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

AND EXHIBITS

OF

ROBERT J. HENKES

PUBLIC VERSION - REDACTED

On Behalf of the Office Of Rate Intervention Of The Attorney General Of The Commonwealth Of Kentucky

February 23, 2009

Kentucky-American Water Company
Case No. 2008-00427
Direct Testimony of Robert J. Henkes

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I. STATEMENT OF QUALIFICATIONS

Q. WOULD YOU STATE YOUR NAME AND ADDRESS?

A. My name is Robert J. Henkes and my business address is 7 Sunset Road, Old Greenwich, Connecticut 06870.

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. I am Principal and founder of Henkes Consulting, a financial consulting firm that specializes in utility regulation.

Q. WHAT IS YOUR REGULATORY EXPERIENCE?

A. I have prepared and presented numerous testimonies in rate proceedings involving electric, gas, telephone, water and wastewater companies in jurisdictions nationwide including Arkansas, Delaware, District of Columbia, Georgia, Kentucky, Maryland, New Jersey, New Mexico, Pennsylvania, Vermont, the U.S. Virgin Islands and before the Federal Energy Regulatory Commission. A complete listing of jurisdictions and rate proceedings in which I have been involved is provided in Appendix I attached to this testimony.

Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?

A. Prior to founding Henkes Consulting in 1999, I was a Principal of The Georgetown Consulting Group, Inc. for over 20 years. At Georgetown Consulting I performed the same type of consulting services as I am currently rendering through Henkes

Consulting. Prior to my association with Georgetown Consulting, I was employed by the American Can Company as Manager of Financial Controls. Before joining the American Can Company, I was employed by the management consulting division of Touche Ross & Company (now Deloitte & Touche) for over six years. At Touche Ross, my experience, in addition to regulatory work, included numerous projects in a wide variety of industries and financial disciplines such as cash flow projections, bonding feasibility, capital and profit forecasting, and the design and implementation of accounting and budgetary reporting and control systems.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I hold a Bachelor degree in Management Science received from the Netherlands School of Business, The Netherlands in 1966; a Bachelor of Arts degree received from the University of Puget Sound, Tacoma, Washington in 1971; and an MBA degree in Finance received from Michigan State University, East Lansing, Michigan in 1973. I have also completed the CPA program of the New York University Graduate School of Business.

II. SCOPE AND PURPOSE OF TESTIMONY

Q. WHAT IS THE SCOPE AND PURPOSE OF THIS TESTIMONY?

A. On October 31, 2008, Kentucky-American Water Company ("KAWC" or the "Company") filed for an increase in its base rates for water service of $18,494,634, representing an overall increase of 31.27% over the Company's current rates. This rate increase request is based on forecasted operating results for the forward-looking 12-month period ended May 31, 2010 ("test period"). I was engaged by the Office of Rate Intervention of the Attorney General of Kentucky ("AG") to conduct a review and analysis and present testimony regarding all revenue requirement aspects of this filing.

The purpose of this testimony is to present to the Kentucky Public Service Commission ("KPSC" or the "Commission") the appropriate test period rate base, overall rate of return, and utility operating income, as well as the appropriate overall revenue requirement and rate increase for the Company in this proceeding.

In the determination of the AG's recommended overall revenue requirement and rate increase, I have relied on and incorporated the recommendations of AG witness Stephen G. Hill concerning the appropriate capital structure ratios, cost rates for short- and long term debt, preferred stock and return on common equity, and the resulting overall rate of return for the Company in this proceeding.

In developing this testimony, I have reviewed and analyzed the Company's October 31, 2008 filing; supporting testimonies, exhibits, filing requirements and workpapers; the Company's responses to initial and follow-up data requests by the KPSC Staff, AG and other intervenors; and other relevant financial documents and data.

III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS IN THIS CASE.

A. I have reached the following findings and conclusions in this case:

1. The appropriate test period 13-month average rate base amounts to $303,759,370, which is $1,785,101 lower than the Company's proposed test period rate base of $305,544,471 [Schedule RJH-1, line 1 and Schedule RJH-3].
2. The AG's expert rate of return witness, Mr. Hill, has recommended an overall rate of return on rate base of 7.548%, incorporating a return on equity of 9.50%. By comparison, the Company has proposed an overall rate of return on rate base of 8.54%, including a requested return on equity of 11.50% [Schedule RJH-2].
3. The appropriate test period utility operating income amounts to $20,583,587, which is $5,685,396 higher than the Company's proposed test period utility operating income of $14,898,191 [Schedule RJH-1, line 4 and schedule RJH-8].
4. The appropriate revenue conversion factor to be used for rate making purposes in this case is 1.6519988. This factor has been used by both the Company and the AG [Schedule RJH-1, line 6].
5. The application of the recommended overall rate of return of 7.548% to the

recommended test period rate base of $303,759,370, combined with the recommended test period utility operating income of $20,583,587 and the revenue conversion factor of 1.6519988 indicates that the Company has an annual revenue requirement deficiency of $3,873,191. This represents a difference of $14,621,443 from the Company's proposed annual revenue deficiency of $18,494,634 [Schedule RJH-1, lines 1-7].

6. The recommended rate increase of $3,873,191 reflects the AG's recommended rejection of KAWC's proposal in this case to receive a current cash return on a portion of the 13-month average KRS II CWIP included in the test period. The Commission should continue to accrue AFUDC on all KRS II CWIP until this project is placed in service.

IV. REVENUE REQUIREMENT ISSUES

A. OVERALL RATE OF RETURN

Q. PLEASE DESCRIBE THE OVERALL RATE OF RETURN NUMBER USED BY YOU IN THE DETERMINATION OF THE COMPANY'S APPROPRIATE REVENUE REQUIREMENT.

A. As mentioned before, I have adopted the overall rate of return recommended by AG witness Stephen Hill in this case. His recommendations are summarized in the lower part of my Schedule RJH-2. As shown on this schedule, Mr. Hill recommends capital structure ratios of 10.337% for short-term debt, 45.408% for long-term debt, 1.946% for preferred stock, and 42.309% for common equity. His recommended capital cost rates are 2.50% for short-term debt, 6.87% for long-term debt, 7.75% for preferred stock, and 9.50% for the common equity return rate. The combination of the capital structure ratios and the corresponding capital cost rates produces Mr. Hill's recommended overall rate of return on 7.548%.

B. RATE BASE

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED AND YOUR RECOMMENDED NET RATE BASE LEVELS FOR THE TEST PERIOD IN THIS CASE.

A. The Company's proposed net rate base of $305,544,471 is summarized by specific rate base component on Schedule RJH-3. With the exception of Cash Working Capital, Other Working Capital and Other Rate Base Elements, all of the Company's proposed rate base components are based on projected 13-month average balances for the test period ended May 31, 2010. The Company's proposed Cash Working Capital requirement is based on a detailed lead/lag study, and the proposed Other Working Capital and Other Rate Base Element balances represent the actual average balances for the 24-month period ended July 31, 2008.

As shown on Schedule RJH-3, I have recommended 5 rate base adjustments with the net effect of reducing the Company's proposed net rate base by $1,785,101. Each of these recommended rate base adjustments are explained, quantified and source-referenced in more detail in the supporting rate base schedules referenced on Schedule RJH-3 and will be discussed in detail in the next sections of this testimony.

- **CWIP**

Q. PLEASE EXPLAIN THE MAKE UP OF KAWC'S PROPOSED $102,817,344 CONSTRUCTION WORK IN PROGRESS ("CWIP") BALANCE IN RATE BASE, AS SHOWN ON SCHEDULE RJH-3, LINE 5.

A. This rate base balance of $102,817,344 represents the projected 13-month average CWIP balance for the test period ended May 31, 2010. Of this total balance of

$102,817,344, an amount of $98,203,884[1] represents the test period 13-month average CWIP balance associated with the KRS II project and $4,613,460 represents test period 13-month average non-KRS II CWIP. I have accepted the proposed CWIP rate base balance of $102,817,344 for ratemaking purposes in this case. The Company's proposed and the AG's recommended rate treatments for the AFUDC income associated with the $102,817,344 test period CWIP balance is discussed later on in this testimony.

- **Cash Working Capital**

Q. PLEASE SUMMARIZE THE METHOD EMPLOYED BY THE COMPANY TO DETERMINE ITS PROPOSED TEST PERIOD CASH WORKING CAPITAL ("CWC") REQUIREMENT.

A. The Company's proposed test period CWC requirement of $4,271,000 has been determined by way of a detailed lead/lag study. The Company chose not to prepare a new, updated lead/lag study for this case;[2] rather, it has based its proposed cash working capital on the lead/lag study that was approved by the Commission in the Company's most recent litigated rate proceeding, Case No. 2004-00103.

The lion's share of the proposed CWC requirement of $4,271,000 is caused by the inclusion (with a 0 payment lag) in the Company's lead/lag study of (1) non-cash

[1] Michael Miller testimony page 32 and WP1-4, p. 62 of 65.
[2] See response to AG-1-17.

expense items such as depreciation/amortization expenses and deferred taxes; and (2) the return on equity component (Net Income). I do not agree that depreciation/amortization expenses and deferred taxes should be included in a lead/lag study with a 0 payment lag because such expenses do not require a cash outlay in the lead/lag study period. Neither do I agree with the proposition that the entire return on equity be included in the lead/lag study with a 0 payment lag based on the assumption that the stockholder is entitled to his return at the exact time that service is rendered. The simple fact is that stockholders receive their return through common dividend payments and any gain in the Company's stock. This is the mechanism by which the common shareholder is compensated in the real world, and this mechanism would suggest a payment lag significantly higher than 0 days. However, based on my review of prior PSC Orders involving lead/lag studies, including KAWC's lead/lag study in Case No. 2004-00103, I understand that the PSC has consistently allowed depreciation/amortization expenses, deferred taxes and the return on equity in the lead/lag studies with a 0 payment lag. In recognition of this and in an attempt to limit the issues in this case, I have chosen to reflect the inclusion of depreciation/amortization, deferred taxes and net income with a 0 payment lag in the recommended lead/lag study to be used for ratemaking purposes in this case.

Q. ARE YOU RECOMMENDING THAT ADJUSTMENTS BE MADE TO THE COMPANY'S PROPOSED LEAD/LAG STUDY AND ASSOCIATED CWC REQUIREMENT?

A. Yes. I recommend that four adjustments be made to the Company's lead/lag study. First, I recommend that the Company's proposed chemical expense payment lag of 6.65 days be replaced with a payment lag of 30.49 days. Second, rather than including in the lead/lag study a separate line item for pension expenses with a negative payment lag of (5.50) days, as the Company has proposed, I have included the pension expenses in the lead/lag study line item for Other Operating expenses. Third, I recommend that the Company's proposed revenue collection lag of 43.50 days be replaced with a revenue collection lag of 41.04 days. Finally, where applicable, I have replaced the Company's proposed test period expense levels in the lead/lag study with the corresponding test period expense levels recommended by me in this testimony.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING YOUR RECOMMENDED CWC REQUIREMENT BASED ON THE APPLICATION OF THE PREVIOUSLY DISCUSSED FOUR LEAD/LAG STUDY ADJUSTMENTS?

A. Yes. My recommended CWC requirement and all underlying calculations are shown on Schedule RJH-4. The four recommended lead/lag study adjustments are highlighted in columns A and B of Schedule RJH-4. As shown on Schedule RJH-4, line 38 and summarized on Schedule RJH-3, line 6, my recommended CWC requirement amounts to $2,588,495 which is $1,682,505 lower than KAWC's proposed CWC requirement of $4,271,000.

Q. PLEASE EXPLAIN THE FIRST RECOMMENDED LEAD/LAG STUDY ADJUSTMENT REGARDING THE CHEMICAL EXPENSE PAYMENT LAG.

A. As agreed by the Company in its response to AG-1-20, in Case No. 2004-00103 the Commission rejected the Company's proposed chemical expense payment lag of 6.65 days and, instead, ordered the use of a 30.49 chemical expense payment lag. For that reason, there should be a similar 30.49 chemical expense payment lag reflected in the lead/lag study in the instant proceeding. I have reflected this corrected payment lag number in the recommended lead/lag study results on Schedule RJH-4, line 3.

Q. PLEASE EXPLAIN THE SECOND RECOMMENDED LEAD/LAG STUDY ADJUSTMENT REGARDING PENSION EXPENSES.

A. As mentioned before, in the current case, the Company has reflected pension expenses as a separate line item with a negative payment lag of (5.50) days in its proposed lead/lag study. However, as confirmed in its response to AG-1-21, in Case No. 2004-00103,[3] the Company did not include pension expenses in the lead/lag study as a separate item with a negative payment lag of (5.50) days. Rather, the pension expenses in the Case No. 2004-00103 lead/lag study were included in the Other Operating Expense lead/lag study line item with a payment lag of 21.44 days. While the Company agrees with this fact, it argues that this pension expense lead/lag study treatment is no longer accurate because of changes

[3] As well as in the next KAWC rate case, Case No. 2007-00143.

that have occurred in the Company's pension payments since Case No. 2004-00103. I do not believe it is appropriate to reflect only this selective change in an expense payment pattern since Case No. 2004-00103. The Company consciously chose not to perform an updated lead/lag study for this case and, instead, based the CWC requirement claim on the Commission-approved lead/lag study that was conducted in Case No. 2004-00103 based on conditions that existed at that time for *all* expense items included in the lead/lag study. The Company's proposal to update the Case No. 2004-00103 lead/lag study results for just one expense item without updating the same lead/lag study results for changes in payment patterns for all other expense items is inappropriate and could result in an inaccurate CWC determination. For this reason, I have treated the pension expenses in the same way as they were treated in the Commission-approved lead/lag study in Case No. 2004-00103. I have reflected this recommended pension expense treatment in the lead/lag study results on Schedule RJH-4, lines 7 and 18.

Q. PLEASE EXPLAIN THE THIRD RECOMMENDED LEAD/LAG STUDY ADJUSTMENT REGARDING THE REVENUE COLLECTION LAG.

A. The Commission-approved lead/lag study in Case No. 2004-00103 incorporated an overall composite revenue collection lag of approximately 36.7 days. By contrast, in the current filing, the Company's proposed lead/lag study uses an overall composite revenue collection lag of 43.50 days. Under a strict implementation of the Company's proposal to base its current CWC requirement on the Commission-approved lead/lag study in Case No. 2004-00103, one could take the position that the Case No. 2004-00103 overall composite revenue collection lag of approximately 36.7 days should also be used in the current case. However, I have not followed that approach since the Company has used updated data for each revenue category and revenue lag component to determine the overall composite revenue collection lag rather than only updating for certain selective revenue lag components as it has done for the expenses in its proposed lead/lag study.

It should be noted, though, that the Company made an error in the calculation of its proposed updated revenue collection lag of 43.50 days. Specifically, as described in data request AG-1-18, in the determination of the overall composite revenue collection lag of 43.50 days, the Company has erroneously assumed that its Other Revenues not only have a service period collection lag of 34.54 days, but also a billing period collection lag of 4.17 days and collection period collection lag of 24.27 days. As shown in data request AG-1-18(e), the correction for this error would change the proposed overall composite revenue collection lag from 43.50 days to 41.04 days. In response to AG-1-18, the Company has agreed that this error correction should be made and that the appropriate corrected overall composite revenue collection lag should be 41.04 days. I have reflected this recommended revenue collection lag number in the lead/lag study results on Schedule RJH-4, line 35.

Q. PLEASE EXPLAIN THE FOURTH RECOMMENDED LEAD/LAG STUDY ADJUSTMENT REGARDING THE REPLACEMENT OF THE

COMPANY'S PROPOSED TEST PERIOD EXPENSES IN THE LEAD/LAG STUDY WITH THE CORRESPONDING TEST PERIOD EXPENSES RECOMMENDED BY YOU.

A. There are a number of Company-proposed test period expenses shown in Schedule RJH-4, column B which I have adjusted in this case. For those expense items for which I have made relatively large adjustments, I have reflected my recommended test period expense levels in the lead/lag study. These recommended expense items are highlighted on Schedule RJH-4, column B, lines 1, 4, 9, 14, 18, 20, 26-27, and 29-32. The sources for these recommended expense levels are referenced on Schedule RJH-4, column C and further detailed on Schedule RJH-4A. It should be noted that I have also made adjustments to other Company-proposed expenses[4] in the lead/lag study, however, since the reflection of these adjustments would have a minimal impact on the overall CWC requirement calculation, I have not bothered to reflect these additional expense adjustments.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE CWC REQUIREMENT ISSUE?

A. Yes. All components expense components of the lead/lag study results shown in Schedule RJH-4 should eventually be updated to reflect the Commission's findings in this case.

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[4] For example, uncollectible expenses, fuel & power and chemical expenses, insurance other than group expenses, etc.

- **Deferred Income Taxes**

Q. PLEASE EXPLAIN THE DEFERRED INCOME TAXES ADJUSTMENT SHOWN ON SCHEDULE RJH-5.

A. The adjustments shown on Schedule RJH-5, lines 2 and 3 represent "flow-through" adjustments that are required as a direct result of my recommended deferred maintenance and deferred debit adjustments that will be discussed in subsequent sections of this testimony. The adjustment on line 4 represents a required deferred income tax balance correction that was conceded by KAWC in its response to AG-2-5.

- **Deferred Investment Tax Credits**

Q. PLEASE EXPLAIN THE DEFERRED INVESTMENT TAX CREDIT ADJUSTMENT SHOWN ON SCHEDULE RJH-3, LINE 11.

A. This adjustment is to correct for an error in the Company's proposed test period deferred investment tax credit balance which was conceded by KAWC in its response to AG-1-50.

- **Deferred Maintenance Costs**

Q. PLEASE EXPLAIN THE DEFERRED MAINTENANCE COST ADJUSTMENT SHOWN ON SCHEDULE RJH-6.

A. The Company has proposed to include in rate base and amortize to income a balance of $2,951,785 for deferred maintenance costs. In its response to AG-1-47, the Company has confirmed that approximately 1.68%, or $49,590, of the total deferred maintenance cost balance consists of the Company's internal labor and labor overhead costs. It is my recommendation that this deferred labor related cost portion of $49,590 not receive rate recovery as the allowance of this deferred cost would represent a double-count of the test period labor and labor overhead charges. I believe that my recommendation is consistent with Commission precedent. For example, on page 8 of its Rehearing Order in KAWC's Case No. 2000-120, the Commission ruled that deferred company labor costs included as part of KAWC's proposed acquisition adjustment in that case should not receive rate recovery:

> We have, however, removed from the proposed acquisition adjustment deferred company labor expenses of $46,350. To defer payroll expense between rate cases and then amortize those costs, in addition to the normal recurring payroll expense, would artificially inflate forecasted test year operations.[5]

In its response to AG-1-47(b), the Company argues that this deferred internal labor cost does not represent a double-count with the proposed test period labor expenses because the labor capitalization ratio of 21.06% used in this case "includes the small historical charges to the deferred maintenance projects." However, there is no information in the record of this case proving this statement and as long as this is the case, I do not believe that the Company has met its burden of proof on this matter.

[5] Case 2000-010 Order on Rehearing, dated May 9, 2001, at 8.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE?

A. Yes. My recommendation also impacts the Company's proposed amortization of the deferred maintenance costs. This will be addressed in a subsequent section of this testimony.

- **<u>Deferred Debits</u>**

Q. PLEASE EXPLAIN THE DEFERRED DEBIT ADJUSTMENT SHOWN ON SCHEDULE RJH-7.

A. The recommended $18,488 deferred debit adjustment represents the removal of the double-counted Boonesboro Acquisition Adjustment rate base balance, as conceded by KAWC in its response to AG-1-41.

C. OPERATING INCOME

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED AND YOUR RECOMMENDED TEST PERIOD UTILITY OPERATING INCOME IN THIS CASE.

A. The Company's proposed and my recommended test period utility operating income numbers are summarized on Schedule RJH-8. The starting point on that schedule is KAWC's proposed test period utility operating income of $14,898,191. I then adjusted this Company-proposed test period operating income with a large number of operating income adjustments in order to arrive at the recommended test period utility operating income amount of $20,583,587. Each of the recommended operating income adjustments listed on Schedule RJH-8 represent revenue, expense or tax adjustments that have been stated on an after-tax net income basis, as explained, quantified and source-referenced in the supporting operating income schedules referenced on Schedule RJH-8. They will be discussed in detail in the next sections of this testimony.

- **Interest Synchronization Adjustment**

Q. PLEASE EXPLAIN THE RECOMMENDED INCOME TAX ADJUSTMENT TO ACCOUNT FOR INTEREST SYNCHRONIZATION SHOWN ON SCHEDULE RJH-9.

A. The tax deduction for interest expense that has been used by KAWC for purposes of calculating its proposed income taxes in this case is based on the multiplication of the weighted debt component included in KAWC's proposed overall rate of return times KAWC's proposed rate base. This concept is generally referred to as "interest synchronization." I agree that this is an appropriate method to determine the interest expense deduction for income tax calculation purposes in rate cases. However, because I have recommended a lower rate base and a lower weighted cost of debt than KAWC, my recommended interest deduction amount using this interest synchronization method is less than that reflected by KAWC. This, in turn, results in higher recommended income taxes. As shown on Schedule RJH-9, the use of the interest synchronization method increases the Company's proposed test period income taxes. This means that the Company's proposed net operating income is decreased by the same amount.

- **Consolidated Income Tax Adjustment**

Q. ARE THE PROJECTED TEST PERIOD FEDERAL INCOME TAXES PROPOSED BY KAWC IN THIS CASE BASED ON THE ASSUMPTION THAT KAWC FILES ITS INCOME TAXES ON THE SO-CALLED "STAND-ALONE" BASIS?

A. Yes. The Company's proposed test period federal income tax amount has been computed by applying a 35% federal income tax rate to the Company's determination of the test period's taxable income. This is referred to as the "stand-alone" method which assumes that the Company files a separate federal income tax return.

Q. DOES KAWC ACTUALLY FILE A FEDERAL INCOME TAX RETURN ON A STAND-ALONE BASIS?

A. No. In order to minimize their federal income tax liabilities, American Water and its subsidiaries, including KAWC, participate in a single, consolidated federal income tax return with the IRS.

Q. WHY DOES A CONSOLIDATED INCOME TAX FILING GENERATE TAX SAVINGS?

A. Certain members of the consolidated income tax filing generate tax losses. These tax losses are used to offset a portion of the taxable income generated by other affiliates, including KAWC, to reduce income taxes payable for the entire consolidated entity. Without a consolidated tax filing, it could take several years under the IRS' carry-forward and carry-back restrictions, if ever, before the recurring loss companies would be able to fully realize tax savings. By filing a consolidated return, however, the consolidated entity as a whole is able to realize, in the current tax year, the tax benefits generated by the loss companies.

Q. SHOULD KAWC'S RATEPAYERS SHARE IN THE TAX SAVINGS REALIZED FROM THE CONSOLIDATED INCOME TAX FILINGS?

A. Yes. KAWC's ratepayers should only reimburse the Company for actual income taxes paid. If the tax savings from the consolidated income tax filings are not flowed through to the KAWC ratepayers on an appropriate, proportionate basis, the ratepayers will pay rates that are higher than necessary to compensate KAWC for its actual costs. I therefore recommend that an appropriate consolidated income tax benefit be calculated for KAWC and reflected for ratemaking purposes in this case.

Q. HOW DID YOU CALCULATE YOUR RECOMMENDED CONSOLIDATED INCOME TAX BENEFIT ADJUSTMENT FOR KAWC?

A. This calculation, which is based on the so-called "effective tax rate methodology", is summarized on Schedule RJH-10. First, I considered the combined annual taxable income of all of the "positive taxable income" consolidated group members (including both regulated and non-regulated group members) for the 5 years from 2003 through 2007. For each of these years, I then calculated the ratio of KAWC's positive taxable income to the total combined taxable income of all positive taxable income consolidated group members. Next, I determined the combined annual taxable losses of all non-regulated[6] group members for each of the 5 years. I then applied the KAWC ratios to these combined annual tax loss amounts to arrive at the annual tax losses that should be allocated to KAWC in order to calculate KAWC's tax benefits produced by the consolidated filing. Finally, I averaged the 5-year consolidated tax loss benefits allocated to KAWC and applied the federal income tax rate of 35% to this average. This calculation indicates an average normalized consolidated income tax benefit for KAWC of $1,354,888.

Q. IS THIS CONSOLIDATED INCOME TAX ADJUSTMENT METHODOLOGY CONSISTENT WITH THE METHODOLOGY USED TO CALCULATE THE CONSOLIDATED INCOME TAX ADJUSTMENT THAT WAS APPROVED BY THE COMMISSION IN CASE NO. 2004-00103?

A. Yes. The only difference is that in this case I used a five-year historic average rather than a three-year historic average to determine the prospective consolidated income tax adjustment. I have done so to be conservative as the consolidated income tax adjustment calculated based on the three-year historic average indicates

[6] Regulated group members with tax losses are not considered in the analysis as these tax losses cannot be considered recurring events.

a consolidated income tax benefit for KAWC of $1,748,590 rather than the amount of $1,354,888 reflected by me in this case.

- **Industrial Sales Adjustment**

Q. PLEASE EXPLAIN THE BASIS OF THE COMPANY'S PROJECTED TEST PERIOD INDUSTRIAL SALES.

A. The Company's proposed projected test period industrial sales amounts to 683,004 thousand gallons (Tgs). As confirmed by the Company in its response to AG-1-62, this projected test period sales number represents the actual sales volume experienced by KAWC during the 12-monthy period ended July 31, 2008. In this regard, the Company states in its response to AG-1-62(g):

> As stated in response to part (f) above, the Company utilized actual sales for the industrial class for the 12 month period ended July 31, 2008. The Company believed that the sales for this period were reflective of the expected usage for the forecasted test-year including lower sales to Toyota than were experienced in 2005-2007....

Q. HAVE YOU ACCEPTED THE COMPANY'S PROJECTED TEST PERIOD INDUSTRIAL SALES LEVEL?

A. No. Updating the actual industrial sales for the 12-month period ended July 31, 2008 with the actual industrial sales in the 12-month period ended December 31, 2008 indicates a lower annual sales level of 619,381 Tgs. Since this latter sales volume represents the most recent actual annual sales level available at this time, I recommend that this lower sales level be used as a proxy for the projected test period industrial sales.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE IMPACT OF YOUR RECOMMENDATION ON THE COMPANY'S PROPOSED TEST PERIOD AFTER-TAX OPERATING INCOME?

A. Yes. On Schedule RJH-11, I show that my proposed industrial sales adjustment reduces the Company's proposed revenues by $145,421. This same schedule also shows that, after taking into account associated variable O&M expenses[7], uncollectible expenses, PSC fees and income taxes, my recommended revenue adjustment decreases the Company's proposed test period after-tax operating income by $72,234.

- **Other Public Authority (OPA) Sales Adjustment**

Q. PLEASE EXPLAIN THE BASIS OF THE COMPANY'S PROJECTED TEST PERIOD OPA SALES.

A. The Company's proposed projected test period OPA sales amounts to 1,514,700 thousand gallons (Tgs). As shown on WP2-1, page 22 and explained in response to AG-1-4(f), the Company first calculated its projected test period sales level based on its budgeted OPA sales forecast for the years 2009 and 2010 and then compared this calculated sales level to the actual average OPA sales level for the 3-year period 2005-2007. Since the calculated sales level 1,514,700 Tgs was almost the

[7] Such as fuel & power, chemical and waste disposal expenses.

same as the actual 3-year average sales level of 1,512,765, the Company felt comfortable in using the calculated sales level as a proxy for the projected test period sales level.

Q. HAVE YOU ACCEPTED THE COMPANY'S PROJECTED TEST PERIOD INDUSTRIAL SALES LEVEL?

A. No. The actual OPA sales level for calendar year 2008 was 1,629,748. This is substantially higher than the Company's projected test period sales level of 1,514,700 which was essentially based on the actual 3-year average sales level for the years 2005-2007. Below, I have listed the Company's actual OPA sales levels experienced during the 4-year period 2005-2008:

2005	1,530,265 Tgs
2006	1,436,818
2007	1,571,213
2008	1,629,748
3-Yr Avg. 05-07	1,512,765
3-Yr Avg. 06-08	1,545,926

As is evident from this table, the Company's OPA sales have increased in each of the last three years. Based on this fact, one could take the position of using the most recent actual sales level (the 2008 sales of 1,629,748 Tgs) as the projected test period sales level. However, to be conservative, I have not taken that approach. Rather, I have updated the Company's historic 3-year average approach by replacing the 3-year average for the years 2005-2007 used by the Company with the average for the more recent 3-year period, 2006-2008. This updated 3-year average indicates annual OPA sales of 1,545,926 Tgs. Since this latter OPA sales volume is based on the most recent available 3-year average sales number, I recommend that this sales level be used as a proxy for the projected test period OPA sales.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE IMPACT OF YOUR RECOMMENDATION ON THE COMPANY'S PROPOSED TEST PERIOD AFTER-TAX OPERATING INCOME?

A. Yes. On Schedule RJH-12, I show that my proposed OPA sales adjustment increases the Company's proposed revenues by $83,039. This same schedule also shows that, after taking into account associated variable O&M expenses, uncollectible expenses, PSC fees and income taxes, my recommended revenue adjustment increases the Company's proposed test period after-tax operating income by $42,515.

- **Other Water Utility (OWU) Sales Adjustment**

Q. PLEASE EXPLAIN THE BASIS OF THE COMPANY'S PROJECTED TEST PERIOD OWU SALES.

A. The Company's proposed projected test period OWU sales volume amounts to 492,676 thousand gallons (Tgs). As confirmed by the Company in its response to AG-1-62, this projected test period sales number represents the actual sales volume experienced by KAWC during the 12-monthy period ended July 31, 2008. In this regard, the Company states in its response to AG-1-57(e):

The Company's projected sales level for the forecasted test-year sales

> level of 492,676 thousand gallon consumption are the actual sales units for the OWU sales class for the 12 month period ended July 31, 2008…

Q. HAVE YOU ACCEPTED THE COMPANY'S PROJECTED TEST PERIOD OWU SALES LEVEL?

A. No. Updating the actual OWU sales for the 12-month period ended July 31, 2008 with the actual OWU sales in the 12-month period ended December 31, 2008 indicates a higher annual sales level of 518,502 Tgs. Since this latter sales volume represents the most recent actual annual sales level available at this time, I recommend that this higher sales level be used as a proxy for the projected test period OWU sales. This recommendation is consistent with my previously discussed recommendation regarding the Company's industrial sales for which I also reflected the most recent actual calendar year 2008 sales level rather than the Company's proposed sales level based on actual results in the 12-month period ended July 31, 2008. In that case, my recommendation resulted in a lower projected test period sales level.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE IMPACT OF YOUR RECOMMENDATION ON THE COMPANY'S PROPOSED TEST PERIOD AFTER-TAX OPERATING INCOME?

A. Yes. On Schedule RJH-13, I show that my proposed OWU sales adjustment reduces the Company's proposed revenues by $69,338. This same schedule also shows that, after taking into account associated variable O&M expenses, uncollectible expenses, PSC fees and income taxes, my recommended revenue adjustment decreases the Company's proposed test period after-tax operating income by $35,562.

- **Fire Service Revenue Adjustment**

Q. PLEASE EXPLAIN THE FIRE SERVICE REVENUE ADJUSTMENT SHOWN ON SCHEDULE RJH-14.

A. In its response to AG-1-60, the Company indicated that it inadvertently overstated its test period public fire hydrant revenues by $43,374. While I agree that the test period public fire hydrants are overstated, I do not agree that the correction for this overstatement would be a revenue reduction of $43,374. Rather, as shown in footnote (1) on Schedule RJH-14, I have calculated that the revenue overstatement amounts to $37,128.

In its response to AG-2-10, the Company confirmed that its originally projected private fire revenues were understated and should be revised. From the table in the response to AG-2-10(b), I have calculated that the revised private fire revenues amount to $1,283,769 which is $29,699 higher than the originally proposed private fire revenues of $1,254,070.

As shown on Schedule RJH-14, after taking into account associated uncollectible expenses, PSC fees and income taxes, my two recommended fire service revenue adjustments decrease the Company's proposed test period after-tax operating income by $4,497.

- **Other Operating Revenue Adjustment**

Q. PLEASE EXPLAIN THE BASIS OF THE COMPANY'S PROJECTED TEST PERIOD OTHER OPERATING REVENUES.

A. The Company has proposed projected Other Operating Revenues of $2,289,756 for the test period. When the Company was asked in AG-1-52 for the basis of this revenue projection, it responded as follows:

> Each category of the Other Operating Revenues was compared to the previous three year's history and base period, as well as the budgeted amounts for 2009 and 2010. The Company used the budget for the categories of rents from water property, collection for others, and NSF checks because the amounts were consistent over time. The Company utilized the base period amounts for the reconnection fees and application/initiation fees since that category tends to fluctuate from year to year and the budgeted amounts for 2009 and 2010 were below the activity for the base period.

Q. HAVE THE COMPANY'S ACTUAL OTHER OPERATING REVENUES FLUCTUATED FROM YEAR TO YEAR?

A. No. In the table below, I have listed the actual Other Operating Revenues booked by KAWC during the last 4 years:[8]

2005:	$1,735,954
2006:	$1,912,432
2007:	$2,221,671
2008:	$2,525,698

Thus, the Company has experienced a consistent upward trend in its actual Other

[8] Source: responses to AG-1-52 and AG-2-9.

Operating Revenue during this recent historic period. Moreover, a review of the responses to AG-1-52 and AG-2-9 indicates that the (partially) projected base period Other Operating Revenue activities were substantially below the actual 2008 Other Operating Revenues activities.

Q. WHAT IS YOUR RECOMMENDATION BASED ON THE PREVIOUSLY DISCUSSED FINDINGS?

A. I recommend that the projected test period Other Operating Revenues be based on the actual 2008 revenue level of $2,525,698. This is the most recent actual revenue level available at this time and, in my opinion, represents a conservative test period revenue projection, given the fact that the actual annual Other Operating Revenues have consistently increased in the last 4 years.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE IMPACT OF YOUR RECOMMENDATION ON THE COMPANY'S PROPOSED TEST PERIOD AFTER-TAX OPERATING INCOME?

A. Yes. On Schedule RJH-15, I show that my proposed Other Operating Revenue adjustment increases the Company's proposed revenues by $235,942. This same schedule also shows that, after taking into account associated uncollectible expenses, PSC fees and income taxes, my recommended revenue adjustment increases the Company's proposed test period after-tax operating income by $142,822.

- **Miscellaneous Sales Revenue Adjustment**

Q. PLEASE EXPLAIN THE MISCELLANEOUS SALES REVENUE ADJUSTMENT SHOWN ON SCHEDULE RJH-16.

A. Miscellaneous sales represents sales from the Company's water loading stations. While the Company has experienced miscellaneous sales revenues each year in the past, it has failed to reflect any of such sales revenues for the test period. For example, as shown in footnote (1) of Schedule RJH-16, during the most recent historic 14-year period from 1995 through 2008, the Company's miscellaneous sales revenues have averaged approximately $20,000 annually. When questioned about this issue in AG-1-37(d), the Company responded that it "agrees that it should have included a level of miscellaneous sales in the going-level revenues for the forecasted test year" and that "it would be fair to utilize the 3-year average of miscellaneous sales for the years 2005-2007." This suggested 3-year average amounts to an annual sales revenue level of $14,690. I do not believe that this suggested revenue level is representative of what can be expected in the going-level revenues for the test period. Rather, I recommend that an annual miscellaneous sales revenue level of $21,626 be reflected for ratemaking purposes in this case. This represents the average annual revenue level for the most recent 3-year period 2006 – 2008 and is more reflective of the historic average revenues in the range of about $20,000 experienced by the Company since 1995.

As shown on Schedule RJH-16, after taking into account associated uncollectible expenses, PSC fees and income taxes, my recommendation increases the Company's proposed test period after-tax operating income by $13,091.

- **Personnel Transfer Between KAWC and AWWSC**

Q. PLEASE EXPLAIN THE ADJUSTMENT FOR THE TRANSFERS OF PERSONNEL BETWEEN KAWC AND THE SERVICE COMPANY, AWWSC, SHOWN ON SCHEDULE RJH-17.

A. The recommended expense adjustments shown on Schedule RJH-17, lines 1 and 2, concern the net impacts on the Company's test period O&M expenses resulting from the recent transfers of KAWC's President, Nick Rowe, to AWWSC and two AWWSC employees to KAWC. The net result of these employee transfers is a reduction in the Company's proposed test period O&M expenses of $34,150 which, in turn, results in a $20,866 increase in the Company's proposed test period after-tax operating income.

Q PLEASE EXPLAIN THE FIRST EMPLOYEE TRANSFER CONCERNING MR. ROWE.

A. In its response to LFUCG-1-8, KAWC made the following announcement:

> On December 15, 2008, Nick Rowe was promoted to Eastern Regional President of AWWSC, and in that role he is responsible for the nine states that make up the Eastern Region of AWW, including KAWC. Mr. Rowe's labor, benefits and expenses are currently fully embedded in the expense KAWC is requesting in this case. As part of the update to this case, which is due by March 17, 2009, the Company will amend its filing to eliminate the labor, benefits and expenses of Mr. Rowe from the

> filing, and add the appropriate portion of Mr. Rowe's expenses to AWWSC costs.

In response to data request AG-1-46, the Company quantified that the removal of Mr. Rowe's labor and labor overhead expenses reduces the proposed test period O&M expenses by $307,078. The Company also stated in this same data response:

> Mr. Rowe has determined that 75% of his time will be dedicated to KAWC, which will increase the AWWSC fees charged to KAWC by $230,308 ($307,078 x 75%)..... The net of the reduced KAWC labor and overheads and the increased AWWSC costs produces a reduced overall revenue requirement of $78,709...

On Schedule RJH-17, footnote (1), I have calculated that this revenue requirement reduction translates into the net O&M expense reduction of $78,000 shown on Schedule RJH-17, line 1.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS REGARDING THIS ISSUE?

A. Yes. At this time, I have reflected the offsetting $230,308 AWWSC cost increase to KAWC that is based on the assumption that Mr. Rowe will be dedicating 75% of his time to KAWC. However, I find it curious that Mr. Rowe, who will be responsible for overseeing AWW's operations in nine states, intends to spend three quarters of his time on only one state, Kentucky. Since this issue was introduced late in this case, there has been no opportunity to do further discovery on this matter. I therefore recommend that the Company provide information in its rebuttal testimony to clarify this issue. If this information does not adequately explain the reason for this 75% time allocation, I recommend that the Commission should calculate the offsetting AWWSC cost increase on a more logical and appropriate basis.

Q PLEASE EXPLAIN THE SECOND PERSONNEL TRANSFER CONCERNING THE TWO FORMER AWWSC EMPLOYEES.

A. In its response to LFUCG-1-8, KAWC made the following announcement regarding this personnel transfer:

> …effective January 1, 2009, Donna Braxton, Manager of Human Resources and Michael Shyrock, Sr., Support Specialist – IT, have been transferred to the payroll of KAWC from AWWSC. In the update to the case due on March 17, 2009, KAWC will amend its filing to include the labor and benefits of Ms. Braxton and Mr. Shyrock, in the labor and benefits expense of KAWC and eliminate those costs from the AWWSC costs [charged to KAWC].

In response to data request AG-2-52, the Company quantified that the transfer of Ms. Braxton and Mr. Shyrock from AWWSC to KAWC would increase KAWC's test period labor and labor overhead O&M expenses by $276,156 and decrease the AWWSC costs charged to KAWC by $231,980, resulting in an overall revenue requirement increase of $44,260.

On Schedule RJH-17, footnote (2), I have calculated that this revenue requirement increase is equivalent to the net O&M expense increase of $43,850 shown on Schedule RJH-17, line 2.

- **Incentive Compensation Expense Adjustment**

Q. HAS THE COMPANY INCLUDED INCENTIVE COMPENSATION IN THE TEST PERIOD EXPENSES CLAIMED IN THIS CASE?

A. Yes. First, the test period payroll expenses for KAWC include total incentive costs of $373,711,[9] consisting of $358,066 for Annual Incentive Plan ("AIP") expenses and $15,645 for Long Term Incentive Plan ("LTIP") expenses. In addition, KAWC is being charged with the incentive expenses included in the management fee allocated from AWWSC. These allocated AWWSC incentive compensation expenses total $514,749, consisting of $395,971 for AIP expenses and $118,778 for LTIP expenses. In summary, the Company's proposed test period O&M expenses include the following levels of incentive compensation expenses:

	AIP	LTIP	Total
KAWC Payroll	$358,066	$ 15,645	$373,711
Included in Management Fee	395,971	118,778	514,749
Total	$754,037	$134,423	$888,460

Q. TURNING FIRST TO THE COMPANY'S PROPOSED RATE INCLUSION OF THE $134,423 FOR LTIP INCENTIVE COMPENSATION EXPENSES, PLEASE PROVIDE ADDITIONAL DETAILS REGARDING THIS LTIP PROGRAM.

A. As shown on page 43 of the Company's response to AG-1-105, the purpose of the LTIP program is as follows:

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[9] Response to AG-1-106.

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While not specifically specified in the response to AG-1-105, it is my understanding that 100% of the awards to be paid out under the LTIP are based on corporate financial performance goals and indicators.

Q. TURNING NOW TO THE COMPANY'S PROPOSED RATE INCLUSION OF THE $754,037 FOR AIP INCENTIVE COMPENSATION EXPENSES, PLEASE PROVIDE ADDITIONAL DETAILS REGARDING THIS AIP PROGRAM.

A As described in the response to AG-1-105, the American Water Annual Incentive Plan (AIP) is offered to ****begin confidential**
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Q. WHAT IS YOUR RECOMMENDATION WITH REGARD TO THE RATE TREATMENT FOR THE PREVIOUSLY DESCRIBED INCENTIVE COMPENSATION EXPENSES PROPOSED BY KAWC?

A. I recommend that all of the Company's proposed test period incentive compensation expenses be removed for ratemaking purposes in this case. My recommendation is shown on Schedule RJH-18, line 1 for the KAWC payroll incentive compensation and on Schedule RJH-19, line 2 for the AWWSC incentive compensation charged to KAWC through the management fee.

Q. WHAT ARE THE REASONS FOR YOUR RECOMMENDATION?

A. There are many reasons for this recommendation. First, the criteria for determining the awards to be paid out under the LTIP and AIP incentive compensation programs are, respectively, 100% and 40% dependent on the achievement of corporate financial performance. American Water's shareholders are the primary beneficiaries of such corporate financial performance improvements by virtue of the resulting increases in their stock value or dividend receipts. For that reason, American Water's stockholders should be made responsible for these discretionary costs.

Second, the response to AG-1-108, page 2 shows that the 45 KAWC employees for which the Company is requesting incentive compensation rate recovery in this case have, on average, received the following base salary increases (separate from and in addition to incentive compensation increases) in each of the last 5 years:

2004	4.87%
2005	6.33%
2006	5.32%
2007	4.72%
2008	4.39%

Given these healthy base salary increases that have already been received by the KAWC employees eligible for incentive compensation in the last 5 years, and given that the current rate case includes additional projected increases of 4% in 2009 and 4% in 2010 (which I have accepted), I do not believe it reasonable and appropriate to saddle the ratepayers with additional discretionary compensation under the AIP and LTIP incentive compensation programs. In addition, the AIP is clearly described as a "bonus" plan in the response to AG-1-105:

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In my opinion, this indicates that incentive compensation awarded under the AIP represents bonus compensation that is additive to the employee's regular compensation.

Third, the incentive compensation awarded under the AIP and LTIP programs are not known and measurable.

Q. WHAT IS THE BASIS FOR THIS CONCLUSION?

A. First of all, the fact that no incentive compensation is paid out under the AIP if the ****begin confidential** xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx **end confidential****

Furthermore, the history of both the budgeted and actual incentive compensation included in KAWC's payroll and KAWC's management fee (for AWWSC-allocated incentive compensation) clearly indicates that incentive compensation cannot be considered known and measurable. This history, which was provided by the Company in its responses to AG-1-106 and AG-1-107, is summarized below:

	KAWC Actual	KAWC Budget
2003	$ 0	$113,136
2004	22,151	223,008
2005	83,375	0
2006	62,772	158,613
2007	161,579	243,598
2008	278,428	354,238
2009	-	367,761
2010	-	382,480

	AWWSC Actual	AWWSC Budget
2003	$217,373	NA[10]
2004	313,605	NA
2005	313,905	NA
2006	382,545	NA
2007	314,305	201,114
2008	412,111	302,217
2009	-	514,749
2010	-	514,749

Thus, as is evident from the above table, there is really no correlation between annual budgeted and actual incentive compensation amounts. In other words, the budgeted incentive compensation numbers consistently turn out to be poor indicators of the actual incentive compensation that will eventually be paid out in the corresponding year. Based on the data in the above tables, one can conclude that the projected test period incentive compensation expenses of $373,711 (KAWC payroll) and $514,749 (AWWSC-allocated), which have been derived from the 2009/2010 budgets, should be considered unreliable and not known and measurable.

[10] The response to AG-1-107 states that "detailed historic budget data from 2003 to 2006 is not readily available."

Fourth, another fact that is evident from the above table is that the budgeted test period KAWC payroll and AWSSC-allocated incentive compensation amounts have increased substantially since the last rate case in 2007. Specifically, the budgeted 2009 AWWSC-allocated incentive compensation charged to KAWC of $514,749 has increased by <u>156%</u> over the corresponding budgeted incentive compensation amount of $201,114 in 2007; and for the incentive compensation in KAWC's payroll, the budgeted 2009 incentive compensation of $367,761 has increased by <u>51%</u> over the corresponding budgeted incentive compensation amount of $243,598 in 2007. This should be a cause of concern to the Commission. If ratepayers are forced to fund these incentive compensation costs, there would be no incentive for KAWC and AWWSC to contain these costs.

Fifth, the Company has not presented any quantitative evidence[11] in this case showing the specific benefits that are accruing to the ratepayers as opposed to American Water's stockholders from the LTIP and AIP incentive compensation programs for which these same ratepayers are asked to pay 100% of the costs. Neither has KAWC presented any evidence in this case showing that there is any appreciable difference in the productivity level of KAWC's and AWWSC's employees as a direct result of the incentive compensation received by these employees.

Finally, I find the Company's request in this case for rate recovery of $888,460 in

[11] See responses to AG-1-109, PSC-3-2 and PSC-3-3.

bonus compensation on top of regular compensation particularly egregious to the ratepayers because this proposal is being made during the worst economic downturn since the Great Depression, where ratepayers are faced with job losses, plunging home values, and 401(k)s that have turned into 201(k)s. It is especially during these very difficult economic conditions that ratepayers need relief from these discretionary costs.

- **Other Labor Expense Adjustments**

Q. PLEASE EXPLAIN THE OTHER LABOR EXPENSE ADJUSTMENTS SHOWN ON SCHEDULE RJH-18, LINES 2, 3 AND 4.

A. The first labor expense adjustment of $62,100 concerns the removal from the Company's proposed test period O&M expense of a vacant treatment plant operator position. In data request PSC-2-10, the Company was questioned about the status of 2 vacant treatment plant operator positions included in the test period. In response to that request, the Company indicated that one of the vacant treatment plant operator positions was recently filled. However, with regard to the remaining vacant treatment plant operator position the Company provided the following information in its response to PSC-3-7:

> KAW has reviewed the sole remaining treatment plant operator vacancy, and has concluded that at this time we will maintain this vacancy, which is a second third shift operator position, as a vacancy. The Company will amend its current filing to reflect this change.

Based on this information, I have removed the test period cost associated with this treatment plant operator position. As calculated in footnote (2) of Schedule RJH-

18, my recommendation reduces the Company's test period O&M expenses by $62,100.

The second labor expense adjustment of $49,341 concerns the removal from the Company's proposed test period O&M expense of a vacant administrative assistant position. In its response to data request PSC-2-10, where the Company was questioned about the status of this vacant position, the Company indicated that this position has been fulfilled on a part-time basis by another employee and that "KAW anticipates posting the position as the [cross connection] program matures and clerical demand, cross connection and otherwise, increase beyond the capacity of the current support." When further questioned about this matter in data request PSC-3-7(d), the Company stated:

> …As indicated, we have been successful to this point in addressing program needs through multi-tasking of other support personnel, which we believe to be prudent. However, KAW has not determined whether that is a feasible long-term solution to support the needs of a growing cross connection program.

Based on the aforementioned information, I do not believe it to be appropriate to reflect the cost associated with this vacant position. First, it is not known and measurable at this time when the cross connection program will mature to the point where a new position would be needed. Second, by its own admission, the Company has at this time not made a determination as to whether there is indeed a need for this position in the long term. Thus, I have removed the test period cost associated with this administrative assistant position. As calculated in footnote (3) of Schedule RJH-18, my recommendation reduces the Company's test period O&M

expenses by $49,341.

The third labor expense adjustment of $102,000 concerns the removal from the Company's proposed test period O&M expense of the estimated 60% portion of KAWC's Director of Governmental Affairs' labor and labor overhead costs related to lobbying activities and activities with the sole purpose to enhance the image of American Water.

Q. WHAT IS THE BASIS FOR YOUR ESTIMATE THAT APPROXIMATELY 60% OF THE LABOR RELATED COSTS OF KAWC'S DIRECTOR OF GOVERNMENTAL AFFAIRS IS RELATED TO LOBBYING AND IMAGE ENHANCING ACTIVITES?

A. My estimate was based on a review of the detailed job description of KAWC's Director of Governmental Affairs (GA) that is included in the Company's response to PSC-2-9, pages 72 through 76. Page 72 of this response states that the primary role of the Director of GA is:

> … to provide strategic government affairs counsel to the state president and state senior management team… track[ing] all legislation with the potential to impact the company, either positively or negatively, and provides strategy recommendations and tactical implementation regarding how to employ government affairs activities in support of legislative objectives …[being] responsible for establishing, nurturing and maintaining relationships with elected and appointed individuals at the state, county and municipal levels of government…

Pages 72 and 73 indicate that <u>35%</u> of the Director of GA's time is spent on the following activities:

- …enhance the company's reputation, and position American Water as the trusted expert and industry leader relative to water and wastewater issues.
- … insure [that] state and local political relationships are solidified and American Water is looked upon across all service territories with respect and positioned as the industry leader and trusted expert.
- …establish a level of trust between American Water, mayors and other appointed and elected officials.
- ...Is poised as the lead state lobbyist for the company, charged with helping to change or support key legislation on water, wastewater or utility/business issues that may have an adverse or positive effect on the company.
- …Manages local contract lobbyists and maximizes effectiveness. Holds regular meetings with the contract lobbyist(s) to ensure they are kept abreast of services needed and that they understand they are not just "bill trackers", but rather are additional eyes and ears for the company and are expected to help identify business development opportunities, as well as other opportunities for the company.
- …Establishes and maintains an effective bill tracking program… provides oversight and strategic input on bills that are being tracked to ensure they are beneficial to the state operations…
- …Helps identify business development opportunities through established relationships and through relationships that the company's contract lobbyist and other employees may have.

Page 74 indicates that <u>15%</u> of the Director of GA's time is spent on the following activities:

- Implements and manages timely processes to track all pertinent legislation that has the potential to impact the company and/or its state and local operations. Coordinates with various functional colleagues to determine types of legislation/regulation that would facilitate our business agenda and collaborates with key stakeholders to drive promulgation of such legislation/regulation. Works with internal resources to analyze and assess proposed legislation relative to the implications on the company's operations. Prepares a synopsis as to how legislation may affect the company and reviews options, strategic recommendations and tactical implementation with the state president and senior management team.
- Implements and directs all lobbying activities on behalf of the company. Prepares and manages the development of legislative testimony. Testifies on behalf of the company and/or prepares the state president or other members of the state senior management team to provide legislative testimony, as appropriate.
- Creates and manages a state-focused PAC to ensure all Election Law Enforcement rules, regulations and other reporting requirements are met. Ensures the senior management team is aware of PAC-related opportunities

to derive maximum benefit from PAC-related expenditures.

Page 74 also indicates that 10% of the Director of GA's time is spent on the following activities:

- …Works with key political, industry and business organizations to solidify relationships and foster business development opportunities for American Water.
- …Is active and visible at various state and national conferences to ensure American Water is properly and effectively positioned. Represents the company at key business organization functions, political fundraisers, etc. and ensures that senior management is poised to participate.
- …Assist in regulatory relationship building, making sure regulators are kept abreast of key issues within the company…

In my opinion, the aforementioned information clearly indicates that at least 60% of the Director of GA's responsibilities is related to lobbying and image enhancing activities.

Q. IS ONE OF THE REQUIREMENTS IN THE JOB DESCRIPTION FOR THE DIRECTOR OF GOVERNMENT AFFAIRS THAT THIS EMPLOYEE MUST BE A REGISTERED LOBBYIST?

A. Yes, this is shown at the top of page 76 of the response to PSC-2-9. The Company's current Director of GA is a registered lobbyist.[12]

- **Management Fee Adjustments**

Q. DO YOU RECOMMEND THAT ADJUSTMENTS BE MADE TO THE

[12] See response to AG-2-48(b).

COMPANY'S PROPOSED AWWSC MANAGEMENT FEE CHARGED TO KAWC?

A. Yes. As summarized on Schedule RJH-19, I recommend that the Company's proposed test period management fee of $7,612,592 be reduced by $1,132,178 to $6,480,414. Schedule RJH-19, lines 15-17 show that the recommended $1,132,178 expense adjustment has the effect of increasing the Company's proposed test period after-tax operating income by $691,761. The recommended overall expense reduction of $1,132,178 consists of 11 separate adjustments, each of which I will now discuss.

Q. **PLEASE EXPLAIN THE MANAGEMENT FEE ADJUSTMENT SHOWN ON SCHEDULE RJH-19, LINE 2.**

A. This expense adjustment removes all incentive compensation included in the AWWSC management fee charged to KAWC. The total incentive compensation included in the management fee amounts to $514,749, consisting of $395,971 for the Annual Incentive Plan (AIP) and $118,778 for the Long Term Incentive Plan (LTIP). The AIP and LTIP plans offered to AWWSC employees are essentially the same plans as are offered to KAWC employees. In an earlier section of my testimony, I have discussed the reasons why I recommend that all incentive compensation be removed for ratemaking purposes in this case.

Q. **PLEASE EXPLAIN THE MANAGEMENT FEE ADJUSTMENT SHOWN ON SCHEDULE RJH-19, LINE 3 REGARDING BUSINESS**

DEVELOPMENT EXPENSES.

A. KAWC does not have employees on staff dedicated to business development. However, through the management fee, KAWC is charged on an allocated basis for business development activities performed by AWWSC. The response to AG-2-32 shows that about 2.2% of AWWSC's Corporate Business Development and 13.2% of AWWSC's Southeast Region Business Development is allocated to KAWC for a total allocated business development cost amount of $226,147. This cost amount includes direct charges and allocated charges billed in accordance with the contract between KAWC and AWWSC.

Q. DO YOU BELIEVE THAT THE ENTIRE BUSINESS DEVELOPMENT COST ALLOCATED BY AWWSC TO KAWC SHOULD BE RECOVERED FROM THE KAWC RATEPAYERS?

A. No. I recommend rate recovery for only the portion of the AWWSC business development costs that represents direct charges to KAWC. I am making this recommendation based on the assumption that AWWSC's direct charges to KAWC indeed involve activities specific to KAWC from which the KAWC ratepayers will derive benefits. I do not believe that the AWWSC business development costs that are simply allocated to KAWC based on a formula allocation factor rather than based on direct charges should be funded by the KAWC ratepayers. There is no information in the record of this case showing how and to what extent KAWC's ratepayers directly benefit from AWWSC's general business development activities that are not specific to KAWC and can not be identified as such.

Q. HOW DID YOU CALCULATE THE PORTION OF THE AWWSC BUSINESS DEVELOPMENT COSTS THAT YOU RECOMMEND SHOULD NOT RECEIVE RATE RECOVERY IN THIS CASE?

A As shown in footnote (2) of Schedule RJH-19, I started out with the total AWWSC business development cost of $226,147 included in the management fee charged to KAWC. I then removed from this total cost any incentive compensation expenses that were already separately removed from the management fee on line 2 of Schedule RJH-19, leaving a net cost amount of $192,333. Finally, I removed from this net cost amount the estimated business development cost portion directly charged to KAWC that should receive rate recovery, amounting to $67,317. Thus, the end result of these calculations is that $125,016 worth of business development cost should be removed from the management fee charged by AWWSC to KAWC. I have reflected this expense adjustment on Schedule RJH-19, line 3.

Q. HOW DID YOU DETERMINE THE ESTIMATED PORTION OF THE AWWSC BUSINESS DEVELOPMENT COSTS THAT ARE DIRECTLY CHARGED TO KAWC?

A. I made this determination based on the average ratio of AWWSC business development costs directly charged to KAWC as compared to the total AWWSC business development costs charged to KAWC during the most recent 4-year period

2005-2008.[13] I have shown this determination below:

	Total Cost	Directly Charged	Ratio
2005	$105,926	$33,096	
2006	83,897	12,674	
2007	155,150	21,751	
2008	163,990	110,804	
Total	$508,963	$178,325	35.0%

Q. PLEASE EXPLAIN THE MANAGEMENT FEE ADJUSTMENT SHOWN ON SCHEDULE RJH-19, LINE 4 REGARDING GOVERNMENT AND EXTERNAL AFFAIRS EXPENSES.

A. The AWWSC management fee charged to KAWC in this case includes $244,515[14] for expenses associated with government and external affairs. Of this total expense amount, approximately $221,635 represents allocated External Affairs expenses and $22,880 represents allocated Government Affairs expenses. When questioned about the nature and purpose of these expenses in data request AG-1-115, the Company did not provide the specific activities making up the allocated $22,880 Government Affairs expenses. However, based on the detailed functional descriptions provided by the Company for KAWC's Government Affairs department which I previously discussed in this testimony, I have assumed that the lion's share of this allocated AWWSC Government Affairs expense is related to lobbying activities. With regard to the allocated External Affairs expenses, the response to AG-1-115 provides the following functional descriptions:

[13] This information can be derived from the response to PSC-3-5, page 3 of 6.
[14] Response to AG-2-33.

- Contribute to the development of company strategies and policies associated with community affairs and government relations.
- Promote the interests of the business.
- Promote the understanding of activities for corporate citizenship, community investment, corporate accountability, environmental stewardship and sustainability within the business.
- Embed corporate social responsibility into all business operations, supply chain and decision making processes.
- Develop comprehensive strategic communication plans and supporting materials for public communications including media relations, conference participation, community relations/events, local government relations, and sponsorship/memberships and execute in a proactive manner. Develop effective crisis plan, crisis communications and serves as spokesperson in a crisis situation.
- Predicts and anticipates the needs of the news media/reporters and is cognizant of meeting those needs. Plans and manages large press and community events.

Based on the aforementioned functional descriptions, I believe that most of AWWSC's Government and External Affairs activities is dedicated to both lobbying activities and promotional/institutional activities to build up goodwill for, and enhance the reputation and image of, American Water. While a portion of AWWSC's External Affairs activities may be of some benefit to KAWC's ratepayers - particularly if it is specific to and directly chargeable to KAWC - there is no information in the record of this case identifying these activities and quantifying their associated costs. For that reason, I have at this time removed the entire allocated Government and External Affairs cost from the management fee.

As previously mentioned, the total allocated Government and External Affairs cost included in the management fee amounts to $244,515. However, this total cost amount includes $32,574 worth of incentive compensation expenses that were already separately removed from the management fee on line 2 of Schedule RJH-

19. Thus, as I show on line 4 and in footnote (3) of Schedule RJH-19, I recommend the removal of a net Government and External Affairs cost amount of $211,941 from the management fee.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE?

A. Yes. If the Commission were not to accept the previously discussed recommendation, I would urge that it at least disallow (1) the allocated Government Affairs expense of approximately $22,880; and (2) the portion of the External Affairs cost of $221,635 that is simply allocated to KAWC based on a formula allocation factor rather than based on direct charges. After all, there is no information in the record of this case showing how and to what extent KAWC's ratepayers directly benefit from AWWSC's general External Affairs activities that are not specific to KAWC and can not be identified as such. For the Commission's information, the response to AG-2-33 provides the Company's estimated percentages of AWWSC's directly charged and allocated Government and External Affairs expenses.

Q. PLEASE EXPLAIN THE MANAGEMENT FEE ADJUSTMENT SHOWN ON SCHEDULE RJH-19, LINE 5.

A. In its response to PSC-2-22, the Company put the parties on notice that, due to recent AWWSC 2009/2010 budget revisions, the as-filed management fee amount of $7,612,592 was overstated and should be reduced. In its response to AG-2-47, the Company specified that the required management fee reduction to correct for the budget overstatement should be $167,344. I have reflected this expense adjustment on line 5.

Q. PLEASE EXPLAIN THE VARIOUS EXPENSE ADJUSTMENTS YOU RECOMMEND BE MADE TO THE MANAGEMENT FEES CHARGED TO KAWC THAT ARE SHOWN ON SCHEDULE RJH-19, LINES 6 THROUGH 12.

A. The expense adjustment on line 6 is to remove AWWSC charitable contribution expenses of $9,106. The Commission has a ratemaking policy not to allow rate recovery for charitable contributions. Such expenses should properly be funded by the stockholders of American Water.

The expense adjustment on line 7 is to remove expenses related to sponsorships of various community organizations in which employees of AWWSC participate. The primary purpose of these community organization sponsorship activities is to create goodwill for and enhance the image of American Water. These sponsorships may not even be in the communities served by KAWC. These expenses do not benefit KAWC ratepayers and should not be recovered from them.

The expense adjustment on line 8 is to remove promotional advertising expenses incurred by AWWSC. First of all, I do not understand why a service company like AWWSC would have a need for promotional advertising. Be that as it may, the rate recovery of promotional and institutional advertising is also prohibited in Kentucky under Administrative Regulation 807 KAR 5:016. Moreover, I don't see how this service company promotional advertising would provide any benefits to KAWC's ratepayers. These expenses should not be recovered from the KAWC's ratepayers.

The expense adjustment on line 9 is to remove certain AWWSC dues and membership expenses proposed to be charged to the KAWC ratepayers. As shown in footnote (8) of Schedule RJH-19, expenses to be removed concern membership expenses for the Mayors Council, National Council, Philadelphia Chamber of Commerce, PRSA, US Chamber of Commerce, CERES, Boston College and BSR. I do not believe that KAWC's ratepayers receive any benefits from these memberships. They should therefore not pay for them.

The expense adjustment on line 10 is to remove $24,200 worth of Other Welfare expenses incurred by AWWSC and charged to KAWC. While there are no specific descriptions available for these AWWSC Other Welfare expenses, if they are for activities similar to the type of activities underlying KAWC's Other Welfare expenses (which consist of award banquets, company picnic, United Way function, and holiday luncheon – see Schedule RJH-24, line 3), they should be removed for ratemaking purposes. Based on the description of the AWWSC account, I have assumed that they are similar.

The expense adjustment on line 11 is to remove AWWSC's Employee Award expenses charged to KAWC. I do not believe that the Commission allows rate recovery for these type of expenses. These expenses should be funded by American Water's stockholders rather than KAWC's ratepayers. It is questionable at best that KAWC's ratepayers receive any benefits from these award expenses.

The expense adjustment on line 12 is to remove AWWSC's expenses associated with non-deductible meals and travel that are proposed to be charged to the KAWC ratepayers. The IRS has a rule that certain types of meals and travel activities do not represent reasonable and legitimate business expenses and, therefore, these expenses cannot be used as a tax deduction. I recommend that the Commission use this federal rule as a guideline and disallow these expenses for ratemaking purposes in this case.

- **<u>Defined Contribution Plan Expense Adjustment</u>**

Q. PLEASE EXPLAIN THE DEFINED CONTRIBUTION PLAN (DCP) EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-8, LINE 13.

A. As conceded in the Company's response to AG-1-97, KAWC's proposed test period DCP expense is overstated by $14,682 due to the incorrect inclusion of Tri Village and Owenton employees. As shown in footnote (1) of Schedule RJH-8, the removal of this overstated DCP expenses increases KAWC's proposed test period after-tax operating income by $8,971.

- **<u>Regulatory Expense Adjustment</u>**

Q. PLEASE EXPLAIN THE REGULATORY EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-20.

A. As shown on Schedule RJH-20, for the current rate proceeding, the Company has proposed total rate case expenses of $592,000, consisting of $25,000 for Cost of Service (COS) study expenses and $567,000 for the remaining rate case expenses. The Company has proposed to amortize the $25,000 COS study expenses over a 5-year period and the remaining rate case expenses of $592,000 over a 3-year period. I have accepted these proposed rate treatments for the current rate case.

As shown on Schedule RJH-20, lines 7, 8 and 9, the Company has also proposed to charge the ratepayers in this case for $161,582 worth of unamortized rate case, depreciation study and COS study expenses from the prior rate case, Case No. 2007-00143. I object to this proposed rate treatment and recommend that it be rejected by the Commission in this case.

Q. WHY DO YOU MAKE THIS RECOMMENDATION?

A. Case No. 2007-00143 was not a litigated case in which the Commission made specific findings regarding specific issues. Rather, Case No. 2007-00143 was resolved through a so-called "black box" settlement that only made mention of the total agreed upon rate increase amount and an agreed upon overall composite depreciation rate. Given these facts, I believe it is inappropriate to then assume for ratemaking purposes in the instant rate case that specific rate case, depreciation study and COS study expense amount with specific amortization periods were decided by the Commission in Case No. 2007-00143. Since rate case settlements always involve compromises and other "give and take" actions, it is impossible to determine from a black box settlement what specific rate treatments are or are not included in the agreed upon rate increase amount.

Q. WHAT IS THE IMPACT OF YOUR RECOMMENDATION ON THE COMPANY'S PROPOSED TEST PERIOD AFTER-TAX OPERATING INCOME?

A. As shown on Schedule RJH-20, my recommended regulatory expense adjustment of $161,582 increases the Company's proposed test year after-tax operating income by $98,727.

- **Insurance Other Than Group Expense Adjustment**

Q. PLEASE EXPLAIN THE INSURANCE OTHER THAN GROUP EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-21.

A. The Company's proposed total test period insurance expenses of $694,597 consist of $155,642 for Property Insurance, $152,830 for Workers Comp, and $386,125 for General Liability insurance. While the Company regularly books Retro

Adjustments[15] for each of these three insurance expense categories, it has not reflected such Retro Adjustments for the projected test period Property Insurance and Workers Comp expenses, presumably because such Retro Adjustments can vary significantly from year to year and are therefore very difficult to forecast. However, the Company *has* proposed a Retro Adjustment charge of $29,240 for its projected test period General Liability insurance expenses. When asked for the basis of this expense estimate in data request AG-1-87(g), the Company responded that the projected $29,240 charge is based on historic and current claims. Below, I have listed the actual General Liability Retro Adjustments actually booked by KAWC since 1998:[16]

1998	($133,671)	- expense credit
1999	($50,351)	- expense credit
2000	-	
2001	-	
2002	$28,255	- expense charge
2003	$31,479	- expense charge
2004	$23,122	- expense charge
2005	$23,136	- expense charge
2006	$22,559	- expense charge
2007	($43,702)	- expense credit
2008	($97,494)	- expense credit
Average	($17,879)	- expense credit

The data in the above table indicate that the Company has averaged a Retro Adjustment *credit* of approximately $18,000. Based on this information, I believe that the Company's proposed Retro Adjustment *charge* of $29,240 should not be allowed for ratemaking purposes in this case.

[15] See response to AG-1-87, page 4 of 4.
[16] See response to AG-1-87, page 4 of 4.

As shown on Schedule RJH-21, the removal of this proposed estimated Retro Adjustment charge of $29,240 increases KAWC's proposed test period after-tax operating income by $17,866.

- **Maintenance Expense Adjustment**

Q. PLEASE EXPLAIN THE MAINTENANCE EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-22.

A. The total maintenance expense adjustment of $206,658 consists of three parts. First, I recommend a maintenance expense removal of $72,000 to correct for an error in the Company's proposed test period maintenance expenses in account 675000. This required expense correction was conceded by KAWC in its responses to AG-1-77 and AG-2-40.

Second, I recommend a maintenance expense removal of $128,513 to correct for an error in the Company's proposed test period Paving/Backfill maintenance expenses in account 675650. This required expense correction was conceded by KAWC in its response to PSC-1-37 and is calculated in footnote (2) of Schedule RJH-22.

Third, I recommend a $6,175 reduction in the Company's proposed test period Deferred Maintenance amortization expense. The reason for this expense adjustment is discussed in a previous section of this testimony.[17] The calculations underlying the recommended amortization expense adjustment of $6,175 are shown in footnote (3) of Schedule RJH-22.

As shown on Schedule RJH-22, the recommended total maintenance expense adjustment of $206,658 increases KAWC's proposed test period after-tax operating income by $126,268.

- **Gasoline Expense Adjustment**

Q. PLEASE EXPLAIN THE GASOLINE EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-23.

A. The cost of gasoline has experienced a precipitous drop since the Company prepared its filing. To illustrate this, below I have listed the most current available gasoline unit prices as compared to the corresponding unit prices upon which the Company's proposed test period gasoline expenses were based:

	KAWC	Current
Diesel	$3.97	$2.46
Gasohol	$3.40	$1.80
Unleaded Plus	$3.47	$1.77
Unleaded Super	$3.61	$1.92
Unleaded Regular	$3.37	$1.72

Since nobody really knows at this time at what level the gasoline unit prices will be in the forecasted test period, I believe it is appropriate to price the projected test

[17] The rate base testimony section regarding Deferred Maintenance Costs.

period gasoline expenses based on the most current available unit prices. As shown on Schedule RJH-23, this re-pricing of the test period gasoline costs results in an expense reduction of $182,363 which, in turn, increases KAWC's proposed test period after-tax operating income by $111,424.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE?

A. Yes. Given the volatility in the price of gasoline, the various gasoline unit prices listed on Schedule RJH-23 should be monitored up until the close of record in this proceeding. If, at that time, it appears that the unit prices are significantly different from the most recent available unit prices reflected on Schedule RJH-23, I recommend that the test period expenses be based on these latest gasoline unit prices.

- **Janitorial Expense Adjustment**

Q. PLEASE EXPLAIN THE JANITORIAL EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-8, LINE 18.

A. As conceded in the Company's response to AG-1-78, KAWC's proposed test period Janitorial expense is overstated by $41,270 ($35,438 + $5,832). As shown in footnote (2) of Schedule RJH-8, the removal of this overstated Janitorial expense increases KAWC's proposed test period after-tax operating income by $25,216.

- **Institutional Advertising Expense Adjustment**

Q. PLEASE EXPLAIN THE INSTITUTIONAL ADVERTISING EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-8, LINE 19.

A. As conceded in the Company's response to AG-1-83,[18] KAWC's proposed test period advertising expenses include $41,243 for institutional advertising that is prohibited from rate recovery under Administrative Regulation 807 KAR 5:016. As shown in footnote (3) of Schedule RJH-8, the removal of this institutional advertising expense increases KAWC's proposed test period after-tax operating income by $25,199.

- **Miscellaneous Expense Adjustments**

Q. PLEASE EXPLAIN THE MISCELLANEOUS EXPENSE ADJUSTMENTS SHOWN ON SCHEDULE RJH-24.

A. The miscellaneous expenses that I recommend be removed from test period expenses for ratemaking purposes in this case concern expenses for employee awards; employee dinner and gift cards; award banquets; company picnic; United Way function; holiday luncheon; and memberships for the Rotary Club, Lexington Forum and Commerce Lexington. Utility rates should include a reasonable level of costs that are necessary for the provision of safe, adequate and proper utility service. The miscellaneous expenses that I recommend be removed do not meet

[18] Also, see response to PSC-2-35.

this standard and should not be borne by the Company's customers; rather, they should be funded by KAWC's stockholders.

As shown on Schedule RJH-24, the removal of these miscellaneous expenses increases KAWC's proposed test period after-tax operating income by $29,920.

- **AFUDC Adjustment**

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED CONSTRUCTION WORK IN PROGRESS ("CWIP") AND ASSOCIATED ALLOWANCE FOR FUNDS USED DURING CONTRUCTION ("AFUDC") RATE TREATMENT IN THIS CASE.

A. As stated earlier in this testimony, the Company's proposed test period rate base in this case includes a 13-month average CWIP balance of $102,809,975, consisting of $98,203,884[19] for CWIP associated with the KRS II project and $4,613,460 for non-KRS II CWIP. While the entire test period KRS II CWIP balance of $98,203,884 represents AFUDC-accruing CWIP under the Company's AFUDC Policy and Guidelines, in this case the Company is seeking approval from the Commission to cease the accruing of AFUDC and, instead, receive a current rate of return on $66,569,975 of the total test period KRS II CWIP balance of $98,203,884. The KRS II CWIP balance of $66,569,975 for which the Company is requesting to

[19] Michael Miller testimony page 32 and WP1-4, p. 62 of 65.

earn a current rate of return represents the total projected KRS II CWIP balance on May 31, 2009, the start of the test period.

Q. WHY HAS THE COMPANY MADE THIS PROPOSAL?

A. The KRS II project is expected to be completed in November 2010[20] at an estimated total cost of approximately $162.7 million. On page 33 of his testimony, Michael Miller states with regard to the anticipated project completion:

> If no rate increase associated with the $162.741 million KRS II cost is embedded in rates (cash revenue) until completion of the KRS II Project in 2010, a significant rate increase will occur at that time. The Company believes the better approach for its customers would be to phase-in a portion of the KRS II Project in this case, thus avoiding the rate shock that would occur if the full cost of the KRS II Project were passed on to the customers in one rate case.

Q. HAS THE COMPANY CLAIMED THAT ONE OF THE MAJOR BENEFITS OF PROVIDING A CURRENT RETURN ON THE KRS II CWIP BALANCE OF $66.570 MILLION IS THAT THIS PROPOSED APPROACH IS SIGNIFICANTLY LESS COSTLY TO THE RATEPAYERS THAN CONTINUING TO ACCRUE AFUDC ON THIS BALANCE UNTIL COMPLETION OF THE PROJECT?

A. Yes. Not only has Mr. Miller made this claim in his testimony, he has also provided two Net Present Value ("NPV") analyses in his Exhibit MAM-7 that supposedly prove his point.

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[20] Response to AG-1-10.

Q. PLEASE DESCRIBE THE NPV ANALYSES IN EXHIBIT MAM-7.

A. On page 1 of Exhibit MAM-7, Mr. Miller has calculated the NPV over the assumed 56-year life of the KRS II Project based on the traditional CWIP approach with full AFUDC capitalized to the project ("Traditional CWIP Approach"). Mr. Miller has assumed that, under this approach, an additional $7.263 million[21] of AFUDC would be capitalized as CWIP in the first rate-effective year of this case, thereby increasing the total KRS II Project balance from $162.7 million to approximately $170.0 million ($162.7 + $7.263 million). Mr. Miller has calculated that the total revenue requirement over the assumed 56-year life of the entire KRS II Project on a present value basis would be $240.841 million in this Traditional CWIP Approach scenario.

On page 2 of Exhibit MAM-7, Mr. Miller has calculated the NPV over the assumed 56-year life of the KRS II Project based on the Company's proposed alternative phase-in approach ("Phase-In Approach"). Under this approach, no additional AFUDC of $7.263 million would be capitalized as CWIP in the first rate-effective year of this case but, instead, there will be a corresponding $7.263 million current return revenue requirement. Thus, while this approach holds the total KRS II Project balance to $162.7 million, the ratepayers will be charged with a current revenue requirement of $7.263 million in the first rate-effective year of this case. Mr. Miller has calculated that the total revenue requirement over the assumed 56-

[21] Since this represents the AFUDC for only <u>one year</u> on the $66.57 million KRS II CWIP at issue, Mr. Miller's illustration assumes that there will only be one year from the rate effective date of the current case until the rate effective date of KAWC's next rate case which would at that point include the entire KRS II project in plant in service earning a current return.

year life of the entire KRS II Project on a present value basis would be $220.113 million in this Phase-In Approach scenario.

From these two analyses, Mr. Miller then concludes that the Company's proposed Phase-In Approach costs the ratepayers of KAWC almost $21 million ($240.841 - $220.113 = $20.728 million) less over the life of the KRS II Project as compared to the rate treatment under the Traditional CWIP Approach.

Q. DO YOU AGREE WITH MR. MILLERS CONCLUSION AND NPV ANALYSES IN EXHIBIT MAM-7?

A. Not at all. With all due respect to Mr. Miller, his NPV analyses in his Exhibit MAM-7 are plain wrong. They are replete with computational and conceptual errors and lead to the wrong conclusions. While Mr. Miller concedes certain computational errors in his responses to AG data requests, he refuses to admit other errors that are quite obvious in his MAM-7 analyses and that dramatically impact his NPV results. I will show that once these errors are corrected, the NPV results of the Traditional CWIP Approach and the Phase-In Approach over the life of the KRS II Project are virtually the same. In fact, the ratepayers are slightly better off with the Traditional CWIP approach than with KAWC's proposed Phase-In Approach. It should also be noted that this conclusion is based on the assumption that KAWC will not experience *any* customer growth during the 56-year period used in the MAM-7 analyses. If one assumes customer growth and calculates the NPV difference between the Traditional CWIP Approach and Phase-In Approach on a per customer basis, the cost benefit to the ratepayers of using the Traditional CWIP Approach as opposed to the Phase-In Approach would even become larger. I will explain this in more detail this later on.

Q. PLEASE EXPLAIN THE FIRST ERROR IN MR. MILLER'S MAM-7 ANALYSES.

A. The first error is that Mr. Miller double-counted the tax gross up for the cost of debt used in the NPV analyses on MAM-7. This tax gross up issue is described in detail in data request AG-1-13. In response to this data request, Mr. Miller admitted his error and provided revised MAM-7 NPV analyses. The required revisions changed the NPV of the total revenue requirement over the assumed 56-year life of the KRS II Project under the Traditional CWIP Approach scenario from $240.841 million to $207.895 million and under the Company's proposed Phase-In Approach from $220.113 million to $190.922 million. Thus, this required correction changed the NPV difference between the Traditional CWIP Approach and the Phase-In Approach from $20.728 million to $16.973 million. Below, I have summarized Mr. Miller's original versus corrected MAM-7 NPV analyses (NPV in $millions):

	Traditional	Phase-In	Difference
Original Analyses	$240.841	$220.113	$20.728
Corrected for Tax Gross Up Double Count	$207.895	$190.922	$16.973

Q. PLEASE EXPLAIN THE SECOND ERROR IN MR. MILLER'S MAM-7 ANALYSES.

A. Both NPV analyses must look at revenue requirements over the same time period.

Mr. Miller's Traditional CWIP Approach analysis starts one year later than his Phase-In Approach analysis. This is patently incorrect – you cannot accurately compare two streams of revenue requirements if you are not using the same time periods. Specifically, in his proposed Phase-In Approach NPV analysis on MAM-7, page 2, Mr. Miller properly assumed that the ratepayers will begin paying the revenue requirement of $7.263 million associated with the proposed KRS II phase-in starting on the rate effective date of the instant rate case (let's call this Year 0). In deriving the Phase-In Approach original NPV amount of $220.113 million (and also the revised NPV amount $190.922 million that was corrected for the tax gross up error), Mr. Miller's NPV analysis properly started with the revenue requirement of $7.263 in Year 0, i.e., the NPV analysis was started effective with the date that the rates from this case will go into effect.

However, Mr. Miller incorrectly did not use the same appropriate present value method in his NPV analysis for the Traditional CWIP Approach on MAM-7, page 1. Specifically, Mr. Miller's NPV analysis did not recognize that in Year 0, i.e., effective with the rate effective date of this case, the ratepayers will have a zero revenue requirement associated with KRS II. That revenue requirement will not start until the rate effective date of the Company's next rate case (assumed to be Year 1 in Mr. Miller's NPV analysis). Thus, in deriving the Traditional CWIP Approach original NPV amount of $240.841 million (and also the revised NPV amount $207.895 million that was corrected for the tax gross up error), Mr. Miller's NPV analysis ignored the fact that there will be a $0 requirement associated with

KRS II starting with the rate effective date of this case. By starting his Traditional CWIP Approach analysis one year later, he effectively assumed that the full revenue requirement of KRS II will become effective with the rate effective date of this case, which is obviously incorrect. The correct Traditional CWIP Approach NPV analysis (that would be consistent with the NPV analysis for the Phase-In Approach on MAM-7, page 2) would show $0 revenue requirements in Year 0 and would then start the NPV analysis in Year 0. When this correct approach is used, the total Traditional CWIP Approach NPV amount would be $192.442 million. These facts were clearly presented to Mr. Miller in data request AG-1-39. While Mr. Miller agrees with my calculation of an NPV amount of $192.442 million, he does not want to concede that a correction should be made for this.

Q. COULD YOU NOW SUMMARIZE HOW MR. MILLER'S ORIGINAL MAM-7 NPV ANALYSES HAVE CHANGED AFTER CORRECTING FOR THE TAX GROSS UP DOUBLE COUNT AND MR. MILLER'S IGNORING OF THE $0 REVENUE REQUIREMENT IN YEAR 0 IN THE NPV ANALYSIS FOR THE TRADITIONAL CWIP APPROACH?

A. Yes. This summary is presented below (NPV in $millions):

	Traditional	Phase-In	Difference
Original Analyses	$240.841	$220.113	$20.728
Corrected for Tax Gross Up Double Count	$207.895	$190.922	$16.973
Corrected for Year 0 in NPV analysis	$192.442	$190.922	$ 1.52

Q. PLEASE EXPLAIN THE THIRD ERROR IN MR. MILLER'S MAM-7

ANALYSES.

A. An important element of Mr. Miller's MAM-7 NPV analyses is the discount rate used to "present value" the revenue requirement stream over the assumed 56-year life of the KRS II Project. Mr. Miller used a discount rate of 8.03%, which approximates the Company's requested after-tax cost of capital of 8.54%. Mr. Miller's Exhibit MAM-7 also shows that the after-tax rate of 8.03% is equivalent to a pre-tax rate of 10.91%. Mr. Miller performed the NPV analyses from the Company's perspective – that is, he used a discount rate that approximates KAWC's requested after-tax cost of capital. But the question of whether CWIP should be allowed in rates should be addressed from the ratepayers' perspective, i.e., are ratepayers better off paying before KRS II enters service (thereby reducing AFUDC), or are they better off waiting until the plant enters service with a higher (including AFUDC) rate base value? Ratepayers pay the pre-tax cost of capital because they not only pay for the cost of capital, they also pay for the income taxes associated with the equity component of the cost of capital. Thus, the discount rate to be used in the MAM-7 NPV analyses should be 10.91%, not 8.03%.

Using a discount rate of 10.91% rather than 8.03% (and including the two NPV corrections previously discussed) results in a total NPV amount of $150.052 million for the Traditional CWIP Approach and a total NPV amount of $150.174 million for the Company's proposed Phase-In Approach.

Q. COULD YOU NOW SUMMARIZE HOW MR. MILLER'S ORIGINAL

MAM-7 NPV ANALYSES HAVE CHANGED AFTER CORRECTING FOR (1) THE TAX GROSS UP DOUBLE COUNT, (2) MR. MILLER'S IGNORING OF THE $0 REVENUE REQUIREMENT IN YEAR 0 IN THE NPV ANALYSIS FOR THE TRADITIONAL CWIP APPROACH, AND (3) THE USE OF A DISCOUNT RATE OF 10.91%?

A. Yes. This summary is presented below (NPV in $millions):

	Traditional	Phase-In	Difference
Original Analyses	$240.841	$220.113	$20.728
Corrected for Tax Gross Up Double Count	$207.895	$190.922	$16.973
Corrected for Year 0 in NPV analysis	$192.442	$190.922	$ 1.52
Corrected for Discount Rate of 10.91%	$150.052	$150.174	$ (0.12)

Q. **HAVE YOU PREPARED EXHIBITS WITH THE NPV RUNS IN SUPPORT OF THE NPV NUMBERS IN THE ABOVE TABLE?**

A. Yes. I have prepared Exhibit I and Exhibit II which are attached to this testimony. Exhibit I contains the NPV runs for the 4 different Traditional CWIP Approach scenarios. Exhibit II contains the NPV runs for the 3 different Phase-In Approach scenarios.

Q. **DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE?**

A. Yes. While the previously described corrected MAM-7 NPV analysis indicates that the Traditional CWIP Approach is slightly less costly to the ratepayers of KAWC, this favorable cost differential only becomes larger when one takes customer growth into account and computes the cost differential on a per customer basis. On Exhibit III, attached to this testimony, I have performed an analysis showing the following information:

1) Without customer growth, the Traditional CWIP Approach is approximately $121,000 less costly to the ratepayers than the Phase-In Approach. Assuming a total number of customers of 123,197,[22] this equates to approximately $1,000 per customer.
2) With assumed customer growth of only .50% per year, the $1,000 per customer benefit under the Traditional CWIP Approach increases to $3,000 per customer. This benefit would only get larger if one assumes a higher customer growth rate.

Q. BASED ON THE PREVIOUSLY DISCUSSED FINDINGS AND CONCLUSIONS, DO YOU BELIEVE THAT THE COMPANY'S PROPOSAL TO PARTIALLY PHASE-IN THE KRS II CWIP SHOULD BE IMPLEMENTED IN THIS CASE?

A. No, I do not. Contrary to the Company's assertions, I have proven that the ratepayers are better off with the Traditional CWIP Approach than with KAWC's proposed Phase-In Approach. Thus, from a ratepayer benefit viewpoint, the Traditional CWIP Approach should continue to be adhered to by the Commission.

Q. ARE THERE OTHER REASONS WHY THE COMPANY'S PROPOSAL FOR A CURRENT RETURN ON THE $66.570 MILLION OF KRS II CWIP SHOULD BE REJECTED IN THIS CASE?

[22] KAWC Exhibit 36, page 42 of 42.

A. Yes. When it comes to the question as to who should finance the construction of the KRS II Project, I do not believe that the ratepayers should be forced to start doing so. First, this project is not currently used and useful in providing water service to KAWC's customers. Second, the Company's cost of financing this project is lower than the opportunity cost of many of the ratepayers who may face borrowing costs as high as 18%. Third, the Company has not argued in this case that it does not have the finances available to fund the project. Finally, this is not the time to make this novel ratemaking proposal that would significantly increase the charges to the ratepayers. Given the current economic crisis, it is now, more than ever, that the ratepayers need relief from increasing utility rates.

Q. COULD YOU SUMMARIZE YOUR RECOMMENDATION REGARDING THIS ISSUE?

A. I recommend that the Company should continue to accrue AFUDC on the entire KRS II investment balance included in the test period CWIP.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE COMPANY'S PROPOSED AFUDC POSITION AS COMPARED TO YOUR RECOMMENDED AFUDC POSITION?

A. Yes. I show this information on Schedule RJH-25. First, at the top of this schedule I show that the proposed average test period CWIP balance of $102,809,975 consists of $36,240,000 for AFUDC-accruing CWIP[23] and $66,569,975 for the test period KRS II CWIP portion for which the Company is requesting approval to cease the accruing of AFUDC and, instead, receive a current cash return. This information was confirmed by the Company in its response to AG-2-6.

In the lower part of Schedule RJH-25, I show that the Company's proposed above-the-line AFUDC income in this case amounts to $3,094,804, calculated by applying its proposed overall rate of return of 8.54%[24] to the average test period AFUDC-accruing CWIP balance of $36,240,000. Since the Company is requesting a current cash return on the remaining average test period CWIP balance of $66,569,945, the total AFUDC amount proposed by KAWC remains an amount of $3,094,804.

Q. HOW DOES THIS KAWC-PROPOSED AFUDC OF $3,094,804 COMPARE TO YOUR RECOMMENDED AFUDC AMOUNT IN THIS CASE?

A. As shown on Schedule RJH-25, I am recommending a total AFUDC amount of $7,760,223 in this case. This recommended AFUDC amount is lower to the extent that the AG's recommended overall rate of return of 7.548% is lower than KAWC overall rate of return of 8.54%, and higher to the extent that I am recommending that the test period KRS II CWIP portion of $66.570 million continue to accrue AFUDC rather than earn a current cash return.

[23] This $36,240,000 of AFUDC-accruing CWIP includes $31,633,909 of KRS II CWIP on which AFUDC will continue to be accrued.
[24] It is Commission policy to equalize the AFUDC rate and the overall rate of return for ratemaking purposes.

Q. HOW DOES YOUR RECOMMENDED AFUDC ADJUSTMENT IMPACT THE COMPANY'S AFTER-TAX OPERATING INCOME?

A. As shown on Schedule RJH-25, my AFUDC recommendation increases KAWC's proposed test period after-tax operating income by $2,850,571.

D. REVENUE REQUIREMENT IMPACT OF ADJUSTMENTS

Q HAVE YOU PREPARED A SCHEDULE SHOWING THE REVENUE REQUIREMENT IMPACT OF EACH OF YOUR RECOMMENDED ADJUSTMENTS IN THIS CASE?

A. Yes. On Schedule RJH-26, I have quantified the revenue requirement impact of each of the rate of return, rate base, revenue and expense adjustments recommended by me in this testimony.

Q. MR. HENKES, DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.