" to the ratepayers of paying even more than they would have had merger Conditions 1 and 2 never been imposed at all (due to the imposition of the return and the tax costs on the accruals). Therefore, the LFUCG respectfully requests that this proposal be denied.

2. The Allowance of Security Costs Rewards *Ex Parte* Behavior

When Kentucky-American did seek the Commission's approval regarding the treatment of security costs, it informally contacted the Executive Director of the Commission by letter on at least three separate occasions (and in each

instance without notifying any other interested party) -- July 2, 2002; September 24, 2003; and November 18, 2003 -- before finally filing a formal application in on December 12, 2003.[15] After the company's September 24, 2003 informal request became public, the Commission staff made a finding that it was inconsistent with Condition 2 of the merger order in Case No. 2002-00018, and instructed the company to file a formal application for such treatment, if desired. (See October 15, 2003 letter (Exhibit to Application in Case No. 2003-00478)).

Rather than doing so, Kentucky-American once again filed an informal request by letter dated November 15, 2003 before finally (and in full recognition of the fact that none of the previous letters constituted such an application), filed a formal application on December 12, 2003 (Case No. 2003-00478). Although this application did mention some of the company's previous contacts with the Commission staff, it did not mention the July 2, 2002 letter.

Nor, despite the previous requests of the LFUCG for the company to disclose any contacts with the Commission staff and produce related documents, was this letter ultimately provided until mere days before the hearing. (See Attachment Number 4 (pp. 10-11) to LFUCG's Third Request for Information; Responses to Question No.'s 70 (especially 70(b)), 71, and 78, LFUCG's First

[15] The September 24, 2003 letter was not directly provided to the LFUCG by either the Commission or the company, but did later come into its possession. As result of Mr. Dorman's October 15, 2003 letter and the November 18, 2003 response of the company, the LFUCG ultimately sent a letter to the Commissioners on or about December 9, 2003, objecting to Kentucky-American's requests.

Request for Information).[16] No reasonable explanation for the belated appearance of this letter was ever provided.[17]

Instead, the company initially took the position at the hearing that it was just as likely that the signed and dated letter had never been sent at all (see Transcript of Evidence, Volume III, Lindsey Ingram, Jr., p. 10, line 21 through p. 11, line 5); and, ironically, it was also not included in the Commission's disclosure of known *ex parte* contacts in its November 5, 2004 Order, which was issued ***after the letter was finally disclosed***.

The July 2, 2002 letter is the company's most significant *ex parte* contact with the Commission because it occurred while Case No. 2002-00018 was still before the Commission for ruling on rehearing, and its content involved an issue of great concern to all of the parties -- Kentucky-American's interpretation of the tariff withdrawal condition (Condition No. 2), which if accepted, rendered that condition a nullity. Had the LFUCG known at that time that Kentucky-American intended to recover even more dollars from rate payers for its "accrued" security costs, it would have placed the issue directly before the Commission, and perhaps the Commission (or the Franklin Circuit Court) would have closed this "loophole".

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[16] The letter was provided by Mr. Miller in support of his testimony that he had informed auditors that recovery of the accrued security costs was "likely", as required by FAS 71 for creation of a regulatory asset. See Response to Question No. 4, LFUCG's Third Request for Information.

[17] Mr. Miller also acknowledged that the letter was faxed to him at a later date. See Transcript of Evidence, Volume III, Michael Miller, p. 117 lines 17 through 25.

The evidence finally elicited is that Kentucky-American, during the pendancy of Case No. 2002-00018 before the Commission, advised the Commission's Executive Director that it intended to interpret an agreed to condition in a manner that would eviscerate that condition. That contact was never revealed to the parties to that proceeding for whose benefit the condition was supposedly adopted. That contact was never revealed during any of the merger proceedings before the Commission, nor during the appeal to Franklin Circuit Court. It was not revealed even when the Commission disclosed (albeit in a limited manner) the *ex parte* contacts of which it was aware.

This secret, extremely significant contact falls squarely within the type of action that was censured by the Court of Appeals in LG & E v. Commonwealth, 862 S.W. 2d 897 (1993), and again raises the specter of *ex parte* contact being the "bread and butter" of the administrative process -- a proposition that was forcefully rejected by the Court of Appeals. (Id.)

The record in this proceeding presents ample evidence that Kentucky-American is under the impression that important issues pending before the Commission can be resolved by informal communications with its staff -- and without the involvement of any other affected parties.[18] This behavior must now be forcefully rejected by the Commission if the ratemaking and regulatory process is to have both the appearance and reality of propriety. The company's

[18] The company also discussed a similar approach to resolving other issues related to the Order in Case No. 2000-00120. See Response to Question No. 30(e) (page 245 of 246), Commission's Third Request for Information: "Is this something we should approach the Commission staff on ***informally***, or should we ask for clarification in the rehearing?" (emphasis added).

continual efforts to resolve important issues behind closed doors must be rejected, and Kentucky-American must not profit from such behavior.

Kentucky-American's failure to disclose its qualification in accepting Condition 2, made through an *ex parte* communication during the pendancy of Case No. 2002-00018, is more than cause, in and of itself, to reject Kentucky-American's proposed treatment of the security expenses. When combined with the company's failure to follow the requirements of the Commission's previous rate order and the other merger conditions, as argued, above, it would be a great injustice to allow Kentucky-American to recover these costs. Therefore, the LFUCG respectfully requests that the Commission reject the company's proposal with respect to the treatment of security costs.

VI. EMPLOYEE SALARIES AND OVERHEAD SPENT ON LOBBYING AND POLITICAL ACTIVITIES SHOULD NOT BE BORNE BY THE RATEPAYERS

The Commission has consistently held that ratepayers should not pay for lobbying or political activities of the employees of regulated utilities, and there should be no exception made here. (See, e.g., Case No. 97-304, Application of Kentucky-American Water Company to Increase Its Rates, Order of September 30, 1997 at pp. 16-17). The LFUCG made determined efforts in this case to assess how a reasonable allocation of time and overhead might be made for Kentucky-American's employees engaged in lobbying and political activities.

However, Kentucky-American repeatedly refused to make ***any effort*** or provide information with which to make such an allocation,[19] instead claiming that any of its employees that had spent any time on such activities had merely put in extra time in addition to their normal responsibilities, and that the company had not tracked and could not account for how much time had actually been spent. (See Response to Question 9, Commission's Third Request for Information).[20] Given Kentucky-American's refusal to provide such information, the only reasonable option available to the Commission is to completely remove the salaries and overheads attributable to such activities from the costs to be included in rates.

These include (at the very least) costs related to the President and his executive assistant; the Director of Government Relations[21]; and the Communications Director. In addition to moving these costs below-the-line for ratemaking purposes, the Commission should specifically advise Kentucky-American that it must implement a reasonable and reliable system for tracking

[19] The company even went so far as to argue (without any quantification or proof) that its exorbitant costs spent on this case were at least partially the fault of this "irrelevant" line of questioning, despite the Commission's previous ruling that rate-related condemnation questions ***were relevant***. Jarrett even later apologized at the hearing for his testimony that led to much of this line of questioning. See Transcript of Evidence, Volume III, Chris Jarrett, p. 195 line 19 through p. 196, line 1; Response to Question 18, Commission's Third Request for Information.

[20] This begs the question as to whether this will be the company's position on its future non-regulated activities as well.

[21] A registered legislative lobbyist (with the Legislative Research Commission) under the supervision of the President. See http://lrc.ky.gov/Ethics/lec/TempReports/lec41c5.PDF. The company employs a total of six lobbyists. http://lrc.ky.gov/Ethics/lec/TempReports/lec41c6.PDF.

employee costs for employees who are engaged in such activities if it intends to seek rate recovery for such costs in the future.

It is also the company's position that there is no way to determine from service company billings the extent to which such billings would involve the condemnation proceeding or other possible public-issue related work. Given the remedy it has requested above, the LFUCG does not recommend the denial or reduction of such costs in this proceeding, but respectfully requests that the Commission specifically advise Kentucky-American that it must keep its records in such a manner as to segregate any service company costs incurred for advice or assistance on public or political issues if it intends to seek recovery for service company expenses in future cases.

A. Other Employee Issues

In 2000, Kentucky-American had three full time management officers in Lexington -- a President, a Vice-President of Operations, and a Vice-President/Treasurer. This full-time presence has now been reduced to one senior management employee -- a President.[22] However, this reduction hasn't prevented the company from retaining a full-time Government Affairs Director and a full-time Communications Director, thus emphasizing the value that it places on lobbying and public relations versus operations.

[22] It should be noted that Kentucky-American's President, Nick Rowe, was too busy with other functions to attend the rate case hearing, and that he was still spending a significant amount of his time on other American Water Works Company duties that were not directly beneficial to the ratepayers of Kentucky-American. See, e.g., Transcript of Evidence Volume III, Chris Jarrett, p. 197, lines 17 through 23, p. 198, line 20.

Moreover, while the source of supply issue remains a key future issue, the company has also lost the full-time presence of its Director of Engineering, Linda Bridwell, as she now splits her time among various American Water Works entities (including an even larger regional structure based in Hershey, Pennsylvania) -- even though her salary and overhead apparently continues to be assigned only to Kentucky-American's ratepayers. (See Response to Question No. 16, Hearing Data Requests). Additionally, the company paid consultant wages to former employees of Kentucky-American and American Water Works Company just to have the ability to file its application. (see e.g., Coleman Bush).

Unfortunately, the merger conditions only contained short-term restrictions on managerial and other work force reductions by the company. Now that the exodus is in full flower (with the notable exception of Kentucky-American's lobbying and public relations capability), it is at least necessary that this Commission not allow Kentucky-American to charge ratepayers with the full-time salaries of employees who are now only part-time employees, or whose main function is to represent the company's corporate image and interests.

As argued above, the LFUCG believes that the Commission should fully remove the salary and overhead of the President from ratemaking consideration. The LFUCG further requests that the Commission, in order to reflect her true part-time status, include only 1/3 of the Director of Engineering's salary and overhead currently included in the forecast period. Although Kentucky-American speculates that some offsetting benefit may come to the ratepayers as a result of

this time sharing arrangement, there is no evidence to demonstrate that this is true, and such speculation should not offset the certainty that the ratepayers are being asked to pay full-time salary and overhead for a part-time employee.[23] This response also does nothing to address the loss of a full-time Director of Engineering, particularly when Kentucky-American is ostensibly heavily involved in assisting a regional water supply initiative.

VII. THE PROPOSED ACTIVATION FEE IS NOT NECESSARY, BUT IF ALLOWED SHOULD BE SUBJECT TO CONDITIONS

The company has also proposed a $24 activation fee in order to collect certain costs that were previously recovered through usage charges. The LFUCG does not believe such a fee is necessary, and is particularly concerned about its negative impact on low-income customers, who are often forced to move or otherwise obtain new service that would apparently be subject to this fee. Indeed, the single application of such a fee would apparently eliminate any benefit a qualifying customer would otherwise obtain from the proposed low-income discount (assuming that it is approved).

Furthermore, the company apparently intends to refuse to collect franchise fees on this "new" fee, as it erroneously believes that it does not meet the definition of "gross revenues" contained in its franchise agreement with the LFUCG. (See Response to Question No. 17, LFUCG's Second Request for Information). The LFUCG does not agree with this interpretation, and any effort

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[23] Although Linda Bridwell testified that she had changed positions in July 2004, the company apparently believed that this was not noteworthy enough to require disclosure prior to being brought up at the hearing. See Transcript of Evidence, Volume II, Linda Bridwell, p. 76, line 24, through p. 77, line 3; p. 90, lines 18 through 21.

to create "new" fees or charges to recover costs that would otherwise be subject to the franchise fee (or that have, as a practical matter been collected previously under a different mechanism that was subject to the franchise fee) is not reasonable, nor is it consistent with Kentucky-American's obligation under the merger conditions to honor its obligations to the LFUCG. (See Orders from Case No. 2002-00018, Condition No. 54).

Therefore, in the event that the Commission agrees to allow the proposed activation fee, at least three conditions should be placed on it. First, the Attorney General's recommendation as to the rate structure implications of the new fee should be accepted. (See, Testimony of Scott Rubin at pp. 14-16). Second, the company must agree that the imposition of the fee does not relieve it of its obligation to collect franchise fees on the revenue collected from it. Finally, a waiver of the new charge for any household that is eligible for Kentucky-American's proposed low income credit should be adopted.

VIII. THE EMERGENCY PRICING TARIFF SHOULD BE MORE FULLY CONSIDERED IN A DIFFERENT PROCEEDING

Kentucky-American has also proposed a new emergency pricing tariff ("EPT"), to be imposed in the event of a water shortage emergency. Although the LFUCG is not opposed to the concept of an EPT, it is concerned with the manner in which this has been requested in the application.

The company has acknowledged that other parties to this proceeding had previously worked with it to come up with the concept of an EPT. (See Response to Question No. 1, LFUCG's Third Request for Information; Transcript of

Evidence, Volume I, Coleman Bush, p. 143, lines 9 through 12). However, Kentucky-American has now abandoned this approach, and instead seeks approval of an EPT that will be of significant cost to ratepayers to implement, and that is less than clear on how it would work.

It makes no sense to hurry to resolution of this particular issue at this time. The LFUCG, which has historically been charged with enforcing water restrictions during drought conditions (see Section 11-9, Lexington-Fayette Urban County Government Code of Ordinances), is prepared to resume meaningful discussions with Kentucky-American and other interested parties (including the Commission if appropriate), to develop an EPT that will work and will have the full support of all interested parties. Therefore, the LFUCG respectfully recommends that the Commission institute a separate administrative action to address this matter rather than resolving it as part of this case.

IX. THE COMMISSION SHOULD TAKE MEASURES TO ENSURE THAT THE RATEPAYERS RECEIVE BENEFIT FROM THE PROPOSED OWENTON (AND FUTURE) ACQUISITIONS

Kentucky-American is in the process of acquiring the Owenton Water and Sewer Works. This acquisition has been delayed since the filing of the application, and the company has refused to include any revenues from Owenton in its forecasted test period. It has seen fit, however, to charge ratepayers for certain "business development" expenses, including costs related to the negotiation of the Owenton purchase agreement. (See Response to Question No. 23, Hearing Data Requests). In addition, after originally producing a copy of

an "opinion letter" from the Commission staff stating that the acquisition of Owenton is not subject to the Commission's approval (and originally taking this position), the company now claims that it will seek such approval from the Commission in a future application. (See Response to Question No. 7, LFUCG's Third Request for Information; Transcript of Evidence, Volume I, Coleman Bush, p. 139, lines 16 through 21).

The Owenton acquisition is potentially the tip of the iceberg for the company's future expansion of its operations, and deserves close scrutiny from the Commission. As stated in its 2004-2008 Business Plan, Kentucky-American plans to acquire Owenton and then raise rates for Owenton's customers in Year 2. (See Response to Question No. 176, Supplemental Response to Attorney General's First Request for Information, page 61 of 69).

Kentucky-American is at least generally aware (despite protests to the contrary) that its rates are often higher than those charged by its acquisition targets, as it has complained of the "unfair" comparison between its rates and those of municipal and other utilities -- which it attributes in part to its payment of federal and state income tax.[24] (See Supplemental Response to Question 176, Attorney General's First Request for Information, at page 64 of 69). Moreover, a study by the Bluegrass Area Development District indicates that Kentucky-American's proposed rates would be an increase for nearly all of the customers

[24] Although it claims to have rates that are a "good value", and compares them to "other utilities" such as electric and gas companies, Kentucky-American also claims that it has no knowledge of how its rates compares to other water service providers. See Response to Question No. 18, LFUCG's Second Request for Information.

of the other utilities covered by the study. (See Response to Question No. 5, LFUCG's Third Request for Information).

If Kentucky-American is allowed to acquire utilities and automatically raise rates without significant regulatory review then the process is flawed, even more so because there is no apparent mechanism for these increased revenues to benefit the company's other ratepayers, who are being asked to support salaries, overhead and other costs for these "business development" activities. Although it could be argued that any increased revenues will be recognized at the time the company files its next rate case, Kentucky-American is attempting to grow its way out of the necessity of filing future rate cases[25], so future recognition is not certain. This will be particularly true if the company is successful in the far more aggressive acquisition strategy that is a major component of its business development plan.

In Simpson County Water District v. City of Franklin, 872 S.W. 2d 460 (1994), the Supreme Court was presented with the ambiguous statutory situation of municipalities selling water under contracts to regulated utilities. The Court determined by a 4-3 margin that such contracts were in fact subject to the Commission's jurisdiction. An important factor in that decision was that with a regulated utility involved, any contract would have an impact on that utility's customers. (Simpson County, at 464). Certainly the acquisition of Owenton by Kentucky-American also creates a compelling case for Commission involvement,

[25] See Supplemental Response to Question No. 176, Attorney General's First Request for Information, page 2 of 69.

given Kentucky-American's stated desire to ***raise*** Owenton's rates while avoiding the recognition of additional revenues that would benefit the company's existing ratepayers.[26] Under this business model, both the new and old customers (who are being asked to pay for "business development"[27] -- but who are not receiving any benefit from such acquisitions -- need to be protected.

Even if Owenton customers have to pay higher rates as the cost of receiving service from Kentucky-American, the existing ratepayers can and must be protected by the Commission. Therefore, if the company is unwilling to forecast its margins from the new Owenton customers for ratemaking purposes, the Commission should impose a tracker to cover such revenues and adjust the bills of Kentucky-American's current customers to reflect the increased margins from such customers automatically, rather than depending on the speculative filing of a future rate case.[28]

In addition to this action, the LFUCG respectfully requests that the Commission order Kentucky-American to file, with a copy to all parties to this proceeding, its updated five year business plan. (See Response to Question No. 8, LFUCG's Third Request for Information). Given the many changes occurring at

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[26] The company has not included any forecasted revenues for Owenton, although it forecast a "value contribution" of $86,460 for Owenton in 2005 as part of its five year business plan. See Supplemental Response to Question No. 176, Attorney General's First Request for Information, page 58 of 69.

[27] Including costs in the base period for developing the acquisition models and negotiations for the Owenton acquisition. See Response to Question No. 23, Hearing Data Requests.

[28] The Commission recently approved the continuation of such a tracker for AEP of Kentucky – this system sales tracker has been in effect for many years, and has substantially benefited ratepayers without harming the utility. See Order of December 13, 2004, Case No. 2004-00420.

Kentucky-American, it is essential that the Commission and Kentucky-American's customers have accurate information concerning the company's business plans and objectives.

X. LOW INCOME PROPOSAL

Kentucky-American has proposed to provide a $2 per month reduction in the customer charge for specified low income customers. The Company estimates the cost of this program to be $30,000, or about 2.5 cents per month for other customers. (See Miller Rebuttal Testimony at page 47). The LFUCG has no objection to this proposal, or to paying its fair share as a customer of the cost of this benefit to low-income customers, as the cost is minimal and the potential benefit for the proposed recipients is great.

Given the minimal cost to other ratepayers, the proposal does not appear to create an unreasonable preference or disadvantage for any customers. However, in order to assuage any possible concerns about the program, the Commission should clearly state that the proposal will not create any precedent to be used to argue for similar programs or for any other sort of special tariff for any other purpose.

XI. CONCLUSION

For the reasons provided above, Kentucky-American is not entitled to a rate increase in the amount sought, nor should the allocation of any rate increase be unfairly borne by the public fire hydrant classification. The company

seeks an excessive rate increase for public fire hydrants with nothing in the record to support it.

There is no basis to allow for the recovery of the accrued costs sought by the company, and the allowance of such costs by this Commission sends a strong signal that a utility is free to ignore the clear directive of the Commission at the ultimate expense of the rate payers. If adopted, the proposed activation fee should have restrictions placed on it that protect the LFUCG and other customers.

Finally, the ratepayers are being asked to pay for salaries and associated costs activities that do not benefit them, and the company is prematurely seeking to implement an Emergency Pricing Tariff without full input from the affected parties. Therefore, the LFUCG respectfully requests that the Commission deny Kentucky-American's Application for the amount sought and grant the LFUCG all of the relief that it has specified above, including but not limited to a *de minimis* (or no) increase to the public fire hydrant rates along with a return (with interest) of any overcharge retroactive to December 1, 2004, and all of the other relief it has requested above.

Respectfully submitted,

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CERTIFICATION

In accordance with the Commission's procedural orders the undersigned counsel hereby certifies that the original and one copy of the foregoing document have been filed by United States Mail, first class postage prepaid, to Elizabeth O'Donnell, Executive Director, Public Service Commission, 211 Sower Boulevard, P.O. Box 615, Frankfort, Kentucky 40602-0615, and by uploading the document to the file transfer protocol site designated by the Commission. The undersigned counsel hereby certifies that the electronic version is a true and accurate copy of the document(s) filed in paper medium, the electronic version has been transferred to the Commission, and the Commission and other parties have been notified by electronic mail that the electronic version has been transmitted to the Commission. Undersigned counsel also certifies that a copy of the foregoing was served by first class U.S. Mail delivery, postage prepaid, on the following, all on this the ____ day of January 2005:

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