COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	:	
NOTICE OF ADJUSTMENT OF THE RATES OF	:	CASE NO. 2007-00143
KENTUCKY-AMERICAN WATER COMPANY	:	
EFFECTIVE ON AND AFTER MAY 30, 2007	:	

Direct Testimony of
Michael J. Majoros, Jr.

on Behalf of
the Office of the Attorney General

July 30, 2007

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<u>Introduction</u>

Q. State your name, position, and business address.

A. My name is Michael J. Majoros, Jr. I am Vice President of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"), located at 1111 14th Street, N.W., Suite 300, Washington, D.C. 20005.

Q. Describe Snavely King.

A. Snavely King is an economic consulting firm founded in 1970 to conduct research on a consulting basis into the rates, revenues, costs, and economic performance of regulated firms and industries. Snavely King represents the interests of government agencies, businesses, and individuals who are consumers of telecom, public utility, and transportation services.

We have a professional staff of twelve economists, accountants, engineers and cost analysts. Most of our work involves the development, preparation, and presentation of expert witness testimony before Federal and state regulatory agencies. Over the course of our 37-year history, members of the firm have participated in more than 1,000 proceedings before almost all of the state commissions and all Federal commissions that regulate utilities or transportation industries.

Q. Have you prepared a summary of your qualifications and experience?

A. Yes, Appendix A is a summary of my qualifications and experience. Appendix B contains a tabulation of my appearances as an expert witness before state and Federal regulatory agencies.

Q. For whom are you appearing in this proceeding?

A. I am appearing on behalf of the Attorney General of the Commonwealth of Kentucky ("AG").

<u>Subject and Purpose of Testimony</u>

Q. What is the subject of your testimony?

A. This case involves Kentucky-American Water Company's ("KAWC") Application to increase its service rates by $13.2 million or 25.10 percent.[1] The Company subsequently reduced its request to $11.0 million.[2] My testimony addresses the Company's filing including its depreciation proposals.

<u>Prior Experience</u>

Q. Do you have any specific experience in the public utility field?

A. Yes, I have been in the field of public utility regulation since the late 1970's. My testimony has encompassed numerous complex cost of service issues. Furthermore, I and other members of my firm specialize in the field of public utility depreciation. We have appeared as expert witnesses on this subject before the regulatory commissions of almost every state in the country.

<u>Summary of Company's Filing</u>

Q. Summarize the Company's filing.

A. KAWC's Application cites to its need to "expend money to renovate its existing facilities, to improve and enlarge its facilities, to construct new facilities, and to reinforce and extend its distribution system through the forecasted test year."[3] KAWC proposes

[1] KAWC Application, Statement and Notice ("Application"), page 3.
[2] KAWC Revised Schedule A.
[3] Id., page 1.

the twelve months ending November 31, 2008 as its forward-looking test period. It states "The increase in cost of service and the additional capital expenditures have not been offset by the additional income produced by the increase in rates effective December 1, 2004 in Case No. 2004-00103."[4]

Q. How did KAWC structure the timing of its filing?

A. KAWC used a base period of the twelve months ending July 31, 2007. KAWC states it will file "actuals" within 45 days after the last day of the base period. KAWC's forward-looking test period is the twelve months ending November 30, 2008.[5]

Q. Why did KAWC reduce its request from $13.2 million to $11.0 million?

A. The Company corrected many errors in its updated filing. One of the errors was its failure to "include the reclassified net salvage as recorded under FASB 143 in its regulated accumulated rate base reduction."[6] The Company's correction of that error has additional implications, as I shall discuss below.

<u>Case No. 2004-00103</u>

Q. Have you reviewed the Commission's Order in Case No. 2004-00103?

A. Yes, I have reviewed the Commission's Order in Case No. 2004-00103. KAWC proposed a $6.6 million increase, and the Commission authorized a $3.6 million increase in Case No. 2004-00103.[7]

<u>Summary of Conclusions</u>

Q. Please summarize your conclusions.

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[4] Id.
[5] Id., page 2.
[6] Response to PSCDR 1-5.
[7] Case No. 2004-00103, Commission Order Dated February 28, 2005, page 75.

A. My conclusions are as follows:

1. The company has an overall cost of capital of 7.77 percent.
2. The Company has a pro-forma test period rate base of $202,245,239.
3. The Company has pro-forma test period operating income of $12,785,107 at present rates.
4. KAWC's test period revenue deficiency is $4,840,724 in contrast to KAWC's claimed $11,005,465 revenue deficiency.

<u>Summary Explanation of Exhibits</u>

Q. Please summarize and explain the structure of your exhibits.

A. I have four exhibits consisting of varying numbers of schedules. Exhibit___ (MJM-1) contains my summary schedules. Exhibit___ (MJM-2) is a one-page exhibit containing Dr. Woolbidge's Cost of Capital recommendations. Exhibit___ (MJM-3) contains my rate base exhibits. These include a summary and my individual Adjustment Nos. 1 and 2. Exhibit___ (MJM-4) contains my operating income adjustments, which I have labeled Adjustment Nos. 3 to 10. I have summarized all of the rate based and operating income adjustments, including their individual revenue requirement impacts on Exhibit___ (MJM-1) Schedule 2.

<u>Cost of Capital</u>

Q. What overall cost of capital did you use to calculate your proposed revenue requirement?

A. I used Dr. Wooldridge's recommended capital structure and cost rates as summarized in Exhibit___ (MJM-2).

<u>Tax Rates and Conversion Factors</u>

Q. Please summarize and explain the income tax rates and conversion factors you used in your analyses.

A. I used all of KAWC's tax and conversion factors except that I changed the uncollectible factor from .85 percent to .79 percent. KAWC based its .85 percent on the 2004 to 2006 three-year average. This represents a startling increase since Case No. 2004-00103. While I am not challenging an increase, I note that the actual factors during the three subject years show a distinct downward trend. Hence, I used the most recent 2006 factor, which is .79 percent.[8]

Rate Base Adjustments

Q. Please explain your rate base adjustments.

A. I made two adjustments to KAWC's rate base claim. My Adjustment No. 1 increases accumulated depreciation corresponding to my depreciation rate and expense decrease adjustment. My Adjustment No. 2 reduces the cash working capital component of rate base in conjunction with our expense adjustments.

Q. Do you have any other comments concerning rate base?

A. Yes, I do. A major portion of KAWC's update was to reclassify an $8.7 million Regulatory Liability into accumulated depreciation. This Regulatory Liability resulted from prior charges to ratepayers, in the form of higher depreciation expense for future removal costs for which KAWC does not have any corresponding legal liability to spend the money. The Federal Energy Regulatory Commission ("FERC") defined these

[8] Response to PSCDR2-32.

amounts as non-legal asset retirement obligations ("AROs"). The public accounting profession's generally accepted accounting principles ("GAAP") and the Securities and Exchange Commission ("SEC") require reporting this amount as a liability to ratepayers.

The amount was originally included in accumulated depreciation, which reduces rate base. Consistent with GAAP and SEC rules, KAWC reclassified the amount to a Regulatory Liability. It failed, however, to reduce its rate base by the Regulatory Liability in its original filing. Without any other changes, I merely would have proposed that the Regulatory Liability be subtracted from rate base as it should be, and perhaps amortized back to ratepayers over the average remaining life of the corresponding plant. This recommendation would have resolved an issue that has arisen in several recent Kentucky cases in which I have testified. It would have enabled the Commission to recognize this amount as Regulatory Liability. In certain prior cases the Commission has chosen not to recognize this amount as a Regulatory Liability, however, in my opinion, this case provides an ideal opportunity to reconsider the issue.

Q. Do you have any other comments about this issue?

A. Yes, I do. While KAWC transferred the regulatory liability into accumulated depreciation for rate base purposes, it failed to adjust its depreciation study for the reclassification. That has an impact on depreciation rates because KAWC uses the remaining life depreciation technique to calculate depreciation. The remaining life technique incorporates the accumulated depreciation balances into the depreciation rate calculations. In this case, KAWC failed to recognize its reclassification in the depreciation study, which in turn resulted in overstated depreciation rates. I have corrected that mistake, but again, should the Commission decide to recognize the Regulatory Liability as a separate amount, this correction is not necessary.

The Commission has two options for this adjustment. The first alternative merely allows the amount to remain as a Regulatory Liability and reduce rate base by that amount. In conjunction with this approach, the Commission could amortize the regulatory liability over the remaining life of the plant, which is what will happen if it is included in accumulated depreciation. The second alternative is to accept KAWC's transfer; however, a corresponding recalculation of KAWC's depreciation rates is required to account for the additional reserve amount. I have used the second alternative in my exhibits.

Operating Income Adjustments

Q. Will you please explain your operating income adjustments?

A. Yes, I will. As you can see by referring to my Exhibit___ (MJM-1) Schedule 2, I have arranged my adjustments by order of magnitude from the largest to the smallest in terms of dollars.

Consolidated Tax Savings

Q. Please explain your Adjustment No. 3.

A. My adjustment No. 3 reduces KAWC's income tax expense by the average consolidated tax savings attributable to KAWC. I used the "effective tax rate methodology" approved the Commission in Case No. 2004-00103. This adjustment reflects the average tax losses, excluding regulated losses, for the three years ending in 2006.

Q. Do you agree with consolidated tax adjustments?

A. Yes, I do. In my opinion, it is incorrect to charge ratepayers for taxes that neither the Company nor its parent will not ultimately pay to the federal government.

<u>Excess Management Fees</u>

Q. What is the purpose of Adjustment No. 4?

A. Adjustment No. 4 removes $922,871 in excess management fees resulting from the Company's reorganization initiatives.

Q. Please explain the adjustment.

A. Company witness Michael Miller filed Exhibit MAM-7 to support the greatly increased level of management fees proposed in this case. According to Mr. Miller, the purpose of Exhibit MAM-7 is to "capture the effect of the reorganizations of [American Water Works] AWW and the impact on KAWC operations and costs."[9] Mr. Miller calculated a fully loaded 2008 labor cost based on 2001 pre-reorganization labor, overhead and management fees, adjusted for inflation and additional employees. He then compared these amounts to the equivalent amounts requested in this case. Based on his initial Exhibit MAM-7, Mr. Miller determined that "there had been a savings of "$365,012 from the reorganization of AWW and KAWC."[10]

Q. Did Mr. Miller provide a revised Exhibit MAM-7?

A. Yes. In response to PSC Data Request 3-13, Mr. Miller submitted a revised Exhibit MAM-7, which included several corrections.

Q. What result was calculated in the revised Exhibit MAM-7?

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[9] Direct Testimony of Michael Miller, p. 26.
[10] Direct Testimony of Michael Miller, p. 28.

A. Mr. Miller's revised Exhibit MAM-7 demonstrated that instead of a $365,012 savings from the reorganizations, there was a $1,002,235 increase in costs.

Q. Did Mr. Miller incorporate any additional adjustments into his revised Exhibit MAM-7?

A. Yes. In his updated Exhibit MAM-7, Mr. Miller incorporated several additional adjustments below his initial calculation. These adjustments decreased the cost increase to $256,395, which he then refers to as an "unexplained variance."[11]

Q. How did you calculate your adjustment?

A. I started with Mr. Miller's initial calculation of the $1,002,236 cost increase. I subtracted $79.365 of management fees related to business development that I address in my adjustment No. 8. Adjustment No. 7 eliminates the remaining $922,871, which I removed from management fee expense.

Q. Why did you use the $1,002,236 amount as your starting point?

A. It is inappropriate for service company management fees to increase operating company costs charged to ratepayers. I used this amount because it is equivalent to what Mr. Miller initially reported in his testimony. I have disregarded the additional adjustments on the revised Exhibit MAM-7 because initially Mr. Miller did not deem them important enough to make.

<u>Depreciation Expense</u>

Q. Please explain your adjustment No. 5.

A. My adjustment No. 5 reduces the Company's overall depreciation expense request for

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[11] Response to PSC 3-13, Exhibit MAM-7, p. 1 of 2.

two reasons.[12] First, I have added KAWC's Regulatory Liability for non-legal AROs back to the accumulated depreciation balances used in the depreciation study. This is consistent with KAWC's rate base reclassification in its updated filing. I distributed the additional reserve to the accounts that had negative net salvage ratios underlying their current depreciation rates. This adjustment reduces the resulting depreciation rates and expense because the additional reserve is effectively flowed back to ratepayers over the remaining life of the plant. Should the Commission decide to require KAWC to continue to report the amount as a Regulatory Liability, it could accept the Company's revised depreciation rates as filed, with one exception.

Q. What is the exception?

A. The exception is plant account 333-Services where the Company's depreciation witness Mr. Spanos is proposing a negative 120 future net salvage ratio. That ratio contains a substantial amount of future inflation that has not been incurred. This results from the mechanics of allocating replacement project cost of removal and also from the nature of the analysis Mr. Spanos used as a basis for his recommendations. The future net salvage ratio should be stated at its present value, not its future inflated value.

Q. Are Mr. Spanos' other negative net salvage ratios stated at their present value?

A. As shown on Exhibit___(MJM-4) Schedule 3 page 5, Mr. Spanos appears to have made a conscious effort to remove future inflation from the other cost of removal ratios he is recommending. In fact, Mr. Spanos states, "No inflation factor expected to be incurred in

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[12] KAWC's Depreciation Study was conducted by John J. Spanos. Mr. Spanos used the straight-line, vintage group, remaining life method, procedure and technique to calculate rates.

the future is included in Mr. Spanos' net salvage recommendations."[13] Mr. Spanos also states, "There is no future inflation built into the net salvage estimate of the depreciation studies."[14]

Q. How did Mr. Spanos remove the future inflation from his future net salvage estimates?

A. Mr. Spanos used his judgment to remove the future inflation from his future net salvage estimates. While I could challenge some of his ratios, I am generally inclined to accept them since at least theoretically they are stated at their "present value."

Q. What is wrong with Mr. Spanos' recommendation for account 333-Service?

A. Notwithstanding his judgmental adjustment, Mr. Spanos still proposes a future net salvage ratio for this account that is far too negative. It will seriously contribute to the growing Regulatory Liability for non-legal AROs. Mr. Spanos' negative 120 percent future net salvage will increase the regulatory liability because the annual accruals will vastly exceed KAWC's annual cost of removal experience. Furthermore, the negative 120 percent sticks out like a sore thumb when compared to Mr. Spanos' more reasonable future net salvage ratios.

Q. Is there any factual basis for Mr. Spanos' negative 120 percent ratio?

A. No, it is entirely judgmental.

Q. What do you recommend?

A. I recommend a negative 20 percent net salvage ratio for account 333-Services. This is clearly more reasonable on its face, and it is much closer to the true present value

[13] Response to AG 186.
[14] Id., 188.

estimate for this account.

Q. Do you have any evidence to support your claim that negative 20 percent is much closer to the true present value estimate for this account?

A. Yes, on Exhibit__(MJM-4) Schedule 3, page 4, I have multiplied KAWC's actual average net salvage experience for this account by its remaining life to obtain a present value estimate of the total future net salvage. This estimate is approximately 17 percent of the existing plant balance. Hence, I conclude that negative 20 percent is reasonable, on not only its face, but also based on KAWC's actual experience.

Q. Have you calculated depreciation rates using the negative 20 percent for Account 333-Services?

A. Yes, the rates are included in Exhibit___(MJM-4) Schedule 3, page 2. My Adjustment No. 5 incorporates both the negative 20 percent for Services and the reclassification of KAWC's Regulatory Liability for non-legal AROs.

<u>Incentive Pay</u>

Q. What is the purpose of Adjustment No. 6?

A. Adjustment No. 6 removes $252,550 in incentive pay from labor expense.

Q. How did the Commission treat incentive pay in the last case?

A. In Case No. 2004-00103, the Commission disallowed incentive pay because the Company could not demonstrate that the costs of incentive plans benefit ratepayers and thus should be recovered through rates.[15] In that case the AG recommended disallowance of the incentive pay tied to the financial performance of the Company, while allowing the

[15] Case No. 2004-00103, Order issued February 28, 2005, p. 49.

remaining portion tied to operational and individual performance metrics.[16] The Commission noted that KAWC was not able to provide any studies demonstrating that incentive plans of any type provided benefits to ratepayers, and opted to remove the entire incentive pay claim.[17]

Q. Has the Company made any changes to its incentive plans in this case to address the AG's recommendations in the last case?

A. Yes. In response to PSC Data Request 2-5, the Company notes that the 2007 Annual Incentive Plan ("AIP") has "been modified to be more heavily weighted to the operational and individual goals than the AIP in place at the time of the Company's last rate filing" and it does not have a Long-term Incentive Plan ("LIP") in place at this time.[18]

Q. Has the Company produced any studies that show the benefits of incentive plans to ratepayers?

A. No. PSC Data Request 3-3 asked for such studies, but as in the last case, KAWC was not able to provide any.

Q. What do you recommend?

A. Although the Company has reduced the weighting in its incentive plans related to financial performance, it still is unable to provide any studies demonstrating that incentive plans benefit ratepayers. Therefore, I recommend disallowance of the entire $252,550 incentive pay amount, consistent with the Order in the last case.

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[16] Id., p. 48.
[17] Id., p. 49.
[18] Response to PSC 2-5a.

<u>Group Insurance</u>

Q. Please explain your Adjustment No. 7.

A. My adjustment No. 7 disallows an 8 percent increase for group insurance. Staff asked KAWC to provide the documents upon which the Company relied to support its proposed 8 percent increase to this expense.[19] KAWC responded with a few pieces of paper "which is the latest information on medical trends as supplied by the Company's actuary Towers Perrin."[20] I reviewed that information but did not find any justification for the increase, merely a general assumption there would be such an increase. I recommend disallowance of this increase for the same reason the Commission disallowed certain expenses in Case No. 2004-00103, i.e., there is insufficient support to accept the increase.

<u>Business Development Portion of Management Fees</u>

Q. What is the purpose of Adjustment No. 8?

A. Adjustment No. 8 removes $79,365 in management fees related to business development.[21]

Q. Why have you made this adjustment?

A. The Company states that, "the BD function is responsible for developing a comprehensive plan for all potential growth opportunities of KAWC."[22] While growth opportunities can be good for an organization, they primarily benefit shareholders. It is true that by growing their system, KAWC is able to spread its fixed costs over more ratepayers, however, in many cases "growth" comes with a price, as the Company incurs

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19 Response to PSCDR 2-24.
20 Id.
21 See response to PSC DR 2-22, p. 2.
22 See response to PSC DR 2-22, p. 2.

large capital expenses to bring the acquired water systems up to par. Improving the water system is good public policy, and I do not object to ratepayers funding such improvements, if they are reasonable. However, shareholders should fund business development costs. As such, I have removed the $79,365 portion of management fees related to business development.

<u>Wastewater Technician</u>

Q. What is the purpose of Adjustment No. 9?

A. Adjustment No. 9 removes $12,497 in labor related to the wastewater duties of a Production Maintenance Technician employee.

Q. Why have you made this adjustment?

A. In response to PSC Data Request 3-1, the Company calculated that $12,497 of the fully loaded labor amount related to a Production Maintenance Technician position relates to wastewater. Therefore, I have removed this amount from labor expense.

<u>Interest Synchronization</u>

Q. Please explain your adjustment No. 10.

A. My adjustment No. 10 synchronizes the interest expense resulting from my recommended rate base and Dr. Wooldridge's capital structure and cost of capital, with the tax allowance calculation.

<u>Summary</u>

Q. Please summarize your testimony and recommendations

A. KAWC initially proposed a $13.2 million increase, which it subsequently reduced due to corrections of errors throughout the filing. One of the major errors was its failure to reduce rate base by its $8.7 million Regulatory Liability relating to non-legal AROs. This correction reduced KAWC's initial increase by 17 percent to $11 million. The rest of KAWC's rate case is driven primarily by capital additions, an overstated cost of capital, and several overstated operation, maintenance and tax-related expenses. I have, however, adjusted or eliminated several of the expense overstatements. The adjustments, combined with Dr. Woodbridge's cost of capital result in an AG proposal of a $4.8 million revenue increase. This is a reasonable amount. Further, I note that the lack of discussion in my testimony of any other aspects of the Company's request does <u>not</u> constitute an endorsement of such aspects.

Q. Does this conclude your testimony?

A. Yes, it does.