

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE JOINT PETITION OF KENTUCKY-)	
AMERICAN WATER COMPANY, THAMES)	
WATER AQUA HOLDINGS GMBH, RWE)	
AKTIENGESELLSCHAFT, THAMES WATER)	
AQUA US HOLDINGS, INC., AND AMERICAN)	CASE NO. 2006-00197
WATER WORKS COMPANY, INC. FOR)	
APPROVAL OF A CHANGE IN CONTROL OF)	
KENTUCKY-AMERICAN WATER COMPANY)	

DIRECT TESTIMONY OF MICHAEL A. MILLER

June 5, 2006

1 **Q1. Please state your name and business address.**

2

3 A1. Michael A. Miller, 1600 Pennsylvania Avenue, Charleston, WV, 25302.

4

5 **Q2. What is your position with American Water Works Service Co.?**

6

7 A2. I am the Manager of Rates and Revenue for the Southeast Region of American Water
8 Works Service Company, Inc. In that capacity I also serve as the Treasurer/Comptroller
9 for Kentucky-American Water Company ("Kentucky American), Tennessee-American
10 Water Co., Virginia-American Water Co., Maryland-American Water Co.,and V.P &
11 Treasurer/Comptroller of West Virginia-American Water Co. and Bluefield Valley
12 Water Works Co.

13

14 **Q3. What are your responsibilities as manager rates and regulation for American Water
15 Works Service Co.?**

16

17 A3. I am responsible for the rate filings and other regulatory filings before the regulatory
18 commissions in Kentucky, Tennessee, Maryland, Virginia, Pennsylvania, and
19 West Virginia. I also oversee the preparation of budgets, forecasts, debt and equity
20 financings, and financial statements for the seven operating companies. I also work with
21 internal and external auditors in performance of their audits.

22

23 **Q4. Please describe your professional education and experience.**

24

25 A4. My professional education and work experience are attached to the testimony in
26 Appendix A.

27

28 **Q5. Have you previously testified before state utility regulatory bodies?**

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30 A5. I have appeared on numerous occasions before the regulatory commissions in Kentucky,
31 Tennessee, West Virginia, and Virginia.

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Q6. What is the purpose of your testimony in this case?

A6. In my testimony, I will address (1) Kentucky American’s current capital structure and continued access to the capital market, (2) the impact of the Proposed Transaction on the rates of Kentucky American’s customers, and (3) the current and future financial performance of Kentucky American.

CAPITAL STRUCTURE

Q7. Please describe Kentucky American’s capital structure?

A7. Kentucky American’s capital structure consists of common stock and equity, long and short-term debt, and preferred stock. All of Kentucky American’s common stock is and has been owned by American Water Works Company, Inc. (“American Water”). That will not change as a result of the merger of Thames Water Aqua US Holdings, Inc. (“TWAUSHI”) into American Water and the sale by Thames Water Aqua Holdings GmbH of up to 100% of the shares of common stock of American Water in one or more public offerings (“Proposed Transaction”).

Kentucky American has issued and outstanding long-term debt in the total principal amount of \$77,000,000 as of December 31, 2005. The long-term debt consists of (i) third-party debt issued by Kentucky American in the capital markets, and (ii) inter-company debt of Kentucky American issued to American Water Capital Corp. (“AWCC”). AWCC is a direct subsidiary of American Water. As of December 31, 2005, Kentucky American’s long-term debt consisted of \$23,500,000 in third party debt and \$53,500,000 in notes issued to AWCC. Kentucky American also had inter-company short-term debt as of December 31, 2005 of \$9,308,000. On June 12, 2007 \$24,000,000 of the long-term debt to AWCC will mature in the normal course of business.

1 American Water has utilized AWCC as its financing vehicle since before RWE's
2 acquisition of American Water. The purpose of AWCC is to borrow funds for the benefit
3 of American Water's operating subsidiaries and then loan such borrowed funds to the
4 operating subsidiaries. The advantage of this financing structure is that it allows
5 Kentucky American, and all other American Water operating subsidiaries, to benefit from
6 the economies of scale associated with group-wide financings. Those economies of scale
7 include improving the borrowing power and reduced administrative costs. Those benefits
8 will remain once RWE divests of American Water since AWCC will remain the
9 financing structure for American Water post divestiture.

10
11 **Q8. Describe any changes in Kentucky American's debt structure, if any, as a result of**
12 **the proposed transaction?**

13
14 A8. The Proposed Transaction will have no impact on the third-party debt. As a result of the
15 Proposed Transaction, Kentucky American has \$38,000,000 of inter-company long-term
16 notes that could be called depending on timing of the IPO. The short-term notes will also
17 need to be refinanced. Kentucky American will utilize AWCC to obtain the debt for this
18 refinancing. Kentucky American will file a separate petition for the refinancing if that is
19 required by the terms of the Order of the Commission approving the affiliated
20 arrangement between Kentucky American and AWCC.

21
22 **Q9. Will the proposed transaction result in any changes to Kentucky American's equity**
23 **to capital ratio?**

24
25 A9. No. Kentucky American expects to maintain its equity ratio between 40-45% of total
26 capital as it has historically done. As will be explained later in this testimony,
27 Kentucky American will require a major debt and equity investment over the next five
28 years to finance the planned capital investment, including the investment in the source of
29 supply solution mentioned by Mr. Rowe.

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RATES

Q10. Please explain how Kentucky American water will have the ability to provide adequate, economical and reliable water service at just and reasonable rates.

A10. Returning American Water to publicly-traded status will not impair the ability of Kentucky American to provide adequate, economical and reliable water service at just and reasonable rates. The Proposed Transaction makes American Water a publicly-traded company that can be focused on providing water and wastewater services to the public in North America.

Q11. Will the rates of Kentucky American customers increase as a result of the proposed transaction?

A11. No. The proposed transaction will have no material impact on Kentucky American. Any changes in the cost of service and rates after the Proposed Transaction will be the result of changes in the general business and economic conditions. Any future change in rates will occur only after modification of Kentucky American's approved tariff in a formal filing before the Commission.

KENTUCKY AMERICAN FINANCIAL POSITION

Q12. Describe Kentucky American's financial performance over the last five years?

A12. The Company has struggled. I have attached to this testimony Exhibit 1 that provides historical financial information for Kentucky American for the last five years. The Company has significantly underachieved its authorized ROE from 2001-2005. The earnings were particularly bleak for 2004 and 2005.

Q13. What were the factors that drove earnings down in 2004 and 2005?

1
2 A13. The Company was precluded from filing a rate case before March 14, 2004 as a condition
3 to the Change of Control Filing in Case No. 2002-0018, Application For Approval of
4 the Transfer of Control of Kentucky American Water Company to RWE
5 Aktiengesellschaft and Thames Aqua Holdings GMBH. Before rates from the 2004
6 case became effective in December 2004, Kentucky American had not had an increase
7 since November 27, 2000 (as amended by the Commission Order dated May 9, 2001).
8 During this time Kentucky American constructed capital improvements in excess of
9 \$60 million, experienced significant costs associated with additional security measures in
10 the post September 11, 2001 environment, and absorbed inflationary expense increases
11 including significant increases in employee benefit costs. In addition, 2004 was a wet
12 year and the average usage per customer for 2004 was significantly below the historical
13 trends. All of the above lead to a very disappointing financial performance in 2004.

14
15 Kentucky American placed rates in effect, subject to refund on December 1, 2004
16 (approved by final Order of February 28, 2005). Under normal circumstances this should
17 have placed it in a position to achieve an ROE at or near the authorized ROE from that
18 case during 2005. However, it was unsuccessful in convincing the Commission that rate
19 recovery for the security expenses deferred from 2002-2004 was appropriate, or that rate
20 recovery for the transition costs to the national call and shared service centers was
21 appropriate. The Commission's decision required Kentucky American to comply with
22 U.S. GAAP and write-off those expenses during 2005. These write-offs totaled
23 \$3,904,000 and were entirely borne by the Kentucky American's shareholders even
24 though the customers fully benefited from the additional security costs during 2002-2004,
25 and the customers received the full benefit of the cost savings and cost-effective services
26 from the shared services functions. These write-offs negated the impact of the 2004 rate
27 case on 2005 earnings. The shareholders have paid a hefty price regarding the rate filing
28 moratorium imposed on Kentucky American in the previous change of control
29 proceeding.
30
31

1 **Q14. Why is it important that Kentucky American remain financially strong?**

2
3 A14. Kentucky American faces unprecedented capital spending levels over the next five years.
4 It must maintain achieve financial results if it is to attract the necessary debt and equity
5 investment required to carry-out the major capital improvements that are required over
6 the next five years. Kentucky American has been assured that the capital investment will
7 be available for its construction plans, but as with any investment, the holder of that debt
8 and equity expects a fair and reasonable return on that investment commensurate with the
9 returns on investments of similar risk, such as, the other regulated subsidiaries of
10 American Water.

11
12 **Q15. Please explain the capital investment needed over the next five years?**

13
14 A15. In addition to the normal recurring capital investment, Kentucky American expects to
15 invest \$150 million between 2006-2010 to solve the source of supply deficit. To put this
16 in perspective, investment in the anticipated source of supply solution represents an
17 increase in capital spending of \$69.076 million or 85% over the total of the previous five
18 years .

19
20 **Q16. What other problems are presented by the anticipated investment in the source of
21 supply solution?**

22
23 A16. Without regular rate increases over this future construction period the earnings of
24 Kentucky American would be predominately driven by non-cash AFUDC. Clearly
25 capital investment of this magnitude comes with a substantial cost in rates. If no rate
26 increases were granted before completion of the project, the impact of the rate increase in
27 one case could constitute rate shock for the customers.

28
29 **Q17. How will the company address the capital investment situation?**

1 A17. Because of the unique situation of Kentucky American regarding its capital improvement
2 level, it plans to propose innovative rate making concepts for the Commission's
3 consideration. Kentucky American is aware that step-rate increases tied to CWIP levels
4 have been included as rate base and embedded in rates at pre-determined timeframes
5 during construction in the certificate filings in other states. Our research has not
6 indicated any instance where the Commission has approved that type of rate recovery in
7 Kentucky, but it would be one method to consider.

8
9 Another option would be to include CWIP in rate base, without imputing AFUDC related
10 to that CWIP in above the line revenues. The CWIP (without AFUDC) would require
11 regular general rate filings to address the significant CWIP associated with the multi-year
12 construction required for the source of supply project.

13
14 **Q18. Would either of the two methods address the earnings and cash concerns related to
15 the unprecedented capital improvement plan?**

16
17 A18. Yes, either method would permit Kentucky American to place in rates the large CWIP
18 balances related to the source of supply project during construction of the multi-year
19 project and permit it to maintain adequate earnings and interest coverage. In addition,
20 regular rate increases during the construction would permit a phased-in approach to rate
21 increases and avoid a significant rate shock to the customers if rate coverage for the
22 source of supply project were delayed until completion of the project. It will be critical
23 for Kentucky American to maintain reasonable earnings and adequate interest coverage
24 during the next five years if it is to attract the debt and equity investment required to
25 complete the capital improvement plan.

26
27 **Q19. Does this conclude your direct testimony?**

28
29 A19. Yes.

Appendix A

Resume of Michael A. Miller

I received my B.S. degree in Accounting from West Virginia Tech in May of 1976, and my West Virginia Certified Public Accounting Certificate on February 2, 1987.

I joined the American Water Works Service Company - Southern Division ("Service Company") in July of 1976, and have held various positions in the American Water System ("AWS") for over 29 years. I served as a Junior Accountant in the rate department until August 1977, at which time I was transferred to the Huntington Water Corporation as Accounting Superintendent. I held this position until July 1978, when I was transferred to the Southern Division Service Company as the Director - Budget Procedures, which position I held until April 1981. At that time, I became Customer Service Superintendent at West Virginia-American Water Company. In December 1981, I became Assistant Director of Accounting for the Southern Region Service Company. I held this position until August 1991, when I became the Business Manager at West-Virginia American Water Company. On January 1, 1994, I was promoted to Vice President and Treasurer at West-Virginia American Water Company. On April 1, 2000, I became an employee of the Service Company as Vice-President and Treasurer for the Southeast Region Companies located in West Virginia, Kentucky, Tennessee, Virginia, and Maryland. In January 2002 I was also named the Comptroller for each of the five Southeast Region Companies. In January 2004 my title was changed to Manager of Rates and Regulation for the Southeast Region of American Water Works Service Company and on May 16, 2006 I was given responsibility for the rates function for Pennsylvania American.

**Kentucky-American Water Company
Case No. 2006-00197**

Direct Testimony of Michael A. Miller

MAM - Exhibit 1

<u>(000) Omitted</u>	<u>Actual</u>					<u>Total</u>
	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	
Net Income	6,473	5,488	4,313	1,531	1,697	
Common Equity	60,997	61,768	62,689	62,525	62,523	
Total Capitalization	150,115	151,827	154,318	152,163	153,484	
ROE	10.61%	8.88%	6.88%	2.45%	2.71%	
Authorized ROE	11.00%	11.00%	11.00%	10.00%	10.00%	
Utility Plant Balance	249,932	261,177	274,545	289,329	315,488	
Approved Rate Base	136,822	136,822	136,822	156,262	156,262	
Capital Improvements	14,891	13,863	14,602	17,143	20,425	80,924
Cash from Operations	13,149	14,162	11,326	8,126	11,075	57,838
Cash Available for Construction	10,694	12,999	11,864	10,932	12,227	58,716
Cash Interest Coverage	3.50	3.87	3.45	2.60	2.99	