COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	**)**	
	)	
NOTICE OF ADJUSTMENT OF THE RATES OF	**)**	**CASE NO. 2008-00427**
KENTUCKY-AMERICAN WATER COMPANY	**)**	
EFFECTIVE ON AND AFTER NOVEMBER 30, 2008	**)**	

DIRECT TESTIMONY OF SHEILA A. MILLER

October 31, 2008

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2008-00427
Direct Testimony
Sheila A. Miller

1. Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS FOR THE RECORD.

A. My name is Sheila A. Miller and my business address is 1600 Pennsylvania Avenue, Charleston, West Virginia 25302.

2. Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the American Water Service Company, Inc. ("Service Company") as Manager of Rates and Regulation for the Eastern Regional Service Company Office.

3. Q. PLEASE ELABORATE UPON YOUR DUTIES AS MANAGER OF RATES AND REGULATION FOR THE EASTERN REGIONAL SERVICE COMPANY.

A. My responsibilities include the preparation and presentation of rate filings requested by three operating companies comprising a portion of the Eastern Region of American Water. I am also responsible for various accounting duties including account reconciliation and financial statement analysis.

4. Q. HAVE YOU PREVIOUSLY PARTICIPATED IN REGULATORY MATTERS?

A. Yes, I have prepared rate cases and presented testimony before the Kentucky Public Service Commission, Tennessee Regulatory Authority and the State Corporation Commission of Virginia. I have also worked on the preparation of exhibits and data requests for West Virginia American.

5. Q. WOULD YOU PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE?

A. Yes. In 1983, I graduated Summa Cum Laude with a Bachelor of Arts degree from Glenville State College with a major in Accounting and Management, and a minor in Economics. In 1988, I received my Certified Public Accountant license.

I have worked in the American System for 24 years and began my career in December 1984 as a Junior Accountant. In that capacity I worked in the Construction Accounting Department for the Service Company.

I assisted with the system-wide acquisition integration of Citizens Water by serving on the Acquisition Team. I also participated in the set up of the system-wide conversion process for the Shared Services Center by assisting Information Services with reporting processes.

Throughout the years, I have moved through the ranks of the financial side of the business from Accountant in 1985, Construction Accounting Supervisor for the Southeast Region in 1988, Construction Accounting Superintendent for West Virginia American Water Company in 1992, Assistant Director of Accounting for West Virginia American in 1995, Director of Accounting for West Virginia American in 1997, Director of Accounting for the Southeast Region in 2000, and due to the reorganization of the Shared Services Center, I was transferred to Senior Financial Analyst for the Southeast Region in 2002. In 2008 I was promoted to Manager of Rates and Regulation. I have significant knowledge and expertise in accounting and other financial aspects of American Water, including Kentucky American Water.

6. Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

The purpose of my testimony is to support the Company's adjustments to forecasted Labor, Purchased Water, Group Insurance, Regulatory Expense, Insurance Other than Group, Customer Accounting, Rents, General Office Expense, Miscellaneous Expense, and General Taxes. I will discuss the Rate Base for rate recovery and I will also address the Filing Requirements and the General Rate Case Structure.

7. Q. WHAT IS THE AMOUNT OF THE REVENUE INCREASE THAT THE COMPANY IS REQUESTING?

A. The Company is requesting an overall revenue increase of $18,494,634 or 31.27%.

8. Q. WHAT IS THE TEST PERIOD REFLECTED IN THIS CASE?

A. The Company has used a forecasted test period of the twelve months ending May 31, 2010 and a base period of twelve months ended January 31, 2009. The base period data reflects six months of actual data and six months of forecasted data.

9. Q. MRS. MILLER, WHAT GUIDELINES HAS THE COMPANY FOLLOWED IN ADJUSTING THE BASE PERIOD DATA?

A. The Company has adjusted its base period revenues, expenses, rate base and capitalization to reflect these items based on a forecasted test period ending May 31, 2010. The Company has utilized the same guidelines in developing its forecasted test period as it uses in its budgeting process. These guidelines are designed to reflect, as accurately as possible, the Company's need to operate and maintain its assets, provide quality service to its customers and provide a reasonable return to its stockholder.

10. Q. MRS. MILLER, WOULD YOU PLEASE SUMMARIZE THE COMPANY'S RATE FILING?

A. Yes. As noted earlier, the Company is filing this application for an increase in rates based upon a fully forecasted test period of 12 months ending May 31, 2010, as currently allowed by 807 KAR 5:001 Section 10(1)(b). The Commission has outlined various filing requirements concerning a forecasted test period. The Company's filing is supported by a series of 37 exhibits. We have allocated direct and indirect costs between the water and sewer operations which will be discussed in the testimony of Mr. Michael Miller.

11. Q. MRS. MILLER, ARE THERE ANY EXHIBITS YOU WISH TO COMMENT ON BEFORE YOU CONTINUE?

A. Yes. I would like to briefly discuss Exhibit 37. Exhibit 37 represents the standard schedules required by the Commission when a utility files a general adjustment in rates supported by a forecasted test period. This exhibit contains 14 schedules identified as Schedules A through N. I would like to identify each schedule.

Schedule A is a jurisdictional financial summary for both the base period and the forecasted period, which details how the utility derived the amount of the requested revenue increase.

Schedule B is a jurisdictional rate base summary for the base period and the forecasted period with the supporting schedules, which include detailed analysis of each component of rate base.

Schedule C is a jurisdictional operating income summary for the base period and the forecasted period with supporting schedules that are broken-down by major account group and by individual account.

Schedule D is a summary of jurisdictional adjustments to operating income by major account with supporting schedules for individual adjustments and jurisdictional factors.

Schedule E is the jurisdictional federal and state income tax summary for the base period and the forecasted period with supporting schedules of the various components of jurisdictional income taxes.

Schedule F contains summary schedules for the base period and the forecasted period of organization membership dues, initiation fees, expenditures at country clubs, charitable contributions, marketing, sales, and advertising expenditures, professional service expenses, civic and political expenses, expenditures for employee awards functions and outings, employee gift expenses, and rate case expenses.

Schedule G is an analysis of payroll costs including schedules for wages and salaries, employee benefits, payroll taxes, straight time and overtime hours, and executive compensation.

Schedule H is a computation of the gross revenue conversion factor for the forecasted period.

<u>Schedule I</u> provides comparative income statements, revenue statistics and sales statistics for the five most recent calendar years from the application filing date, the base period, the forecasted period, and two calendar years beyond the forecast period.

<u>Schedule J</u> provides a cost of capital summary for both the base period and forecasted period and supporting schedules providing detail on each component of the capital structure.

<u>Schedule K</u> provides comparative financial data and earnings measures with the 10 most recent calendar years, the base period and the forecasted period.

<u>Schedule L</u> provides a narrative explanation of all proposed tariff changes.

<u>Schedule M</u> provides a revenue summary for both the base period and forecasted period with supporting schedules, which provide detailed billing analyses for all customer classes.

<u>Schedule N</u> provides a typical bill comparison of the present and proposed rates for all customer classes.

12. Q. WHAT IS THE SOURCE OF THE INFORMATION CONTAINED ON THE EXHIBITS 1 THROUGH 37 AND SCHEDULES MARKED A THROUGH N UNDER EXHIBIT 37?

A. The information utilized in all exhibits and schedules was taken from the books and records of the Company or from information provided to me and other Company witnesses and by management of the Company. Where appropriate, each schedule refers to a supplementary schedule or work paper, which was used to develop Exhibit 37. Each schedule also identifies a witness or witnesses who will be responsible for responding to questions concerning information on the schedule.

OPERATION & MAINTENANCE EXPENSES

13. Q. HOW DID THE COMPANY CALCULATE THE FORECASTED LABOR EXPENSE?

The Company calculated the labor expense by individual employee. Each employee's wages were adjusted to the wage level that would be paid during the forecasted test period. Hours were budgeted to O & M and Capital for a total of 2088 hours and a forecasted number of overtime hours. The hours that employees devote to the sewer operations were eliminated from the filing. A capitalized percentage of 21.06% was calculated based on the budgeted wages between O & M and capital. As a result this amount was excluded from O & M labor expense. Labor expense for the forecasted period is $7,062,548.

14. Q. PLEASE EXPLAIN THE CALCULATIONS OF THE FORECASTED LEVEL OF PURCHASED WATER EXPENSE.

The Company purchases water from Winchester Municipal Utilities (WMU) for Central Division customers in Clark County. The Agreement with WMU to purchase water expires October 13, 2021. The Company also purchases water from Georgetown Municipal Water and Sewer System (GMWSS) for water sold in Owen County. Additional purchases for the Northern Division are made from Carroll and Gallatin Counties. The forecasted Purchased Water Expense was estimated based on the actual usage during the twelve months ending July 2008 and applying the appropriate cost rate per cubic feet. Purchased water expense for the forecasted test year is $114,586.

15. Q. HOW DID THE COMPANY CALCULATE ITS GROUP INSURANCE EXPENSE?

A. The total group insurance expense for the forecasted test year is $1,810,270. This expense is comprised of 1) current group insurance costs for current associates and 2) post retirement employee benefits costs (OPEB's) for both its current employees and its retired employees.

The OPEB's expense is based on projections provided by the actuarial firm of Towers Perrin.

The current group insurance costs reflect the use of the Company's current group insurance premium statement rates in effect as of July 31, 2008. These rates were then applied to the current coverage levels for the full time employees included in the Company's case. Since 21.06% of the labor expense is capitalized, this same percentage of group insurance expense was eliminated from O & M.

The Company provides its current associates with life insurance, group medical insurance, prescription drug, accidental death, accident, sickness and disability coverage.

16. Q. WHAT ARE REGULATORY COMMISSION EXPENSES?

A. Regulatory expenses are estimated costs incurred for preparing and litigating this case, including studies and investigations. We are requesting a three-year amortization of rate case expense and a five-year amortization of the cost of service study expense.

17. Q. HOW WAS KENTUCKY-AMERICAN WATER'S LEVEL OF INSURANCE OTHER THAN GROUP EXPENSE CALCULATED?

A. KAW's level of insurance other than group is based on the Company's estimated premiums for 2009 and 2010. Insurance other than group includes payments for insurance to cover such items as excess general liability, property liability, fiduciary liability, commercial crime coverage, flood liability and worker's compensation. The insurance other than group for the forecasted period is $694,598.

18. Q. PLEASE DISCUSS KENTUCKY-AMERICAN WATER'S FORECASTED LEVEL OF CUSTOMER ACCOUNTING EXPENSE.

A. KAW's customer accounting expense includes costs for such items as postage, telephone, forms utilized for customer service and billings, uncollectible accounts and collection agencies. This is not a complete listing but it does represent most of the larger dollar items in this expense. In comparison, our forecast is slightly above the amount experienced in the base period. The forecast reflects an expense of $1,598,785 for customer accounting costs. The uncollectible percentage was calculated using a three-year average and applied to forecasted revenues at present rates.

19. Q. CAN YOU PLEASE DESCRIBE WHAT ITEMS ARE INCLUDED IN RENT EXPENSE?

A. KAW's forecast for rent expense is based upon signed agreements and anticipated agreements. These agreements cover such items as copiers and a postage machine. These items were all included in KAW's previous rate case. The rent expense included in the forecast is $31,968.

20. Q. PLEASE EXPLAIN WHAT ITEMS ARE INCLUDED IN THE GENERAL OFFICE CATEGORY.

A. Items in this category include dues and memberships, employee travel and meal expenses, office supplies, and general office utility costs. The Company's forecasted expense is $576,256.

21. Q. WHAT IS INCLUDED IN THE CATEGORY OF MISCELLANEOUS EXPENSES?

A. Included in this category are various expense items that are incurred throughout the year that are a part of carrying out of normal business functions. Included in this category are costs for services such as janitorial, legal, advertising, employee training programs, uniforms, telephone and some amortizations. Also included are expenditures related to conservation and security services, as well as amortizations for the non-revenue water study and water conservation study. The Company's forecast for miscellaneous expense is $3,288,854.

<u>**GENERAL TAXES**</u>

22. Q. PLEASE DISCUSS EACH COMPONENT OF THE COMPANY'S FORECASTED LEVEL FOR GENERAL TAXES.

A. The first component that I will discuss is property taxes. The Company's forecasted level of property tax is $3,113,602. It is based upon a ratio of the actual 2007 tax payments to the applicable total tax base as of December 31, 2006. The rate of $.9777 per $100 of property was applied to the projected tax base of December 31, 2008 and to the projected tax base of December 31, 2009 to arrive at a forecasted property tax expense for the 12-months ended May 31, 2010.

The second component of General Taxes is the Public Service Commission Fee. The Company has forecasted its Public Service Commission (PSC) fee for the forecasted test period by arriving at an average PSC fee rate of .1651%. The percent was calculated by dividing the actual tax payments for 2006-2008 by their associated revenues and then calculating a three-year average PSC fee rate. By applying this three-year average PSC fee rate to the total forecasted revenues, less AFUDC, the Company's forecasted level of PSC fee is $97,656 at present rates.

The final component of General Taxes is payroll taxes. The Company has forecasted its payroll tax expense based upon the forecasted level of labor costs. For FICA taxes, the rate used was 6.2% on a base of $109,740 and a Medicare tax rate of 1.45% on all wages. Federal unemployment is calculated based upon a tax rate of .8% and a base of $7,000. State unemployment tax of .5% is calculated on a base of $8,000. These tax rates and bases were then applied to the total forecasted level of labor cost with amounts being expensed and capitalized. The Company's total forecasted level of payroll tax expense is $541,285.

Total forecasted General Taxes is $3,752,543 at present rates.

RATE BASE

23. Q. MRS. MILLER, HOW DID THE COMPANY DEVELOP ITS FORECASTED LEVEL OF RATE BASE OF $305.544 MILLION AS SHOWN ON SCHEDULE B-1, PAGE 2 OF 2?

A. The Company developed its rate base by using a 13-month average for most of the items shown on Schedule B-1, page 2 of 2. Some of the elements were calculated using a 24-month average based on the Commission's final order in Case No. 1997-034. Many of the rate base elements shown on this schedule, i.e., utility plant in service, accumulated depreciation, customer advances, etc. were analyzed from actual per books data as of July 31, 2008. Using data and projections for each of the rate base elements, the Company developed a 13-month average for the forecasted test period ending May 31, 2010.

24. Q. PLEASE DESCRIBE HOW THE 13-MONTH AVERAGE FOR THE UTILITY PLANT IN SERVICE (UPIS) WAS CALCULATED?

A. The starting point for the calculation of the 13-month average for utility plant in service was the actual level as of July 31, 2008. From that point through the end of the test period, the Company has forecasted capital expenditures by month for investment projects DV through S (normal recurring plant investment) and for special Investment Projects (IP) that are related to larger, specific capital investment projects. These capital expenditures have been approved by the Company's Board of Directors. The forecasted expenditures for all projects were slotted by month based upon the expected cash flow of each project. When the project is complete, all expenditures related to that project will be placed into service. Therefore, the 13-month average of forecasted utility plant in service only reflects the inclusion of projects when they are complete and in service.

The Company also projects utility plant retirements by month. These retirements were deducted from the balance of utility plant in service in the month in which the retirement is expected to occur. Ms. Bridwell will be discussing in further detail in her testimony the Company's planned capital investment program for 2009 and 2010. Mr. Miller will be discussing the details of the source of supply project in his testimony. The total 13-month average forecasted level of Utility Plant in Service is $387.568 million.

25. Q. PLEASE DISCUSS THE REMAINING RATE BASE ELEMENTS ON SCHEDULE B-1, PAGE 2 OF 2.

A. <u>Rate Base - Utility Plant Acquisition Adjustment (UPAA)</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is utility plant acquisition adjustments. The actual balance in the account as of July 31, 2008 was $35,889. The UPAA relates to the Acquisition of the Boonesboro Water Association. The Company is using a 10-year amortization based on prior Commission treatment of UPAA for Boonesboro. The level included in the 13-month average rate base calculation (net of amortizations) for the UPAA in rate base is $18,488 which includes only Boonesboro.

<u>Rate Base - Accumulated Depreciation</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is accumulated depreciation. The accumulated depreciation was developed in the same manner as the utility plant in service. The actual balance as of July, 2008 was used as a starting point. This balance was adjusted for forecasted depreciation expense by month, and forecasted retirements by month. The depreciation rates used to develop this item of rate base were those approved in Case Number 2007-00143. The accumulated reserve for depreciation was developed by month by account from May 2009 through May 2010, with a 13-month average balance of $98.516 million being deducted from rate base.

<u>Rate Base - Construction Work in Progress (CWIP)</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is Construction Work in Progress. The Company is proposing to include in its 13-month average rate base a level of CWIP for the forecasted test period. The 13-month average is $102.817 million. This amount is based on the actual balance as of July 2008, adding forecasted expenditures by month and then deducting amounts transferred to Utility Plant in Service. The forecasted expenditures for all projects were taken from the approved capital expenditures plan and were slotted by month based on expected cash flow. When a project (work order) is complete and in service, the dollars are transferred from CWIP to UPIS.

26. Q. MRS. MILLER, THE RATE BASE ELEMENT AS SHOWN ON SCHEDULE B-5, PAGE 2 OF 2 IS THE WORKING CAPITAL ALLOWANCE. WHAT IS WORKING CAPITAL AND WHAT METHOD DID THE COMPANY USE IN CALCULATING ITS WORKING CAPITAL ALLOWANCE IN THE CASE?

A. Working capital is a rate base element that recognizes the amount of investor supplied funds that are used to fund the day to day operations of the Company and to recognize the delay in the recovery of certain expenses from the customers. The Company is using a lead/lag study that was prepared in Case No. 2004-00103. The Company is proposing a working capital allowance of $4.271 million.

27. Q. PLEASE CONTINUE WITH YOUR DISCUSSION OF RATE BASE.

A. <u>Rate Base - Contributions in Aid of Construction</u>

The next rate base element as shown on Schedule B-1, page 2 of 2 is Contributions In Aid of Construction (CIAC). Again, this element was developed by starting with the actual balance as of July, 2008. The Company has forecasted an increase in these contributions based upon either:

1) Direct contributions from developers, businesses or government agencies.
2) Increases in CIAC as a result of transfers from Customer Advances after 10-year agreements expire.

The 13-month average balance was developed by analyzing the forecasted activity in the CIAC accounts beginning with May, 2009 through May, 2010 resulting in a forecasted 13-month average balance of $45.275 million.

The Company's forecasted CIAC balance includes the impact of the Company's proposed revision to the tap fee tariff. The revised tap fee tariff is found under Exhibit 2 of the Company's filing.

The revised tap fee tariff indicates the Company will collect from developers or other parties $702 for residential service, $1,287 for 1” service, and $3,129 for 2” service, which is based on a 3-year average of actual costs to install these services and the cost of a meter. The tap fee for services over 2” is based on the actual cost of installation.

The Company forecasts collection of CIAC from the revised tap fee tariff of $1.002 million with the new tap fee becoming effective June 1, 2009. Mr. Cartier will discuss the calculation of the proposed revision to the tap fee tariff in his direct testimony.

<u>Rate Base - Customer Advances</u>

The next rate base element is customer advances. The 13-month balance for customer advances was developed in the same manner as were CIAC’s. The Company forecasted receipts and refunds of customer advances and transfer of customer advances to the contributions account by month through the end of the forecasted test period, thus resulting in a 13-month average balance of $15.618 million for the forecasted test period. These forecasted receipts are based on management discussions with local developers and refunds are based on a review of historical trends in this category.

<u>Rate Base - Deferred Income Taxes</u>

Deferred Income Taxes are included in rate base as a reduction to the forecasted 13-month average rate base. The forecasted amount in rate base is $33.911 million. The forecasted amount is shown on Schedule B-1, page 2 of 2 and further detailed on B-6, page 2 of 2 and in the workpapers. There are Deferred Taxes associated with UPIS, Deferred Maintenance, and Deferred Debits. All of these items have been recognized by the Commission in prior cases.

In this rate case the Company has incorporated SFAS 109 – Accounting for Income Taxes. Both the rate base reduction for income taxes and the calculation of forecasted federal and state income tax expense is based on SFAS 109.

Rate Base - Deferred Investment Tax Credit

The next rate base element is deferred investment tax credit. The Company is currently amortizing its 3% deferred investment tax credit (pre-1971). The actual balance of the 3% deferred investment tax credit as of the end of July, 2008 was $97,362. The forecasted monthly amortization is applied, producing a forecasted test-year, 13-month average balance of $83,326 which is being deducted from rate base.

Rate Base-Deferred Maintenance

The next rate base element is deferred maintenance. The Company has developed a 13-month average of deferred maintenance projects based upon both actual projects deferred and projects forecasted to be deferred.

These projects include the repainting and repairs of system water storage tanks, and other major repairs of pumps and traveling screens as shown in the workpapers that support Schedule B. New deferred maintenance items include five tank paintings scheduled for completion by May 2010, three hydrotreator paintings, KRS clearwell painting, and hydrant painting at a total cost of $2,880,000. These types of deferred maintenance expenses have been afforded rate making treatment by the Commission in past proceedings. Based upon these actual expenditures and the forecasted expenditures for 2009 thru May 2010, as adjusted for amortizations, the Company has developed a 13-month average of these deferred maintenance items totaling $2.952 million.

Rate Base - Deferred Debits

The Company is requesting a rate base addition of $1.959 million for various deferred debit items. These amounts are offset by their applicable deferred taxes discussed earlier. The Company developed its 13-month average addition to rate base for items both deferred and recognized in prior cases by the Commission. There are two new deferred items being requested in the current case which includes the Non-Revenue Water Study and the Water Conservation Study. Mr. Keith Cartier will discuss the Non-Revenue Water Study and Ms. Linda Bridwell will discuss the Water Conservation Study in their testimonies. The Company is seeking a five-year amortization of both studies.

28. Q. MRS. MILLER, PLEASE CONTINUE WITH THE NEXT RATE BASE ELEMENT SHOWN ON SCHEDULE B-1, PAGE 2 OF 2.

A. The next Rate Base element is titled Other Rate Base elements, which is comprised of five items as discussed below:

Rate Base – Other Rate Base Elements

In Case No. 2004-00103, the Commission reduced rate base for Contract Retentions, Unclaimed Extension Deposit Refunds, Retirement Work in Progress, Deferred Compensation and Accrued Pension. The Company has calculated a rate base reduction of $1.212 million for these items consistent with the Commission's Order in Case No. 2004-00103.

29. Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.