COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES ON AND AFTER MARCH 28, 2010	))))	**CASE NO. 2010-00036**

REBUTTAL TESTIMONY OF KEITH CARTIER

---

1. Q. WHAT IS YOUR NAME, TITLE AND BUSINESS ADDRESS AND HAVE YOU FILED DIRECT TESTIMONY IN THIS CASE?

A. My name is Keith Cartier. I am Vice President, Operations for Kentucky American Water. My business address is 2300 Richmond Road, Lexington, Kentucky 40502. I filed Direct Testimony on February 26, 2010 in support of the Company's Application.

2. Q. HAVE YOU REVIEWED THE TESTIMONY OF MR. RALPH SMITH AND DO YOU HAVE ANY COMMENTS REGARDING ASPECTS OF THAT TESTIMONY?

A. Yes, I have reviewed Mr. Smith's testimony and have comments on the portion of it regarding the KRS I lagoon cleaning cost projection.

3. Q. WHAT ARE YOUR COMMENTS ON MR. SMITH'S TESTIMONY REGARDING KRS I LAGOON CLEANING?

A. Mr. Smith suggests that averaging the last four lagoon cleaning costs is an appropriate methodology for arriving at a suggested cost for 2011 cleaning. I believe that is a flawed methodology for projecting what a future bid will be. Mr. Smith's methodology uses non-inflated costs from ten, seven, five and two years back.

4. Q. WHAT INFORMATION SHOULD BE CONSIDERED IN ADDITION TO YOUR ORIGINAL TESTIMONY REGARDING LAGOON CLEANING COSTS?

A. For the most recent (2009) cleaning, the attached bids (KC Rebuttal Exhibit 1) were received from four contractors. The bids ranged in price from the low of $180,000 to a high of $635,000 and averaged $339,836.

Contractor	Bid
C. B. Construction Co.	$180,000
C. J. Hughes Construction	$316,345
Dix and Associates Pipeline, Inc.	$635,000
SLA Inc. dba Adkins Excavating	$228,000
Average	$339,836
Average w/o high bid	$241,448

In reviewing the bids, one may presume the high bid is an outlier as it is double the next highest bid. A reasonable projection may be derived by throwing out the high bid, and averaging the remaining three bids. That yields an average of $241,448. Inflating that even minimally over the two years (from 2009 when those bids were received to 2011 when the new bids will be solicited) yields a figure greater than the $245,000 included in the 2011 budget. I also believe one must consider the economic environment in which those most recent bids were received, and its impact on construction trades at that time. I do not believe it prudent to expect a similar low bid when proposals are solicited next year. Therefore, I believe the original budget number submitted for lagoon cleaning is appropriate and a prudent estimate of costs that KAW will incur to clean the lagoon.

5. Q. DO YOU HAVE ANY OTHER CONCERNS REGARDING MR. SMITH'S TESTIMONY REGARDING LAGOON CLEANING?

Yes. The methodology implies that the cleaning is nearly identical each time and that is generally the case. However, KAW plans to conduct an engineering study of the dewatering area at KRS I in advance of next year's lagoon cleaning. Recommendations from that assessment may lead to changes in process, (i.e., more dried material removal than has been the case in prior clean outs before wet material is added to the drying area). KAW anticipates that recommendations arising from that study may include structural changes to the dewatering area or changes to dewatering process. A change in either will affect the proposals solicited and bids received.

6. Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

C. B. Construction Company

P.O. Box 965
233 East French Ave.
Burnside, Kentucky 42519
(606) 561-9963

Mob. 859-361-6750

From: William Christopher
C. B. Const. Co.
Time 11:00 AM 3-26-09

To: William E. Hardy Jr.
American Water
800 West Hershey PA 17033

Bid Form,
Ky. River Station Sludge Removal
5 pages to Follow

BID FORM

PUMPING, TRANSPORTATION, AND BENEFICIAL USE OF WATER TREATMENT RESIDUALS FROM:

KENTUCKY RIVER STATION

Bid Due Date: Thursday March ~~25~~ 26, 2008 – 4 PM (via e-mail, fax or regular mail)

THIS BID IS SUBMITTED TO:

William E. Hardy, Jr.
American Water
800 West Hershey Park Dr.
Hershey, PA 17033
717-531.3287 Fax 717-531-3235
William.hardy@amwater.com

1. The undersigned Bidder proposes and agrees, if this Bid is accepted, to enter into an Agreement with OWNER in the form included in the Contract Documents to perform and furnish all Work as specified in the Contract Documents for the Contract Price and within the Contract Times indicated and in accordance with the other terms and conditions of the Contract Documents.

2. Bidder accepts all of the terms and conditions of the Invitation to Bid, Instructions to Bidders and Project Specifications. This Bid will remain subject to acceptance as stated in the Instructions to Bidders. Bidder will sign and submit the Agreement and other documents required by the Bidding Requirements within ten (10) days after the date of OWNER's notice of award.

3. In submitting this Bid, Bidder represents, as more fully set forth in the Agreement:

   (a) Bidder has examined copies of all the Bidding Documents.

   (b) Bidder has familiarized itself with the nature and extent of the Contract Documents, Work, site, locality, and all local conditions and Laws and Regulations that in any manner may affect cost, progress, performance or furnishing of the Work.

   (c) Bidder has familiarized itself with the site conditions.

   (d) Bidder has given written notice of all conflicts, errors or discrepancies that it has discovered in the Contract Documents and the written resolution thereof by OWNER is acceptable to Bidder.

   (e) This Bid is genuine and not made in the interest of or on behalf of any undisclosed person, firm or corporation and is not submitted in conformity with any agreement or rules of any group, association, organization or

corporation; Bidder has not directly or indirectly induced or solicited any other Bidder to submit a false or sham Bid; Bidder has not solicited or induced any person, firm or corporation to refrain from bidding; and Bidder has not sought by collusion to obtain for itself any advantage over any other Bidder or over OWNER.

4. Bidder will provide a total lump sum price for all required Work as outlined in the Exhibit A –Scope of Work:

- **Kentucky River Station**

  Lump Sum Proposal for 2009 Residuals Project: # 180,000.00

5. Bidder will complete the Work for the prices shown above.

6. Bidder acknowledges receipt of the following Addenda issued by OWNER:

   Addenda Numbers: - 0 -

7. The terms used in this Bid which are defined in the Terms and Conditions of the Contract Documents have the meanings assigned to them in the Terms and Conditions.

SUBMITTED on: March 26th, 2009.

If Bidder is:
An Individual

By William Christopher
(Signature)

William Christopher
(Print/Type Individual's Name)

Doing Business As: C. B. Const. Co.

Business Address: 233 East French Ave. P.O. Box 965 Burnside Ky 42519

Phone No.: 606-561-9963 Mob. 859-361-6750

A Partnership

By ______________________
(Signature)

____
(Print/Type General Partner's Name)

By ______________________ (SEAL)
(Firm Name)

Business Address:______________________________

Phone No.:______________________________

<u>A Corporation</u>

By ______________________________(CORPORATE SEAL)
(Print Corporation Name)

____
(State of Incorporation)

By ______________________________
(Name of Person Authorized to Sign)

____
(Title)

Attest ______________________________
(Secretary)

Business Address: ______________________________

Phone No.: ______________________________

ACORD CERTIFICATE OF LIABILITY INSURANCE

DATE (MM/DD/YYYY) 03/20/2009

PRODUCER
Jarvis Insurance Agency, Inc.
37 Public Square
P O Box 13
Somerset, KY 42502

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW.

INSURED
William Christopher DBA C B Construction Company
P O Box 985
Burnside, KY 42519

INSURERS AFFORDING COVERAGE	NAIC #
INSURER A: OHIO CASUALTY INSURANCE CO	
INSURER B: Kentucky Employers Mutual Insurance	
INSURER C:	
INSURER D:	
INSURER E:	

COVERAGES

THE POLICIES OF INSURANCE LISTED BELOW HAVE BEEN ISSUED TO THE INSURED NAMED ABOVE FOR THE POLICY PERIOD INDICATED. NOTWITHSTANDING ANY REQUIREMENT, TERM OR CONDITION OF ANY CONTRACT OR OTHER DOCUMENT WITH RESPECT TO WHICH THIS CERTIFICATE MAY BE ISSUED OR MAY PERTAIN, THE INSURANCE AFFORDED BY THE POLICIES DESCRIBED HEREIN IS SUBJECT TO ALL THE TERMS, EXCLUSIONS AND CONDITIONS OF SUCH POLICIES. AGGREGATE LIMITS SHOWN MAY HAVE BEEN REDUCED BY PAID CLAIMS.

INSR LTR	ADD'L INSRD	TYPE OF INSURANCE	POLICY NUMBER	POLICY EFFECTIVE DATE (MM/DD/YY)	POLICY EXPIRATION DATE (MM/DD/YY)	LIMITS	
A	X	GENERAL LIABILITY X COMMERCIAL GENERAL LIABILITY CLAIMS MADE X OCCUR X $250 Property Damage Deductible GEN'L AGGREGATE LIMIT APPLIES PER: X POLICY / PRO-JECT / LOC	BHO50631446	05/28/08	05/28/09	EACH OCCURRENCE	$ 1,000,000
						DAMAGE TO RENTED PREMISES (Ea occurence)	$ 100,000
						MED EXP (Any one person)	$ 10,000
						PERSONAL & ADV INJURY	$ 1,000,000
						GENERAL AGGREGATE	$ 2,000,000
						PRODUCTS - COMP/OP AGG	$ 2,000,000
A		AUTOMOBILE LIABILITY ANY AUTO ALL OWNED AUTOS X SCHEDULED AUTOS X HIRED AUTOS X NON-OWNED AUTOS	BAO50631446	05/28/08	05/28/09	COMBINED SINGLE LIMIT (Ea accident)	$ 1,000,000
						BODILY INJURY (Per person)	$
						BODILY INJURY (Per accident)	$
						PROPERTY DAMAGE (Per accident)	$
		GARAGE LIABILITY ANY AUTO				AUTO ONLY - EA ACCIDENT	$
						OTHER THAN AUTO ONLY: EA ACC	$
						AGG	$
A		EXCESS/UMBRELLA LIABILITY X OCCUR CLAIMS MADE DEDUCTIBLE X RETENTION $ 10,000	USO50631446	05/28/2008	05/28/2009	EACH OCCURRENCE	$ 4,000,000
						AGGREGATE	$ 4,000,000
							$
							$
							$
B		WORKERS COMPENSATION AND EMPLOYERS' LIABILITY ANY PROPRIETOR/PARTNER/EXECUTIVE OFFICER/MEMBER EXCLUDED? If yes, describe under SPECIAL PROVISIONS below	304482	09/23/2008	09/23/2009	X WC STATU-TORY LIMITS / OTH-ER	
						E.L. EACH ACCIDENT	$ 1,000,000
						E.L. DISEASE - EA EMPLOYEE	$ 1,000,000
						E.L. DISEASE - POLICY LIMIT	$ 1,000,000
		OTHER					

DESCRIPTION OF OPERATIONS / LOCATIONS / VEHICLES / EXCLUSIONS ADDED BY ENDORSEMENT / SPECIAL PROVISIONS

Certificate holder is included as additional insured with respect to liability arising out of the named insured's operations performed on behalf of holder as required by written contract. Excess policy follows form for Employers Liability, General Liability and Auto Liability policies without exception and shall be indicated as such with an endorsement from the insurer. Any coverage afforded to the Additional Insured shall apply as primary & not excess to any other insurance or self insurance available to the Additional Insured. William Christopher is excluded under the workers compensation coverage.

CERTIFICATE HOLDER

William E. Hardy, Jr.
American Water
800 West Hershey Park Dr.
Hershey, PA 17033

CANCELLATION

SHOULD ANY OF THE ABOVE DESCRIBED POLICIES BE CANCELLED BEFORE THE EXPIRATION DATE THEREOF, THE ISSUING INSURER WILL ENDEAVOR TO MAIL 10 DAYS WRITTEN NOTICE TO THE CERTIFICATE HOLDER NAMED TO THE LEFT, BUT FAILURE TO DO SO SHALL IMPOSE NO OBLIGATION OR LIABILITY OF ANY KIND UPON THE INSURER, ITS AGENTS OR REPRESENTATIVES.

AUTHORIZED REPRESENTATIVE
James Mc McClung

ACORD 25 (2001/08)

BID FORM

PUMPING, TRANSPORTATION, AND BENEFICIAL USE OF WATER TREATMENT RESIDUALS FROM:

KENTUCKY RIVER STATION

Bid Due Date: Thursday March 19, 2008 – 4 PM (via e-mail, fax or regular mail)

THIS BID IS SUBMITTED TO:

William E. Hardy, Jr.
American Water
800 West Hershey Park Dr.
Hershey, PA 17033
717-531.3287
William.hardy@amwater.com

1. The undersigned Bidder proposes and agrees, if this Bid is accepted, to enter into an Agreement with OWNER in the form included in the Contract Documents to perform and furnish all Work as specified in the Contract Documents for the Contract Price and within the Contract Times indicated and in accordance with the other terms and conditions of the Contract Documents.

2. Bidder accepts all of the terms and conditions of the Invitation to Bid, Instructions to Bidders and Project Specifications. This Bid will remain subject to acceptance as stated in the Instructions to Bidders. Bidder will sign and submit the Agreement and other documents required by the Bidding Requirements within ten (10) days after the date of OWNER's notice of award.

3. In submitting this Bid, Bidder represents, as more fully set forth in the Agreement:

   (a) Bidder has examined copies of all the Bidding Documents.

   (b) Bidder has familiarized itself with the nature and extent of the Contract Documents, Work, site, locality, and all local conditions and Laws and Regulations that in any manner may affect cost, progress, performance or furnishing of the Work.

   (c) Bidder has familiarized itself with the site conditions.

   (d) Bidder has given written notice of all conflicts, errors or discrepancies that it has discovered in the Contract Documents and the written resolution thereof by OWNER is acceptable to Bidder.

   (e) This Bid is genuine and not made in the interest of or on behalf of any undisclosed person, firm or corporation and is not submitted in conformity with any agreement or rules of any group, association, organization or

corporation; Bidder has not directly or indirectly induced or solicited any other Bidder to submit a false or sham Bid; Bidder has not solicited or induced any person, firm or corporation to refrain from bidding; and Bidder has not sought by collusion to obtain for itself any advantage over any other Bidder or over OWNER.

4. Bidder will provide a total lump sum price for all required Work as outlined in the Exhibit A –Scope of Work:

- **Kentucky River Station**

  Lump Sum Proposal for 2009 Residuals Project: $316,345.00

5. Bidder will complete the Work for the prices shown above.

6. Bidder acknowledges receipt of the following Addenda issued by OWNER:

   Addenda Numbers: 1

7. The terms used in this Bid which are defined in the Terms and Conditions of the Contract Documents have the meanings assigned to them in the Terms and Conditions.

SUBMITTED on: March 26, 2009.

If Bidder is:
An Individual

By______________________________
(Signature)

____
(Print/Type Individual's Name)

Doing Business As:______________________________

Business Address:______________________________

Phone No.:______________________________

A Partnership

By______________________________
(Signature)

____
(Print/Type General Partner's Name)

By______________________________(SEAL)
(Firm Name)

Business Address:____

Phone No.:____

A Corporation

By C. J. Hughes Construction Co. Inc. (CORPORATE SEAL)
(Print Corporation Name)

West Virginia
(State of Incorporation)

By Dwight Randolph
(Name of Person Authorized to Sign)

President
(Title)

Attest ____
(Secretary)

Business Address: 75 West 3rd Ave Huntington, WV
Phone No.: 304-399-2305

AMERICAN WATER

Request for Quotes

Residuals Removal

Kentucky River Station

Kentucky American Water
2300 Richmond Road
Lexington, KY 40502

1. CONFIDENTIALITY AND NON-DISCLOSURE

This Request for Proposal (RFQ) and the information contained herein, and any other information, data, materials of or about American Water (AW) or its business operations in connection with this RFQ, constitute highly sensitive and confidential information, and is the property of AW. Each potential supplier (Supplier) shall regard this RFQ and all such information, data, and materials as strictly confidential. This RFQ and all proposals submitted to AW, and all other information, data, materials, and communications relating to this RFQ shall be subject to the terms of the Non-Disclosure Agreement (NDA) that has been executed between AW and Supplier. Each Supplier must recognize that AW operates in a highly competitive business environment and, for that reason, the Supplier must not disclose any portion or portions of this RFQ, or of any such information, data, and materials, to any of its business partners, affiliates, or subcontractors, or to any other third party, unless each such business partner, affiliate, subcontractor, or other third party, as the case may be, first executes a confidentiality agreement no less restrictive than the NDA that has been signed by the Supplier and AW.

2. GENERAL COMPANY INFORMATION

With headquarters in Voorhees, NJ, American Water employs approximately 6,900 dedicated professionals who provide drinking water, wastewater and other related services to approximately 16.2 million people in 32 states and Ontario, Canada. More information can be found by visiting www.amwater.com.

Supplier's Proposal

1.1 Invoicing

AW requires that all suppliers break down each invoice such that labor, material, and any taxes are shown as separate line items for each purchase. Please confirm your company's ability to comply with this requirement.

YES

2.1. Labor

Do you employ union or non-union workers? If union, please provide answers to the following:

1. When was the last time, if ever, that you had a strike?
2. When does your current labor agreement end?
3. What contingency plans do you have in the event of a strike?

Non-Union

2.2. Health & Safety

Does your company have a written safety policy, mission statement or other document addressing your company's attitude and responsibility towards worker safety and the safety of the general public?

YES

Does your company have a designated safety officer? If yes, please provide this individual's name, qualifications, work experience, etc.

YES; Justin M. Dix

Please provide the number of OSHA Lost Workdays and Recordable Incident Rate for each year for the past five (3) years. OSHA Form 200 or equivalent document may be requested.

Will Provide If Low Bidder

Please list all OSHA (or other health and safety agency) violations issued against your company for the last three (3) years and include a description for each offense.

None

Please provide your Worker's Compensation Experience Ratings (Experience Modifier) for the past five (5) years.

1.	(Year)	(EMR)
2.	(Year)	(EMR)
3.	(Year)	(EMR)
4.	(Year)	(EMR)
5.	(Year)	(EMR)

Has your company received notice of any violations related to the environment, labor, health and safety, or other matters from any government or governmental agency in the past 7 years? If you answered yes, please explain.

No

2.3. *Equipment*

Please provide us with a listing of equipment to be used to perform the required services.

Excavators, Dozers, Trucks, Etc.

2.4. *Sub-Contractor Disclosure*

You cannot subcontract without AW's express written permission. If the execution of work to be performed by your company requires the hiring of sub-contractors, you must clearly state this in your proposal. Sub-contractors must be identified and the work they will perform must be defined. AW will not refuse a proposal based upon the use of sub-contractors; however AW retains the right to refuse the sub-contractors you have selected. Your company shall remain solely responsible for the performance of all work, including work that you sub-contract.

Do you anticipate utilizing subcontractors to fulfill your obligations under an agreement with AW? If so, what percentage of work do you anticipate will be subcontracted? Also, how does your company qualify its subcontractors?

No

3. SUPPLIER BACKGROUND INFORMATION

3.1. *Supplier Organizational Structure*

Provide your company's full legal name, company mailing address and phone number. Indicate whether your company is a sole proprietorship, a partnership or a corporation.

Dix And Assoc. Pipeline, Inc., 210 Industry Pkwy., Nich. KY 40356

How many employees does your company currently have?

35

Describe your company's current and former relationship with AW.

40 Years

3.2. *Supplier Contacts*

Provide the name, title, fax number, email address, and telephone number of the person who will be the principal point of contact for your company relative to this RFQ, including the person who will be the principal contact related to any contractual dialogue and administration of any agreement resulting from this RFQ.

R.L Dix, Wes Naylor, and Justin M. Dix

3.3. *Experience*

How many years has your company been in the business associated with this solicitation? Identify your company's primary business and secondary business, including all subsidiaries.

30 Years, Underground Utilities, and Site Work

What percentage of your business is currently with AW?

60%

3.4. Supplier Diversity Status

Is your company certified as being any of the diverse supplier classifications (defined by being at least 51% owned, operated and controlled) by an identified group? If yes, please indicate your company's classification by marking the appropriate box.

- Minority-Owned Business Enterprise ☐
- Women-Owned Business Enterprise ☐
- Veteran-Owned Business Enterprise ☐
- Service Disabled Veteran-Owned Business Enterprise ☐
- Small Business ☐
- Small Disadvantaged Business ☐
- HUB Zone Business ☐
- Other ☐

Please use the box below to list the name of the organization which certified your business as a diverse supplier, as well as the expiration date of that certification. In addition please attach a copy of the certification when responding to the RFQ and include the specific name of the document. If your company is not currently certified, please detail any future plans your company may have to become certified.

N/A

3.5. Supplier References

Provide relevant references and/or customer testimonies.

Greg Tomko, Gerald Jackson, and Linda Bridwell

Non-Disclosure Agreement

During the course of discussions between American Water Works Service Company, Inc. (AW) and Dix & Associates Pipeline ("Supplier") relating to and for the purpose of proposing and evaluating potential supply agreements, each company may disclose to the other information it considers proprietary and confidential ("Confidential Information"). Confidential Information includes (a) all information provided by AW relating to contract terms and the identity, kind, quality and quantity of materials for which bids are sought, (b) the price submitted by each Supplier when taken together with the identity of that Supplier, and (c) all other information in tangible form marked by the disclosing party as confidential or which the disclosing party orally indicates is confidential if such information is provided orally. The company providing the Confidential Information is the "Provider" and the company receiving it is the "Recipient". We each agree, as a Recipient, as follows:

Recipient will use the Confidential Information of the Provider only in the furtherance of the purpose described above and will protect the confidentiality of Provider's Confidential Information in the same manner it protects the confidentiality of its own proprietary and confidential information.

Recipient will restrict disclosure or availability of the Confidential Information to only those subsidiaries, and employees (and, in AW's case, consultants contracted to assist in the overall evaluation and selection of qualified suppliers) who (a) have a need to know based on participation in and contribution to the project with Provider and who (b) have been informed by Recipient of Provider's proprietary interest and of Recipient's obligations of confidentiality.

Recipient is not prohibited or limited in the use of information (included but not limited to ideas, concepts, know-how, techniques, and methodologies) (I) previously known to it, (II) independently developed by it, (III) acquired by it from a third party which was not, to the best of the Recipient's knowledge, under an obligation to Provider not to disclose such information, or (IV) which is or becomes publicly available through no breach by Recipient.

Recipient shall be responsible and liable to Provider for any breach of this agreement by Recipient, including without limitation any of its affiliates, subsidiaries, directors, officers, or employees. We both recognize and acknowledge that any breach or threatened breach may result in irreparable injury to Provider for which monetary damages may not be an adequate remedy, and Provider shall be entitled (without proving monetary damages) to temporary and/or permanent injunctions from a court restraining such breach or threatened breach. Injunctive relief shall not be deemed to be the exclusive remedy for any such breach or threatened breach of this Agreement, but shall be in addition to all other remedies available to Provider at law or in equity. The rights and obligations provided in this Agreement shall continue whether or not the parties enter into a supply agreement.

Agreed and Accepted by:		
Company Name	American Water	Dix & Associates Pipeline Cont. Inc.
By:	William E. Hardy, Jr.	Robert L. Dix
Title:	Manager	President
Date:	3/5/09	3/11/09
Signature:	William E. Hardy, Jr.	RLD Dix Pres.

BID FORM

PUMPING, TRANSPORTATION, AND BENEFICIAL USE OF WATER TREATMENT RESIDUALS FROM:

KENTUCKY RIVER STATION

Bid Due Date: Thursday March 19, 2008 – 4 PM (via e-mail, fax or regular mail)

THIS BID IS SUBMITTED TO:

William E. Hardy, Jr.
American Water
800 West Hershey Park Dr.
Hershey, PA 17033
717-531.3287
William.hardy@amwater.com

1. The undersigned Bidder proposes and agrees, if this Bid is accepted, to enter into an Agreement with OWNER in the form included in the Contract Documents to perform and furnish all Work as specified in the Contract Documents for the Contract Price and within the Contract Times indicated and in accordance with the other terms and conditions of the Contract Documents.

2. Bidder accepts all of the terms and conditions of the Invitation to Bid, Instructions to Bidders and Project Specifications. This Bid will remain subject to acceptance as stated in the Instructions to Bidders. Bidder will sign and submit the Agreement and other documents required by the Bidding Requirements within ten (10) days after the date of OWNER's notice of award.

3. In submitting this Bid, Bidder represents, as more fully set forth in the Agreement:

   (a) Bidder has examined copies of all the Bidding Documents.

   (b) Bidder has familiarized itself with the nature and extent of the Contract Documents, Work, site, locality, and all local conditions and Laws and Regulations that in any manner may affect cost, progress, performance or furnishing of the Work.

   (c) Bidder has familiarized itself with the site conditions.

   (d) Bidder has given written notice of all conflicts, errors or discrepancies that it has discovered in the Contract Documents and the written resolution thereof by OWNER is acceptable to Bidder.

   (e) This Bid is genuine and not made in the interest of or on behalf of any undisclosed person, firm or corporation and is not submitted in conformity with any agreement or rules of any group, association, organization or

corporation; Bidder has not directly or indirectly induced or solicited any other Bidder to submit a false or sham Bid; Bidder has not solicited or induced any person, firm or corporation to refrain from bidding; and Bidder has not sought by collusion to obtain for itself any advantage over any other Bidder or over OWNER.

4. Bidder will provide a total lump sum price for all required Work as outlined in the Exhibit A –Scope of Work:

- **Kentucky River Station**

  Lump Sum Proposal for 2009 Residuals Project: $635,000.00

5. Bidder will complete the Work for the prices shown above.

6. Bidder acknowledges receipt of the following Addenda issued by OWNER:

   Addenda Numbers: #1, #2 E-mail

7. The terms used in this Bid which are defined in the Terms and Conditions of the Contract Documents have the meanings assigned to them in the Terms and Conditions.

SUBMITTED on: March 26, 2009.

If Bidder is:
An Individual

By ______________________
(Signature)

____
(Print/Type Individual's Name)

Doing Business As: N/A.

Business Address: ______________________

Phone No.: ______________________

A Partnership

By ______________________
(Signature)

N/A.
(Print/Type General Partner's Name)

By ______________________(SEAL)
(Firm Name)

Business Address: ______________________________

Phone No.(859) ______________________________

A Corporation

By Dix And Associates Pipeline, Inc. (CORPORATE SEAL)

(Print Corporation Name)

Kentucky

(State of Incorporation)

By Robert L. Dix [signature] Pres.

(Name of Person Authorized to Sign)

President

(Title)

Attest X [signature]

(Secretary)

Business Address: 210 Industry Parkway, Nicholasville, KY 40356

Phone No.: (859) 887-2661

BID FORM

PUMPING, TRANSPORTATION, AND BENEFICIAL USE OF WATER TREATMENT RESIDUALS FROM:

KENTUCKY RIVER STATION

Bid Due Date: Thursday March 19, 2008 – 4 PM (via e-mail, fax or regular mail)

THIS BID IS SUBMITTED TO:

William E. Hardy, Jr.
American Water
800 West Hershey Park Dr.
Hershey, PA 17033
717-531.3287
William.hardy@amwater.com

1. The undersigned Bidder proposes and agrees, if this Bid is accepted, to enter into an Agreement with OWNER in the form included in the Contract Documents to perform and furnish all Work as specified in the Contract Documents for the Contract Price and within the Contract Times indicated and in accordance with the other terms and conditions of the Contract Documents.

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   (b) Bidder has familiarized itself with the nature and extent of the Contract Documents, Work, site, locality, and all local conditions and Laws and Regulations that in any manner may affect cost, progress, performance or furnishing of the Work.

   (c) Bidder has familiarized itself with the site conditions.

   (d) Bidder has given written notice of all conflicts, errors or discrepancies that it has discovered in the Contract Documents and the written resolution thereof by OWNER is acceptable to Bidder.

   (e) This Bid is genuine and not made in the interest of or on behalf of any undisclosed person, firm or corporation and is not submitted in conformity with any agreement or rules of any group, association, organization or

corporation; Bidder has not directly or indirectly induced or solicited any other Bidder to submit a false or sham Bid; Bidder has not solicited or induced any person, firm or corporation to refrain from bidding; and Bidder has not sought by collusion to obtain for itself any advantage over any other Bidder or over OWNER.

4. Bidder will provide a total lump sum price for all required Work as outlined in the Exhibit A –Scope of Work:

- **Kentucky River Station**

Lump Sum Proposal for 2009 Residuals Project: **$ 228,000.00**

5. Bidder will complete the Work for the prices shown above.

6. Bidder acknowledges receipt of the following Addenda issued by OWNER:

   Addenda Numbers: n/a

7. The terms used in this Bid which are defined in the Terms and Conditions of the Contract Documents have the meanings assigned to them in the Terms and Conditions.

SUBMITTED on: March 26, 2009.

If Bidder is:
An Individual

By______________________________
(Signature)

____
(Print/Type Individual's Name)

Doing Business As:________________________

Business Address:________________________

Phone No.:____________________________

A Partnership

By______________________________
(Signature)

____
(Print/Type General Partner's Name)

By______________________________(SEAL)
(Firm Name)

Business Address:____

Phone No.:____

A Corporation

By SLA INC dba Adkins Excavating (CORPORATE SEAL)
(Print Corporation Name)

West Virginia
(State of Incorporation)

By Steven L. Adkins
(Name of Person Authorized to Sign)

President/Owner
(Title)

Attest ____
(Secretary)

Business Address: 5205 State Route 10, Barboursville, WV 25504

Phone No.: 304-736-8960

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	**)**	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES ON AND AFTER March 28, 2010	**))))**	**CASE NO. 2010-00036**

REBUTTAL TESTIMONY OF MICHAEL A. MILLER

KENTUCKY-AMERICAN WATER COMPANY
PSC CASE NO. 2010-00036
REBUTTAL TESTIMONY OF MICHAEL A. MILLER

1. Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

A. Michael A. Miller, 1600 Pennsylvania Avenue, Charleston, West Virginia.

2. Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?

A. Yes.

3. Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I will address several recommendations discussed in the direct testimony of AG witnesses Smith and Woolridge, and LFUCG witness Baudino:

1. General/Forecasted Test-Year - - Page 1
2. Capital Structure & Cost of Long-term and Short-term Debt - - Page 4
3. Return on Equity - - Page 7
4. Rate Base - - Page 12:
   - CWIP - - Page 13_
   - UPAA - - Page 16
   - Deferred Maint. Expense–Labor - - Page 17
   - ADIT –Deferred Maintenance - - Page 19
   - Accum. Depr & ADIT-ACRS - - Page 19
   - Cash Working Capital - - Page 20
   - Major Accounting Change - - Page 20
5. Incentive Compensation - - Page 25
6. Pension and OPEBs - - Page 38
7. Rate Case Expense - - Page 38
8. AWWSC Costs - - Page 46
9. Federal Income Taxes - - Page 61
10. Employee Related Expenses - - Page 72
11. Cost Cap - KRS II - - Page 72
12. Interest Synchronization - - Page 73
13. Low Income Tariff - - Page 73

GENERAL - FORECASTED TEST-YEAR

4. Q. DO YOU HAVE ANY GENERAL COMMENTS ON THE POSITIONS TAKEN BY THE AG WITNESS SMITH?

A. Yes. Mr. Smith on a number of cost of service elements is attempting to change long-standing policy of the Commission. He loosely uses such terms as matching issues in the forecasted test-year approach, single issue regulation problems with amortization of certain expenses as permitted under FAS 71, and the term normalization as a cure for all problems. While AG witness Crane in case number 2004-00103 showed outright disdain for the use of a forecasted test-year approach to establishing fair and reasonable rates, Mr. Smith's approach is more subtle regarding the forecasted test-year. He is also very selective in his references and applications of regulatory concepts mentioned above, but he attempts to change long-standing Commission policy for items such as CWIP/AFUDC and rate case expense by saying there are matching principle issues, or that FAS 71 doesn't apply to forecasted test-year cases, or there are single issue rate making.

Mr. Smith attempts to "muddy the waters" with his rhetoric, but he is just wrong about the applicability of those rate making concepts as they apply to forecasted test-year filings. His testimony ignores long-standing Commission policy and practice and lacks credible supporting evidence or analysis supporting his positions. In some cases his sole support for adjustments is the position of a different AG witness in the Company's 2007 and 2008 rate cases which ended in settlement. It also struck me as somewhat contradictory in his testimony that in the case of the Kentucky-American Water Company's ("Company or KAWC") proposal for recovery of rate case expense from prior cases through the amortization periods historically used by the Commission, he uses those same settlement agreements as support for his position. The testimony that follows will address a number of cost of service elements addressed by Mr. Smith where his misapplication of accepted regulatory concepts will be highlighted to show his recommendations should not be accepted by the Commission. The most noticeable feature of the AG's recommendations is that there is little, if any, support to deviate from Commission precedent other than to indicate that different methods are used in other regulatory jurisdictions. The Company's case comports with Commission practice and precedent. I will explain where Mr. Smith's suggested deviations are offered in an obvious attempt to unjustly and unreasonably understate a fair and reasonable cost of service.

5. Q. DOES KENTUCKY LAW PERMIT THE USE OF A FORECASTED TEST YEAR?

A. Yes. As permitted under 807 KAR Chapter 5 and as authorized by KRS 278.192 and 278.310, the Company has filed each case since 1993 using a fully forecasted test-year.

6. Q. HAVE THERE BEEN PROBLEMS WITH THE USE OF A FORECASTED TEST-YEAR APPROACH?

A. Not from the Company's perspective and we don't believe from the Commission's perspective either. The Commission's rules require a very defined and detailed filing exhibit to support the forecasted test-year filings, but the process has resulted in fair and reasonable results for the Company and its customers. The Company has been able to maintain stable financial results, it has not overachieved authorized ROE, but has been able to attract capital, adequately carry out its public service obligation, improve service and address its major cost needs, including the KRS II plant and pipeline project. The method of determining fair and reasonable rates takes many different forms in the various state regulatory jurisdictions. Some states utilize fully forecasted test years and others use historical test years. There are literally hundreds of variations regarding determining cost of service elements. However, I know of no state that does not permit known and measurable adjustments to historical test-years in order to determine the proper cost of service during the time rates will be effective. Other states require a historical test-year but permit post-test year rate base additions for committed construction and other states also permit CWIP. The Company believes that a fully forecasted test-year filing has the best potential for the establishment of fair and reasonable rates and has worked well for the Company, its customers, and the Commission.

7. Q. WOULD YOU SPEAK TO MR. SMITH'S COMMENTS THAT THE USE OF CWIP AND DEFERRED ASSETS ARE INCONSISTENT WITH A FORECASTED TEST-YEAR?

A. Mr. Smith has raised the exact same argument put forth by AG witness Ms. Crane in case number 2004-00103. This Commission has appropriately recognized CWIP in the forecasted test-year (along with a corresponding offset for AFUDC) in the Company's past filings which I will cover in detail later in this testimony. The use of a forecasted test-year has absolutely nothing to do with the Commission's consideration for the ratemaking treatment of CWIP and other deferred assets requested by the Company in this case. This area will also be addressed in detail later in the testimony.

CAPITAL STRUCTURE AND COST OF LONG-TERM AND SHORT-TERM DEBT

8. Q. HAVE YOU REVIEWED THE TESTIMONY CONCERNING CAPITAL STRUCTURE FILED BY DR. WOOLRIDGE AND MR. BAUDINO?

A. Yes.

9. Q. WHAT CAPITAL STRUCTURE WAS USED BY DR. WOOLRIDGE AND MR. BAUDINO IN ARRIVING AT THEIR RECOMMENDATIONS FOR THE COST OF CAPITAL?

A. Both Dr. Woolridge and Mr. Baudino used the thirteen-month average capital structure for the forecasted test-year proposed by the Company without adjustment.

10. Q. DID DR. WOOLRIDGE OR MR. BAUDINO SUGGEST CHANGES TO THE SHORT-TERM AND LONG-TERM INTEREST RATES PROPOSED BY THE COMPANY?

A. Mr. Baudino did not take exception to either the Short-term ("ST") or Long-term ("LT") debt rates proposed by the Company. Dr. Woolridge proposes a lower ST debt interest rate than the Company and proposes a lower LT debt interest rate on the Company's proposed $25.0 million LT debt financing that will be closed in November 2010.

11. Q. DO YOU AGREE WITH THE SHORT-TERM DEBT RATE PROPOSED BY DR. WOOLRIDGE?

A. No.

12. Q. WHY DO YOU NOT AGREE WITH DR. WOOLRIDGE'S SHORT-TERM DEBT RATE?

A. Dr. Woolridge limits his analysis to the average spread between KAW ST debt rates for the six months ended November 2009 and Fed Funds Rate (per Exhibit MAM-6) applied to the current Fed Funds Rate (per Exhibit JRW-5, page 3 of 4). The problem with this approach is that it does not attempt to determine what a reasonable ST debt rate would be for the forecasted test-year in this case, even though financial forecasts permitting such an analysis are obviously available to Dr. Woolridge.

13. Q. HAVE YOU PERFORMED AN ANALYSIS FROM AVAILABLE, CREDIBLE FINANCIAL FORECASTS OF A REASONABLE SHORT-TERM DEBT RATE FOR THE FORECASTED TEST-YEAR IN THIS CASE?

A. Yes. In my direct testimony I performed such an analysis using the most current information available to me at the time this case was filed which produced a ST interest rate for the forecasted test-year of 2.0847%. That analysis was attached to my direct testimony as Exhibit MAM-6 and applied the spread of actual ST debt rates of KAW for the six months ended November 2009 to the fed funds rate forecasted by the Value Line Publication for 2011. I also indicated in my direct testimony that I would update that information as we moved forward in this case.

14. Q. HAVE YOU PREPARED AN UPDATE TO THE ANALYSIS PROVIDED IN EXHIBIT MAM-6?

A. Yes. That update is provided with this rebuttal testimony and identified as Rebuttal Exhibit MAM-1. The schedule determines the average spread between actual KAW ST debt rates for the twelve months ended June 2010 to fed funds rates. This average spread was then added to the forecasted fed funds rate for 2011 of 1.6% as published in the Value Line Publication of May 28, 2010, the latest information available to me. This resulted in a ST interest rate of $1.9004% which I recommend be used to establish the Weighted Average Cost of Capital ("WACC") used to establish the rates approved by the Commission in this case. In the update to the base year filed on July 15, the Company changed its requested ST debt rate to 1.900% for the forecasted test-year WACC.

15. Q. DO YOU AGREE WITH DR. WOOLRIDGE'S LONG-TERM DEBT RATE FOR THE $25.0 MILLION TAXABLE LONG-TERM DEBT ISSUE THAT THE COMPANY WILL PLACE IN NOVEMBER 2010?

A. No. The reason is essentially the same as my issue with Dr. Woolridge's approach to the ST debt rate; he makes no effort to perform an analysis to determine a reasonable rate based on a long-term bond to be issued in November 2010. As shown on Exhibit JRW-5, page 4 of 4, Dr. Woolridge limits his analysis of the interest rate for the November 2010 bond rate to the five week actual data ended June 4, 2010, although sufficient forecasted data is or should be available to Dr. Woolridge to do so. I find it very interesting, but troubling that Dr. Woolridge is able to determine in this case a much more complicated analysis regarding the future cost of equity capital using in part the same Financial Publication that I use to look at the forecasted cost of equity, but he fails to do so for the cost of ST and LT debt rates.

16. Q. HAVE YOU PERFORMED AN ANALYSIS OF WHAT A REASONABLE LONG-TERM TAXABLE INTEREST RATE WOULD BE IN NOVEMBER 2010 FOR A BBB- RATED UTILITY BOND?

A. Yes. That analysis is attached to this testimony and identified as Rebuttal Exhibit MAM-2. The schedule used the Value Line publication to determine the spreads between 30-year BBB-rated utility bonds and 30-year treasury bonds for the four quarters ended June 2010. Those quarterly average spreads are then added to the Value Line Publication of May 28, 2010 forecasts for 30-year Treasury Bonds for November 2010. This results in a range of 30-year taxable bond rates for the Company of 6.200% to 6.387% as shown on the bottom right of page 2 of 2 of Rebuttal Exhibit MAM-2. This rate is above the 5.9% rate proposed by Dr. Woolridge, but below the 6.663% used by the Company in its filing.

RETURN ON EQUITY

17. Q. HAVE YOUR REVIEWED THE TESTIMONY OF DR. WOOLRIDGE AND MR. BAUDINO REGARDING RETURN ON EQUITY?

A. Yes.

18. Q. DO YOU HAVE ANY GENERAL COMMENTS ABOUT THAT TESTIMONY?

A. Yes. As I read their testimony it is their opinion and belief that their analysis fully captures investor expectations and produces an ROE of 9.5% (Mr. Baudino) and 9.25% (Dr. Woolridge). The bottom line is their recommendations are below any reasonable expectation of the cost of equity capital for KAW, and below the level at which it would be difficult for the Company to attract equity capital. Their recommendations should not be adopted in this case. Dr. Vander Weide's rebuttal testimony will address the problems, issues and shortcomings the Company has with their approaches to the various DCF, Risk Premium and CAPM methods, I will focus on the end results of their recommendation.

19. WHAT IS THE DIFFERENCE IN REVENUE REQUIREMENT AT 9.25% ROE RECOMMENDED BY THE ATTORNEY GENERAL AND THE 9.5% ROE RECOMMENDED BY THE LFUCG TO THE 11.50% INCLUDED IN THE COMPANY'S FILING?

A. Based on the Company's revenue requirement model each change of 25 basis points (0.25%) changes the revenue requirement by approximately $656,000. Based on that data, the differences between the Company's and the AG's ROE is equivalent to approximately $5.904 million of revenue requirement, and the difference between the Company's and LFUCG's ROE is equivalent to approximately $5.248 million of revenue requirement. These differences demonstrate how important the ROE issue is in this case.

20. Q. DID MR. BAUDINO MAKE REFERENCE TO THE AUTHORIZED ROE OF THE OTHER AWW REGULATED SUBSIDIARIES?

A. Yes.

21. Q. HOW DID HE USE THIS DATA?

A. I agree with Mr. Baudino that a comparison of the ROE recommendations in this case to other AWW subsidiaries is meaningful but in an entirely different context than the one used by Mr. Baudino. On page 35 of his testimony, Mr. Baudino provides Table 2 which indicates the authorized ROEs of various AWW regulated subsidiaries arriving at an average ROE of the regulated subsidiaries of 10.29%. He reaches the conclusion from his review of this data that Dr. Vander Weide's recommendation of 11.5% ROE in this case is unreasonable. Dr. Vander Weide's range of ROE is 10.8% - 12.1%. It was the Company who choose to use the 11.5% within Dr. Vander Weide's range, which was the mid-point of his range and a reasonable return on which to base its filing based on the Company's assessment. Dr. Vander Weide's range is within the range of authorized ROEs of AWW subsidiaries with the highest being 12% and several in 10.5% to 10.8% range. In reviewing Mr. Baudino's recommendations on page 31, his range is 8.12% to 10.07% (DCF only). Under Mr. Baudino's misplaced theory one could just as easily say his range is excessively low. The same may be said for the 7.3% - 9.3% range of Dr. Woolridge (page 2 of his testimony) when compared to the AWW regulated subsidiaries authorized ROEs. While I believe that Mr. Baudino's use of the data is misplaced, I do believe a more thorough analysis of the authorized ROEs of other AWW regulated subsidiaries is useful to assess the reasonableness of the wide range of ROE recommendations by the three cost of capital witnesses in this case.

22. Q. HAVE YOU PREPARED AN ANALYSIS THAT UTILIZES THE AUTHORIZED ROES OF AMERICAN WATER REGULATED SUBSIDIARIES TO ASSESS THE RATE OF RETURN RECOMMENDATION OF MR. BAUDINO AND DR. WOOLRIDGE?

A. Yes. That analysis is attached to this testimony and identified as Rebuttal Exhibit MAM-3. This analysis includes the most recent authorized ROE for the regulated AWW subsidiaries compared to the A-Rated utility bond rate per the Value Line publication at the time of the Order in each of those rate proceedings.

23. Q. WHY SHOULD THE COMMISSION CONSIDER THE A-RATED UTILITY BONDS TO ASSESS THE BASIS POINTS SPREAD (RISK PREMIUM) FOR THE COMPANY'S ROE IN THIS CASE?

A. The utility business is a long-term business. Utility plant investments are recovered over many years, with useful depreciation lives for water mains, for instance, of upwards of 70 years. Many water lines and treatment plants remain in service for over 100 years. It is also a ratemaking and financial community axiom that there is greater risk associated with the ownership of the equity in a company than with the ownership of the debt of a company, based on the simple fact that the shareholders stand "last in line" in the event of dissolution. Consequently, a comparison of current rates for long-term bonds in relation to authorized ROEs provides a viable and meaningful calculation of the extent of that additional risk.

24. Q. YOU INDICATED EARLIER THAT YOU DISAGREE WITH THE ROE RECOMMENDATIONS OF THE AG AND LFUCG WITNESSES. WHY?

A. The recently authorized ROEs for other AWW operating subsidiaries, when compared to the Value Line interest rate for A-rated utility bonds at the time of the Order, demonstrates just how low the AG's and LFUCG's ROE recommendations are. The analysis contained on Rebuttal Exhibit MAM-3 is a simple comparison method the Commission can use to assess the risk between A-rated utility bonds and equity recognized by Commissions in other jurisdictions in determining a fair and reasonable rate of return on equity, and to assess the fairness and reasonableness of the recommended ranges of ROE in this case.

25. Q. PLEASE RECAP YOUR ANALYSIS SHOWN ON REBUTTAL EXHIBIT MAM-3?

A. In the top section of the exhibit the authorized ROEs of AWW regulated subsidiaries are compared to the A-rated utility bonds at the time of the order in each case establishing that authorized ROE. Then the spread (difference between the authorized ROE and A-rated utility bond rate) is calculated. The first shaded line shows the averages for the AWW subsidiaries of 10.29% ROE and a 4.33% average spread to A-rated utility bonds. In the middle section I compare those results to the recommendations of Dr. Woolridge's and Mr. Baudino's for ROE of 9.25% and 9.5% respectively. The results were the AG's recommended ROE of 9.25% was 104 basis points below the average AWW subsidiary ROE and 123 basis points below the average spread of AWW ROE to A-rated utility bonds. For this purpose I used the forecasted A-rated utility bonds for 2011, which were taken from Rebuttal Exhibit MAM-2, page 2 of 2. The results for the LFUCG recommended ROE of 9.5% was 79 basis points below the AWW average ROE and 98 basis points below the average spread of AWW ROE to A-rated utility bonds. I believe this comparison shows the recommendations of Dr. Woolridge and Mr. Baudino are unreasonably low when compared to the other AWW regulated subsidiaries.

26. Q. DID YOU DETERMINE WHAT THE ROE WOULD BE USING THE AVERAGE SPREAD OF AWW AUTHORIZED ROE APPLIED TO THE A-RATED UTILITY BONDS FOR THE FORECASTED TEST-YEAR?

A. Yes. In the bottom section of Rebuttal Exhibit MAM-3 I applied the average spread of AWW ROE to A-rated utility bonds for 2011 (the first full year which rates for this case will be effective) as calculated on page 2 of 2 of Rebuttal Exhibit MAM-2. The result of this calculation produces ROEs of 10.50%, 10.45% and 10.48% respectively.

27. Q. WHY IS IT IMPORTANT TO CONSIDER THE ROES OF THE OTHER AWW REGULATED SUBSIDIARIES IN ESTABLISHING THE AUTHORIZED ROE IN THIS PROCEEDING?

A. The Company does not obtain its equity capital in the open market, but obtains that equity from its parent, AWW. Each of the rate of return witnesses recognizes this fact and utilizes a proxy group of publicly-traded water companies to determine a market expectation of ROE. There is an incredibly wide range of recommendations from the cost of capital witnesses for the Company, the AG and the LFUCG in this case. If the Company (as would any company) is to be able to obtain capital when needed to maintain facilities and improve service, it must have the opportunity to achieve an ROE that is equivalent to companies with similar risk. I believe it is appropriate, if not essential, that the Commission review all available data on ROE, including the level of ROE that other regulatory commissions are recognizing as fair and reasonable based on the most current data. All of these AWW subsidiaries obtain their equity capital from the same parent, all obtain their debt from AWCC, all have similar capital structures, and all face similar financial and business risks. These returns can, at the very least, provide a frame of reference and comparison in the Commission's determination for a fair and reasonable return on equity in this case. Given the extremely wide range of results in the recommendations in this case, it is both reasonable and essential that the Commission look at all available data, including other commission decisions, to test the fairness and reasonableness of the ROE recommendations in this case. AWW is again a publicly traded company and it must obtain its equity in the market place, as AWCC must do for the debt needed by the AWW subsidiaries. As we know financial market conditions are tough, and credit is tight. It should not be assumed that AWW or AWCC will provide additional capital to under-performing subsidiaries. Like any prudent investor, AWW will invest its available equity capital where it can earn a fair rate of return, one that is commensurate with the returns it earns from other regulated subsidiaries. All else being equal, a prudent investor will not invest capital in KAWC at 9.25% if higher returns are available elsewhere.

28. Q. IS THE COMPANY ASKING THE COMMISSION TO USE THE METHOD JUST DESCRIBED TO DETERMINE THE ROE?

A. No. The Company is only asking that Commission consider the information in determining the reasonableness of the ROE it establishes in this case. The Company believes that a comparison of other Commission established risk premiums between ROE and the A-rated utility bonds at the time the ROE was established, when compared to the current bond market expectations, provides a valuable point of reference for the Commission. This is particularly true when the comparative companies compete for the same equity capital, obtain their capital from the same source, and have very similar business and financial risk.

RATE BASE

29. Q. WHAT RATE BASE IS BEING RECOMMENDED BY MR. SMITH?

A. The AG is recommending a rate base of $352,362,756. This compares to the rate base request of the Company in its updated Exhibit 37-schedule B of $363,668,114 or a difference of $11,305,358 (See Exhibit RCS-1) The updated Schedule B was provided with the base period update filed on July 15, 2010.

30. Q. WHAT IS THE MAJOR DIFFERENCE IN THE RATE BASE RECOMMENDATIONS?

A. The primary difference is related to the proposed elimination of CWIP by Mr. Smith, with other reductions to acquisition adjustment, cash working capital, deferred maintenance, accumulated depreciation and accumulated income taxes as shown on RCS-1, page 2 of 2.

31. Q. WHAT PROBLEMS ARE CREATED FOR THE COMPANY IF RATE BASE IS REDUCED BY $11.305 MILLION?

A. The Company provided a reconciliation of invested capital to rate base as Exhibit 9 to its filing. That exhibit indicates the Company will have capital invested in the Company of $360.229 million based on the 13-month average capital structure determined in the forecasted test-year. The Company simply cannot be expected to absorb the carrying cost of $11.305 million of capital and have any expectation of a reasonable opportunity to achieve whatever ROE the Commission establishes in this case. The annual revenue requirement difference on the unrecovered invested capital (rate base) of $11.305 million not included in the AG's rate base recommendation is approximately $1.135 million (offset by $646,180 of AFUDC included as going-level revenue in the Company's filing). If the AG's recommendation for rate base were approved, on the first day the rates from this case are effective the Company would have to overcome an erosion of its earnings of 19 basis points in order to achieve it authorized ROE.

<u>Construction Work In Progress</u>

32. Q. DOES MR. SMITH ELIMINATE THE CWIP INCLUDED AS RATE BASE IN THE COMPANY'S FILING?

A. Yes. He excludes the CWIP saying essentially the same things that AG witness Andrea Crane said in case number 2004-00103:

1. CWIP should not be included in rate base without compelling reasons.
2. KAWC has not demonstrated why CWIP should be included in rate base.
3. CWIP is not yet in service.
4. KAWC has not shown CWIP to be non-revenue producing.

5. CWIP violates the matching principle.
6. Revenues have not been extended past the test-year (presumably he means the historical test-year) to correspond with customer growth.
7. CWIP is not used and useful and may never serve customers.
8. CWIP should never be a rate base item, and
9. Inclusion of CWIP is inappropriate in a forecasted test year filing.

33. Q. HOW HAS THE COMMISSION HISTORICALLY TREATED CWIP IN THE COMPANY'S RATE FILINGS?

A. In the exact manner as proposed by the Company in this filing, with the CWIP included in rate base and an offsetting adjustment to AFUDC above the line for rate making purposes. As explained in the responses to questions 6 and 7 above, Commissions use various methods in their regulatory practices to arrive at a just and reasonable cost of service on which to base rates. Just because Mr. Smith has not seen CWIP in rate base in other states where he has appeared before Commissions (he mentions Illinois and Arizona), does not support his proposal in Kentucky, and certainly is not justification for the Commission to change its long-established rate making methodology. On pages 2-3 of his testimony I see where Mr. Smith has appeared previously in Kentucky, New Jersey, Pennsylvania and Virginia, states where other AWW regulated subsidiaries are located and where I believe Commissions recognize post test-year committed construction and/or CWIP in rate base. Regardless, without a full examination and explanation of how other state commissions treat cost of service elements and test years, comparison to results in those jurisdictions is meaningless. Consequently, Mr. Smith's reference to Illinois and Arizona regulation is of no value to this Commission, and his selective reference to only those two states is misleading at best.

34. Q. DO YOU HAVE OTHER COMMENTS ON THE ITEMS OF MR. SMITH'S RECOMMENDATION CONCERNING CWIP ENUMERATED IN THE RESPONSE TO QUESTION 32 ABOVE?

A. Yes. The Company has provided a massive amount of information about its Capital Spending levels and individual projects both in its original filing and in response to numerous data requests issued by the AG. In addition, the Company has calculated the slippage factors regarding its capital spending versus budget as has been the Commission's practice and policy, and supplied updates to its case about the impact of those factors in response to Commission Staff data requests. Mr. Smith's contention that the Company has not met its burden of proof concerning forecasted test-year capital investment is simply not accurate.

Mr. Smith's assertion concerning a matching problem between forecasted test-year capital investment and revenues or customer growth is again simply inaccurate. The Company fully forecasted customer growth through the end of the forecasted test-year in determining going-level revenue. The Company's inclusion of customer growth properly matches going–level revenue with the capital investment included in the forecasted test-year related to new customers.

35. Q. HAS THE COMPANY ACHIEVED SOME WINDFALL IN ITS EARNINGS FROM THE MANNER IN WHICH THE COMMISSION HAS TREATED RATE BASE?

A. No. As indicated in my direct testimony and previously in this rebuttal testimony, the Company has not been above the level of ROE authorized by the Commission. The Commission's historical treatment of CWIP with above the line AFUDC properly matches the invested capital and rate base during the forecasted test-year for which rates in this case will be established.

36. Q. DOES MR. SMITH'S ADJUSTMENT CONSIDER ALL ASPECTS OF THE RATEMAKING PROCESS?

A. No. The Commission recognizes the components of the capital structure on a 13-month average of the forecasted test-year in its rate setting process. The capital structure then includes any ST debt used to finance the CWIP during the forecasted test year. Therefore there is a proper matching of the rate base and the actual invested capital in the Company's forecasted test-year capital structure.

37. Q. YOU SAID EARLIER THAT MR. SMITH HAS INTRODUCED NOTHING DIFFERENT IN SUPPORT OF HIS ELIMINATION OF CWIP FROM THE FORECASTED TEST-YEAR THAN AG WITNESS CRANE DID IN CASE NUMBER 2004-00103. DID THE COMMISSION AGREE WITH THE AG IN THE 2004 CASE?

A. No. In its order in case number 2004-00103 the Commission said, "We find no merit in the AG's argument that CWIP should be eliminated because of Kentucky-American's use of a forecasted test year. Theoretically, the purpose of a forecasted test-year is to reduce the regulatory lag experienced in historical test period rate cases by forecasting and matching revenue requirements and rates with the actual 12-month period for which rates will first be placed into effect. Kentucky-American is entitled to a return on non-AFUDC bearing CWIP regardless of the test period employed."[1]

<u>Utility Plant Acquisition Adjustments</u>

38. Q. PLEASE DESCRIBE THE ADJUSTMENTS MADE BY THE AG TO THE COMPANY'S FILING FOR UTILITY PLANT ACQUISITION ADJUSTMENTS?

A. As Mr. Smith indicates on page 17 of his testimony, in response to data request PSC-2-41 the Company indicated it had erred in double counting the unamortized balance of the Boonesboro acquisition adjustment in rate base. The Company does not contest this issue, and in fact included this adjustment to the forecasted test-year as part of its filing of the updated base year information filed July 15.

[1] See Commission Order in case number 2004-00103, page 12 (For entire discussion about CWIP see pages 10-12).

Deferred Maintenance – Labor Cost

39. Q. DOES MR. SMITH PROPOSE ANY ADJUSTMENT TO DEFERRED MAINTENANCE COSTS?

A. Yes. He applies a 1.68% labor factor to the $2,708,236 of deferred maintenance costs included in the Company's filing to arrive at a reduction in the deferred maintenance expense of $45,500 as shown on Exhibit RCS-1, Schedule B-4.

40. Q. WHAT SUPPORT DOES MR. SMITH GIVE FOR THIS ADJUSTMENT?

A. His only support is to reference an adjustment proposed by AG witness Robert Henkes in case number 2008-00427. He did not provide or reference any other support for this adjustment and it does not appear that he performed any analysis to support this adjustment.

41. Q. DID THE SETTLEMENT AGREEMENT OR COMMISSION ORDER IN CASE NUMBER 2008-00427 INCLUDE ANY MENTION THAT THE PARTIES OR THE COMMISSION UTILIZED MR. HENKES' ADJUSTMENT IN DETERMINING FAIR AND REASONABLE RATES IN THAT CASE?

A. No.

42. Q. DID MR. SMITH REFERENCE ANY OTHER COMMISSION PROCEEDING ON THIS SUBJECT?

A. Yes, he references the Commission order in case number 2000-120. In that order the Commission eliminated a portion of the Boonesboro acquisition adjustment related to Company labor that had been charged to the cost of that acquisition. This was done based on an analysis of those costs prepared and supported by testimony in that case. However, in this case, Mr. Smith made no effort or performed no analysis to determine if any Company labor was included in the deferred maintenance balances or to determine the actual, if any, impact on the forecasted test-year labor and benefit costs utilized in the Company's filing.

43. Q. SHOULD THE COMMISSION GIVE ANY WEIGHT TO MR. SMITH'S RECOMMENDATION CONCERNING REDUCTIONS TO DEFERRED MAINTENANCE?

A. No. Mr. Henkes' testimony in a prior case is no support for adjustments in this case, particularly so when the AG witness in this case did not perform any independent analysis on the topic. As evidenced on WP-1-10, the deferred maintenance balances related to tank inspections, paintings and maintenance, and hydrant paintings that are primarily performed by contractors.

44. Q. HAS THE COMPANY CHARGED LABOR TO DEFERRED MAINTENANCE?

A. I have not performed an analysis to determine that, but the Company in past cases has indicated that the engineering staff has charged some time to the inspection of tanks. I believe this practice is appropriate and has resulted in a small amount of company labor to be included in the deferred maintenance balance.

45. Q. WHY IS IT APPROPRIATE TO CHARGE A PORTION OF ENGINEERING LABOR TO DEFERRED MAINTENANCE-TANK PAINTING EXPENSE?

A. Because that charge by the engineering staff accurately reflects what duties they perform. This does not result in the Company recovering that labor twice in this case. The Company's forecasted test-year O&M labor is determined by applying an appropriate capitalization rate to total labor and labor related benefit costs. Since the engineering costs charged to tank inspections are embedded in the Company's capitalization rate, as well as the capitalization rate proposed by the AG and LFUCG, the Company is not recovering that engineering labor as a period (O&M) cost in the forecasted test-year. Appropriately the Company is only recovering that engineering cost through the amortization of the deferred maintenance-tank painting cost over the life of the maintenance job -- 15 years (as historically approved by the Commission and proposed by the Company in this case).

Accumulated Deferred Income Tax – Deferred Maintenance

46. Q. WHAT ADJUSTMENT DID MR. SMITH MAKE TO THE ACCUMULATED DEFERRED INCOME TAX – DEFERRED MAINTENANCE PROPOSED BY THE COMPANY?

A. Mr. Smith adjusted ADIT-Deferred Maintenance for the impact of his adjustment to deferred maintenance expense as shown on RCS-1, Schedule B-6. The testimony above demonstrates that Mr. Smith's adjustment to deferred maintenance expense is without merit, thus this adjustment to the Company's proposed deferred income taxes should also not be utilized by the Commission in setting appropriate rates in this case.

Accumulated Depreciation and Deferred Income Tax on Accelerated Depreciation

47. Q. DID MR. SMITH MAKE AN ADJUSTMENT TO ACCUMULATED DEPRECIATION RELATED TO HIS PROPOSED ADJUSTMENT TO DEPRECIATION EXPENSE FOR NET NEGATIVE SALVAGE ON SERVICES?

A. Yes as shown on RCS-1, Schedule B-5.

48. Q. DOES THE COMPANY AGREE WITH THIS ADJUSTMENT?

A. No. Mr. Spanos is providing rebuttal testimony regarding Mr. Smith's adjustment to the Net Negative Salvage ("NNS") percentage proposed by Mr. Spanos in his direct testimony and supporting depreciation study. The Company believes the NNS percentage for services proposed by Mr. Spanos in his testimony and supporting depreciation study is appropriate to recover the cost of that class of asset of its remaining useful life and should be approved by the Commission. This adjustment to accumulated depreciation and accumulated deferred income taxes as proposed by Mr. Smith is not appropriate based on the appropriate depreciation rate supported by Mr. Spanos.

Cash Working Capital

49. Q. WILL YOU ADDRESS THE ADJUSTMENT TO CASH WORKING CAPITAL PROPOSED BY MR. SMITH?

A. Yes. Mr. Smith expresses his disagreement with the inclusion of several items in the lead lag study and working capital calculation related to depreciation expense, amortizations, deferred income taxes and return on equity. All of these items were raised by AG witness Crane in case number 2004-00103. The Commission's order in that case sided with the Company on those issues. Mr. Smith, while disagreeing with the Company approach, appropriately did not adjust the working cash allowance for the non-cash items. He did adjust the working cash allowance for each of his adjustments to applicable cost of service elements. The Company is rebutting most of those AG adjustments and the Commission should appropriately adjust working cash allowance to reflect its final decision on each area in the led-lag study.

Major Accounting Change – Capitalized Repairs (Accumulated Deferred Income Tax Rate Base Deduction)

50. Q. DID AMERICAN WATER WORKS APPLY FOR AND INCLUDE IN ITS 2008 FEDERAL INCOME TAX RETURN A PERIOD DEDUCTION FOR EXPENSES PREVIOUSLY CAPITALIZED AND DEPRECIATED ON BOTH A BOOK AND TAX BASIS?

A. Yes. Mr. Smith quotes on page 21 of his testimony KAWC's response to data request AG-2-122 in which KAW states that AWW changed the method of tax accounting related to repairs and maintenance by the filing of Form 3116 with the IRS on December 31, 2008. Mr. Smith also quotes from the Company's response to AG-2-85 that the IRS subsequently approved AWW's requested change in tax accounting. AWW also included those book capitalized repairs as period tax deductions on the 2008 tax return retroactively to the capitalized repairs beginning in 2001.

51. Q. DID MR. SMITH MAKE ANY ADJUSTMENT TO THE COMPANY'S REQUESTED ACCUMULATED DEFERRED INCOME TAX BASED ON THE CHANGE IN INCOME TAX ACCOUNTING RELATED TO CAPITALIZED REPAIRS?

A. No, but on pages 25-26 of his testimony Mr. Smith appears to say the Company did not reflect the proper reduction to rate base for the deferred income taxes related to the timing differences in the per books and per tax return difference in the treatment of capitalized repairs expense. He goes on to say on page 27 that the Commission should require the Company to identify the amount of ADIT-Capitalized Repairs requested in AG-2-129(e), and to confirm that KAW did **not** reflect that amount as a reduction to rate base in its filing. First, the Company denies Mr. Smith's contention that it did not reflect a rate base reduction for the proper accumulated deferred income taxes related to the capitalized repairs tax deduction which will be clearly demonstrated below. Second, the Company would like to dispel the allegation that it was not responsive to AG-2-129(e). In response, for the second time, KAWC directed Mr. Smith to areas of the previous discovery responses and the Company's filing where he could find that information. In addition, the Company willingly provided follow-up information on this topic to the AG when they requested that we do so after discovery was complete and after Mr. Smith raised this issue in his testimony.

52. Q. IS MR. SMITH CORRECT TO SAY THE COMPANY DID NOT PROPERLY REFLECT ACCUMULATED DEFERRED INCOME TAXES RELATED TO CAPITALIZED REPAIRS DEDUCTIONS IN ITS FILING?

A. No. The Company did properly reflect the rate base reduction related to the accumulated deferred income taxes recorded on the books at December 2009 and appropriately adjusted the 2009 accumulated deferred income taxes for capitalized repairs to reflect capitalized repairs forecasted for 2010 and through the forecasted test-year ended September 30, 2011 in its filing.

In establishing the FIN 48 reserve for a portion of the capitalized repairs deduction, the Company and its auditors determined those deductions are more likely than not to <u>not</u> be recognized as tax deductions by the IRS. The Company clearly indicated in the response to AG-2-123 that the FIN 48 reserve was only a partial offset to the entire capitalized repairs deduction taken on the income tax return. AG-2-16 was a follow-up to the response to AG-1-28. In AG-1-28 the AG asked for detail about the accumulated deferred income taxes related to all book/tax timing differences. On pages 22 and 23 of the response to AG-1-28 (line 170) the Company provided the accumulated deferred income tax balance at December 31, 2009 of $4,335,857 related to the capitalized repairs book/tax timing difference. The response to AG-1-28(c) also directed the AG to proper documents to identify the accumulated deferred income taxes for 2010 and the forecasted test-year.

53. Q. WOULD YOU PLEASE ADDRESS THE RECOMMENDATION OF MR. SMITH ON PAGE 27 OF HIS TESTIMONY?

A. Yes, on page 27, line 7 of his testimony Mr. Smith indicates the Company should be ordered by the Commission to provide a detailed analysis of the impact of this major tax accounting change on KAWC’s forecasted test-year ADIT balance. A Commission order is not necessary. When the AG’s office contacted the Company about Mr. Smith’s concerns, the Company promptly provided schedules to clarify the Company’s position and levels of accumulated deferred income tax (offset by the FIN 48 reserve) in this filing related to the capitalized repairs issue. The Company understands it has a burden of proof to support its request for increased rates, and has taken steps to clarify its position with the AG and is doing so in this rebuttal testimony as well as the rebuttal testimony of Mr. James Warren. The Company is fully prepared to address any further questions concerning this area at the hearing in this proceeding.

54. Q. WOULD YOU ADDRESS WHAT IS IN THE COMPANY'S FILING RELATED TO THE RATE BASE REDUCTION FOR ACCUMULATED DEFERRED INCOME TAXES FOR THE CAPITALIZED REPAIRS BOOK/TAX TIMING DIFFERENCE?

A. Yes. I am attaching to this testimony Rebuttal Exhibit MAM-4 which I believe clearly demonstrates what level of rate base reduction is in the Company's filing related to deferred income taxes-capitalized repairs (net of the FIN 48 reserve). On page 1 of 2, I address the accumulated deferred income tax for the book/tax timing differences related to the capitalized repairs deduction. As shown on that schedule the Company reflected tax deductions of $16,662,439 on the 2008 tax return and will reflect a deduction of $2,171,059 on its 2009 tax return. The Company carried forward the 2009 deduction for 2010 and through September 2011 to properly reflect the impact of capitalized repairs on rate base reduction for accumulated deferred income taxes (net of FIN 48 reserve) in the forecasted test-year. The Company believes based on its capital spending plan that the $2,171,059 is a reasonable estimate of the capitalized repairs deduction for 2010/2011. As shown on page 1 of 2, total capitalized repairs through the forecasted test-year is $22,012,953. This amount is then multiplied by the applicable state and federal income taxes to determine the level of deferred income tax applicable to the capitalized repairs deduction. The Company then reduced the tax liability to reflect the reserve for uncertain tax treatment as required under FIN 48. The result was a $972,807 rate base reduction for the accumulated deferred state income tax and $5,197,430 rate base reduction for the accumulated deferred federal income tax. These two amounts reflect the amount of rate base reduction included in the Company's rate base filing applicable to the book/tax timing differences for capitalized repairs. Page 2 of 2 reflects the current state and federal income tax expense (net of the FIN 48 reserve) included in the filing, which normalizes the current tax deduction for capitalized repairs taken on the forecasted test-year income tax calculations shown on Schedules E-1.3 and E-1.4 included in the Company's filing.

55. Q. IS THE METHODOLOGY FOR NORMALIZING THE INCOME TAX EFFECT DESCRIBED IN THE PREVIOUS Q&A CONSISTENT WITH THE SFAS 109 APPROACH TO DEFERRED INCOME TAXES HISTORICALLY USED BY THE COMMISSION IN SETTING JUST AND REASONABLE RATES FOR THE COMPANY?

A. Yes.

56. Q. WHY IS IT NECESSARY TO REFLECT THE FIN 48 RESERVE IN THE RATE BASE REDUCTION FOR DEFERRED INCOME TAXES CALCULATIONS REFLECTED IN REBUTTAL EXHIBIT MAM-4?

A. Mr. Warren will also cover the FIN 48 reserve requirements in his testimony. The Company took a very aggressive approach to the capitalized repairs deduction in order to maximize the potential cash benefit to the Company and its customers. In other words, by not taking this approach, the Company could have foregone benefits that may accrue to the Company and its customers under a less aggressive approach, with less uncertainty about the eventual IRS determination on the capitalized repairs deduction. However, the Company did not believe that was the best option.

Under FIN 48 the Company is required to assess the likelihood of IRS acceptance of its tax deductions. The Company undertook such an assessment which was provided confidentially in response to AG-2-125. The FIN 48 reserve is an appropriate offset to the accumulated deferred income taxes related to the capitalized repairs deductions actually being reflected on the tax returns because it is more likely than not based on the FIN 48 assessment that the IRS will not recognize the entire capitalized repairs deductions claimed by the Company. Therefore it is not appropriate to pass the full benefit to the Company's customers until a final IRS determination is made or the statute of limitations expire on a future IRS audit. As stated in the response to AG-2-16(c)(5), "*the FIN 48 liability represents the difference between KAW's position taken on the tax return versus* *the position utilizing the "more likely than not standard" as required for U. S. GAAP. Fin 48 recognized that differences in the interpretation of tax law (i.e. legislation and statutes, legislative intent, regulations, rulings and case law) exist, and seeks to eliminate any uncertain tax benefit from the financial statements until the uncertainty associated with the position has been removed. An uncertainty may be removed by either a) review of the technical merits of the position by the relevant taxing authority, b) expiration of the statute of limitations, or c) law change. Consequently the FIN 48 liability has been excluded because it represents an uncertain liability that does not reduce rate base until the uncertainty has been removed by audit, statute expiration, or law change".*

57. Q. BASED ON YOUR ASSESSMENT OF THE IMPACT OF THE CAPITALIZED REPAIRS, DOES THE COMPANY'S PROPOSED RATE TREATMENT AND FILING APPROPRIATELY REFLECT THE AMOUNT OF ACCUMULATED DEFERRED INCOME TAX DEDUCTION FROM RATE BASE?

A. Yes.

58. Q DO YOU HAVE ANYTHING FURTHER TO ADD TO THE DISCUSSION ON CAPITALIZED REPAIRS?

A. Yes. On page 23 of his testimony Mr. Smith indicates that AWW spent a considerable amount of money with PwC regarding a review of the fixed asset reconciliation and Capitalized Repairs. While Mr. Smith does not make a recommendation about this expense the Company would like to clarify. The amount of $47,324 charged to KAW occurred in the base period for this case. However, because that expense is not expected to be present in the forecasted test-year the Company did not include any expense related to the assessment for capitalized repairs in the PwC fees included in the forecasted test-year and that is the primary reason PwC fees are lower in the forecasted test-year than in the base period as shown in the response to AG-2-130.

<u>INCENTIVE PLAN COSTS</u>

59. Q. WHAT ADJUSTMENTS TO THE COMPANY'S FILING DID THE AG MAKE RELATED TO INCENTIVE PLAN COSTS?

A. The AG witness eliminated all AIP and Stock Based Compensation for both employees of KAWC and AWWSC who charge time to KAWC through management fees. The AG adjustment RCS-1, Schedule C-4 reduces the Company's requested labor and management fee expense by $736,516 for AIP compensation, and AG adjustment RCS-1, Schedule C-5 reduces the Company's labor and management fee expense by $206,436 for stock based compensation.

60. Q. DESCRIBE THE IMPACT ON THE COMPANY'S FINANCIAL RESULTS IF THE ADJUSTMENT FOR AIP AND STOCK BASED COMPENSATION PROPOSED BY THE AG WERE ADOPTED BY THE COMMISSION?

A. If the AG's position were adopted by the Commission the Company and its shareholders would be asked to absorb the entire cost of the AIP and Stock Based Compensation. The $946,000 expense equals 1.4% of the total current revenues, 2.7% of total O&M expenses, and 9.5% of the total labor expense that the company has requested in this case. Given the fixed nature of most operating expenses needed to provide adequate service (i.e. labor and benefits, production costs, maintenance, adequate insurance, etc.), the Company would have limited flexibility to offset such an expense. For example, the $946,000 reduction in expense for the AIP and Stock Based Compensation would equal the compensation of 12-14 employees. The Company does not believe it can provide adequate service with 12-14 fewer employees.

61. Q. WHAT ARE THE REASONS MR. SMITH CITES FOR HIS ADJUSTMENTS C-4 AND C-5?

A. I believe Mr. Smith's position boils down to two areas. Mr. Smith claims the entire AIP compensation is driven by corporate financial performance, and he claims the Company's customers receive no benefit from the Incentive Compensation Plans.

62. Q. DOES THE COMPANY AGREE WITH MR. SMITH?

A. No, the Company disagrees with Mr. Smith on both counts.

63. Q. PLEASE EXPLAIN WHY THE COMPANY DISAGREES WITH MR. SMITH'S POSITIONS ON INCENTIVE COMPENSATION?

A. Mr. Smith fails to recognize or admit that the Company's incentive compensation is part of the overall compensation plan, that the overall compensation plan is established to drive employee performance, that the overall compensation plan, including the incentive compensation, is market driven and most importantly that the performance driven culture and compensation plans result in benefits to KAWC's customers. The Company provided in the response to several data requests explanations of the changes to the AIP plan beginning in 2009, as well as explanations and supporting data about the performance culture created at AWWSC and KAWC through the overall compensation plan, including the incentive compensation plans. Those responses also included explanations that achieving the overall financial, operational, environmental, and customer satisfaction goals of AWW only determines the amount of AIP available in any given year, but it is the performance of each individual employee that determines his/her incentive compensation, if any. The performance goals of each employee are related to matters that are specific to that job function, not to the financial parameters which determine the overall amount of AIP available. The Company also provided data about its performance improvements over the last five years which are difficult to quantify financially, but clearly benefit the customer through both improved service and lower costs.

64. Q. MR. SMITH PROVIDES REFERENCE TO TESTIMONY IN OTHER STATES AND DECISIONS OF OTHER STATE REGULATORY COMMISSIONS. WHAT IS YOUR POSITION ON THAT?

A. I will cover some of those specific areas of Mr. Smith's testimony below; however, I don't believe Mr. Smith portrays some of that information in the proper context. Different state commissions handle things differently regarding test-years, filing requirements, and a myriad of other areas which must be considered in looking at the overall revenue requirement and the impact of rate orders to provide proper context and meaning. Mr. Smith obviously limited his comments to only two recent cases where he may have been involved.

65. Q. YOU DO REGULATORY WORK IN A NUMBER OF JURISDICTIONS, CAN YOU TELL US HOW THOSE JURISDICTIONS TREAT INCENTIVE COMPENSATION?

A. Yes. Virginia recognized the incentive compensation for rate recovery, West Virginia recognizes incentive compensation for rate recovery, and based on the pre-2009 AWW/KAWC incentive compensation plan, Tennessee recognized both the operation and customer portions (about 60%) of the total incentive compensation. I believe a section of an Order from the West Virginia Commission provided a perspective about incentive compensation that is worth mentioning.

> "The Commission does not find the position of the CAD and the Cities to be persuasive. Indeed, incentive compensation is a known and measurable expense in this case. It was contained in the test year and shall be allowed for ratemaking purposes. The Commission understands the arguments made by the Cities that bonuses awarded to executives for putting more money in the shareholder pockets should be borne by shareholders, not by ratepayers. Looking at the situation from a slightly different perspective, however, it appears that it is the "incentive" and not the compensation that draws the ire of the Cities and the CAD. The Commission realizes that the Company could very well do away with its long-term incentive plan and instead spread the money in the form of salaries. In the present case, no party objected to the overall salary expense and it is unlikely that the addition of an additional $139,070 to the current salary expense would have triggered any outrage among the parties. Furthermore, at the bottom line, the Commission realizes that all employees of the Company are working not only to provide clean, safe, and potable water to the citizens of West Virginia but are also working as employees of the stockholders with an end towards maximizing stockholder wealth. The incentive compensation is merely a

> different means of providing such motivation. To the extent employee incentives result in efficiencies and/or increased productivity stockholders are benefited, but eventually such benefits will be reflected in lower revenue requirements and lower rates. Thus, both stockholders and ratepayers benefit from increased productivity and operating efficiencies.
>
> The Commission rejects the Cities and CAD arguments and will allow the inclusion of the costs of the Long-Term Incentive Plan in the revenue requirements in this case."[2]

66. Q. DOES MR. SMITH INDICATE THAT THE 2009 AIP DOCUMENTS WERE THE LATEST AVAILABLE FOR THE PLAN?

A. Yes, the 2010 AIP Brochure had not been issued as of the date of filling discovery requests. Since that time the 2010 AIP Brochure has been issued. I have attached a copy of that document to this testimony identified as Rebuttal Exhibit MAM-5. There are no material changes in the Plan from 2009, except the AIP for an individual is capped at 150% of the target amount for each wage band instead of 200% for 2009.

67. Q DOES MR. SMITH ACCURATELY ASSESS THE 2009/2010 PLAN AS IT COMPARES TO THE PRIOR AIP PLAN?

A. No. In the AIP plan prior to 2009, there was a corporate financial threshold that had to be met for the incentive plan awards to be applicable. In addition, each individual's incentive plan compensation was determined in large part (30%-40% depending on employees functional area) on those same financial results for AWW (corporate AWWSC employees), or each regulated subsidiary (i.e. KAWC), or group of regulated subsidiaries (i.e. Eastern Division). However, in 2009/2010 the AIP Plan changed in that AWW, Region/Division or regulated subsidiary financial results do not determine any portion of each individual's incentive compensation award. Contrary to the assertions of Mr. Smith, the overall financial, operational, customer satisfaction, environmental, business transformation and diversity targets of AWW only determine the "pool" of AIP

[2] Case #03-0353, Final Order of WV PSC, in general rate proceeding regarding West Virginia American Water Co.,

compensation each year, but once the AIP "pool" of compensation available is determined, it is each individual employee's performance that drives the employee's incentive compensation payment. This is a significant change from the pre-2009 AIP plans in effect.

68. A. DID THE COMPANY PROVIDE COPIES OF THE INDIVIDUAL EMPLOYEE PERFORMANCE REVIEWS IN THIS CASE?

A. Yes. In response to AG-1-38 and AG-2-19, the Company provided copies of the 2009 Performance Reviews. The Company provided these confidentially due to the obvious confidential nature of the data and potential employee issues surrounding the performance reviews if made public. The purpose of supplying those documents was to show that the individual employee performance is not tied to financial performance (although some finance and accounting related employees have goals financial in nature due to the very nature of their duties), and to show the types of challenging goals that drive performance, efficiency, safety, regulatory compliance, service levels, and customer service (satisfaction). They were also provided to demonstrate that the incentive compensation is not just an "add-on" for each employee. Those performance reviews reflect that inadequate performance results in lower (and in some case no) awards for incentive compensation.

69. Q. WHY WOULD THE INCENTIVE COMPENSATION "POOL" AVAILABLE IN ANY YEAR BE AT LEAST PARTIALLY DRIVEN BY FINANCIAL RESULTS?

A. Certainly the overall financial performance of AWW and KAWC are important to management, shareholders and other investors. However, Mr. Smith is wrong to indicate that KAWC's customers don't share in those benefits, or that the Commission should not be concerned about the overall AWW financial position. I do not personally know of any incentive compensation plan where financial results are not part of the equation and cannot imagine that any reasonable

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at page 39.

incentive compensation plan would not at some level be based on overall financial goals. It would be unreasonable to expect incentive compensation be awarded in a year in which financial results did not allow for incentive compensation.

70. Q. WHAT ARE SOME OF THE BENEFITS THAT THE CUSTOMERS SHARE AS A RESULT OF A FINANCIALLY HEALTHY, EFFICIENT AND PRODUCTIVE COMPANY?

A. The overall financial performance of AWW can and does directly impact KAWC's customers. KAW obtains its capital through AWCC for debt and AWW for equity. As demonstrated in Exhibit MAM-4 attached to my direct testimony, the financial benefits to KAW and its customers through the use of AWCC have been substantial. The debt issued by AWCC is only secured by the overall financial strength of AWW. Both AWCC and AWW's credit rating is tied to overall AWW financial strength, interest coverage, debt/equity ratio, free cash flow and various other financial criteria. These financial benchmarks directly impact the investment grade bond rating for AWCC and AWW which drive the financial benefits for KAWC's customers shown on Exhibit MAM-4. Also, strong performance by AWW's stock permits the attraction of capital by AWW which is needed to fund the financing needs of KAWC, such as the KRS II facilities, which are needed to meet and maintain adequate service to the customers. Mr. Smith believes that only KAWC's shareholders benefit from strong financial performance, but he is mistaken.

71. Q. UPON ADOPTION OF THE INCENTIVE COMPENSATION PLANS, WAS THE BASE PAY OF AWWSC AND KAW EMPLOYEES MODIFIED?

A. On page 40 of Mr. Smith's testimony he indicates that the Company's response to AG-1-39 indicated the Company had not reduced base pay. Mr. Smith is correct in this statement; however, he did not place it in the proper context. The Company went on to indicate that development of the incentive compensation plans have taken place over more than a 10 year period, and that the current base pay bands were developed to target base pay at the 50th percentile of the market based salary range. He also failed to mention that the response provided that the at-risk incentive compensation awards were targeted to provide incentive compensation at the 65^{th} percentile of the market based base pay bands. Mr. Smith seems to interpret this to mean the Company pays above market based wages when the incentive compensation is included. What he fails to indicate is that the 65^{th} percentile target is only met by strong job performance by eligible employees, and that strong performance is based on reviews that determine achievement (or non-achievement) of challenging goals developed to enhance the employee's job performance and abilities, improve customer service and satisfaction, and promote effective and efficient operations in the employee's area of responsibility. Also, in response to AG-2-21, the Company provided copies of the latest market based compensation study performed by AWW to the AG.

72. Q. IS MR. SMITH'S CONTENTION THAT KAW OVERALL EMPLOYEE COMPENSATION IS ABOVE MARKET BASED SALARIES CORRECT?

A. No. Mr. Smith paints with a wide brush in this area. It appears Mr. Smith believes no employees should be compensated above the 50^{th} percentile of the wage band regardless of whether they are high performers. The 50^{th} percentile means the mid-point or average and in that context some employees will be higher and some lower than the mid-point. What Mr. Smith fails to acknowledge is that under the current performance based culture and overall compensation plan, it is the high performers who are recognized in overall compensation and it is the lower performing employees or employees needing to improve performance that receive less compensation. It seems Mr. Smith is saying that all employees should be at the 50^{th} percentile of their wage band regardless of their performance. The Company does not agree with this contention and believes Mr. Smith's approach would discourage high performance to the detriment of the customers.

73. Q. ON PAGE 44 OF HIS TESTIMONY, MR. SMITH DESCRIBES THE INCENTIVE COMPENSATION EXPENSE AS DISCRETIONARY. IS HE CORRECT?

A. No. The incentive compensation plans are not discretionary. Those plans, as stated numerous times in this testimony, are and should be viewed as an integral part of the overall compensation policy of AWW, AWWSC and KAW. Mr. Smith attempts to replace what the incentive plans are, which is **at-risk pay**, with discretionary pay and this is not accurate. Due to the at-risk nature of this compensation there can be variability from year-to-year, but that does not support the elimination of the entire amount of incentive compensation. Some level of incentive compensation has been paid from 2006-2009 as indicated in the response to PSC-2-4 and there is no evidence or reason to believe that incentive compensation will not be paid in the forecasted test-year. If the variability related to the compensation being at-risk is what Mr. Smith is attempting to address in this area of his testimony, there are any number of ways to address that in rate recovery other than elimination of the expense. As Mr. Smith suggests regarding uncollectible expense, you can use an average, or adjust based on historical actual to budget much like the Commission historically treats forecasted test-year capital spending.

74. Q. DID MR. SMITH REFERENCE PAST COMPANY WAGE INCREASES AS JUSTIFICATION FOR HIS RECOMMENDATION TO ELIMINATE THE INCENTIVE COMPENSATION EXPENSE?

A. Yes, on page 41 of his testimony, Mr. Smith indicates that it would not be reasonable or appropriate to charge rate payers for additional compensation cost in the form of incentive compensation given the healthy base wage increases given from 2004-2008.

75. Q. WHAT IS THE COMPANY'S POSITION ON MR. SMITH'S COMMENTS IN THIS AREA?

A. Mr. Smith bases his recommendation on the response to an AG discovery request in the Company's last rate case. Upon review of that response, the information on which Mr. Smith relied was indicative of the total increase in wages and salaries, which included new hires, and filling of vacancies and was not limited to base pay increases as indicated by Mr. Smith. That difference should have been apparent because the information from the 2008 rate case response is in stark contrast to the data Mr. Smith uses in his RCS-1, Schedule C-15 to support a reduced forecasted test-year pay increase in this case. Actual salary increases are shown on Schedule C-15, page 2 of 2 and those are significantly lower than the numbers in the table at the top of page 41 of his testimony. Regardless, Mr. Smith's attempt to portray excessive increases in base pay as a justification for elimination of the incentive compensation is misplaced. Increases in base pay are intended to keep total base pay at the 50th percentile of the applicable wage band and those wage bands are adjusted regularly to reflect updated market conditions and adjust for inflationary trends. Base wage increases are predominantly inflation driven or wage band driven and have no bearing on the intent or actual application of the performance based incentive compensation plans.

76. Q IN RESPONSE TO DISCOVERY DID KAWC DEMONSTRATE THE BENEFITS OF A PERFORMANCE BASED CULTURE AND PERFORMANCE BASED COMPENSATION PLAN?

A. Yes. The Company provided information on performance regarding a number of areas that directly benefit the customers in both the form of lower rates and improved service. That information was provided with the response to data request PSC-3-1 and those schedules are being provided with this testimony identified as Rebuttal Exhibit MAM-6. On page 1 of 3 of the Exhibit the Company has shown its O&M costs on a per customer basis from 2004-2009. Those costs have been adjusted (as shown in Note 1 of the Schedule) to reflect only those costs that are primarily impacted by inflationary trends. The schedule also shows the rate of inflation for the same five year period. Page 2 of 3 of Rebuttal Exhibit MAM-6 shows the results graphically. The result of this analysis shows that for most of this period the Company's O&M expenses have been below the rate of inflation and the Company's O&M expenses have only slightly exceeded the cumulative rate of inflation, even when the Company experienced dramatic increases in: i) its electricity costs from the electric providers (55%), ii) increased chemical costs and chemical delivery costs driven by the relationship to the petroleum markets (82%), iii) a 48% increase in insurance costs due to insurance market conditions, and iv) an increase of over 200% in the cost of gasoline and fuel to run its service vehicle fleet. The Company believes keeping its O&M costs per customer near the rate of inflation during the troubled financial conditions experienced and identified above is a direct customer benefit that resulted in large part due to the performance based culture (of which the incentive compensation plans are a large part) at KAWC and AWWSC.

77. Q. REBUTTAL EXHIBIT MAM-6 HAS THREE PAGES, WHAT INFORMATION WAS INCLUDED ON PAGE 3?

A. Page 3 of Rebuttal Exhibit MAM-6 captures the Company's performance on a number of Key Performance Indicators (KPIs), which are specifically identified in the incentive compensation plans and are incorporated into each employee's performance goals. These KPIs are regularly reviewed to track progress and improvement in customer satisfaction, operational integrity, meter reading accuracy, customer service order execution, effective collections, non-revenue water, and safety. Some of the metrics are shown, but information was not readily available for all three years. The schedule shows the trends, with green indicating improvement, yellow indicating neutral, and red indicating needs improvement. The schedule shows improvement in all areas except the recordable injury rate for 2009. The Company provided the KAWC performance reviews for 2009 which show a number of KAWC supervisory employees were given a "does not meet" for this employee goal, which did impact their overall AIP awards negatively. Again the improvements shown in those ratios are driven by the performance based culture of KAWC and AWWSC, which in turn is driven by the meaningful and challenging employee performance goals. While it is difficult to quantify the impact of those improvements in dollars, a more productive, safer and improved environmentally compliant workforce benefits the customers in the form of lower costs and improved service.

78. Q. CAN YOU SUMMARIZE THE COMPANY'S POSITION ON INCENTIVE COMPENSATION?

A. Yes. The incentive compensation costs should be included in the cost of service because they are part of the overall market based compensation package offered by the Company. The overall compensation package, including the incentive compensation, is designed to pay employees at the market based salary range with a significant portion of that compensation directly tied to performance driven goals and objectives. It is entirely up to the employee and supervisor to meet or exceed those goals structured to benefit both the Company and its customers, with the understanding that strong performance will be rewarded appropriately and lacking performance will not. It is a fact of being a regulated utility that the enhanced performance of Company employees will result in better service and lower costs, which directly flow to the benefit of the Company's customers each time the Company files a rate case. A utility company can only retain cost savings as long as it doesn't file a rate case. When other factors, such as capital investment and inflation, drive the need to file a case any gains in efficiency and cost savings then flow directly to the benefit of the customers. Obviously service improvements driven by the performance based culture flow to the benefit of the Company's customers immediately.

In addition, because the Company's overall employee compensation package is market based, including the at-risk portion of employee compensation in the incentive compensation plans, the elimination of the incentive compensation costs would require the Company to increase the base salary to remain competitive in the employee marketplace if the Company is to attract and retain qualified employees. If this hypothetical situation were to become a reality, presumably the

Commission would permit the recovery of that compensation if it were base salary/wages instead of the incentive compensation. The Company believes under that scenario the Company's customers would lose. An increase in base pay would make it much more difficult to encourage a performance based culture, and would result in compensating low performing employees at a higher level than the current at-risk incentive based performance compensation plan. The Company does not believe customers would be better off under this type of compensation plan. According to Mr. Smith's recommendation in this proceeding, he is attempting to tell the Commission that it should provide the obvious benefits of the performance based compensation plan that accrue to the customers in this case for **free**. Obviously, that would be an inappropriate result and a message the Commission should not want to convey to any utility with respect to efforts to work more efficiently and provide a high level of service to its customers.

79. Q. DO YOU HAVE ANY COMMENTS SPECIFIC TO MR. SMITH'S TESTIMONY ABOUT STOCK BASED COMPENSATION?

A. Yes. Mr. Smith I believe was involved in a recent case involving Arizona American Water. Mr. Smith mentions in his testimony and provides copies of testimony given by Thomas Broderick and Miles Kiger on behalf of Arizona American. He uses that testimony to indicate Arizona American agreed to the removal of the stock based compensation expense and to support his elimination of stock based compensation in this proceeding.

80. Q. WERE THE CIRCUMSTANCES IN ARIZONA AMERICAN THE SAME AS FOR KAWC IN THIS CASE?

A. No, and a simple reading of the testimony in Arizona attached to his testimony would make that clear. Arizona is an historical test-year state, and the historical test-year for Arizona American in that case was 2008. The testimony indicates that the stock based compensation in the historical test-year was high due to a one-time grant of restricted stock that was awarded to all non-union employees at the close of the IPO and the historical test-year level was not representative of what was applicable for rate recovery. Upon discussion with Mr. Broderick, my counterpart in the Western Division of AWWSC, Arizona American did not forgo stock based compensation that may be applicable under a different plan than the one-time stock grant that is present in a future case with a different historical test-year where those expenses are present. The circumstances in this case are entirely different and not consistent with Mr. Smith's portrayal. The testimony above regarding incentive compensation is applicable to both the current AIP and stock based compensation and the Company's believes cost recovery is fully supported by the facts in this case.

PENSION AND OTHER POST EMPLOYMENT BENEFITS

81. Q. DID THE AG MAKE AN ADJUSTMENT TO THE COMPANY'S PROPOSED FAS 87 PENSION COSTS AND FAS 106 OPEB COSTS?

A. Yes, Mr. Smith reduced the Company's requested FAS 87 pension cost by $253,262 and the FAS 106 OPEB expense by $52,206. He based this adjustment on the Company's response to data request PSC-2-23 to reflect the latest Towers Watson actuarial projections for the forecasted test-year. In the base period update filing of July 15, the Company incorporated that adjustment into its forecasted test-year expenses to reflect the most current pension and OPEB costs.

RATE CASE EXPENSE

82. Q. WHAT LEVEL OF RATE CASE EXPENSE DID THE COMPANY INCLUDE IN ITS FILING?

A. The Company included $391,328 in its amended filing provided with the base period update filed on July 15, 2010. The updated filing included a correction of the amortization amount for the 2007 rate case omitted in the Company's original filing. The Company is requesting a three-year amortization of the $590,000 forecasted cost of the current case, a three year amortization of the $42,500 forecasted cost of the cost of service study filed in this case, and a five-year amortization of the $37,500 forecasted cost of the deprecation study filed in this case. In addition, the Company is requesting the recovery of the unamortized expenses of the 2008 rate case (amortized over 3 years beginning in June 2009), the unamortized expenses of the 2007 rate case (amortized over 3 years beginning December 2007), the unamortized cost of service study filed in the 2008 rate case (amortized over 3 years beginning in June 2009), and the unamortized cost of the depreciation study filed in the 2007 rate case (amortized over 5 years beginning in December 2007).

83. Q. WHY DID THE COMPANY CHOOSE TO AMORTIZE RATE CASE EXPENSE OVER THREE YEARS, COST OF SERVICE STUDY EXPENSE OVER THREE YEARS AND DEPRECIATION STUDY EXPENSE OVER FIVE YEARS?

A. The Company believes amortization of these expenses is appropriate because the Company has not historically filed annual rate cases, therefore it would be appropriate to spread these costs over a timeframe more consistent with the time between rate cases or between depreciation studies. It has been the Company's practice to file depreciation study updates on a five year interval, although it has filed them more often recently due to the major investment in the KRS II facilities and the impact that major investment may have on the depreciation rates.

84. Q. WHAT POSITION DID MR. SMITH PROPOSE?

A. Mr. Smith proposes to first lower the Company's forecasted amount of the current case by $66,000 based on the Company's actual to forecasted rate case expense in the 2007 and 2008 rate cases. He then proposes to "normalize" rate case expense, cost of service study expense and deprecation study expense related to this rate case going forward to recognize them as period costs by spreading them over 3 years. Finally, Mr. Smith under his normalization approach eliminates any recovery for the 2008 rate case expense, cost of service study and depreciation study, and the 2007 rate case and depreciation study. The end result of these adjustments is to recommend rate recovery of $210,833 as shown on RCS-1, Schedule C-11, a reduction of $180,495 from the level of rate case expense included in the Company's base period update filed on July 15, 2010.

85. Q. DOES THE COMPANY AGREE WITH MR. SMITH?

A. No, for a number of reasons which will be addressed in this testimony.

86. Q. WHY IS MR. SMITH'S JUSTIFICATION FOR REDUCTION OF THE COST OF THE CURRENT CASE INCORRECT?

A. The premise on which Mr. Smith bases this adjustment is that the forecasted cost of KAW's 2007 and 2008 rate cases were higher than the actual costs. The Company bases its forecasted rate case costs on the assumption that the case will go to full litigation. If the Company filed its rate case assuming settlement, but the case was fully litigated that estimate would obviously be low. The reason the 2007 and 2008 actual rate case expense was lower than forecasted was because those cases settled and the cost of a fully litigated case was avoided. There is no expectation that this case will settle. Given that this case will be fully litigated, the entire basis for Mr. Smith's adjustment goes away. The Company believes its cost of $590,000 for a fully litigated case is reasonable, and in fact lower than estimates for fully litigated cases in 2007 and 2008 and lower than the actual cost of the fully litigated 2004 rate case.

87. Q. DOES THE COMPANY AGREE WITH MR. SMITH'S ELIMINATION OF THE AMORTIZATION OF PRIOR RATE CASE, COST OF SERVICE AND DEPRECIATION STUDY EXPENSES?

A. No. Mr. Smith uses several rate making terms to justify this under his normalization approach. He claims that the deferral of rate case, depreciation study and cost of study expenses to be amortized for rate recovery violates the matching principle and FAS 71 should not apply. He claims deferral and amortization of prior rate case expenses constitutes single issue rate making. It appears that Mr. Smith, while taking advantage of the settlement agreements in the 2007 and 2008 rate cases to justify lower current rate case expense, is then using those same settlement agreements to say that prior rate case expenses were somehow a part of the overall revenue requirement agreed to in those settlement agreements precluding rate recovery in a future period. He indicates that prior rate case expenses should be prior period expenses under his new normalization approach. He claims unamortized rate case is immaterial to the level of rate base as justification for eliminating those expenses from recovery in this case.

88. Q. WHY IS IT PROPER TO RECOVER RATE CASE EXPENSE IN CUSTOMER RATES?

A. The Company as a regulated utility has an obligation to provide reliable service. It also has a responsibility to provide non-discriminatory service in the most cost effective manner possible. As a public utility and upon meeting its public service obligation in a cost effective manner, if the revenues do not cover the cost of providing that service including a fair and reasonable return to its investors the Company has no other option than to seek a rate increase before its regulatory commission. Likewise the Commission has an obligation to review the rate application and to establish just and reasonable rates based on the evidence presented by the utility and all other parties to the preceding. This is often referred to as the "Regulatory Compact." Contrary to Mr. Smith's assertions, the Company's shareholders get no "windfall" from a rate increase, what the Company gets is fair and reasonable rates and the opportunity to achieve a fair and reasonable return on the capital invested in the utility operation. Under the regulatory compact, the Company has no option but to seek Commission approval to increase rates when it is necessary to do so. As such it is not appropriate to ask the Company's shareholders to bear the full cost required to process a rate filing when that is the only manner in which the Company can gain adequate revenue to provide the service it is required to provide. Mr. Smith's approach of normalization would require the Company's shareholders to bear the full cost of the legitimate and prudently incurred 2007/2008 rate case expenses identified in the response to question 82 above.

89. Q. WOULD YOU PLEASE DISCUSS MR. SMITH'S INTERPRETATION OF THE APPLICABILITY OF FAS 71 AND "SINGLE ISSUE" RATEMAKING REGARDING THE COMPANY'S REQUESTED RATE CASE EXPENSE?

A. His interpretation of FAS 71 and claim of a matching issue or "single issue" ratemaking are simply incorrect. The provisions of FAS 71 permit the establishment of a regulatory asset when the probability of future rate recovery is likely. Usually the establishment of a regulatory asset is related to a legitimate and prudently incurred expense that because of its nature or frequency should be recovered in rates over time or more than one year. The Company's history of rate filings has been less frequent than annual, and depreciation studies are targeted for five year intervals. These expenses were prudently incurred and, thus, the Company determined that recovery of those expenses in future rate proceedings was probable. Mr. Smith provides no support for his claims in this area and these claims are nothing more than an effort to inappropriately lower legitimate and prudently incurred rate case expenses through his proposed normalization method. Under Mr. Smith's approach the Company would never be permitted to recover legitimate rate case expenses when previous cases were settled, unless that recovery was specifically addressed in the settlement agreement. I certainly do not agree with Mr. Smith that the Company should be denied rate recovery of the legitimately incurred rate case expenses in the 2007/2008 rate cases when in fact no party advocated that position in either of those cases.

90. Q. WOULD YOU DISCUSS THE SETTLEMENT AGREEMENTS OF THE 2007 AND 2008 COMPANY RATE CASES?

A. Mr. Smith is correct that both the Company's 2007 and 2008 rate cases ended in settlement with limited reference to the positions of the parties about the various cost of service elements. What is implied by Mr. Smith's normalization approach is that the 2007 and 2008 rate cases, cost of service and depreciation study costs should have been expensed in prior years. What is implied by Mr. Smith's approach is that the additional revenue agreed to by the parties in the 2007 and 2008 rate cases included full recovery of the rate case expense. The Company proposed the same amortization periods for its rate case, cost of service and depreciation studies in the 2007 and 2008 rate cases as proposed in this case, and I am certain the parties took into consideration the avoided cost of going to a fully litigated hearing in arriving at those settlements. However, Mr. Smith's position is not consistent with the positions of any party to the 2007/2008 rate cases or with prior Commission rulings in this area. Obviously those settlement agreements ended with "give and take" by all parties, and ended in a significantly lower revenue requirement than requested by the Company. I don't believe Mr. Smith's contention that the rate case expense for the 2007/2008 rate cases should have been written off due to the settlement of those cases is reasonable or based on any evidence about the positions of the parties to those cases.

91. Q. ON PAGE 61 OF HIS TESTIMONY MR. SMITH QUOTES LANGUAGE FROM THE COMMISSION'S ORDER IN CASE NUMBER 2008-00427. DOES THAT LANGUAGE ADDRESS RATE CASE EXPENSE?

A. No. The language he quotes related to the parties agreement about the manner CWIP related to the KRS II was addressed in the settlement agreement. The Company is somewhat confused as to why Mr. Smith quotes this language regarding his position on rate case expense in this case, other than to say language in the 2008 case settlement agreement is not relevant to his position on the rate case expense in this case.

92. Q. WOULD YOU DISCUSS MR. SMITH'S CLAIM ABOUT MATERIALITY?

A. Yes. On page 62 and 63 of his testimony Mr. Smith quotes language from case number 2000-00120 concerning a number of deferred expenses that KAW was seeking recovery of in that case. Rate case expense was not one of the deferred items at issue in that case. Mr. Smith attempts to paint with a wide brush in his use of this language, while ignoring clear language in the Commission's Orders concerning rate case expense in both case number 2000-00120, and case number

2004-00103. The issue surrounded a number of deferrals related to two major expenses related to the source of supply issues as well as Y2K and other less significant deferrals. Related to a number of minor deferrals in the 2000 rate case, the Commission mentioned materiality as an issue for rate recovery in a future case. The Company was ordered to seek approval for certain types of deferrals prior to recording them as regulatory assets on its book in the 2000 Order, but rate case was addressed as an entirely separate item in the Order. This same type of issue regarding expense deferrals resurfaced in the 2004 rate case regarding deferrals related to post 9-11 security measures and the transition costs related to creation of the national call center and shared service center, but not about rate case expense. In addition, the Company requested rate base treatment in its 2004 rate case for the unamortized balance of rate case expense which the Commission denied. In this case Mr. Smith attempts to make a claim about unamortized rate case expense from a materiality issue and uses the relationship of unamortized rate case expense from the 2007/2008 rate cases to rate base in this case to support his claim about materiality, although it was never one of the deferred items in the 2000 case to which the Commission was referring.

93. Q. DID THE COMPANY REQUEST RATE BASE TREATMENT FOR THE UNAMORTIZED BALANCE OF RATE CASE EXPENSE IN THIS CASE?

A. No. Consistent with the Commission's order in case number 2004-00103 the Company did not. The Commission's order in case number 2004-00103 said, "The Commission has historically excluded this item from rate base to share the cost of rate proceedings between stockholders and rate payers."[3] Mr. Smith has now moved from the sharing concept addressed by the Commission in 2004 to the shareholders should bear the full cost of the 2007/2008 rate cases simply because those cases ended in agreement and settlement among the parties to the case.

94. Q. HAS THIS PROPOSAL TO NORMALIZE RATE CASE EXPENSE BEEN PROPOSED BY THE AG IN A PREVIOUS COMPANY RATE CASE?

[3] Commission Order in Case Number 2004-00103, at page 35.

A. Yes. The AG witness Crane made essentially the same normalization of rate case expense approach recommendation in case number 2004-00103 as Mr. Smith is in this case

95. Q. WHAT DID THE COMMISSION SAY ABOUT RATE CASE NORMALIZATION IN CASE NUMBER 2004-00103?

A. The Commission rejected the AG's position. The Commission said,

> "The AG requests that the Commission adopt a policy of normalizing maintenance and rate case costs. Through normalization Kentucky-American would be entitled to recovery not the historical amount of expenditure but rather the future amount that the Commission deems reasonable. Much like the amortized historical amounts, the normalized costs would be divided by their estimated useful lives to determine the annual expense to be recovered through rates. The AG asserts that the normalization approach would eliminate the unamortized account balances from rate base since those accounts would no longer be recorded on Kentucky-American's books.
>
> Switching to normalization would affect Kentucky-American's rates as the unamortized balances would be eliminated from rate base. Annual amortization/normalization expense, however would be higher through normalization since the annual expense would be based on future costs that presumably would exceed historical costs. The AG presented no evidence regarding the appropriate level of normalized costs in this case. Absent such evidence, we cannot determine the reasonableness of the AG's proposal and must deny it.
>
> The AG also questions the reasonableness of Kentucky-American's requested level of rate case expense. We find that introducing additional projected cost estimates into Kentucky-American's rate proceedings through normalization would only result in additional

> litigation in future rate cases and thus unnecessarily increase those rate cases even further. We therefore deny the proposed adjustment."[4]

96. Q. PLEASE STATE THE COMPANY'S POSITION ABOUT THE NORMALIZATION METHOD PROPOSED BY MR. SMITH?

A. The Company's request for recovery of both its current and prior years rate case expense is absolutely consistent with past Commission's rulings in case numbers 2000-00120 and 2004-00103 for both the method and amortization periods. Mr. Smith has introduced no new credible evidence to support the normalization approach. Mr. Smith has totally ignored the prior rate case expenses (stated at current/or forecasted test-year levels) in arriving at some average normalized rate case expense level appropriate for the forecasted test-year. Mr. Smith only used the current rate case expense to determine his normalized rate case expense which effectively requires the Company's shareholders to bear the full cost of its 2007/2008 rate case expenses instead of the sharing policy adopted by the Commission in its order in case number 2004-00103. Further he normalizes the rate case expense over three years without support. The Company has filed its last three rate cases on approximate intervals of 15-18 months. Even if the Commission should adopt a normalized approach to rate case expense that normalized cost should be reflective of the 18-24 month timeframe not the 36 month time frame suggested by the AG witness. The AG's recommendation should be denied in this case.

AMERICAN WATER WORKS SERVICE COMPANY COSTS

97. Q. DID THE AG AND THE LFUCG WITNESSES MAKE ADJUSTMENTS TO THE AWWSC COSTS INCLUDED IN THE COMPANY'S FILING?

A. Yes, but in very different approaches.

98. Q. WHAT APPROACH WAS USED BY LFUCG WITNESS MR. BAUDINO?

[4] Commission Order in Case Number 2004-00103, at page 20.

A. He eliminates $2.145 million of AWWSC claiming that level exceeds the labor savings and that the Company has not shown the AWWSC costs were prudently incurred.

99. Q. WHAT ADJUSTMENTS DID MR. SMITH MAKE TO THE AWWSC COSTS INCLUDED IN THE COMPANY'S FILING?

A. He made five adjustments to AWWSC costs. On RCS-1, in Schedules C-4 and C-5, he eliminated the entire amount of incentive compensation expense for AWWSC for a combined total of $616,195. On Schedule C-6 he lowered the management fees by $133,057 based on updated forecast numbers. On Schedule C-7 he eliminated $198,342 for Business Development costs. And on Schedule C-8 he eliminated $65,793 for several categories of AWWSC expenses he claims are not appropriately covered in rates. The total adjustment to management fees proposed by the AG is $1.013 million or 11.2% of the total request.

100. Q. DO YOU HAVE ANYTHING TO ADD TO YOUR PREVIOUS REBUTTAL TESTIMONY ABOUT INCENTIVE PLAN COSTS?

A. Only to clarify that the incentive plan compensation previously discussed at length in this rebuttal testimony are part of the overall compensation plan of AWW which is applicable to both the employees of AWWSC providing service to KAWC, as well as the KAWC employees. The justification previously given in support of rate recovery of incentive compensation applies equally to Mr. Smith's elimination of this expense regarding AWWSC costs.

101. Q. DID THE COMPANY ADJUST ITS REQUESTED AWWSC COSTS AFTER FILING THE CASE?

A. In response to AG-1-113, the Company indicated that it had updated AWWSC costs for the forecasted test-year. The Company indicated the AWWSC costs were expected to decrease by $133,865, which was primarily related to the same updated actuarially determined pension and OPEB costs for AWWSC as the Company used to lower its requested pension and OPEB costs in response to

PSC-2-23. Mr. Smith has included this adjustment in RCS-1, Schedule C-6. The Company does not contest this adjustment to its filing and in fact the Company modified its AWWSC costs for the forecasted test-year for this adjustment in its base year update filing of July 15, 2010. The Company would note that it takes exception with Mr. Smith's portrayal of this update as inaccurate budgeting. Obviously, once the Company knew the updated pension and OPEB forecasts from Towers Watson, it immediately made that information available to the parties through discovery. His portrayal of this adjustment as inaccurate budgeting is misplaced.

102. Q. DID MR. SMITH INDICATE THAT HE HAD THOROUGHLY REVIEWED THE AFFILIATED CHARGES FROM AWWSC TO KAW?

A. On page 50 of his testimony he indicates that he did not "in the detail that these affiliate charges deserve." He went on to indicate that he had asked for and reviewed discovery of some of the costs that have been included in KAWC's claim for affiliated Management Fees.

103. Q. WHAT IS THE COMPANY'S RESPONSE TO MR. SMITH'S CLAIM ABOUT THE AWWSC INFORMATION PROVIDED TO THE AG?

A. The Company responded to each and every data request on the subject of AWWSC costs that the AG and Mr. Smith inquired. That discovery consisted of at least 30 questions, many with many multiple parts, and the responses consisted of hundreds of pages (if not thousands of pages of data). The Company cannot control what Mr. Smith reviewed, but the Company was responsive to the AG's discovery requests, so the information was available for Mr. Smith's consideration.

104. Q. WHAT OTHER DATA DID MR. SMITH RELY ON IN HIS ANALYSIS OF THE AWWSC COSTS?

A. On pages 50-53, Mr. Smith discusses at length a decision in California concerning California American Water Company regarding General Office Expense of which

AWWSC costs were included. He indicates that he used recommendations of the California DRA (Department of Ratepayer Advocate) to identify classifications of costs that he is proposing to eliminate for rate recovery in this case. As will be shown in the following testimony, Mr. Smith did not perform any independent analysis of his own to support his adjustments shown on Schedules C-7 and C-8 but appears to assume because the California DRA proposed those adjustments they must equally apply to KAWC. Obviously, we do not believe this type of support from a different subsidiary of AWW, with different test-years, different issues, and with which Mr. Smith was not involved, constitutes credible evidence in this case.

105. Q. ARE YOU FAMILIAR WITH THE CALIFORNIA CASE WHICH MR. SMITH USES AS JUSTIFICATION FOR HIS ADJUSTMENTS IN THIS CASE?

A. I have had the opportunity to discuss that case with my counterpart in California and the rate staff at the Shared Services Center who worked on that case. Based on those discussions, I am generally aware of the of California American case. The Department of Ratepayer Advocate ("DRA") made a number of adjustments similar to those proposed by Mr. Smith in this case. California American strongly disagreed with the DRA and the Commission's rulings on many areas and asked for reconsideration. The CPUC reversed several of the DRA recommendations previously adopted by the CPUC. One of the issues related to call center allocations to California American regarding third party billing which California American does not perform. This is an example of why adjustments suggested in California are not applicable to KAWC because KAWC does perform third party billing for the LFUCG and other public wastewater providers, and the revenue from those third party billings is reflected above the line in this case. General statements and conclusions from rulings in other states can be misleading without proper analysis to support a position taken in Kentucky. What is obvious in Mr. Smith's testimony and adjustments is he did no independent analysis to support his position.

106. Q. DID THE AG WITNESS MAKE ADJUSTMENTS TO MANAGEMENT FEES TO ELIMINATE BUSINESS DEVELOPMENT ("BD") COSTS?

A. Yes. He has eliminated $198,342 of AWWSC costs associated with business development as shown on RCS-1, Schedule C-7. Mr. Smith bases this adjustment on his contention that "these charges should be removed because they are unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Kentucky." [5]

107. Q. WHAT SUPPORT DID MR. SMITH GIVE FOR THIS ADJUSTMENT?

A. Mr. Smith's support is, "Similar costs were removed by the CPUC in the most recent California American Water Case and are being removed, with concurrence of Arizona-American Water Company witnesses, in that affiliated utility's current Arizona case."[6] I would note that the Arizona case referenced by Mr. Smith is still active with a final decision not due until next January and that Mr. Smith offers no support for his statements concerning that case.

108. Q. DID MR. SMITH PROVIDE ANY OTHER SUPPORT FOR THIS ADJUSTMENT?

A. No. He does not appear to have done any independent analysis to determine if BD activities have benefited KAWC. He did not do any independent analysis to determine if the circumstances in California or Arizona were different than KAWC.

109. Q. DO YOU AGREE WITH MR. SMITH'S ASSERTION THAT BD COSTS ARE UNNECESSARY FOR THE PROVISION OF SAFE, RELIABLE AND REASONABLY PRICED WATER AND WASTEWATER UTILITY SERVICE IN KENTUCKY?

A. I do not agree with Mr. Smith, and I don't believe the customers in Boonesboro, Tri-Village, Elk Lake or Owenton who are now KAWC customers agree either.

[5] Testimony of Ralph C. Smith, at page 56, beginning on line 6.
[6] Testimony of Ralph C. Smith, at page 56, beginning on line 7.

The Company made significant improvements to those service areas that prior to KAW acquisition experienced a myriad of service issues, water quality issues and high rates. In addition, customer growth from within the existing service areas and through acquisitions is good for existing customers because revenue growth offsets the need to increase rates and the company's fixed costs are spread over a larger customer base to the benefit of existing customers. In this case the Company included revenue for a new billing contract with the LFUCG to provide storm water billing. The $364,000 of new 2010 revenue from that contract was included in forecasted test-year going level revenues in this case above the line, which reduces the rate increase in this rate case dollar for dollar from what it would have otherwise been. Mr. Smith provides no analysis nor gives any recognition to the fact that the Company has been encouraged by various Kentucky governmental bodies, including the Commission, to expand its system when it makes sense to do so. Obviously, the Commission, the Department of Water and Kentucky Infrastructure Authority do not share Mr. Smith's belief that consolidation of water systems through acquisitions when that makes sense and is economically feasible to do so provides no benefit to the customers.

110. Q. DID MR. SMITH DO ANY ANALYSIS TO DETERMINE THE MAKE-UP OF THE BD COSTS TO KAW INCLUDED IN AWWSC COSTS?

A. No. He appears to have made no effort to determine the make-up of the BD costs. If he had he would have learned that the BD costs include an employee of AWWSC located in Lexington, Kentucky whose responsibility is to develop growth for KAWC and Tennessee-American. This employee's time and expenses are a significant portion of the cost he eliminated, in addition to the administrative support he gets from other AWWSC employees who provide research and assistance with financial modeling and business proposals relating to KAWC. Mr. Smith would have learned that, through those efforts, growth revenue from the LFUCG billing contract is providing a direct benefit to the customers of KAW in this case.

111. Q. IS IT ONLY THE SHAREHOLDERS WHO BENEFIT FROM GROWTH THROUGH REVENUE, ACQUISITIONS OR REGULATED CONTRACT OPERATIONS?

A. No. Existing customers benefit in the revenue growth from acquisitions. Any efficiency gains, cost saving measures and growth only remain with the Company and its shareholders until other factors require rates to be adjusted. In each rate case any benefits from these activities then flow to the customers. While I am sure Mr. Smith knows the rate making process, he attempts to incorrectly portray that business development provides no benefits to existing customers. Under Mr. Smith's approach the customers get the benefits of that growth in each rate case, but it is his contention that the shareholders should bear the full cost of the BD personnel required to generate that growth. The Company does not believe Mr. Smith's approach to rate recovery of BD costs is fair, reasonable, or supported by any facts. Mr. Smith's sole justification for this adjustment is "California does it." The Company does not believe that is reason enough given the support for recovery of BD costs provided by the Company.

112. Q. WOULD YOU DISCUSS THE AG'S ADJUSTMENT RCS-1, SCHEDULE C-8?

A. Yes. This adjustment eliminates a number of expenses identified in the AWWSC information provided in response to AG-1-67 and AG-1-89. These items include:

- Charitable Contributions - $4,728 -- The Company does not challenge this adjustment.
- Community Relations Expense - $3,499 - - The Company will not rebut this item.
- Advertising - $11,909 - - The Company will rebut this item.
- Company Dues, Membership Deductible and Non-deductible - $1,427 - - The Company will not rebut this item.
- Membership Dues - $23,961 - - The Company will rebut this issue.
- Penalties Non-deductible - $81 - - The Company will not rebut this issue.
- Meals Non-deductible - $20,587 - - The Company will rebut this issue.

Mr. Smith did no follow-up to determine the nature of these expenses nor any independent analysis to determine if they were appropriate for rate recovery.

113. Q. WHY DOES THE COMPANY DISAGREE WITH MR. SMITH'S ELIMINATION OF ADVERTISING EXPENSE?

A. While AG-1-67 and AG-1-89 did provide the number used by Mr. Smith, he did no follow-up or analysis to determine what made up the advertising expense. This expense was predominantly made up of advertisements and job placement ads related to hiring employees at AWWSC. The Company believes recruitment efforts and hiring is an important function in maintaining proper staffing levels. If this expense were at KAWC there would not be a question about rate recovery. But since Mr. Smith did no follow-up or independent analysis he assumes this expense could not possibly benefit KAWC's customers. Mr. Smith is not correct and did not perform any analysis to determine the justification for his position.

114. Q. WHAT ABOUT MEMBERSHIP DUES?

A. The response to AG-1-67 listed such membership dues as the Accountancy Board of Ohio, AICPA, American Bar Association, American Water Works Assoc., Human Resources Association, IAPP, Institute of CMA's, Institute of Supply Management, ISACA/ITGI, Kentucky Bar Assoc., Mayor's Water Council, National Fire Protection Assoc., NJ Society of CPA's, PA Institute of CPA's, Society of Human Resources Management, U. S. Chamber of Commerce, Water Environmental Federation, and WV Board of Accountancy. As is obviously apparent, these memberships are for water utility and professional trade organizations where employees who provide service to KAW can gain valuable and pertinent information on current industry standards. They also include professional certification membership organizations for employees directly providing service to KAWC. Again if these types of expenses were at KAWC there would be no question of rate recovery and that should not be different for AWWSC employees providing service to KAWC. I would draw your attention to two examples in particular, the Kentucky Bar Association and the WV Board of Accountancy. Those relate to KAWC's portion of those professional certification memberships for A.W. Turner, Sheila Miller and myself who are AWWSC employees sitting is this courtroom today on behalf of KAWC. The AG may not agree but I believe our staying current with our professional licenses is important to our job performance and does benefit the customers of KAWC.

115. Q. PLEASE ADDRESS THE ISSUE OF NON-DEDUCTIBLE MEALS?

A. Mr. Smith suggests that the Commission should adopt the IRS standard for record keeping on employee meals and exclude that amount from rate recovery. Mr. Smith is not correct in his interpretation of the IRS rules. The IRS provides taxpayers with the option to deduct 50 % of legitimate business purpose meals in order to avoid maintenance of the costly and burdensome detail required for full deduction. AWW has elected the administratively less burdensome 50% option for tax deductible purposes only. Mr. Smith has inappropriately turned this tax option into a claim that the meals are not for legitimate business purpose. The fact is the Company and AWWSC do not permit reimbursement for meals that have no legitimate business purpose. Mr. Smith has incorrectly interpreted the IRS rule, and his claim for disallowance should be rejected.

116. Q. YOU STATED EARLIER THAT LFUCG WITNESS BAUDINO MADE AN ADJUSTMENT TO REDUCE AWWSC COSTS BY $2.145 MILLION. WOULD YOU ADDRESS THAT ADJUSTMENT?

A. Yes. On page 44 he claims that KAWC has not shown labor costs from AWWSC have been prudently incurred. He goes on to say that Exhibit MAM-7 attached to my direct testimony demonstrates that if nothing had changed since case number 2000-00120, labor and labor related costs at KAWC would have been $2.145 million lower than current labor and labor related costs from AWWSC. The Company believes Mr. Baudino's conclusions are wrong as is his reasoning in arriving at them.

117. Q. DID THE COMPANY PROVIDE EVIDENCE AS TO THE PRUDENCY OF THE COST FROM AWWSC?

A. Yes. I addressed AWWSC costs extensively in my direct testimony (and will address the problems with Mr. Baudino's conclusions about Exhibit MAM-7 later in this testimony), and the Company provided volumes of support for the AWWSC costs in the expansive discovery issued in this case (to which Mr. Baudino had access). Most importantly, the Company provided a detailed study attached to the testimony of Mr. Baryenbruch about the need and reasonableness of the services provided by AWWSC, and a cost comparison of the AWWSC costs if provided by third party service providers at market based costs. Mr. Baudino failed to discuss or recognize that study in his testimony. There is ample support for the prudency of the AWWSC costs requested in this case, Mr. Baudino just chooses not to acknowledge it. It is telling that Mr. Baudino fails to mention Mr. Baryenbruch's testimony and study in his testimony, and fails to provide any challenge to the conclusions reached in the study. It is also telling that Mr. Smith only mentioned Mr. Baryenbruch's report at the end of his testimony with some very much unsupported brief comments.

118. Q. WOULD YOU BRIEFLY SUMMARIZE THE CONCLUSIONS REACHED IN MR. BARYENBRUCH'S STUDY OF AWWSC COSTS?

A. Yes. Those conclusions regarding AWWSC costs are provided on page 2-5 of Mr. Baryenbruch's direct testimony:

- The AWWSC costs per KAWC customer were very reasonable compared to cost per customer for electric and combination gas/electric service companies providing similar services. KAWC was charged $55/customer which compares to an average cost of the comparison group of $109. Only 3 or 24 utilities in the comparison group had lower service company costs than KAWC;
- KAWC was charged below market rates for managerial and professional services from AWWSC;

- The average rates of outside service providers are 21% higher than AWWSC hourly rates;
- The managerial and professional services provided by AWWSC (to KAWC) are vital and could not be procured externally without careful supervision, with additional employees at KAWC;
- If KAWC had outsourced the services provided by AWWSC the cost would have increased by $1.5 million;
- The study's hourly rate comparison understates cost advantages of AWWSC because AWWSC only charges for 8 hour days when they work more, while outside providers would charge for actual hours worked;
- It would be difficult for KAWC to find local service providers with the same specialized water industry experience possessed by AWWSC employees and the same institutional knowledge of KAWC's operation as AWWSC employees;
- AWWSC service company fees do not include profit markup;
- The cost of AWWSC customer account services, including the National Call Center, is within a reasonable range of the average of the neighboring electric utility comparison group;
- The services from AWWSC are necessary and would be required even if KAWC were a stand-alone water utility; and
- There is no redundancy or overlap in the services provided by AWWSC to KAWC.

119. Q. DO THE CONCLUSIONS REACHED ABOUT AWWSC COST BY MR. BARYENBRUCH INDICATE TO YOU THAT AWWSC COSTS ARE IMPRUDENT?

A. No, just the opposite. Mr. Baryenbruch's testimony and study in this case are presented as evidence in this case and unrebutted by Mr. Baudino. This would seem to me to be a direct contradiction to Mr. Baudino's unsupported claim that

KAWC has not shown labor costs charged from AWWSC have been prudently incurred.

120. Q. WOULD YOU ADDRESS MR. BAUDINO'S CRITICISM OF YOUR DIRECT TESTIMONY EXHIBIT MAM-7?

A. Yes. Mr. Baudino claims that the Commission should only consider the portion of Exhibit MAM-7, page 1of 3 prior to any adjustments for obvious items that are not captured in the labor and labor related benefits analysis sections. Mr. Baudino suggests the Commission should only consider a portion of the overall impact of those shifts in responsibility (presumably only the portion that benefits his position) and ignore the overall impact of those changes in organization alignment. The Company believes the Commission should focus on the overall impact to the customers from those realignments, including savings and benefits that directly resulted from those changes in organization structure and realignment of duties. As indicated in several other areas of this rebuttal testimony the AG and LFUCG witnesses believe the customers should "reap the benefits" of the Company's activities: i) to be more efficient and productive, ii) to improve service, iii) to leverage the use of more current technology, and iv) to be more cost effective by leveraging the overall economies of scale and purchasing power of the entire AWW system, but they indicate the Company's shareholders should bear the full cost to generate those benefits.

121. Q. YOU MENTION ABOVE A CHANGE IN ACCOUNTING BETWEEN AWWSC AND KAWC IS NOT CAPTURED IN THE ANALYSIS OF THE LABOR AND LABOR RELATED BENEFITS SECTION OF EXHIBIT MAM-7. WOULD YOU PLEASE EXPLAIN THAT CHANGE IN ACCOUNTING AND WHY IT MUST BE INCLUDED IN THIS ANALYSIS?

A. Yes. The analysis starts with local KAW and AWWSC labor and benefits costs present in the Commission's authorized cost of service elements in case number 2000-120, a period prior to several reorganizations and realignments of responsibilities between AWWSC and KAW. The analysis projects those costs to the forecasted test-year period in this case, as if those reorganizations and realignments had not occurred, based on known and measurable changes in the labor and related labor benefit costs. The analysis then compares that result to the KAW labor costs, labor related benefit costs, and total AWWSC costs included in the forecasted test-year for this case. There were no capital costs (depreciation, capital leases and interest expense) included in the AWWSC costs in case number 2000-00120, however, there are significant capital costs embedded in the forecasted test-year AWWSC costs (as indicated in adjustment #3 on Exhibit MAM-7 of $1,5335,472).

The difference in accounting between KAWC and AWWSC is that if those Information Technology Systems equipment and software, office space and office equipment had been purchased directly by KAW they would be reflected in depreciation, rent and interest expense, while they are captured as AWWSC costs (management fees) in the forecasted test-year. This change in accounting must be accounted for in the analysis or we have an "apples to oranges" comparison. The purchase of those shared assets used by all AWW subsidiaries through AWWSC versus KAWC purchasing those assets directly resulted in lower costs to KAWC's customers. If those assets had been purchased by KAWC they would been reflected as rate base which would have provided a return of and on those assets at the overall WACC authorized by the Commission. Instead, those assets are financed by debt at AWWSC and billed at cost. This approach results in a lower cost to KAWC's customers. This change in accounting is not captured in the section of the analysis of only labor and labor related costs and contrary to Mr. Baudino's assertion otherwise, they must be considered in this analysis to provide the true impact to KAWC's customers from the shift in functions from KAW to AWWSC.

122. Q. PLEASE DESCRIBE ADJUSTMENT 1 SHOWN ON EXHIBIT MAM-7 AND WHY THAT ADJUSTMENT SHOULD BE INCLUDED IN THE OVERALL IMPACT OF THE SHIFT IN FUNCTIONS?

A. In 2004 AWWSC created a national procurement center as part of the national shared services center to take full advantage of the economies of scale and buying power of the entire AWW system. This required additional staff that was not present in either the KAWC or AWWSC costs authorized in case number 2000-120, but are present in the AWWSC costs for the forecasted test-year. To determine the overall impact of these additional employee costs in the analysis it is both imperative and appropriate to consider the savings accruing to KAWC from those enhanced purchasing practices to determine the overall impact of the realignment and shift of costs captured in this analysis.

123. Q. PLEASE DESCRIBE ADJUSTMENT 2 SHOWN ON EXHIBIT MAM-7 AND WHY THAT ADJUSTMENT SHOULD BE INCLUDED IN THE OVERALL IMPACT OF THE SHIFT IN FUNCTIONS?

A. By starting the analysis with the costs authorized in case number 2000-120 adjusted to the forecasted test-year period included in this case, the analysis does not capture the impact of customer growth that would have been added to KAWC costs if it still maintained its call center, billing and collections functions locally. However, the cost increases related to customer growth are embedded in the AWWSC national call center costs included in the forecasted test-year in this case. To determine the overall impact of these additional employee costs in the analysis it is both imperative and appropriate to consider that cost increase in determining the overall impact of the realignment and shift of costs captured in this analysis.

124. Q. PLEASE DESCRIBE ADJUSTMENT 4 SHOWN ON EXHIBIT MAM-7 AND WHY THAT ADJUSTMENT SHOULD BE INCLUDED IN THE OVERALL IMPACT OF THE SHIFT IN FUNCTIONS?

A. In 2001 the AWWSC created AWCC at the corporate AWWSC level to take full advantage of the economies of scale and buying power of the entire AWW system regarding the placement of long-term debt and short-term debt credit facilities. This required additional staff that was not present in either the KAWC or

AWWSC costs authorized in case number 2000-120, but are present in the AWWSC costs for the forecasted test-year. To determine the overall impact of these additional employee costs in the analysis it is both imperative and appropriate to consider the savings accruing to KAWC from those enhanced financing activities obtained through AWCC to determine the overall impact of the realignment and shift of costs captured in this analysis. The cost benefits of those financing activities generated by the use of AWCC are clearly demonstrated in Exhibit MAM-4 attached to my direct testimony.

125. Q. WOULD THE SAVINGS YOU MENTION IN ADJUSTMENTS 1, 3 AND 4 INCLUDED IN THE ANALYSIS PROVIDED ON EXHIBIT MAM-7 HAVE OCCURRED IF THE FUNCTIONS HAD STAYED LOCAL AT KAWC?

A. No. The procurement savings would not have occurred without the creation of the procurement group and enhanced emphasis on using the national purchasing power of AWW, and KAWC could not have generated the interest savings on a stand-alone basis issuing debt in the private placement market that have been achieved through the creation and use of AWCC in obtaining debt in the financial markets based on the credit rating of AWW. That is why those savings have to be considered in the overall impact of the shift of functions to AWWSC.

126. Q. YOU HAVE COVERED THE AWWSC COST ASPECTS, BUT HAS THE INCREASED USE OF AWWSC ENHANCED SERVICE TO THE CUSTOMERS?

A. Yes. The national call center provides 24/7 service to the customers compared to the 8-5 Monday-Friday provided locally by KAWC, we now have on-line capabilities in the field service vehicles to better coordinate customer contact and permit convenient customer appointment times, and we have coordinated programmed maintenance expertise for SCADA and plant maintenance to name a few. In addition, these activities have contributed to the improved customer satisfaction and service related metric improvements identified in Rebuttal

Exhibit MAM-6 attached to this testimony. Those service related benefits have accrued to the customers immediately upon implementation

127. Q. WOULD YOU PLEASE SUMMARIZE THE COMPANY'S POSITIONS ON THE ADJUSTMENTS TO AWWSC COSTS PROPOSED BY AG WITNESS MR. SMITH AND LFUCG WITNESS MR. BAUDINO?

A. Yes. Both Mr. Smith and Mr. Baudino suggest major reductions to AWWSC costs in their testimony. However, they provide little, if any, support for their positions. Neither provides any meaningful challenge or rebuttal to the conclusions reached in Mr. Baryenbruch's testimony and report on AWWSC costs. As addressed in this rebuttal, neither witnesses' positions are supported by fact or sound reasoning in most instances. The Company believes the information regarding AWWSC costs provided in direct testimony, discovery and this rebuttal testimony clearly indicates that the enhanced use of AWWSC has driven cost savings, increased customer service, resulted in more efficient and cost effective operations, improved customer satisfaction, and provides more than adequate support for the prudency of the AWWSC costs. The Company believes that the unrebutted support by the Company regarding AWWSC costs fully support recovery of those costs as requested by the Company in its filing as amended by the base period update filing of July 15, 2010.

<u>FEDERAL INCOME TAXES</u>

128. Q. HAS THE AG PROPOSED AN ADJUSTMENT TO THE COMPANY'S FEDERAL INCOME TAXES?

A. Yes. In addition to the normal adjustments to income taxes resulting from changes in the operating income impact from the AG's recommendations in this case, Mr. Smith proposes to reduce the Company's current federal income tax ("FIT") expense for a consolidated tax adjustment ("CTA"). Mr. Smith's proposed adjustment would reduce the Company's tax expense by $1.362 million.

Because the Company's FIT expense is properly calculated at the 35% statutory FIT rate the Company is required to pay, Mr. Smith's proposal would produce immediate erosion in the Company's rate of return on equity of 86 basis points. This AG adjustment is shown on RCS-1, Schedule C-2.

129. Q. IS IT THE POLICY OF THIS COMMISSION TO IMPOSE A CONSOLIDATED TAX ADJUSTMENT ON THE COMPANIES THAT IT REGULATES?

A. No, it is not. In fact, the Commission has rejected similar proposals by the AG in recent cases involving Kentucky Utilities Company and Louisville Gas & Electric.

130. Q. IS IT NOT THE CASE, HOWEVER, THAT A CONSOLIDATED TAX ADJUSTMENT WAS PREVIOUSLY IMPOSED ON THE COMPANY BY THE COMMISSION?

A. Yes, it is. Prior to the two cases discussed above, the Commission did impose a CTA in the Company’s rate case number 2004-00103. The Company appealed the Commission’s order in that case, but that appeal case (which contained a cross appeal) was voluntary dismissed as part of the settlement of Company’s 2007 rate case. The settlement agreement specifically preserved the Company’s right to contest the applicability of a CTA in future rate cases. I will cover the Company’s position regarding the Commission’s order and findings concerning the CTA issue in case number 2004-00103 later in this testimony. Prior to the Company’s 2004 rate case, the Company had always been regulated as a stand-alone entity for federal tax purposes. Both the Company’s 2007 and 2008 rate cases ended as settled cases without any determination regarding the federal income tax methodology being included in the settlement agreements approved by the Commission. In fact, in both the KU and LG&E cases, the AG tried to use the Company's 2004 case as precedent for a state-wide CTA and this Commission rejected those proposals, stating that the imposition of the CTA on the Company was due to unique circumstances.

131. Q. PLEASE ADDRESS THE REASONS GIVEN IN THE COMMISSION'S ORDER IN CASE NUMBER 2004-00103 FOR IMPOSING THE CTA ON THE COMPANY.

A. The CTA proposal was made in that case by the AG in the testimony of its witness Andrea Crane. The Commission accepted the AG's position based upon the following findings: "The ability to file such a return (consolidated TWUS) would permit the filing of consolidated U.S. Tax returns. The ability to file such a tax return, Kentucky-American argued, benefited the public because it would reduce administrative expenses by eliminating the need to file multiple tax returns *and permit some savings by allowing payment of taxes calculated on the net profits of all entities within the consolidated group* (emphasis supplied)." [7]

132. Q. IN ARGUING FOR APPROVAL OF THE ACQUISITION OF AWW BY RWE, DID THE COMPANY CONTEND THAT FILING A CONSOLIDATED TAX RETURN WOULD PRODUCE ANY TAX SAVINGS THAT WOULD BENEFIT CUSTOMERS?

A. No. The Company stated that filing a consolidated tax return would produce administrative savings and administrative efficiencies. The Company did not say that tax savings would result from allowing the payment of taxes calculated on the net profits of all entities within the consolidated group or that such savings would be a reason for the Commission to approve the merger acquisition. The Company requested a rehearing on that finding and other aspects of the case, and after that process filed an appeal on that finding with the Franklin Circuit Court. As indicated in the Petition for Rehearing and the Appeal Petition with the Circuit Court, the Company disputed the Commission's finding because KAWC did not make that argument in the RWE acquisition proceedings and does not believe such a benefit existed for KAWC prior to, during or after the ownership by RWE.

[7] Commission Order in case number 2004-00103, page 65.

133. Q. WAS THE PROCEEDING REFERENCED IN THE COMMISSION'S ORDER THE FIRST TIME THAT APPROVAL HAD BEEN SOUGHT FOR THE CHANGE OF CONTROL?

A. No. In fact, in Case No. 2002-00018, the Commission had already approved the ultimate acquisition of American Waterworks by RWE. Nothing in that order indicated that the Company would have to share its federal income tax losses with Kentucky ratepayers as a quid pro quo for approval of the acquisition. Therefore, there would have been no logical reason for the Company to offer up benefits to ratepayers in a subsequent proceeding involving this matter.

134. Q PLEASE EXPLAIN WHY KAWC RETURNED TO THE COMMISSION FOR APPROVAL OF THE CORPORATE ARRANGEMENT WITH THAMES AQUA U. S. HOLDINGS, INC. ("TWAUSHI"), AFTER THE COMMISSION HAD PREVIOUSLY APPROVED THE ACQUISITION OF THE COMPANY BY RWE?

A. At the time of the change of control, Thames Water was the owner of E'Town Corp. and its subsidiaries (Elizabethtown Water Co. and The Mount Holly Water Co.) under the Thames Water subsidiary TWUS. In that corporate structure, E'Town Corp., its subsidiaries, and TWUS could not have been included in the consolidated federal income tax of AWW. In order to include those entities prior to their merger into AWW and maintain one consolidated tax filing for all the U.S. operations of Thames and RWE, TWAUSHI was established as the Parent in the consolidated income tax group. This change required the further approval of the Commission, notwithstanding the fact that the ultimate parent company remained RWE. This arrangement, however, was intended solely to continue the administrative benefits of a combined AWW/TWUS consolidated federal income tax group.

135. Q. WERE ANY OF THE INCOME NETTING BENEFITS REFERRED TO IN THE COMMISSION'S FINDING IN CASE NUMBER 2004-00103

ADVANCED OR ADVOCATED BY KAWC OR AWW IN THE TWAUSHI APPROVAL PROCEEDING?

A. No. The only benefit advocated was to file a consolidated federal income tax return including both the AWW and TWUS subsidiaries with the associated *administrative* savings associated with that combined consolidated federal income tax return. No income netting or tax sharing benefits were ever proposed. The notion that KAWC somehow "promised" to provide consolidated tax savings to its customers as a quid pro quo for the approval of the merger is incorrect. Indeed, as I stated, the merger had already been approved and this was a "clean up" filing so there would have been no need to make that concession - certainly not where the long-time policy of the Commission was to set its jurisdictional utilities' rates based on a stand-alone calculation of federal income tax expense. Accordingly, there is no valid reason to treat KAWC differently for federal income tax purposes than any other utility in the Commonwealth.

136. Q. IN ADDITION TO THE ABOVE, HAS THE CORPORATE STRUCTURE OF AWW, IN FACT, CHANGED SINCE THE COMMISSION'S APPROVAL OF TWAUSHI AS THE PARENT OF AWW AND KAWC?

A. Yes. RWE has since divested its equity holdings in AWW through a series of Initial Public Offerings in the financial markets. AWW is now again a publicly traded domestic (i.e., U.S.) Company (listed on the NYSE as AWK), and AWW is the Parent for the consolidated federal income tax group, which includes E'Town Corp. and its subsidiaries, which are now subsidiaries of AWK through a merger of New Jersey American Water Company and E'Town Corp. Accordingly, there is no conceivable reason for the Commission to carve out KAWC - and KAWC alone - from its established policy that tax expense is to be computed on a stand-alone basis.

137. Q. SHOULD THE COMMISSION ADOPT A CTA FOR REGULATED UTILITIES IN KENTUCKY?

A. No. The Commission has rejected this policy several times in the past, and to adopt a CTA would constitute a major change in the Commission's policy regarding income taxes and would have far reaching implications to every major utility in the Commonwealth that is part of a consolidated tax group. The Company is sponsoring the rebuttal testimony of Mr. James Warren, a tax attorney and CPA who has extensive experience in tax matters and Mr. Warren's rebuttal testimony demonstrates that the imposition of a consolidated tax adjustment is a flawed regulatory concept.

138. Q. WHY IS A CONSOLIDATED TAX SAVINGS APPROACH NOT APPROPRIATE FOR ESTABLISHING THE COMPANY'S RATES IN THIS CASE?

A. The Company is required to expend cash at the statutory federal tax rate (currently 35%) for the federal tax liability generated from the taxable income of the Company under the consolidated AWW federal income tax group policy. It is not appropriate because there are no tax savings "benefits" that arise from participating in a consolidated tax filing. The alleged savings arise simply because the tax losses of non-regulated companies would be confiscated for the benefits of ratepayers. This is wrong because the tax liability for KAWC is the same under the consolidated return of AWW or if a separate return were filed for KAWC. This tax liability is computed by applying the statutory rate provided in the Internal Revenue Code to the taxable income of the Company and subtracting allowable tax credits. A KAWC positive tax liability is not reduced by any nonutility negative tax liability under the consolidated federal income tax return of AWW. Nevertheless, Mr. Smith is suggesting that a lower "effective" tax rate be used than the statutory rate KAWC must pay. This would create a situation whereby the Company would be required to contribute its FIT liability at the statutory FIT rate (if it has positive taxable income) as if it were a stand-alone federal income tax entity, but only recover in rates a federal income expense lower than the statutory rate it is required to pay. As I stated previously, this inappropriate allocation of other subsidiaries' tax losses to KAWC's ratepayers would erode the Company's ability to achieve its authorized ROE by 86 basis points, based on Mr. Smith's proposed adjustment in this case. Mr. Smith's proposed adjustment, if accepted by the Commission, would require the Company's shareholders to absorb $1.362 million annually of "actual taxes paid" by KAWC either as a member of the AWW consolidated tax group or as a stand-alone federal income tax payer. Stated another way, unlike every other utility in Kentucky that participates in a consolidated tax return, Kentucky American Water Company - and only KAWC – would be penalized $1.362 million or 86 basis points for its participation in a consolidated tax group. The Company does not believe such an approach to federal income taxes would constitute just or reasonable rate recovery.

139. Q. WOULD YOU ADDRESS THE MANNER IN WHICH AWW TREATS THE INDIVIDUAL SUBSIDIARIES INCLUDED IN THE CONSOLIDATED FEDERAL INCOME TAX RETURN?

A. Yes. As stated earlier, the policy has remained consistent prior to, during and after RWE ownership and the time when TWAUSHI was the consolidated tax entity. The policy is in place to clearly set forth the manner in which individual members of the AWW consolidated income tax group's federal income tax expense and federal income tax payable to the consolidated group will be addressed. The policy indicates that each individual member of the AWW consolidated group (i.e., KAWC) will be treated as if each member had filed a separate income tax return for that year and all prior years related to federal income tax expense, federal income taxes payable, or federal income tax refunds due.

140. Q. PLEASE EXPLAIN HOW THIS IMPACTS THE CTA RECOMMENDATION OF MR. SMITH?

A. The discussion above demonstrates the many flaws in Mr. Smith's CTA that are fatal to the reasoning behind it. His justification for imposing a CTA on KAWC is predicated on the misplaced assumption that KAWC and its customers should or would benefit from tax losses generated at other AWW subsidiaries. The Company does not receive nor can it take advantage of tax losses experienced by any other consolidated group members as suggested by Mr. Smith. The Company pays its federal income taxes at the same statutory rate as it would as a stand-alone company as long as it has taxable income. The only benefits to the Company of being a part of a consolidated federal income tax return are the administrative savings due to a consolidated filing and the fact, that KAWC is paid immediately for its tax losses in any given year instead of having to follow IRS rules on such recovery (for example, when KAWC has a taxable loss as it did in 2008 due to the catch up of the new Capitalized Repairs deduction (from 2001-2008) it can and has been provided immediate refunds for the tax loss).

Under a stand-alone tax return, the Company would be limited to recouping the tax loss by use of the net operating loss tax provision against a previous or future income tax year. The Company has historically generated taxable income, and certainly will as indicated in the forecasted test-year tax calculation shown on Exhibit 37, Schedule E-1.3 in this case. Therefore, the Company's participation in any tax losses of the consolidated group are strictly passive, meaning the Company has no risk in the expenses or tax strategies that generate those tax losses in other AWW subsidiaries, nor does it recover in rates one penny of the expenses associated with those tax losses at other AWW subsidiaries. What is suggested by Mr. Smith is that a non-existent or "phantom" tax benefit not applicable to KAWC's "actual federal income taxes paid" be provided to the Company's customers, and the Company's shareholders asked to bear the cost of the "phantom" tax savings. What he is suggesting is that the Commission should confiscate the tax benefit of other companies, a tax benefit which KAWC's customers had no part in generating, and which KAWC's customers shared no risk. His position creates a cross subsidization by KAWC's shareholders for tax losses at other subsidiaries to which they are not entitled.

141. Q. DID MR. SMITH APPLY HIS CTA METHODOLOGY CONSISTENTLY TO THE AWW CONSOLIDATED TAX GROUP?

A. No. In fact, Mr. Smith recognizes the problems with this cross subsidy issue regarding tax losses generated by other regulated companies and suggests that regulated company tax losses should be excluded from his calculation[8]. He appears, however, perfectly willing to ignore the subsidy issue when it comes to confiscating the losses of the non-regulated companies in the consolidated group for KAWC's ratepayers. Having recognized that the tax benefits of other regulated companies should not be confiscated for the benefit of KAWC's customers, he illogically proposed to confiscate for those customers the tax benefits belonging to non-regulated subsidiaries. I contend this distinction is illogical on its face. Mr. Smith's proposed CTA approach would amount to confiscation because it permanently assigns to ratepayers the tax benefit resulting from non-utility tax losses. Tax losses are assets in that they ordinarily provide an immediate or near term cash benefit. These assets belong to those subsidiaries and shareholders who bore the expenses that created the tax loss. On its face the CTA proposed by Mr. Smith constitutes confiscation of non-utility shareholder property. To lower KAWC's tax expense in its cost of service as a result of non-utility tax losses that could have been carried back or forward by the non-utility affiliates in a separate return deprives the non-utility group of valuable property rights belonging to these companies.

142 Q. ARE THERE OTHER PROBLEMS WITH MR. SMITH'S CONSOLIDATED TAX ADJUSTMENT THAT RENDER IT UNFIT FOR RATEMAKING?

A. Yes. Generally, an adjustment should be a reasonable proxy for the conditions that will be in existence when rates are in effect. Mr. Smith's adjustment is anything but that. For example, although his exhibit RCS-1. Schedule C-2 presents data for the years 2003 to 2008; Mr. Smith's CTA is calculated only based on the three years 2006 to 2008. His adjustment, briefly, takes the taxable income of the system, figures KAWC's share of that income, then allocates the tax

[8] Testimony of Ralph C. Smith, at page 31, footnote 5.

losses of the non-utility subsidiaries to KAWC based on the Company's share of overall income without any analysis or determination of what drove those tax results or analysis to determine if those factors would be occurring during the forecasted test-year in this case. There are several things that are glaringly apparent (or missing altogether) from this exhibit and testimony:

- An analysis of the tax returns from 2003-2007 would have shown that the tax losses associated with capital cost related to the premium paid by RWE for the stock of AWW and the “divestiture costs” related to both the 2002 Change of Control and the 2007 Divestiture were major contributors to the tax losses.
- Further review would have indicated that the Commission specifically precluded rate recovery for those types of costs, but which now form a substantial portion of the tax losses Mr. Smith now proposes to pass to the customers. Obviously the Company not does not agree with the CTA approach in general, but believes sharing the tax benefit of premium related and divestiture costs specifically precluded from rate recovery by the Commission is just another example of Mr. Smith’s unsupported adjustments and another reason to reject his proposed CTA approach.
- The RWE premium costs and Divestiture costs are obviously not present in 2008-2010 and, therefore much of the CTA proposed by Mr. Smith is based on non-recurring items not present in the forecasted test-year in this case.
- Allocated tax losses fluctuate wildly, from $0 to over $8 million driven in large part by the tax losses identified in the first three bullet points above.
- The results for 2009 and any changes in the AWW tax position for losses for 2010 and 2011 are missing from the document.
- There is no analysis presented of the derivation of the non-utility losses and whether the declining trend is likely to continue.
- There is no analysis presented of the impact of the change in ownership and subsequent IPO of American Water on the level of non-utility losses.

Further study and analysis would likely reveal more deficiencies in Mr. Smith's proposal, methodology and mechanics, even if a CTA had any basis for rate recovery, which it does not.

143. Q. WHAT IS YOUR CONCLUSION REGARDING MR. SMITH'S PROPOSED CTA?

A. Based on the rebuttal testimony that I have presented and that of Mr. Warren, it should be clear that there is no merit to the position proposed by Mr. Smith that KAWC's current taxes should be determined at a rate other than the statutory rate of 35%. Mr. Smith's assertion that a lower effective tax rate should be applied is entirely based on the misplaced theory that the customers of KAWC should share in the tax losses generated by other AWW subsidiaries - losses to which the customers of KAWC contribute nothing in the rates they pay nor in any sharing of risk of investment. Mr. Smith's proposal for a CTA and the "phantom" benefit of a lower tax rate than 35% is nothing more than passing a non-existent tax "benefit" to the customers by confiscating tax losses arising from non-utility operations. His approach effectively denies KAWC full rate recovery for its "actual taxes paid" at the actual rate paid of 35%. There was and remains no justification to discriminate against KAWC - and KAWC alone - by setting the rates of KAWC using a CTA.

The imposition of a CTA on KAWC was based on an incorrect finding in case number 2004-00103 that such "benefits" were being offered to KAWC's ratepayers. The reason for continuing to impose the CTA is particularly inappropriate now that AWW is again a publicly traded company with the same tax structure that existed prior to RWE ownership (when the Commission did not impose a CTA on the Company). Finally, even if the rationale for Mr. Smith's adjustment were sound - and it is clearly not sound – makeup of those tax losses and the fact the major driver of those tax losses are no longer present make it clear that Mr. Smith's proposal would establish a tax expense for KAWC that has no connection to the reality of the income and subsidiary losses that would be likely in the forecasted rate year. For all the above reasons, the Commission should reject the proposed consolidated tax adjustment as bad policy and poor ratemaking.

EMPLOYEE RELATED EXPENSES

144. Q. WOULD YOU PLEASE COMMENT ON AG WITNESS MR. SMITH'S ADJUSTMENT SHOWN ON RCS-1, SCHEDULE C-14 RELATED TO EMPLOYEE AWARDS, OUTINGS AND GIFT EXPENSES?

A. Yes. Mr. Smith eliminates these expenses claiming that it is unreasonable to include them in rates since they are not necessary for the provision of safe, adequate and proper utility service. The adjustment to the Company's requested expenses is $25,070. The Company disagrees with the AG. The annual employee awards function and service milestone gifts are an accepted way of recognizing the hard work and dedication of the employees. The function recognizes both employees that have reached service milestones (i.e. 10, 20, 25, 30 years of service, etc) with a certificate and small gift that is selected from the AWW service award catalog, and employees who performed extraordinarily in providing service (i.e. perfect attendance), helping a customer, or solving a crisis. These functions appropriately recognize those employees' contributions among their peers and co-workers and promote a cohesive and motivated work force. The employee's awards function is appropriate for rate recovery in that it adds to the Company's efforts to promote customer service and satisfaction that is enhanced by having a cohesive and motivated workforce. The United Way rally is a small function to kick-off the annual United Way Fund Drive. The event promotes employee participation and contribution in this important community program that directly benefits many of the Company's customers.

COST CAP (KRS II)

145. Q. DID THE AG WITNESS MR. SMITH INCLUDE A DISCUSSION ON A COST CAP OF THE KRS II FACILITIES?

A. Yes, he acknowledged that the Commission did not impose a cost cap on the KRS II project as proposed by the AG in case number 2007-00134. He then goes on to discuss change orders provided in responses to several discovery requests that exceed the actual difference in costs from the level estimated in the 2007 certificate case to the Company's forecasted final cost. He makes no recommendation regarding these comments other than to say if a cost cap had been approved it would have precluded these additional costs of the project. The Company would only indicate that Mr. Smith did not acknowledge that the final bid price was higher than the original bids due to delays in the certificate proceeding, the Company provided the final bids as required by the Commission in the certificate case, and has filed regular updates with the Commission on the projects progress. The Company would add that its final cost is within any reasonable range of the actual cost versus estimated cost for a project of the major scope and complexities of the KRS II facilities. Company witness Linda Bridwell discussed this issue in great detail in her direct testimony.

<u>INTEREST SYNCHRONIZATION</u>

146. Q. DESCRIBE THE AG'S ADJUSTMENT IN THIS AREA?

A. The AG has synchronized the interest based on the AG's position on rate base, capital structure, and weighted cost of capital. The Company has rebutted all of these issues and the interest synchronization would need to be adjusted to conform to the Commission's final determination in these areas.

<u>LOW INCOME TARIFF</u>

147. Q. WOULD YOU ADDRESS THE TESTIMONY OF MR. BURCH FROM THE COMMUNITY ACTION COUNCIL?

A. Yes. First the issues addressed by Mr. Burch are more social issues than cost of service issues; however KAW understands that social issues are very important to Mr. Burch, and the many agencies and the customers of KAWC which receive services from the Community Action Council ("CAC"). KAWC supports the efforts of the CAC from a social perspective, and as a worthwhile and valued community support service. KAWC also supports the CAC financially with a major shareholder donation each year. Mr. Burch makes reference to the percentage of KAWC's average residential water bills to the federal poverty levels, and the Company wants to make clear the social issues Mr. Burch raises do not impact the cost of providing that service. The Company has and remains supportive of some type of assistance to low income customers as long as any solution introduced through regulation does not impact full recovery of the cost of service or that the cost of service should be adjusted based on affordability. With that said, from the Company's perspective this issue is not a cost of service issue, but is a cost allocation issue.

148. Q. HAS THE COMPANY REQUESTED A LOW INCOME TARIFF IN PRIOR RATE CASES?

A. Yes. In case number 2004-00103 the Company proposed a low income discount applied to the service charge portion of the tariff for customers who met requirements under guidelines of qualification related to the Federal Poverty levels. The Company proposed the impact of that change in service cost revenue related to the discount for qualified low income customers be allocated to the volumetric charges for all residential customers. The AG opposed this proposed tariff adjustment of the Company on the grounds that such a tariff would violate the state code regarding non-discriminatory rates. The Commission sided with the AG on this issue.

149. Q. WHAT IS THE COMPANY'S POSITION ON THE TYPE OF TARIFF PROPOSED BY MR. BURCH ON PAGE 13 OF HIS TESTIMONY?

A. The Company has not prepared a cost of service study or attempted to develop such a tariff based on accepted cost allocation guidelines needed to fully respond to Mr. Burch's hypothetical tariff. The Company does not support the change Mr. Burch suggests. Without further study, such a rate structure may harm low income customers and large families whose higher water usage is not solely related to discretionary outside use, but for normal in-house use. The Company believes the better approach to the issue is an adjustment of the service charge, not volumetric tariffs, which will limit the cost allocation changes related to a low income tariff to only qualified low income users. This approach would eliminate any uncertainty as to which types of customers are being impacted by a multi-tiered rate structure. The Company is open to a service cost oriented discount for qualified low income discount. If the AG and Commission continue their opposition to such an approach due to existing state code, then the Company is willing to work with the CAC to seek a legislative solution.

150. Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

Kentucky - American Water Company
Analysis of Short-term Interest Rates
12 Months ended June 2010

	Month	Avg. ST Int. Rate Paid by KAWC	Avg. Fed Funds Rate	Spread
2009	July	0.6727%	0.2500%	0.4227%
	August	0.5341%	0.1500%	0.3841%
	September	0.4634%	0.1000%	0.3634%
	October	0.3922%	0.1000%	0.2922%
	November	0.3437%	0.1000%	0.2437%
	December	0.3597%	0.1000%	0.2597%
	January	0.3467%	0.1000%	0.2467%
2010	February	0.3203%	0.1000%	0.2203%
	March	0.3268%	0.1000%	0.2268%
	April	0.3732%	0.1000%	0.2732%
	May	0.4195%	0.1000%	0.3195%
	June	0.4523%	0.1000%	0.3523%

Average Spread	0.3004%
Value Line Forecast for 2011 Fed Funds Rate Publication Date - 5-28-2010	1.6000%
ST Interest Rate Forecast Used in case	1.9004%

Kentucky-American Water Company
Analysis of Interest Rates

Rebuttal Exhibit MAM-2
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Value Line Publication Date	As of Market Date	"A" Rated Utility Bonds	30-year Treasury Bonds	Spread	"BBB Rated Utility Bonds	30-year Treasury Bonds	Spread	10-year Corporate Bonds	10-year Treasury Bonds	Spread	13-Week Treasury Bills	Federal Reserve Rate
7/17/2009	7/8/2009	5.710%	4.190%	1.520%	6.850%	4.190%	2.660%	6.530%	3.310%	3.220%	0.180%	0.250%
7/24/2009	7/15/2009	5.970%	4.490%	1.480%	7.190%	4.490%	2.700%	6.620%	3.600%	3.020%	0.180%	0.250%
7/31/2009	7/22/2009	5.810%	4.450%	1.360%	6.970%	4.450%	2.520%	6.580%	3.540%	3.040%	0.180%	0.250%
8/7/2009	7/29/2009	5.790%	4.510%	1.280%	7.140%	4.510%	2.630%	6.950%	3.660%	3.290%	0.180%	0.250%
8/14/2009	8/5/2009	5.700%	4.550%	1.150%	6.700%	4.550%	2.150%	6.850%	3.750%	3.100%	0.180%	0.250%
8/21/2009	8/12/2009	5.790%	4.540%	1.250%	6.620%	4.550%	2.070%	6.450%	3.720%	2.730%	0.170%	0.250%
8/28/2009	8/19/2009	5.640%	4.290%	1.350%	6.230%	4.290%	1.940%	6.230%	3.450%	2.780%	0.160%	0.250%
9/4/2009	8/26/2009	5.530%	4.200%	1.330%	6.170%	4.200%	1.970%	6.130%	3.430%	2.700%	0.150%	0.250%
9/11/2009	9/2/2009	5.450%	4.120%	1.330%	6.140%	4.120%	2.020%	5.790%	3.310%	2.480%	0.130%	0.250%
9/18/2009	9/9/2009	5.650%	4.330%	1.320%	6.400%	4.330%	2.070%	6.040%	3.470%	2.570%	0.140%	0.250%
9/25/2009	9/16/2009	5.590%	4.260%	1.330%	6.210%	4.260%	1.950%	5.740%	3.470%	2.270%	0.100%	0.250%
10/2/2009	9/23/2009	5.580%	4.200%	1.380%	6.140%	4.200%	1.940%	5.680%	3.420%	2.260%	0.090%	0.250%
10/9/2009	9/30/2009	5.400%	4.050%	1.350%	5.730%	4.050%	1.680%	5.610%	3.310%	2.300%	0.100%	0.250%
Quarterly Average		5.662%	4.322%	1.341%	6.499%	4.322%	2.177%	6.246%	3.495%	2.751%	0.149%	0.250%
10/16/2009	10/7/2009	5.440%	4.000%	1.440%	5.950%	4.000%	1.950%	5.460%	3.180%	2.280%	0.060%	0.250%
10/23/2009	10/14/2009	5.650%	4.260%	1.390%	6.220%	4.260%	1.960%	5.450%	3.410%	2.040%	0.070%	0.250%
10/30/2009	10/21/2009	5.530%	4.210%	1.320%	6.160%	4.210%	1.950%	5.480%	3.390%	2.090%	0.060%	0.250%
11/6/2009	10/21/2009	5.530%	4.260%	1.270%	6.200%	4.260%	1.940%	5.450%	3.420%	2.030%	0.060%	0.250%
11/13/2009	11/4/2009	5.710%	4.400%	1.310%	6.390%	4.400%	1.990%	5.350%	3.520%	1.830%	0.040%	0.250%
11/20/2009	11/10/2009	5.640%	4.410%	1.230%	6.320%	4.410%	1.910%	5.260%	3.470%	1.790%	0.060%	0.250%
11/27/2009	11/18/2009	5.510%	4.300%	1.210%	6.240%	4.300%	1.940%	5.210%	3.360%	1.850%	0.020%	0.250%
12/4/2009	11/24/2009	5.520%	4.250%	1.270%	6.220%	4.250%	1.970%	5.190%	3.300%	1.890%	0.030%	0.250%
12/11/2009	12/2/2009	5.580%	4.250%	1.330%	6.250%	4.250%	2.000%	5.260%	3.310%	1.950%	0.040%	0.250%
12/18/2009	12/2/2009	5.710%	4.420%	1.290%	6.320%	4.420%	1.900%	5.340%	3.430%	1.910%	0.020%	0.250%
12/25/2008	12/16/2009	5.740%	4.520%	1.220%	6.450%	4.520%	1.930%	5.320%	3.600%	1.720%	0.030%	0.250%
1/1/2009	12/22/2009	5.860%	4.610%	1.250%	6.590%	4.610%	1.980%	5.500%	3.750%	1.750%	0.070%	0.250%
1/8/2009	12/29/2009	5.980%	4.640%	1.340%	6.530%	4.640%	1.890%	5.520%	3.800%	1.720%	0.080%	0.250%
Quarterly Average		5.646%	4.348%	1.298%	6.295%	4.348%	1.947%	5.368%	3.457%	1.912%	0.049%	0.250%
1/15/2010	1/6/2010	5.860%	4.690%	1.170%	6.500%	4.690%	1.810%	5.600%	3.820%	1.780%	0.050%	0.250%
1/22/2010	1/13/2010	5.890%	4.710%	1.180%	6.490%	4.710%	1.780%	5.650%	3.790%	1.860%	0.050%	0.250%
1/29/2010	1/20/2010	5.720%	4.530%	1.190%	6.320%	4.530%	1.790%	5.440%	3.650%	1.790%	0.050%	0.250%
2/5/2010	1/27/2010	5.720%	4.560%	1.160%	6.320%	4.560%	1.760%	5.490%	3.650%	1.840%	0.070%	0.250%
2/12/2010	2/3/2010	5.800%	4.640%	1.160%	6.410%	4.640%	1.770%	5.460%	3.710%	1.750%	0.090%	0.250%
2/19/2010	2/10/2010	5.800%	4.630%	1.170%	6.340%	4.630%	1.710%	5.400%	3.690%	1.710%	0.100%	0.250%
2/26/2010	2/17/2010	5.930%	4.700%	1.230%	6.440%	4.700%	1.740%	5.410%	3.730%	1.680%	0.090%	0.250%
3/5/2010	2/24/2010	5.850%	4.640%	1.210%	6.340%	4.640%	1.700%	5.330%	3.690%	1.640%	0.110%	0.250%
3/12/2010	3/3/2010	5.790%	4.590%	1.200%	6.280%	4.590%	1.690%	5.160%	3.620%	1.540%	0.140%	0.250%
3/19/2010	3/10/2010	5.860%	4.690%	1.170%	6.350%	4.690%	1.660%	5.220%	3.720%	1.500%	0.150%	0.250%
3/26/2010	3/17/2009	5.750%	4.570%	1.180%	6.240%	4.570%	1.670%	5.080%	3.640%	1.440%	0.150%	0.250%
4/2/2010	3/24/2010	5.930%	4.730%	1.200%	6.400%	4.730%	1.670%	5.180%	3.850%	1.330%	0.130%	0.250%
4/9/2010	3/31/2010	5.920%	4.710%	1.210%	6.370%	4.710%	1.660%	5.240%	3.830%	1.410%	0.150%	0.250%
Quarterly Average		5.832%	4.645%	1.187%	6.369%	4.645%	1.724%	5.358%	3.722%	1.636%	0.102%	0.250%

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4/16/2010	4/7/2010	5.910%	4.740%	1.170%	6.350%	4.740%	1.610%	5.240%	3.850%	1.390%	0.160%	0.250%
4/23/2010	4/14/2010	5.890%	4.730%	1.160%	6.350%	4.730%	1.620%	5.220%	3.860%	1.360%	0.250%	0.250%
4/30/2010	4/21/2010	5.760%	4.620%	1.140%	6.190%	4.620%	1.570%	5.030%	3.740%	1.290%	0.150%	0.250%
5/7/2010	4/28/2010	5.770%	4.630%	1.140%	6.230%	4.630%	1.600%	4.990%	3.760%	1.230%	0.150%	0.250%
5/14/2010	5/5/2010	5.590%	4.390%	1.200%	6.030%	4.390%	1.640%	4.800%	3.540%	1.260%	0.150%	0.250%
5/21/2010	5/12/2010	5.720%	4.480%	1.240%	6.100%	4.480%	1.620%	4.870%	3.570%	1.300%	0.150%	0.250%
5/28/2010	5/19/2010	5.530%	4.240%	1.290%	5.930%	4.240%	1.690%	4.740%	3.370%	1.370%	0.160%	0.250%
6/4/2010	5/26/2010	5.400%	4.090%	1.310%	5.820%	4.090%	1.730%	4.670%	3.190%	1.480%	0.160%	0.250%
6/11/2010	6/2/2010	5.560%	4.240%	1.320%	6.030%	4.240%	1.790%	4.890%	3.340%	1.550%	0.140%	0.250%
6/18/2010	6/9/2010	5.430%	4.110%	1.320%	5.870%	4.110%	1.760%	4.740%	3.170%	1.570%	0.090%	0.250%
6/25/2010	6/16/2010	5.500%	4.180%	1.320%	6.000%	4.180%	1.820%	4.870%	3.260%	1.610%	0.090%	0.250%
7/2/2010	6/23/2010	5.380%	4.060%	1.320%	5.870%	4.060%	1.810%	4.720%	3.120%	1.600%	0.120%	0.250%
7/9/2010	6/30/2010	5.200%	3.890%	1.310%	5.730%	3.890%	1.840%	4.510%	2.930%	1.580%	0.170%	0.250%
Quarterly Average		5.588%	4.338%	1.249%	6.038%	4.338%	1.700%	4.868%	3.438%	1.430%	0.149%	0.250%
Latest 4 Quarter Average		5.682%	4.413%	1.269%	6.301%	4.414%	1.887%	5.460%	3.528%	1.932%	0.113%	0.250%
Latest 2 Quarter Average		5.710%	4.492%	1.218%	6.204%	4.492%	1.712%	5.113%	3.580%	1.533%	0.126%	0.250%
Latest 1 Quarter Average		5.588%	4.338%	1.249%	6.038%	4.338%	1.700%	4.868%	3.438%	1.430%	0.149%	0.250%

2011 Forecast of Interest Rates: **Note: Value Line Publication of 5-28-2010**	**2011 Forecasted 30-year, A Rated Utility Bond**	**Value Line 30-yr. T-bond forecast for 2011**	**Avg. Spread**		**Nov. 2010 Forecasted 30-year, BBB Rated Utility Bond**	**Value Line 30-yr. T-bond forecast for Nov. 2010**	**Avg. Spread**
Based on Latest 4 Quarter Avg. Spread	6.169%	4.900%	1.269%		6.387%	4.500%	1.887%
Based on Latest 2 Quarter Avg. Spread	6.118%	4.900%	1.218%		6.212%	4.500%	1.712%
Based on Latest 1 Quarter Avg. Spread	6.149%	4.900%	1.249%		6.200%	4.500%	1.700%

Kentucky American Water
Comparison of Authorized ROE's - American Water Subsidiaries & Other Water Utilities

Company:	Order Date	Authorized ROE	Value Line "A" Utility Bonds	Date	Spread over "A" Util. Bonds
Long Island Am	4/1/2008	9.50%	6.03%	03/26/10	3.47%
Ohio-Am.	5/19/2010	9.34%	5.59%	05/05/10	3.75%
New Jersey-Am.	12/8/2008	10.30%	6.83%	12/03/08	3.47%
Missouri-Am.	6/18/2010	10.00%	5.50%	06/16/10	4.50%
Indiana-Am.	5/3/2010	10.00%	5.77%	04/28/10	4.23%
Arizona-Am.	12/8/2009	9.90%	5.58%	12/02/09	4.32%
California-Am.	7/1/2010	10.20%	5.38%	06/23/10	4.82%
New Mexico - Am.	4/23/2010	10.00%	5.76%	04/21/10	4.24%
Texas - Am.	12/1/2009	12.00%	5.52%	11/24/09	6.48%
West Virginia-Am.	3/26/2009	10.00%	6.28%	03/25/09	3.72%
Tennessee-Am.	9/1/2008	10.20%	6.15%	08/27/08	4.05%
Illinois-Am.	4/15/2010	10.38%	5.89%	04/14/10	4.49%
Iowa-Am.	2/3/2008	10.40%	6.06%	01/30/08	4.34%
Maryland-Am.	9/1/2009	10.75%	5.53%	08/26/10	5.22%
Virginia-Am.	12/1/2008	10.50%	7.20%	11/25/08	3.30%
Hawaii-Am.	10/10/2008	10.60%	6.58%	10/08/08	4.02%
Pennsylvania-Am.	11/17/2009	10.80%	5.64%	11/10/09	5.16%
Averages		**10.29%**	**5.96%**		**4.33%**
AG's opinion of proper ROE vs. Current Bond Rates		**9.25%**	6.15%		3.10%
LFUCG's opinion of proper ROE vs. Current Bond Rates		**9.50%**	6.15%		3.35%
AG's variance from average AWW Sub. ROE		**-1.04%**			**-1.23%**
LFUCG variance from average AWW Sub. ROE		**-0.79%**			**-0.98%**

Conclusion:	**4 Quarter Average**	**2 Quarter Average**	**Latest 1 Qtr. Avg.**
Current A-Rated UtilityBond Rates per Rebuttal Exhibit MAM-2	6.17%	6.12%	6.15%
Average Spread of AWW Companies	4.33%	4.33%	4.33%
ROE Calculated on Average Spread	**10.50%**	**10.45%**	**10.48%**

Kentucky American Water Company
Calculation of Accumulated Deferred Income Tax Provision
Related to Normalization of Capitalized Repairs Tax Deduction
For Capitalized Repairs Deduction in the Forecasted Test Year Ended September 2011

SIT

2008 Captialized Repairs Deduction	16,662,439			
(Includes catch up from 2001-2008)				
2009 Capitalized Repairs Deduction	2,171,059			
2010 Capitalized Repairs Deduction	2,171,059			
2011 Capitalized Repairs Deduction (thru September)	1,008,396			
Total Capitalized Repairs Subject to Normalization		22,012,953		
State Income Tax Rate		6.00%		
Accumulated Deferred State Income Tax			1,320,777	
FIN 48 Offset			(347,971)	
Accumulated Deferred Income Tax - Rate Base Reduction				**972,807**

Benefits Customers in current by normalizing capitalized repairs for 2001 thru forecasted test-year per SFAS 109, returning the tax benefit to the customers over the book life of the property.

FIT

2008 Captialized Repairs Deduction	16,662,439			
(Includes catch up from 2001-2008)				
2009 Capitalized Repairs Deduction	2,171,059			
2010 Capitalized Repairs Deduction	2,171,059			
2011 Capitalized Repairs Deduction (thru September)	1,008,396			
Total Capitalized Repairs Subject to Normalization		22,012,953		
Less: SIT		1,320,777		
Total Capitalized Repairs Subject to Federal Tax Normalization		20,692,176		
Federal Income Tax Rate		35.00%		
Accumulated Deferred Federal Income Tax			7,242,262	
FIN 48 Offset			(2,044,832)	
Accumulated Deferred Income Tax - Rate Base Reduction				**5,197,430**

Benefits Customers in current by normalizing capitalized repairs for 2001 thru forecasted test-year per SFAS 109, returning the tax benefit to the customers over the book life of the property.

Kentucky American Water Company
Calculation of Current Deferred Income Tax Provision
Related to Normalization of Capitalized Repairs Tax Deduction
For the Forecasted Test-Year Ended September 2011

SIT

FTY Capitalized Repairs Deduction	2,171,059	
Less: FIN 48 Reserve for Deduction Subject to Rejection by IRS	(826,532)	
Income Deduction used in the Forecasted Test-Year	1,344,527	
State Income Tax Rate	6.00%	
Current Deferred State Income		**80,672**

This deduction reduced current taxable income by $1,344,527 reducing current FIT tax by $442,349. See the attached Current Income Calculation included in the application (Schedule E-1.3 and E-1.4. The impact of normalizing the book/tax timing difference under FAS 109 for capitalized repairs has no impact on the Company's filing.

FIT

2009 Capitalized Repairs Deduction (Net of FIN 48 Reserve)	1,344,527	
Less: SIT	80,672	
Capitalized Repairs Deduction subject to Federal Income Tax	1,263,855	
Federal Income Tax Rate	35.00%	
Current Deferred Federal Income Tax		**442,349**

This deduction reduced current taxable income by $1,344,527 reducing current FIT tax by $442,349. See the attached Current Income Calculation included in the application (Schedule E-1.3 and E-1.4. The impact of normalizing the book/tax timing difference under FAS 109 for capitalized repairs has no impact on the income tax included in the Company's filing.

AMERICAN WATER

2010 Annual Incentive Plan Highlights Brochure

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THE 2010 AMERICAN WATER ANNUAL INCENTIVE PLAN

Your Performance — Your Award

At American Water, your performance counts. We rely on our employees' knowledge and skills to help the Company achieve its business objectives.

The American Water 2010 Annual Incentive Plan (AIP) is designed to give eligible exempt employees an annual opportunity to earn a cash award that recognizes and rewards their contributions to the Company's success. We continue to make adjustments to the AIP design to reinforce the link between Company and individual performance and award payouts. This means that Company and individual performance are both taken into account to determine cash awards under the plan. Keeping up our momentum in 2010:

- We are continuing the funding approach that was used in 2009, which directly ties the amount of available cash for AIP payouts to Company performance against specific metrics. AIP funding for all eligible, exempt employees will depend on the Company's achieving its financial and non-financial goals.
- Your **individual performance continues to play a large role in determining the amount of your payout.** Employees who exceed their performance targets could receive higher payouts. Conversely, employees who under-perform and do not meet their performance targets could receive lower payouts or no payout at all. In short, *your* performance directly impacts the amount of *your* award.

The 2010 AIP is designed to challenge and motivate you to perform at your highest level, and promote the creation of value to the customer and shareholder. Read this brochure to learn about how the 2010 plan works and what it means for you.

The 2010 AIP

Elements of the Program

- AIP award pool funding is based on overall corporate performance against specific financial and non-financial goals (represented by the Corporate Multiplier), then allocated across organizational groups/functional areas — at senior management's discretion — depending on organizational group/functional area results.
  - AIP funding for **all eligible exempt employees** depends on the Company achieving its financial as well as non-financial goals.
  - A pre-determined financial threshold for Company performance must be met in order for funding and any award to be provided under the AIP.
- Individual award payouts will be based on individual performance against specific goals (represented by the Individual Performance Factor) and paid from available organizational group/functional area funding.
- For 2010, the Individual Performance Factor range is **0%-150%.** Individual payouts will be capped at 150% of AIP target award.
- Award opportunity (Target Award) is expressed as a percentage of base salary. (See Attachment B).
  - Actual payout may be lower or higher than target depending on Company and individual performance against specific goals.
- Individual performance is assessed by your manager and measured against your pre-determined performance goals.
- Your AIP will be distributed as a cash award in March.
  - You must be actively employed with American Water on the date awards are made to receive your 2010 AIP payout.
  - If you are disabled, retire, or die, you or your beneficiary may be eligible to receive an award prorated to reflect your service during the plan year.
- If actual Company performance differs from forecasted Company performance, the American Water Board or its Designee has the right to adjust the award determination(s) and/or award payouts(s) prior to final approval.

Eligibility

- You are eligible for an AIP award opportunity if you are a regular, full-time exempt employee of American Water.
  - Regular, full-time exempt employees who join American Water on or before September 30, 2010 are also eligible to participate in the AIP on a prorated basis.
  - Employees transferred from nonexempt to exempt status on or after September 30th are not eligible in the current plan year.

- You must be an active employee with American Water on the date the payout is made in order to receive the award. In certain circumstances, such as disability, retirement or death, an award may be made — prorated to reflect your service during the plan year.
- If you are promoted during the plan year to a position with a *higher* AIP target level, or if you are reclassified/transferred to a position with a *lower* AIP target level, your award payout will be based on your new target level as of December 13, 2010.
- If you transfer from exempt status to nonexempt status during the current plan year or your job was reclassified to nonexempt status, you are not eligible for a 2010 AIP award.
- If your performance rating is "Unacceptable" or "Too Soon to Rate," you will not receive a payout.

Why Is the Plan Based on Individual Performance?

Since the value (as reflected in our share price and our return to shareholders) and success of our business depend on the achievement of annual Company and individual performance goals, American Water recognizes the need to differentiate and reward the performance of employees who enable us to reach these goals. The 2010 AIP is designed to ensure that award payouts are directly tied to measurable contributions — both Company and individual — to American Water's success.

DETERMINING AIP AWARDS

AIP award payouts depend on individual performance; they also depend on overall corporate performance and organizational group/functional area results (which determine award pool funding).

AIP awards will be determined according to the following three-step process:

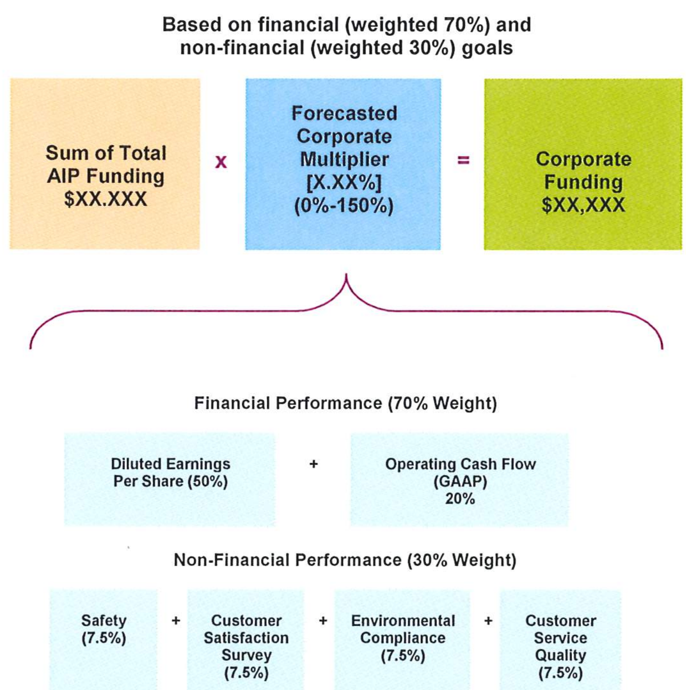
Step 1: **Establish initial award pool based on overall corporate performance**

Step 2: **Allocate overall corporate funding to organizational groups/functional areas, and adjust specific organizational group/functional area funding to reflect results**

Step 3: **Determine AIP award based on individual performance; awards are paid from available organizational group/functional area funding**

Step 1: Establish initial award pool based on overall corporate performance

Each year, American Water establishes funding for the AIP award pool. In 2010, the funding will be directly tied to Company performance and represented by the **Corporate Multiplier**. The Corporate Multiplier can range from 0% to 150% depending on how well the Company performed against the financial and non-financial goals described below. Note that a pre-determined **threshold** for Company performance - **2010 Diluted Earnings Per Share (EPS) must be at least 85% of target** - must be met in order for funding and any award to be provided under the AIP for Operating Cash Flow (20%) and Non-Financial Performance Factors (30%). 2010 Diluted Earnings Per Share (EPS) must be at least 90% of target for any EPS funding (50%) and award to be provided under the AIP.



- **Financial Metrics (Weighted 70%) (See Attachment A)**
  - *Diluted Earnings Per Share (50%)* is a widely tracked measure of financial performance/profitability, and is calculated as follows:

    Net Income to Common Stockholders
    ÷
    Average Outstanding Shares (including dilutive securities such as stock options)
    =
    Diluted Earnings per Share

  - *Operating Cash Flow (GAAP) (20%)* reflects the amount of cash generated from our operations and is used as an additional measure of profitability. Operating cash flow is calculated as follows:

    Net Income
    +
    Depreciation and Amortization
    -
    Deferred Expenses
    +/-
    Changes in Payables and Receivables
    =
    Operating Cash Flow

- **Non-Financial Metrics (Weighted 30%)***
  - Environmental Compliance Notices of Violation (NOVs) (7.5%)
  - Safety Performance (7.5%)
  - Customer Satisfaction Survey (7.5%)
  - Customer Service Quality Survey (7.5%)

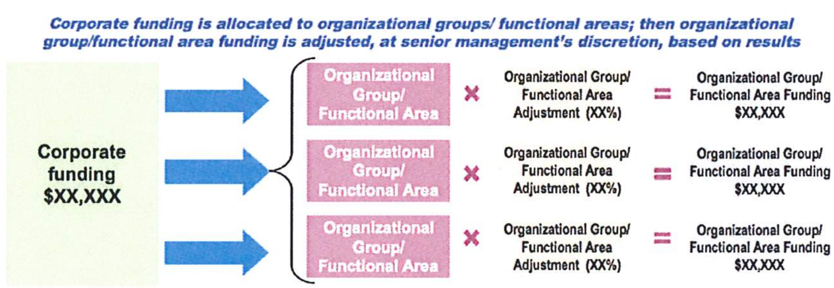
  **These outcomes are based on a combination of surveys, end-of-year results, data and other annual reports (see Attachment A at the back of this brochure).*

Please note that AIP funding for all employees will depend on how well the Company achieves its financial goals as well as non-financial goals. A pre-determined financial threshold for Company performance must be met in order for funding and any award to be provided under the AIP.

The financial and non-financial metrics are added together to determine the Corporate Multiplier. So, even if certain metrics are not achieved, the funding may be reduced, but not eliminated altogether. However, if the Company's financial performance does not meet the threshold, the Corporate Multiplier will be reduced to zero, which would eliminate your award payout (as indicated in the examples on page 10). The Corporate Multiplier (and thus funding for payouts) may be adjusted to take into account "uncontrollable events" including — but not limited to — severe weather conditions that significantly impact financial results (i.e., hurricanes), impairment charges, dissolution or acquisition of businesses or costs related to public offerings.

Step 2: Allocate overall corporate funding to organizational groups/ functional areas, and adjust specific organizational group/functional area funding to reflect results

Once the overall corporate funding is determined as described under Step 1, senior management will allocate the Corporate funding to American Water's organizational groups and functional areas. The funding for each organizational group/functional area may be increased or decreased, at senior management's discretion, to reflect specific organizational group/functional area results.



Step 3: Determine individual AIP award based on (a) individual performance, and (b) available organizational group/functional area funding; awards are paid from available organizational group/functional area award pool

Your **AIP target award** (i.e., your award opportunity) is based on your job with the Company and is expressed as a percentage of your base salary. Your actual award payout may be higher or lower than target depending on whether individual and Company performance goals have been met, and your organizational group's/functional area's results. Contact your manager for information on your individual AIP Target Award.

Your individual performance factor is based on (a) your performance against specific targets, and (b) the amount of organizational group/functional area funding available

$XX,XXX Individual AIP Target (% of Base Salary)	x	**Individual Performance Factor [x.xx%] (0%-150%)**	=	**$XX,XXX Individual Award**	⇠	**Award paid from available organizational group/functional area award pool**

The sum of individual awards for a specific organizational group/functional area must not exceed the funding allocated to that organizational group/functional area

The **Individual Performance Factor** represents how well you achieve your annual individual performance goals. Your Individual Performance Factor (IPF) can range from 0% to 150%, depending on your performance for the plan year and the amount of organizational group/functional area funding available. This performance factor will then be multiplied by your Target Award to determine your 2010 AIP award payout. Individual payouts will be capped at 150% of AIP target award.

Individual AIP awards are then paid from the available organizational group/functional area award funding, which may impact the original (IPF%) determination. The sum of all individual awards within a given organizational group/functional area must not exceed its allocated pool of dollars.

WHAT THE 2010 AIP MEANS FOR YOU

Performance Ratings

Most people are motivated to do their best; therefore the better you perform, the greater your potential award will be under the Plan. It is your responsibility to maximize your award opportunity by achieving or exceeding your goals.

Each year, you and your manager identify four to six high priority and challenging performance targets, which represent where you can directly impact the Company's success. These performance targets and their weightings should be specific, measurable and aligned with the Company's performance targets. During your year-end performance review, you and your manager will discuss how well you performed against the established targets, and rate your performance using one of the following performance ratings:

2010 Performance Rating Scale	
Rating	Description
Exceptional	Contributions are widely recognized as extraordinary. Results far exceed all defined expectations, producing important and substantial impact on the Company, Division, Operating Company, Line of Business or Function.
Significant	Contributions are widely recognized as distinguished. Results exceed all or most expectations, producing a tangible and material impact on the Company, Division, Operating Company, Line of Business or Function.
Commendable	Contributions are widely recognized as meaningful. Results meet, and in some cases exceed expectations, producing a positive and desirable impact on the Company, Division, Operating Company, Line of Business or Function.
Adequate	Contributions are widely recognized as limited. Results generally meet but in some cases fall slightly short of expectations, producing inconsistent and marginal impact on the Company, Division, Operating Company, Line of Business or Function.
Unacceptable	Contributions are widely recognized as unsatisfactory. Results fall considerably short of expectations, producing negligible or no impact on the Company, Division, Operating Company, Line of Business or Function.
Too Soon to Rate	Contributions cannot be measured at this time because more time is needed to see a result.

Later, during the AIP process, your manager will use your rating to determine your Individual Performance Factor. Depending on how you performed during the year, you could potentially earn a higher payout than in previous years — or you could earn a lower payout or no payout at all (as the examples on the following page demonstrate). In other words, the AIP design gives you more power to impact the size of your award. It also means that you are more accountable for meeting your goals.

Award Payout Examples

Let's calculate possible award payouts for a sample AIP participant, under four possible scenarios:

AIP Participant Assumptions	
Salary Level	L07
Annual Base Salary	$90,000
Individual AIP Target	$13,500 (15% of Base Salary)
Total AIP Funding *	$20,000,000
Total AIP Funding for Organizational Group*	$2,000,000

* The total is the sum of the target awards for the eligible employees.

	Performance			
	Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**
■ **Company**	Above Target	Target	Threshold	Below Threshold
— Financial Performance Factor	1.39	0.94	0.50	0.00
— Non-Financial Performance Factor	0.77	1.12	0.50	0.00
■ **Individual**	Adequate	Exceptional	Significant	Commendable
— Individual Performance Factor	0.25	1.50	1.05	.90

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
STEP 1: Establish corporate funding based on overall corporate performance				
Total of AIP Targets (A)	\$20,000,000	\$20,000,000	\$20,000,000	\$20,000,000
Financial Performance Factor (i) (70% weight)	1.39 × 0.70 = **0.97**	0.94 × 0.70 = **0.66**	0.50 × 0.70 = **0.35**	0.00 × 0.70 = **0.00**
Non-Financial Performance Factor (ii) (30% weight)	0.77 × 0.30 = **0.23**	1.12 × 0.30 = **0.34**	0.50 × 0.30 = **0.15**	0.00 × 0.30 = **0.00**
i + ii = Corporate Multiplier (B)	**1.20**	**1.00**	**0.50**	**0.00**
A × B = Corporate Funding	\$20,000,000 ×1.20 = \$24,000,000	\$20,000,000 ×1.00 = \$20,000,000	\$20,000,000 × 0.50 = \$10,000,000	\$20,000,000 × 0.00 = \$0
STEP 2: Allocate overall corporate funding to organizational groups/functional areas; adjust specific organizational group/functional area funding to reflect results				
Organizational Group Pool (C) *(Allocated from corporate funding)*	\$2,400,000	\$2,000,000	\$1,000,000	\$0
Organizational Group Adjustment (D)	1.00 (Target)	.80 (Below Target)	1.20 (Above Target)	1.00 (Target)
C × D = Organizational Group Pool *(adjusted based on results)*	\$2,400,000 ×1.00 = \$2,400,000	\$2,000,000 × 0.80 = \$1,600,000	\$1,000,000 ×1.20 = \$1,200,000	\$0 ×1.00 = \$0
STEP 3: Determine individual award based on individual performance and available organizational group/functional area funding; awards are paid from available organizational group/functional area award pool				
Individual AIP Target (E)	\$13,500	\$13,500	\$13,500	\$13,500
Individual Performance Factor (F) *(Range of 0 – 1.50)*	0.25 (Adequate)	1.50 (Exceptional)	1.05 (Significant)	.90 (Commendable)
E×F = Individual Award	13,500 × 0.25 = **\$3,375** *(25% of AIP target)*	13,500 × 1.50 = **\$20,250** *(150% of AIP target)*	13,500 × 1.05 = **\$14,175** *(105% of AIP target)*	13,500 × .90 = **\$12,150** *However, payout will be \$0, since award pool = \$0*

As you can see, both Company and individual performance can significantly impact your final payout. Also, remember that the sum of individual awards for a specific organizational group/functional area must equal the funding allocated to that organizational group/functional area.

Note: If actual Company performance differs from forecasted Company performance, the American Water Board or its Designee has the right to adjust the award determination(s) and/or award payout(s) prior to final approval.

Please discuss the AIP with your manager to ensure you clearly understand how the formula works and how your performance impacts your potential award payout.

Receiving Your AIP Award

Awards will be paid in cash in March of the year following the year in which they are earned. If you're eligible for an award payout, please keep in mind that:

- The payout will be based on your annual base salary as of December 13, 2010 and subject to all federal, state and local income tax withholdings.
- The American Water Board, or its Designee, reserves the right to determine whether awards are payable to any individual or group of individuals; the Board may withhold all award payouts in certain circumstances.

Remember, it's your performance —and your award: The contributions you make to American Water's success throughout the year ultimately impact the size of your payout. Be sure to carefully review this brochure; then speak with your manager about the AIP and about what you can do to improve your performance and share the financial rewards of American Water's success.

FREQUENTLY ASKED QUESTIONS

Question	Answer
How does the plan reward performance?	The AIP allows us to differentiate and reward the performance of employees who contribute to the achievement of the Company's goals. The 2010 AIP directly ties award payouts to measurable contributions (Company, organizational group/ functional area and individual) to American Water's success.
Who is eligible for the AIP?	All regular, full-time exempt employees are eligible to participate. If you join American Water on or before September 30, 2010, you are also eligible to participate in the plan on a prorated basis.
What do I have to do to receive an AIP award?	Any payout will depend largely on your performance, as well as on Company, organizational group/ functional area performance (including financial and non-financial), which determines funding. If your performance is rated "Adequate" or higher, you may receive an award payout — but only if threshold Company performance metrics have been met. If your performance rating is "Unacceptable" or "Too Soon to Rate," you will not receive a payout. To maximize your award opportunity, it's important to meet with your manager to establish meaningful performance goals, then work hard throughout the year to achieve those goals. If actual Company performance differs from forecasted Company performance, the American Water Board or its Designee has the right to adjust the award determination(s) and/or award payout(s) prior to final approval.
How is my AIP target award opportunity determined? How can I find out what it is?	Your AIP target award opportunity is based on your job and expressed as a percentage of your base salary. Please see your manager to learn more about your target award opportunity for 2010.

Question	Answer
How will my AIP award payout be calculated?	The size of the pool which funds your award is determined based on overall corporate performance and adjusted to reflect specific organizational group/functional area results. AIP funding for all eligible employees, will depend on the Company and/or organizational group/functional area achieving its non-financial as well as financial goals. Once individual awards are calculated, they are paid from the organizational group/functional area funding. If actual Company performance differs from forecasted Company performance, the American Water Board or its Designee has the right to adjust the award determination(s) and/or award payout(s) prior to final approval.
What is the minimum and maximum that could be paid under the plan (as a percent of target)?	AIP award payouts can range from zero, to a maximum of an Individual Performance Factor of 150%. Payouts are capped at 150% of AIP target award.
Will I receive an award payout if I meet my individual performance goals but the Company *does not* achieve minimum (threshold) performance?	No. A pre-determined financial threshold for Company performance must be met in order for funding and any award to be provided under the AIP.
What happens if I leave American Water before I receive my award payout?	To receive the award payout, you must be actively employed with American Water on the date the payment is to be made. If you are disabled, retire, or die during the plan year, you or your beneficiary may be eligible to receive an award, prorated to reflect your service during the year.
What happens if I change job positions within American Water during the plan year?	Your award payout will be based on your base salary and target level percentage as of December 13, 2010.

This brochure is the 2010 American Water Annual Incentive Plan. The American Water Board or its Designee, whose decisions will be final and binding, will determine interpretations of the Plan. The Company reserves the right to amend, modify, or discontinue the Plan during the plan year or at any time in the future. Participation in the Plan does not convey any commitment to ongoing employment.

2010 AIP FINANCIAL PAYOUT CURVE

DILUTED EARNINGS PER SHARE (EPS)

% Target Achieved	% Payout
115%	150%
112%	140%
109%	130%
106%	120%
103%	110%
100%	100%
98%	90%
96%	80%
94%	70%
92%	60%
90%	50%
<90%	0%

OPERATING CASH FLOW

% Target Achieved	% Payout
115%	150%
112%	140%
109%	130%
106%	120%
103%	110%
100%	100%
97%	90%
94%	80%
91%	70%
88%	60%
85%	50%
<85%	0%

2010 AIP NON-FINANCIAL MEASURES

Environmental Compliance

For determining environmental compliance, AW will count Notices of Violation (NOV) for which the Company is responsible as described in the Environmental Non-Compliance Reporting Practice. For 2010 AW will continue to use the NOV target of 21.

NOVs	Award
11	150%
13	140%
15	130%
17	120%
19	110%
21	**100%**
23	90%
25	80%
27	70%
29	60%
30	50%
>30	0%

Safety Performance

Safety performance will be determined using the total OSHA Recordable Incident Rate (ORIR) for American Water. ORIR measures all injuries and illnesses requiring treatment beyond first aid for every 200,000 hours worked. For 2010 the target has been set at 4.5 which is 15% below the Bureau of Labor Statistics (BLS) Water Utility Average ORIR of 5.3.

ORIR	Award
3.5	150%
3.7	140%
3.9	130%
4.1	120%
4.3	110%
4.5	**100%**
4.7	90%
4.9	80%
5.1	70%
5.3	60%
5.5	50%
>5.5	0%

2010 AIP NON-FINANCIAL MEASURES

Service Quality

This metric is measured by the Service Quality Survey (SQS) which is conducted throughout the year for customers having had recent contact with an AW Customer Service Representative (CSR), Field Service Representative (FSR) or the web self service system. The score is based on survey question: "Overall, how satisfied were you with the outcome of your service contact?" taking the top two response categories (extremely satisfied or very satisfied) of a 5 point response scale (Extremely Satisfied, Very Satisfied, Somewhat Satisfied, Somewhat Dissatisfied, Very Dissatisfied). The AW target for 2010 is 85%.

SQS %	Award
90	150%
89	140%
88	130%
87	120%
86	110%
85	**100%**
84	90%
83	80%
82	70%
81	60%
80	50%
< 80	0%

Customer Satisfaction

This metric measures overall customer satisfaction through an annual survey containing the following question, "Overall, how satisfied have you been with (Company Name) in general during the past twelve months", which has a five-point response scale (Extremely Satisfied, Very Satisfied, Somewhat Satisfied, Somewhat Dissatisfied, Very Dissatisfied), response percentages in the top three categories are indicative of overall customer satisfaction levels and a 90% target has been set.

CSS%	Award
95	150%
94	140%
93	130%
92	120%
91	110%
90	**100%**
89	90%
88	80%
87	70%
86	60%
85	50%
<85	0%

2010 ANNUAL INCENTIVE PLAN TARGETS

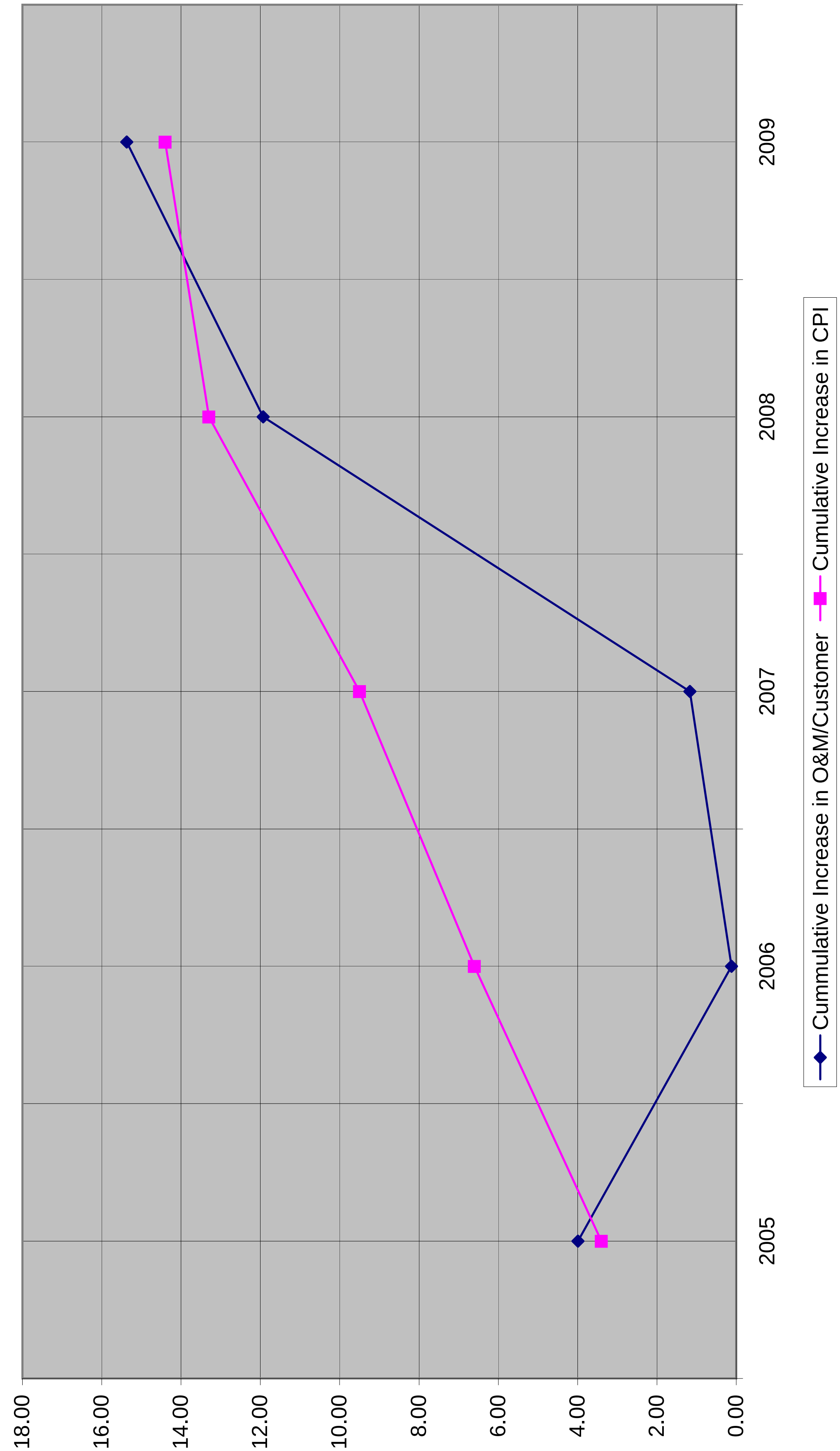
EXEMPT POSITIONS	
Grade	**AIP %**
L5 – L6	20%
L7	15%
L8-L9	10%
L10 – L12	5%

Kentucky American Water
Detail of O&M Costs
Reponse to PSC-3-1

	2004	2005	2006	2007	2008	2009	
Labor	4,930,258	4,665,771	5,170,885	5,896,230	6,585,197	6,848,261	
Purchased Water	496,743	481,098	506,626	427,206	125,573	131,328	
Fuel & Power	1,946,055	2,462,919	2,638,270	2,827,611	3,244,960	3,014,306	54.89%
Chemicals	1,228,405	1,212,789	1,495,887	1,691,698	1,749,092	2,234,754	81.92%
Waste Disposal	160,801	292,070	324,447	260,565	270,251	233,982	
Management Fees	6,024,972	5,738,450	5,589,691	5,917,304	6,898,020	6,736,605	
Insurance Other	485,732	464,344	649,162	576,700	490,147	719,016	48.03%
Customer Accounting	1,361,593	1,377,864	1,399,605	1,425,214	1,536,013	1,617,110	
Rents	74,599	60,506	52,237	30,452	34,904	31,688	
General Office	411,482	440,174	470,171	463,222	566,915	531,596	
Miscellaneous	2,958,384	3,991,756	2,933,442	2,245,208	2,712,475	3,141,398	
Maintenance	1,239,646	1,285,709	1,058,154	1,014,501	1,263,805	1,249,094	
Total O&M Expense (See Note 1)	21,318,670	22,473,450	22,288,577	22,775,911	25,477,352	26,489,138	
Customers	110,706	112,229	115,783	117,088	118,246	118,855	
O*M Cost per Customer	192.57	200.25	192.50	194.52	215.46	222.87	
Annual Increase		3.99%	-3.87%	1.05%	10.77%	3.44%	
Cummulative Increase in O&M/Customer		**3.99%**	**0.12%**	**1.17%**	**11.93%**	**15.37%**	
Consumer Price Index		3.40%	3.20%	2.90%	3.80%	1.10%	
Cumulative Increase in CPI		**3.40%**	**6.60%**	**9.50%**	**13.30%**	**14.40%**	

Note 1: Excludes non-recurring write-offs of reg. assets disallowed for rate recovery, SOX implementation costs, divestiture costs and NNS reclassification. Also excludes Group Insurance and Pension costs which have been driven by financial market conditions other than inflation, for both AWWSC & KAW Also excludes depreciation expense at AWWSC due to change of policy in 2007 concerning purchases of IT hardware & software by AWWSC. This change resulted in an at cost recovery through AWWSC vs. historical rate base at KAW which resulted in a return on the investment saving KAW customers the return component.

KENTUCKY AMERICAN WATER COMPANY
Detail of O & M Costs
Response to PSC-3-1



Kentucky American Water
Key Performance Indicators
Response to PSC-3-1(a)

Trends
Green - Improved
Yellow - Neutral
Red - Needs Improvement

	2007	2008	2009
Overall Customer Satisfaction	86.00%	83.00%	89.00%
Service Quality Satisfaction	83.00%	86.00%	88.00%
Customer Complaints	84	91	89
Customer Appointments Met Timely			99.60%
Service Orders Completed as Scheduled			99.30%
Non-Pay Shut-offs Worked			95.90%
O&M Efficiency Rate	53.50%	51.10%	53.40%
Operating Margin	27.80%	33.00%	30.70%
Account Receivable over 90 days		10.40%	8.00%
NRW %	14.30%	14.00%	12.20%
Estimated Meter Reads		1.20%	0.90%
Valve Operations		4,146	5,116
Hydrant Inspections		6,891	7,571
Enviornmental Notice of Violation (NOV)	5	0	0
OSHA Recordable Injury Rate	6.06	4.18	10.62
Recordable Vehicle Accidents		6	5
General Liability Claims		34	33
Overtime Hours	27,583	27,638	23,460

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	**)**	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN	**)**	**CASE NO. 2010-00036**
WATER COMPANY FOR AN ADJUSTMENT OF	**)**	
RATES ON AND AFTER MARCH 28, 2010	**)**	
	)	

REBUTTAL TESTIMONY OF SHEILA A. MILLER

July 19, 2010

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2010-00036
Rebuttal Testimony
Sheila A. Miller

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1. Q. WHAT IS YOUR NAME AND BUSINESS ADDRESS?

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

2. Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?

A. Yes.

3. Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I will address the Company's revisions filed with the Commission on July 15, 2010. I will also address the recommendations made by the AG witness Mr. Ralph Smith regarding the AFUDC adjustment to revenues, the labor vacancy rate and the labor capitalization rate.

<u>REVISIONS TO THE FILING:</u>

4. Q. WHAT REVENUE REQUIREMENT RESULTS FROM THE REVISIONS MADE IN THE FILING?

A. The revised filing results in a revenue requirement of $25,302,362 which is a reduction of $545,924 from the original filing.

5. Q. PLEASE DISCUSS THE VARIOUS ITEMS INCLUDED IN THE REVISION.

A. The first item in the revised filing is the application of the slippage factor that was addressed in response to PSC data request 2, question 36. The Company applied the slippage factors, as calculated by the Commission, of 120.862% to all recurring capital expenditure projects from December 2009 through the end of the forecasted test year ending September 2011, and a slippage factor of 90.8% to all investment project expenditures for that same time period.

6. Q. DOES THE COMMISSION GENERALLY APPLY A SLIPPAGE FACTOR TO THE UTILITY PLANT IN THE COMPANY'S FILING?

A. Yes, it has been the past practice of this Commission to apply a slippage factor.

7. Q. WHAT WAS THE RESULT OF THIS SLIPPAGE FACTOR ADJUSTMENT?

A. The application of the slippage factors resulted in an increase of $254,121 to the revenue requirement.

8. Q. WERE THERE OTHER RATE BASE ADJUSTMENTS MADE IN THE REVISED FILING?

A. Yes. As Mr. Smith correctly states on page 17 of his testimony, the Company inadvertently duplicated the unamortized balance of the Boonesboro acquisition adjustment in its original filing. The Company has eliminated that duplication which results in a reduction of $279 to the revenue requirement.

9. Q. PLEASE CONTINUES WITH THE RATE BASE ADJUSTMENTS.

A. An additional rate base adjustment was made to eliminate the deferred compensation from the other rate base items. In response to AG data request 1, question 25, the Company realized that the deferred compensation was no longer being deferred which makes this rate base item no longer applicable. The net effect of this adjustment is a reduction of $37,756 to the revenue requirement.

10. Q. WERE ANY REVISIONS MADE TO THE DEPRECIATION RATES TO TAKE INTO CONSIDERATION THE COST OF THE NEW KRS II PLANT?

A. Yes. In response to PSC data request 3, question 6, Mr. John Spanos recalculated depreciation rates to include the cost of utility plant in service as of December 31, 2010, including the KRS II Treatment Plant.

11. Q. DID THE COMPANY INCLUDE THE ADJUSTED DEPRECIATION RATES IN THE REVISED FILING?

A. Yes. By applying the revised depreciation rates, the resulting accumulated depreciation, depreciation expense, and the unrecovered reserve netted a reduction of $180,991 to the original revenue requirement.

12. Q. DID THE COMPANY MAKE ANY ADJUSTMENTS TO THE LEAD LAG STUDY?

A. Yes. The Company made one adjustment to the labor lead/lag days to include the AIP days which was discussed in response to AG data request 2, question 118. With the inclusion of the AIP days, the lag period changes from 12 days to 20.80 days. This adjustment results in a reduction of $31,265 to the revenue requirement.

13. Q. DID THE COMPANY BECOME AWARE OF ANY CHANGES TO EXPENSE ITEMS APPLICABLE TO FORECASTED TEST-YEAR ITEMS FROM THOSE INCLUDED IN THE INITIAL FILING OF THIS RATE CASE?

A. Yes, there were three reductions to the original forecasted years levels for pensions, OPEBs, and management fees, although all three are related to updated actuarial information provided by Towers Watson.

14. Q. WAS THE COMMISSION STAFF AND THE INTERVENORS MADE AWARE OF THESE REVISIONS DURING THE DISCOVERY PROCESS?

A. Yes, in response to PSC data request 2, question 23 the Company discussed the latest actuarial projections from Towers Watson regarding the pensions and OPEBs. The reduction in the management fee budget, which was primarily driven by the revised actuarial projections of the OPEB and pension costs, was discussed in response to AG data request 1, question 113 and PSC data request 2, question 20.

15. Q. WHAT WAS THE RESULT OF INCLUDING THE REVISED NUMBER FOR THESE THREE ITEMS IN THE FORECASTED TEST-YEAR REVENUE REQUIREMENT?

A. The revised pension expense resulted in a revenue requirement reduction of $258,669, OPEBs a reduction of $53,552, and management fees a reduction of $136,133.

16. Q. WERE THERE OTHER ADJUSTMENTS MADE TO THE OPERATION AND MAINTENACE EXPENSES?

A. Yes. In the original filing the Company inadvertently omitted the amortization of the 2007 rate case expense which will be fully amortized in November 2010. The forecasted test year in the base period update includes two months of amortization at a cost of $12,433. This adjustment increases the original revenue requirement an additional $25,464.

17. Q. PLEASE CONTINUE WITH OTHER CHANGES REFLECTED IN THE FORECASTED TEST-YEAR INCLUDED IN THE BASE PERIOD UPDATE?

A. At the time the Company initially filed the rate case, there were several insurance other than group premiums that were due to be renewed. The Company based the initial expense on the 2010 premiums that were available and utilized the budget for items where an invoice had not yet been received. In the revised filing, the Company used the actual 2010 premiums for each item of insurance other than group and applied inflationary increases to the 2010 amounts to arrive at the 2011 expense amounts. The anticipated inflationary percentages were included in the Company's workpapers in response to PSC data request 1, question 1a, workpaper 3-9 page 2 of 14. As a result, the forecast is based on the 2010 actual premiums for October through December 2010, and the remaining months of January 2011 through September 2011 were based on the projected 2011 premium amounts. The Company eliminated the contingency amount, as well as the executive risk amount. The executive risk was a combination of the fiduciary, excess fiduciary, crime, kidnap & ransom, network security and privacy, D&O, business travel, employed lawyers, and employment practices liability, which were detailed as separate line items.

The net result of the adjustment to insurance other than group was a reduction of $49,465 to the revenue requirement.

18. Q. DID THE COMPANY MAKE ANY ADJUSTMENT TO THE FORECASTED TEST-YEAR IN THE BASE PERIOD UPDATE THAT HAD NOT PREVIOUSLY BEEN IDENTIFIED DURING THE DISCOVERY PHASE?

A. Yes. The Company since the filing of its case has transferred the positions of Donna Braxton, Manager Human Resources; Michael Shryock, Senior Specialists Computer Support ITS; and Peggy Slone, Executive Assistant, from

Kentucky American's payroll to AWWSC, to reflect their current shared duties with other Eastern Division regulated subsidiaries. It was determined that these three individuals not only perform duties for Kentucky American but also perform duties for other companies in the Eastern Division and it was more appropriate for them to be included in the service company payroll.

The result of transferring these three employees, including the labor and labor-related overheads, to AWWSC was a reduction of $6,174 to the revenue requirement.

19. Q. WERE THERE ANY REVISIONS TO THE CAPITAL STRUCTURE?

A. Yes. The Company originally estimated a June 2010 long term debt financing in the amount of $26.0 million at a bond rate of 5.625%. The Company was able to obtain a more favorable rate of 5.375% and has adjusted the long term debt accordingly. This resulted in a reduction to the revenue requirement of $71,225.

20. Q. IS THE COMPANY AWARE OF ANY FURTHER ADJUSTMENTS THAT SHOULD BE MADE TO THE ORIGINAL FILING FORECASTED TEST-YEAR?

A. No.

REVENUES

21. Q. DID AG WITNESS SMITH ADDRESS THE GOING-LEVEL REVENUE INCLUDED IN THE COMPANY'S FILING?

A. Yes. Mr. Smith made one adjustment as shown on RCS-1- Schedule C-3. Because Mr. Smith recommends that CWIP be eliminated from the forecasted test-year, he makes the corresponding adjustment to eliminate forecasted test-year AFUDC from going-level revenues. The Company's position on CWIP and discussion of prior Commission rulings on this topic has been covered in Mr. Michael Miller's rebuttal testimony. The Commission has stated in its order in case number 2004-00103 that the Commission rejects the AG's position to eliminate CWIP and corresponding AFUDC from the forecasted test-year. The Company believes it has provided ample support for the Commission renewing its rejection of the AG's position on CWIP in this case. Therefore to the extent

CWIP is included in the forecasted test-year rate base, the AFUDC of $646,180 should be restored to going-level revenues.

22. Q. DO YOU HAVE ANYTHING TO ADD CONCERNING AFUDC?

A. Yes. To the extent the Commission adjusts the WACC proposed by the Company, the AFUDC related to CWIP reflected in going-level revenues should be recalculated using the authorized WACC authorized by the Commission.

SALARIES AND WAGES

Vacancy Rate

23. Q. THE AG WITNESS IMPOSES THREE VACANCIES THAT HE EXPECTS THE COMPANY TO INCUR DURING THE ENTIRE FORECASTED TEST-YEAR. DO YOU AGREE WITH THIS ADJUSTMENT?

A. No. The Company is currently filling open positions and expects to have its full compliment of 150 employees by the time the rates from this case are effective, including the six plant positions required to operate the new KRS II facility. The Company originally included a full compliment of 153 employees but has transferred three employees to the service company as discussed previously in this rebuttal testimony.

24. Q. WHAT REASONING DOES MR. SMITH USE TO JUSTIFY HIS ADJUSTMENT?

A. He indicates that it is normal for utilities to have vacancies and the Company has had vacancies during 2008, 2009 and 2010 to date.

25. Q. IF THE COMPANY HAS HAD REGULAR VACANCIES WHY IS HIS ADJUSTMENT NOT APPROPRIATE?

A. When the Company has vacancies it must use overtime and temporary employees to fill the void. There are two ways to handle this situation in budgets and in rate cases. One way is to assume a vacancy level and include additional overtime and/or temporary employees to cover those vacancies. The other way is to include a full compliment of authorized and necessary employees and reflect overtime and temporary employees commensurate with the full compliment of employees. The Company has reflected in its rate filing a full compliment of employees and overtime and temporary employees matched to the full compliment of employees. You can't have it both ways as suggested by Mr. Smith. Mr. Smith's proposal reflects the permanent employee vacancies but he makes no adjustment to reflect higher overtime and/or temporary employees to fill that void. It would be appropriate to incorporate the vacancies into the rate filing only if the overtime hours and temporary labor charges used to compensate for the vacancies is restored in the forecasted test-year.

Pay Raise Projections

26. Q. DID MR. SMITH MAKE ADJUSTEMENTS TO THE COMPANY'S PAY INCREASES IN THE FORECASTED TEST-YEAR?

A. Yes.

27. Q. DO YOU AGREE WITH HIS ADJUSTMENT?

A. I do not agree with his adjustment. Mr. Smith bases this adjustment shown on RCS-1, Schedule C-15 on the premise that the forecasted test-year is based on budget. That assumption is simply incorrect. The Company has incorporated a 3% increase for union employees based on the current union contract, and an increase for salary employees equal to the union increase, and a 3.5% increase for the non-union hourly employees. A review of the Schedule C-15, page 2 of 2 attached to Mr. Smith's testimony shows that the pay increases included in the Company's forecasted test-year are below the averages he shows at the bottom of the page on line 14-19. The Company believes its projected employee pay increases are reasonable, in line with the Salary Administration policy of the Company and a reasonable expectation for forecasted test-year labor rates for the Company's employees.

Payroll and Related Employee Benefit Capitalization Rate

28. **Q.** **DID AG WITNESS SMITH AND LFUCG WITNESS BAUDINO RECOMMEND ADJUSTMENT TO THE 17.34% PAYROLL CAPITALIZATION RATES PROPOSED BY THE COMPANY?**

A. Yes.

29. **Q.** **WHAT JUSTIFICATION DID THEY GIVE FOR THEIR POSITIONS?**

A. Both Mr. Smith and Mr. Baudino base their recommendation of a 19.742% payroll capitalization rate on the five-year average ending with the year 2009. Mr. Smith's calculations and recommendation are shown on RCS-1, Schedule C-13. It appears that in the view of Mr. Smith and Mr. Baudino the only reliable indicator of future costs is reliance on the past, regardless of the presence of known and measurable factors that may change past results. Their view is not in line with the regulatory doctrine of known and measurable changes or the forecasted test-year standards used by the Commission.

30. **Q.** **WOULD YOU EXPLAIN WHAT YOU MEAN BY KNOWN AND MEASURABLE CHANGES THAT WOULD INDICATE THAT MR. SMITH'S AND MR. BAUDIO'S RECOMMENDATIONS BASED ON HISTORICAL DATA IS NOT REFLECTIVE OF THE FORECASTED TEST-YEAR IS NOT ACCURATE?**

A. Yes. Attached to this testimony is Rebuttal Exhibit SAM-1. The schedule shows the actual O&M and capital labor ratios for 2009, the latest actual calendar year data. As indicated in the response to PSC data request 3, question 4, the 2009 produces a capitalized payroll ratio of 18.65%, not the 19.64% utilized by Mr. Smith and Mr. Baudino for 2009 based on capitalized hours. The Company believes it is attempting to capture the dollar impact in this case and the response to PSC-3-4 does that. What is missing in their review of the 2009 capitalized payroll ratio is the known and measurable impact from the hiring of the six plant operation employees for the KRS II treatment facility. Based on the review of the existing plant operation employees at the Kentucky River (I) and Richmond Road treatment facilities, they charge no time to capital projects because they are solely responsible for the operation and maintenance of the treatment facilities. The plant operators at the KRS II facility will be no different. As shown on Rebuttal Exhibit SAM-1, when the known and measurable wages of the six plant operations employees at the KRS II facilities are added to the

2009 wages breakdown (all fully to O&M), it lowers the capitalized ratio to 17.92%. In addition, during the construction of the KRS II facility, the production superintendent for that facility, Kevin Kruchinski, has been working at the plant to manage the construction, and to also be familiar with the make-up of the plant and to educate himself on its operation. During this time he has capitalized his labor throughout 2009. That will no longer be the case in the forecasted test-year, once the KRS II Treatment Facility becomes operational. Therefore the adjustment to the 2009 capitalization rate to reflect 95% of Mr. Kruchinski's time to O&M is both reasonable and known and measurable.

31. Q. DID THE CAPITALIZATION RATE CHANGE AS A RESULT OF TRANSFERRING THREE POSITIONS TO THE SERVICE COMPANY AS DISCUSSED EARLIER IN THIS REBUTTAL TESTIMONY?

A. Yes. The three positions that were transferred to the service company were O&M labor positions. The capitalization rate increased to 17.80% as a result of this revision.

32. Q. DOES THE COMPANY BELIEVE THAT ITS RECOMMENDATION OF A 17.80% PAYROLL CAPITALIZATION RATE FOR THE FORECASTED TEST-YEAR IS REASONABLE?

A. Yes, it is in line with the adjusted 2009 actual capitalized labor. With no other changes to the 2009 rate other than the known and measurable adjustments shown on Rebuttal Exhibit SAM-5, I have calculated a 17.77% payroll capitalization rate. This analysis also shows the recommendations of Mr. Smith and Mr. Baudino are not reasonable because they ignore known and measurable changes that will occur in the forecasted test-year and thus inappropriately understate the revenue requirement for this case.

33. Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

Kentucky American Water Company **REBUTTAL EXHIBIT SAM-1**
Actual 2009 labor adjusted for KRS II positions

	Actual 2009		Adjusted for 6 tech positions		Act 2009	95% cap Rev 2009	2009 as adj for KRS II	
					K Kruchinski			
	a	b	c	d	e	f	c - e + f	
O&M	6,487,914.01	81.35%	6,487,914.01		50,296.10	63,177.67	6,500,795.58	
6 prod tech O&M			321,844.22	82.08%			321,844.22	82.23%
captial	1,486,957.72	18.65%	1,486,957.72	17.92%	16,206.71	3,325.14	1,474,076.15	17.77%
total	7,974,871.73	100.00%	8,296,715.95	100.00%	66,502.81	66,502.81	8,296,715.95	100.00%

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES ON AND AFTER MARCH 28, 2010	)))))	**CASE NO. 2010-00036**

REBUTTAL TESTIMONY OF JOHN J. SPANOS

July 19, 2010

FRANKFORT, KENTUCKY

INTRODUCTION

1. Q. Please state your name and address.

A. John J. Spanos. My business address is 207 Senate Avenue, Camp Hill, Pennsylvania.

2. Q. Have you previously submitted testimony in this proceeding?

A. Yes, I have. My direct testimony and Exhibit No. JJS-1 were submitted with the rate filing of Kentucky American Water Company (referred to herein as "the Company") on February 22, 2010.

3. Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Ralph C. Smith of the Kentucky Office of Attorney General.

4. Q. What is the subject of your rebuttal testimony?

A. The subject of my rebuttal testimony is the proper net salvage percent for Account 333, Services.

5. Q. What is the currently approved net salvage percent for Account 333, Services?

A. Negative 120 percent.

6. Q. What is the recommended net salvage percent for Account 333, Services by you?

A. Negative 100 percent.

7. Q. `What is the recommended net salvage percent for Account 333, Services, by Mr. Smith?

A. Negative 20 percent.

8. Q. Does Mr. Smith give any support for his adjustment in his testimony?

A. No. Mr. Smith's support for his adjustment is the statement that the negative net salvage for Account 333, "sticks out like a sore thumb when compared to Mr. Spanos' more reasonable future net salvage ratios" for the other KAWC plant accounts. A comparison between other plant accounts with drastically different life characteristics and costs to retire is meaningless.

9. Q. Mr. Smith characterizes your estimate for net salvage for Account 333, Services solely as judgment. Is this correct?

A. No. As described on page II-24 of the Depreciation Study, judgment is an important component in determining a net salvage percent. However, judgment is based on critical factors, not just what looks good compared to other accounts. These critical factors include: (1) analyses of historical data; (2) knowledge of management's plans and operating policies; and (3) net salvage estimates from previous studies of this company and other water companies.

10. Q. Has your estimate of net salvage utilized historical data?

A. Yes. As stated on pages II-24 and II-25 of the Depreciation Study, the historical data for Account 333, Services, was representative of expectations for future net salvage levels. Historical data for the years 1980-2009 are set forth on pages III-106 and III-107 of the Depreciation Study. The historical indications of this 30-year period are negative 106 percent.

11. Q. Has your estimate included knowledge of management's plans and operation policies?

A. Yes. The process and practices of removing services has not changed over the years and there are no plans in the future to change the process.

12. Q. Has your estimate considered the net salvage estimates from previous studies of this company and other water companies?

A. Yes. The current estimate for this Company for Account 333, Services is negative 120 percent. The range of estimates for other water companies is between negative 20 percent and negative 150 percent, which includes a negative 120 percent for Indiana-American Water Company and negative 90 percent for Missouri American Water Company.

13. Q. Can you further detail the historical indications for Account 333, Services?

A. Yes. During the period 1980-2009, there have been $1,489,251 retired in services. The cost to retire these assets has been $1,596,028 and the Company has received $19,303 in salvage value. In other words, the net salvage amount to retire the $1,489,251 in plant was negative $1,576,725 ($19,303 – $1,596,028) or negative 106 percent.

14. Q. Can you summarize your rebuttal testimony related to Account 333, Services?

A. Yes, I can. Mr. Smith randomly selects negative 20 percent in order to have a net salvage percent closer to the other accounts. This estimate is not based on historical data or facts, such as; services are underground so the cost to retire is more expensive per plant being retired than many of the above ground assets. Mr. Smith's estimate does not consider the current estimate for this account. Generally, Mr. Smith's estimate is developed with the sole purpose to reduce depreciation.

My estimate of negative 100 percent is supported by historical data, Company plans and industry estimates, including the current estimate for this account.

15. Does this complete your rebuttal testimony?

A. Yes, it does.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	**)**	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN	**)**	**CASE NO. 2010-00036**
WATER COMPANY FOR AN ADJUSTMENT OF	**)**	
RATES ON AND AFTER MARCH 28, 2010	**)**	

REBUTTAL TESTIMONY OF JAMES H. VANDER WEIDE

July 19, 2010

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I. WITNESS IDENTIFICATION

Q. 1 What is your name and business address?

A. 1 My name is James H. Vander Weide. I am Research Professor of Finance and Economics at Duke University, the Fuqua School of Business. I am also President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to business clients. My business address is 3606 Stoneybrook Drive, Durham, North Carolina 27705.

Q. 2 Are you the same James Vander Weide who previously filed direct testimony in this proceeding?

A. 2 Yes, I am.

Q. 3 What is the purpose of your testimony?

A. 3 I have been asked by Kentucky American Water Company ("KAWC") to review the direct testimonies of Dr. J. Randall Woolridge and Mr. Richard A. Baudino and to respond to their cost of capital recommendations. Dr. Woolridge's testimony is presented on behalf of the Kentucky Office of Attorney General, and Mr. Baudino's testimony is presented on behalf of Lexington-Fayette Urban County Government.

Q. 4 Is there anything in the testimonies of Dr. Woolridge or Mr. Baudino that causes you to change your recommended cost of equity for KAWC?

A. 4 No.

II. REBUTTAL OF DR. WOOLRIDGE

Q. 5 What is Dr. Woolridge's recommended rate of return on equity for KAWC?

A. 5 Dr. Woolridge recommends a rate of return on equity for KAWC equal to 9.25 percent.

Q. 6 How does Dr. Woolridge arrive at his recommended 9.25 percent cost of equity for KAWC?

A. 6 Dr. Woolridge arrives at his recommended 9.25 percent cost of equity for KAWC primarily by applying the DCF model to a proxy group of natural gas distribution companies. [Woolridge at 36.]

Q. 7 Why does Dr. Woolridge rely primarily on the DCF results for a proxy group of natural gas utilities to estimate the cost of equity for a water utility such as KAWC?

A. 7 Dr. Woolridge relies primarily on the DCF results for a proxy group of natural gas utilities to estimate the cost of equity for KAWC because he believes the DCF results for the natural gas utilities are a better indicator of KAWC's cost of equity than the DCF results for water utilities. [Woolridge at 50.]

Q. 8 Does Dr. Woolridge also present Capital Asset Pricing Model ("CAPM") results for his proxy companies?

A. 8 Yes. Dr. Woolridge presents CAPM results both for his proxy group of natural gas distribution companies and his proxy group of water companies. However, he gives little or no weight to his CAPM results in this proceeding because he believes the CAPM provides a less reliable indication of the cost of equity for public utilities. [Woolridge at 22.]

A. Dr. Woolridge's Proxy Companies

Q. 9 What proxy companies does Dr. Woolridge use to estimate KAWC's cost of equity?

A. 9 Dr. Woolridge uses a group of nine natural gas distribution companies followed by Value Line and a group of nine water utilities followed by AUS Utility Reports. As noted above, Dr. Woolridge relies primarily on the cost of equity results for his nine natural gas distribution companies to arrive at his recommended cost of equity in this proceeding.

Q. 10 Does Dr. Woolridge compare the risk of his natural gas distribution companies to the risk of his water utility group?

A. 10 Yes. Dr. Woolridge provides a risk comparison of his natural gas distribution and water utility groups in his testimony at pages 12 - 14 and in Exhibit JRW-4. He concludes:

> Five of the six risk measures (lower Beta and higher Safety, Financial Strength, Stock Price Stability, and Earnings Predictability) suggest that the Gas Proxy Group is less risky than the Water Proxy Group. However, the magnitude of the differences in the risk metrics is not large. Nonetheless, these *Value Line* measures do suggest that the Gas Proxy Group is a little less risky than the Water Proxy Group. [Woolridge at 13.]

Q. 11 What proxy companies do you use to estimate KAWC' cost of equity?

A. 11 I use a proxy group of water utilities and a proxy group of natural gas distribution companies followed by Value Line.

Q. 12 What criteria do you use to select your proxy group of water utilities?

A. 12 As discussed in my direct testimony, I select all water utilities in Value Line's Standard and Extended editions that: (1) pay dividends; (2) did not decrease dividends during any quarter of the past two years; (3) have at least one analyst's long-term growth forecast; and (4) have not announced a merger. In addition, all of the companies included in my group, with the exception of Southwest Water, have a Value Line Safety Rank of 3, where 3 is the average Safety Rank of the Value Line universe of companies.

Q. 13 Do you have any evidence that your proxy group of water utilities is a reasonable proxy for the risk of investing in KAWC and its parent, American Water Works Company ("AWC")?

A. 13 Yes. Based on data from Standard & Poor's and Value Line, my proxy group of water utilities has a higher Standard & Poor's bond rating (A) than AWC (BBB+), and approximately the same average Value Line Safety Rank (3).[1] (See Rebuttal Schedule 1.)

Q. 14 What criteria do you use to select your group of natural gas distribution companies?

A. 14 I select all the companies in Value Line's natural gas industry groups that: (1) are in the business of natural gas distribution; (2) paid dividends during every quarter of the last two years; (3) did not decrease dividends during any quarter of the past two years; (4) have at least two analysts included in the I/B/E/S consensus growth forecast;[2] and (5) have not announced a merger. In

[1] Value Line describes its Safety Rank as "a measurement of potential risk assoiated with inidvidual common stocks." Safety Ranks range from 1 to 5, with the most safe rating being a 1.

[2] As I discuss in my direct testimony, on the basis of my professional judgment, I normally specify that the I/B/E/S long-term earnings growth forecast must include the forecasts of at least three analysts. However, in December 2009 there were only five natural gas companies with growth forecasts from at least three analysts. Therefore, I also include in the studies in my direct testimony the results for companies that have growth forecasts based on two analysts' growth forecasts.

addition, all of the LDCs included in my group have an investment grade bond rating and a Value Line Safety Rank of 1, 2, or 3.

Q. 15 Do you have evidence that your proxy group of natural gas distribution companies is a reasonable proxy for the risk of investing in KAWC and its parent, AWC?

A. 15 Yes. My proxy group of natural gas distribution companies has a higher average Value Line Safety Rank (2) and a slightly higher average bond rating (BBB+ to A-) than AWC, which has a Safety Rank of 3 and a bond rating of BBB+.

Q. 16 Dr. Woolridge claims that the DCF results for water utilities are less reliable than the DCF results for natural gas distribution companies because there is a large difference between their historical growth rates and their forecasted EPS growth rates. Do you agree?

A. 16 No. Although the analysts' EPS growth rates are higher than the historical growth rates for the water utilities, this difference does not imply that the DCF results for the water utilities are less reliable than the DCF results for the natural gas utilities. Differences in historical and projected growth rates for the water utilities indicates that the water utilities are likely to grow more rapidly in the future than they have in the past. The DCF model is intended to capture investors' expectations about the future, and my studies indicate that the analysts' growth forecasts are more highly correlated with stock prices than historical growth rates.

Q. 17 Is it reasonable to expect that water companies would grow at higher rates in the future than they have in the past?

A. 17 Yes. Water companies are expected to have to make significant capital expenditures in their water plant to provide safe and reliable water supplies in the future.

Q. 18 Is there also a relatively large difference between historical and projected EPS growth rates for Dr. Woolridge's proxy group of natural gas distribution companies?

A. 18 Yes. However, for the natural gas distribution companies, the difference is in the opposite direction--that is, the analysts' future growth forecasts tend to be lower than the historical growth rates for these companies. Nonetheless, I believe it is reasonable to use the analysts' growth forecasts to estimate investor growth expectations in the DCF model.

B. Dr. Woolridge's DCF Model

Q. 19 What cost of equity results does Dr. Woolridge obtain from his application of his DCF model?

A. 19 Dr. Woolridge obtains a DCF result of 9.3 percent for his proxy group of nine water utilities and 8.9 percent for his proxy group of nine natural gas distribution companies. [Woolridge at 38.]

Q. 20 What DCF Model does Dr. Woolridge use to estimate KAWC's cost of equity?

A. 20 Dr. Woolridge uses an annual DCF model of the form, $k = D_0(1+.5g)/P_0 + g$, where k is the cost of equity, D_0 is the first period dividend, P_0 is the current stock price, and *g* is the average expected future growth in the company's earnings and dividends.

Q. 21 What are the basic assumptions of Dr. Woolridge's annual DCF model?

A. 21 Dr. Woolridge's annual DCF model is based on the assumptions that: (1) a company's stock price is equal to the present value of the future dividends investors expect to receive from their investment in the company; (2) dividends are paid annually; (3) dividends, earnings, and book values are expected to grow at the same constant rate forever; and (4) the first dividend is received one year from the date of the analysis.

Q. 22 Do you agree with Dr. Woolridge's use of an annual DCF model to estimate KAWC's cost of equity?

A. 22 No. Dr. Woolridge's annual DCF model is based on the assumption that companies pay dividends only at the end of each year. Since Dr. Woolridge's proxy companies all pay dividends quarterly, Dr. Woolridge should have used the quarterly DCF model to estimate KAWC's cost of equity.

Q. 23 Why is it unreasonable to use an annual DCF model to estimate the cost of equity for companies that pay dividends quarterly?

A. 23 It is unreasonable to apply an annual DCF model to companies that pay dividends quarterly because: (1) the DCF model is based on the assumption that a company's stock price is equal to the present value of the expected future dividends associated with investing in the company's stock; and (2) the annual DCF model cannot be derived from this assumption when dividends are paid quarterly.

Q. 24 Does Dr. Woolridge acknowledge that one must recognize the assumptions of the DCF model when estimating the model's inputs?

A. 24 Yes. Dr. Woolridge states, "In general, one must recognize the assumptions under which the DCF model was developed in estimating its components (the dividend yield and expected growth rate)." [Woolridge at 26.]

Q. 25 Recognizing your disagreement with Dr. Woolridge's use of an annual DCF model, did Dr. Woolridge apply the annual DCF model correctly?

A. 25 No. Dr. Woolridge's annual DCF model is based on the assumption that dividends will grow at the same constant rate forever. Under the assumption that dividends will grow at the same constant rate forever, the cost of equity is given by the equation, $k = D_0 (1 + g) / P_0 + g$, where D_0 is the current annualized dividend, P_0 is the stock price, and g is the expected constant annual growth rate. Thus, the correct first period dividend in the annual DCF model is the current annualized dividend multiplied by the factor, (1 + growth rate). Instead, Dr. Woolridge uses the current annualized dividend multiplied by the factor (1 + 0.5 times growth rate) as the first period dividend in his DCF model. This incorrect procedure, apart from other errors in his methods, causes him to underestimate KAWC's cost of equity.

Q. 26 How does Dr. Woolridge estimate the expected future growth component of the DCF cost of equity?

A. 26 Dr. Woolridge considers Value Line data on historical growth rates in earnings, dividends, and book value, as well as Value Line data on projected growth rates in earnings, dividends, and book value. He also considers analysts' forecasts of future growth provided by First Call, Reuters, and Zacks, and internal growth estimates based on Value Line's estimates of retention ratios and rates of return on book equity. Dr. Woolridge's final estimate of the growth rate that investors expect for his proxy companies is based on his judgment of what he considers to be a "reasonable" or "appropriate" growth rate. [Woolridge at 37.]

Q. 27 Do you agree with Dr. Woolridge's use of historical growth rates to estimate investors' expectation of future growth in the DCF model?

A. 27 No. Historical growth rates are inherently inferior to analysts' forecasts because analysts' forecasts already incorporate all relevant information regarding historical growth rates and also incorporate the analysts' knowledge about current conditions and expectations regarding the future. My studies described in my direct testimony indicate that investors use analysts' earnings growth forecasts in making stock buy and sell decisions rather than historical or internal growth rates such as those presented by Dr. Woolridge.

Q. 28 What is the internal growth method of estimating the growth component for the DCF method?

A. 28 The internal growth method estimates expected future growth by multiplying a company's retention ratio, "b," times its expected rate of return on equity, "r." Thus, "g = b x r," where "b" is the percentage of earnings that are retained in the business and "r" is the expected rate of return on equity.

Q. 29 Do you agree with the internal growth method for estimating growth in the DCF model?

A. 29 No. The internal growth method is logically circular because it requires an estimate of the expected rate of return on equity, "r," in order to estimate the cost of equity using the DCF model. Yet, for regulated companies such as KAWC, the allowed rate of return on equity is set equal to the cost of equity.

Q. 30 What rate of return on equity does Dr. Woolridge assume in his calculation of expected growth using his internal growth method?

A. 30 Dr. Woolridge uses a rate of return on equity in the range 11.0 percent to 11.8 percent for his proxy group of water utilities, and a rate of return on equity in the range 11.0 percent to 11.3 percent for his proxy group of natural gas companies (Woolridge Exhibit__JRW-10, p. 5).

Q. 31 Is it reasonable to assume that Dr. Woolridge's proxy companies will earn a rate of return on equity in the range 11.0 percent to 11.8 percent when he is recommending that they be allowed to earn only a return of 9.25 percent?

A. 31 No. Investors are well aware that water and natural gas utilities are regulated by rate of return regulation. If investors truly believed that the utilities' cost of equity were equal to Dr. Woolridge's recommended 9.25 percent, they would forecast that the utilities would earn 9.25 percent on equity. Thus, Dr. Woolridge's recommended 9.25 percent rate of return on equity is inconsistent with his assumed 11.0 percent to 11.8 percent earned rate of return on equity for his proxy companies.

Q. 32 Does Dr. Woolridge's internal growth method recognize that, in addition to growth from retained earnings, the companies in his proxy group can also grow by issuing new equity at prices above book value?

A. 32 No. Dr. Woolridge's internal growth method underestimates the expected future growth of his proxy companies because it neglects the possibility that the companies can also grow by issuing new equity at prices above book value. Since many of the proxy companies are selling at prices in excess of book value, and Value Line forecasts that many of them will issue new equity over the next several years, Dr. Woolridge's failure to recognize the "external" component of future growth causes to him to underestimate his proxy companies' expected future growth. This is noteworthy at a time when the water industry is expected to undertake substantial infrastructure investments and to finance part of this expansion through the capital markets.

Q. 33 Does Dr. Woolridge's internal growth method recognize that Value Line's reported rates of return on equity generally understate each company's average rate of return on equity for the year?

A. 33 No. Dr. Woolridge fails to recognize that Value Line calculates its reported rates of return on equity by dividing a company's net income by end of year equity, whereas most financial analysts calculate a company's rate of return on equity by dividing net income by the average equity for the year. In the general case where a company's equity is increasing, Value Line's reported ROEs will understate the average ROE for the year.

Q. 34 Do you agree with Dr. Woolridge's use of analysts' growth forecasts to estimate the expected growth component of his DCF model?

A. 34 Yes. As discussed in my direct testimony, I recommend the use of analysts' growth forecasts for the purpose of estimating the expected growth component of the DCF model. I have conducted extensive studies that demonstrate that stock prices are more highly correlated with analysts' growth rates than with either historical growth rates or the internal growth rates considered by Dr. Woolridge.

Q. 35 What growth rates does Dr. Woolridge obtain from First Call, Reuters, and Zacks?

A. 35 Dr. Woolridge obtains a mean growth rate of 7.9 percent (median 7.6 percent) for his water utility proxy group and a mean growth rate of 4.6 percent (median 4.8 percent) for his natural gas proxy group (see Woolridge Exhibit__ JRW-10, p. 6).

Q. 36 What DCF result would Dr. Woolridge have obtained for his proxy water companies if he had relied entirely on the average EPS growth rates of First Call, Reuters, and Zacks?

A. 36 Dr. Woolridge reports an average dividend yield of 3.5 percent for his water utility proxy group (see Woolridge JRW-10.2). The average analyst EPS growth rate for his water utility proxy group is 7.9 percent (see Woolridge JRW-10.6). Adding this dividend yield and growth rate, and using Dr. Woolridge's (incorrect) ½ g multiplier, produces a DCF result for his water proxy group equal to 11.5 percent. Correctly implementing the annual DCF model using a full year of growth produces an average DCF result equal to 11.7 percent for the water proxy group.

Q. 37 Have you also calculated DCF results for a group of water utilities that currently meet your proxy selection criteria?

A. 37 Yes. The average DCF result for the companies that currently meet my proxy selection criteria is 11.7 percent. (See Rebuttal Schedule 2)

C. Dr. Woolridge's Rejection of Analysts' Growth Forecasts

Q. 38 How do you recommend estimating the future growth component in the DCF model?

A. 38 As described in my written evidence, I recommend using the analysts' forecasts published by I/B/E/S Thomson Reuters.

Q. 39 Why do you believe that the analysts' forecasts of earnings growth are more accurate indicators of investors' growth expectations than the historical and internal growth data provided by Dr. Woolridge?

A. 39 Security analysts analyze the prospects of companies and forecast earnings. They take into account all available historical and current data plus any additional information that is available, such as changes in projected capital expenditures, regulatory climate, industry restructuring, regulatory rulings, or changes in the competitive environment. The performance of security analysts is measured against their ability to weigh the above factors, to predict earnings growth, and to communicate their views to investors. Financial research indicates that securities analysts are influential, their forecasts are more accurate than simple extrapolation of past growth, and, most importantly, the consensus of their forecasts is impounded in the current structure of market prices. This is a key result, since a proper application of the DCF model requires the matching of stock prices and investors' growth expectations.

Q. 40 Are analysts' forecasts readily available?

A. 40 Yes. An important part of the analysts' job is getting their views across to investors. Major investment firms send out monthly reports with their earnings forecasts, and institutional investors have direct access to analysts. Individual investors can get the same forecasts through their investment advisors or online. Studies reported in the academic literature indicate that recommendations based on these forecasts are relied on by investors. Indeed, because analysts' forecasts are perceived by investors as being useful, there are services which offer analysts' forecasts on all major stocks. I/B/E/S and Zack's are some of the providers of these data. I recommend use of the I/B/E/S growth rates because they have been: (1) shown to be highly correlated with stock prices; (2) widely studied in the finance literature; and (3) widely available to investors for many years.

Q. 41 Is it your contention that analysts make perfectly accurate predictions of future earnings growth?

A. 41 No. Forecasting earnings growth, for either the short-term or long-term, is very difficult. This statement is consistent with the fact that stocks, unlike high-quality bonds, are risky investments whose returns are highly uncertain. Though analysts' forecasts are not perfectly accurate, they are better than either retention growth rates or historical growth in predicting stock prices. One would expect this result, given that analysts have all the past data plus current information. The important consideration is: what growth rates do investors use to value a stock? Financial research suggests that the analysts' growth forecasts are used by investors and therefore most related to stock prices.

Q. 42 Does the observation that analysts' growth forecasts are inherently uncertain imply that investors should ignore analysts' growth forecasts in making stock buy and sell decisions?

A. 42 No. Because growth forecasts have a significant influence on a company's stock price, investors have a great incentive to use the best available forecasts of a company's growth prospects, even if these growth forecasts are inherently uncertain. In this regard, the investor's situation is similar to the situation of a pilot who is flying across the country. Although the pilot recognizes that weather forecasts are inherently uncertain, he or she has a strong incentive to obtain the best available forecasts of cross-country weather patterns before taking off.

Q. 43 Have you done research on the appropriate use of analysts' forecasts in the DCF model?

A. 43 Yes. As described in my direct testimony, I prepared a study in conjunction with Willard T. Carleton, Professor of Finance Emeritus at the University of Arizona, on why analysts' forecasts are the best estimate of investors' expectations of future long-term growth. This study is described in a paper entitled "Investor Growth Expectations and Stock Prices: the Analysts versus History," published in the Spring 1988 edition of *The Journal of Portfolio Management*. My studies indicate that the analysts' forecasts of future growth are superior to historically-oriented growth measures and retention growth measures in predicting a firm's stock price.

Q. 44 Please summarize the results of your study.

A. 44 First, we performed a correlation analysis to identify the historically oriented growth rates which best described a firm's stock price. Then we did a regression study comparing the historical and retention growth rates to the consensus analysts' forecasts. In every case, the regression equations containing the average of analysts' forecasts statistically outperformed the regression equations containing the historical and retention growth estimates. These results are consistent with those found by Cragg and Malkiel, the early major research in this area (John G. Cragg and Burton G. Malkiel, Expectations and the Structure of Share Prices, University of Chicago Press, 1982). These results are also consistent with the hypothesis that investors use analysts' forecasts, rather than historically oriented growth calculations, in making stock buy and sell decisions. They provide overwhelming evidence that the analysts' forecasts of future growth are superior to historically oriented growth measures in predicting a firm's stock price.

Q. 45 Has your study been updated to include more recent data?

A. 45 Yes. Researchers at State Street Financial Advisors updated my study using data through year-end 2003. Their results continue to confirm that analysts' growth forecasts are superior to historical and retention growth measures in predicting a firm's stock price.

Q. 46 Does Dr. Woolridge agree with your assessment that analysts' growth forecasts should be used to estimate the future growth component of the DCF model?

A. 46 No. Dr. Woolridge argues that analysts' growth forecasts should not be used to estimate the future growth component of the DCF model because, in his opinion, it is well known that analysts' growth forecasts are overly optimistic [Woolridge at 33].

Q. 47 Have you reviewed the research literature on the properties of analysts' growth forecasts?

A. 47 Yes, I have reviewed the articles identified in Rebuttal Schedule 3.

Q. 48 What basic questions does the research literature on analysts' forecasts address?

A. 48 The research literature on analysts' growth forecasts addresses three basic questions: (1) Are analysts' forecasts superior to historical growth extrapolations in their ability to forecast future earnings per share? (2) Is the correlation between changes in analysts' EPS growth forecasts and stock prices greater than the correlation between historical earnings growth rates and stock prices? and (3) Are analysts' growth forecasts overly optimistic?

Q. 49 How do researchers test whether analysts' growth forecasts are more accurate than forecasts based on historical growth extrapolations?

A. 49 I have identified at least eight published research studies dating from 1972 to 2006 that compare the accuracy of analysts' growth forecasts to the accuracy of forecasts based on historical extrapolations. Typically, these research studies follow several basic steps: (1) gather data on historical earnings per share for a large sample of firms over a reasonably long historical period of time; (2) gather data on actual earnings per share growth rates for the same firms over a subsequent future time period; (3) apply statistical forecasting techniques to determine the best model for forecasting future earnings growth based on historical growth data; (4) gather data on analysts' growth forecasts for the study period; (5) calculate the difference between the actual growth rate and the forecasted growth rate for both the best statistical forecasting model and the analysts' forecasts; (6) determine whether there is a significant difference between the forecasting errors of the statistical forecasting model and the forecasting errors of analysts' EPS growth forecasts; and (7) if the errors from the analysts' EPS growth forecasts are less than the errors from the statistical forecasting techniques and the difference is statistically significant, conclude that analysts provide superior forecasts to the forecasts obtained by statistical forecasting techniques. The main differences between the studies reported in the literature relate to the time period studied, the size of the database, and the statistical techniques used to forecast future earnings growth based on historical earnings data.

Q. 50 What are the general conclusions of the research literature regarding the accuracy of analysts' growth forecasts compared to the accuracy of growth forecasts based on historical growth extrapolations?

A. 50 Seven of the eight articles strongly support the hypothesis that analysts' forecasts provide better predictions of future earnings growth than statistical models based on historical earnings, and one of the articles neither supports nor rejects this hypothesis (see Table 1 below). These articles strongly support the conclusion that analysts' EPS growth forecasts are better proxies for investor growth expectations than historical growth rates.

TABLE 1
ARTICLES THAT STUDY WHETHER ANALYSTS' FORECASTS OR HISTORICAL GROWTH EXTRAPOLATIONS ARE BETTER PREDICTORS OF EPS GROWTH

Author (Date)	Support Historical	Support Analysts
Elton and Gruber (1972)	Neutral	Neutral
Brown and Rozeff (1978)	No	Yes
Crichfield, Dyckman, and Lakonishok (1978)	No	Yes
Givoly and Lakonishok (1984)	No	Yes
Brown, Hagerman, Griffin, and Zmijewski (1987)	No	Yes
Newbold, Zumwalt, and Kannan (1987)	No	Yes
Brown, Richardson, and Schwager (1987)	No	Yes
Banker and Chen (2006)	No	Yes

Q. 51 Why is the correlation between analysts' EPS growth forecasts and stock prices a significant issue in the research literature on analysts' growth forecasts?

A. 51 If analysts' EPS growth forecasts are good proxies for investor growth expectations, one would expect that changes in analysts' growth forecasts would have a significant impact on stock prices. The impact of changes in analysts' growth expectations on stock prices can be estimated using standard statistical regression techniques.

Q. 52 What are the general conclusions of the research literature regarding the correlation between changes in analysts' EPS forecasts and stock prices?

A. 52 I have identified at least seven published research studies that use regression techniques to test whether the impact of changes in analysts' growth forecasts on stock prices is sufficiently strong to justify the conclusion that analysts' EPS growth forecasts are good proxies for investor growth expectations. All these studies find that changes in analysts' growth forecasts have a large and statistically significant impact on changes in stock prices. Five of these studies also test whether the impact of analysts' growth forecasts on stock prices is stronger than the impact of historical and/or retention growth rates on stock prices. These studies find that changes in analysts' growth forecasts have a significantly stronger impact on stock prices than changes in historical and/or retention earnings growth rates. In summary, financial research strongly supports the conclusion that analysts' growth forecasts are the best proxies for investor growth expectations.

TABLE 2
ARTICLES THAT STUDY THE RELATIONSHIP
BETWEEN ANALYSTS' GROWTH FORECASTS AND STOCK PRICES

Author (Date)	Support Historical	Support Analysts
Malkiel (1970)	No	Yes
Malkiel and Cragg (1970)	No	Yes
Elton, Gruber, and Gultekin (1981)		Yes
Fried and Givoly (1982)		Yes
Vander Weide and Carleton (1988)	No	Yes
Gordon, Gordon, and Gould (1989)	No	Yes
Timme and Eisemann (1989)	No	Yes

Q. 53 What are the general conclusions of the research literature regarding the claim that analysts' forecasts are overly optimistic?

A. 53 A review of available research evidence strongly supports the hypothesis that analysts' growth forecasts are not optimistic. I have reviewed nine articles that address whether analysts' growth forecasts are overly optimistic. At least seven of the nine articles reviewed find no evidence that analysts' growth forecasts are overly optimistic. Two articles find evidence of optimism, but also conclude that optimism is declining significantly over time. Of these two studies, one finds that analysts' forecasts for the Standard & Poor's 500 are pessimistic for the last four years of the study.

TABLE 3
ARTICLES THAT STUDY WHETHER ANALYSTS' FORECASTS ARE BIASED TOWARD OPTIMISM

Author (Date)	Conclusion
Crichfield, Dyckman, and Lakonishok (1978)	Unbiased
Elton, Gruber, and Gultekin (1984)	Unbiased
Givoly and Lakonishok (1984)	Unbiased
Brown (1997)	Declining optimism
Keane and Runkle (1998)	Unbiased
Abarbanell and Lehavy (2003)	Unbiased
Ciccone (2005)	Pessimistic
Clarke, Ferris, Jayaraman, and Lee (2006)	Unbiased
Yang and Mensah (2006)	Unbiased

Q. 54 What is the most important contribution of the more recent research literature on the accuracy of analysts' forecasts?

A. 54 The most important contribution of more recent research is to identify substantial statistical difficulties in earlier research studies that caused some of these studies to unwittingly accept the hypothesis of optimism when no optimism was present. For example, recent studies recognize that the results of earlier studies are heavily influenced by the presence of large unexpected accounting write-offs and special accounting charges at a small number of sample companies. Unexpected accounting write-offs and special charges have a potentially dramatic impact on conclusions concerning analysts' bias because analysts' forecasts intentionally exclude the impact of accounting write-offs and special charges, whereas actual earnings include these items.

Thus, a comparison of analysts' forecasts premised on normalized earnings (that is, earnings that exclude the impact of accounting write-offs and special charges) to reported earnings that include the negative effect of accounting write-offs and special charges will bias the results in favor of concluding that analysts are optimistic. Recent studies demonstrate that, once the distorting effect of unexpected accounting write-offs and special charges are removed from the analysis, there is no evidence that analysts' EPS growth forecasts are optimistic.

Recent research also highlights the potential impact of high correlation in analysts' forecast errors on study conclusions. Analysts' forecast errors tend to be highly correlated because unexpected industry and economy-wide shocks, such as unexpected increases in oil prices or terrorist attacks, have similar effects on all firms in the same industry. However, the relevant statistical tests of optimism are based on the assumption that analysts' forecast errors are independent, that is, the tests assume that the correlation of the analyst errors is zero. Once the statistical tests of optimism are adjusted to account for the high correlation in forecast errors that generally characterize the data, evidence supports the hypothesis that analysts' EPS growth forecasts are unbiased, and hence not optimistic.

Q. 55 Dr. Woolridge argues that analysts face potential conflicts of interest between their companies' research operations and underwriting operations. Has the New York Stock Exchange ("NYSE") and the National

Association of Securities Dealers ("NASD") addressed the issue of analysts' potential conflicts of interest?

A. 55 Yes. Beginning in the early 2000s, the NYSE and NASD implemented a series of rule changes that address potential conflicts of interest. Specifically, they:

- Imposed structural reforms to increase analyst independence, including prohibiting investment banking personnel from supervising analysts or approving research reports;
- Prohibited offering favorable research to induce investment banking business;
- Prohibited research analysts from receiving compensation based on a specific investment banking transaction;
- Required disclosure of financial interests in covered companies by the analyst and the firm;
- Imposed quiet periods for the issuance of research reports after securities offerings managed or co-managed by a member;
- Restricted personal trading by analysts;
- Required disclosure in research reports of data and price charts that help investors track the correlation between an analyst's rating and the stock's price movements; and
- Required disclosure in research reports of the distribution of buy/hold/sell ratings and the percentage of investment banking clients in each category.[3]

Q. 56 What is your overall conclusion regarding the use of analysts' growth forecasts as proxies for investors' growth expectations?

A. 56 Contrary to Dr. Woolridge's assessment that analysts' growth forecasts should not be used in the DCF model because they are well known to be optimistic, I find that the research literature provides strong support for the conclusion that: (1) analysts' EPS growth forecasts are not optimistic; and (2) analysts' EPS growth forecasts are reasonable proxies for investor growth expectations, while the historical growth extrapolations and retention growth rates used by Dr.

[3] "Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules," December 2005, p. 5.

Woolridge are not. Furthermore, Dr. Woolridge's concerns regarding analysts' potential conflicts of interest have been fully addressed by rule changes implemented by the NYSE and NASD in the early 2000s. In addition, Dr. Woolridge fails to recognize that the DCF model requires the growth forecasts of investors, whether accurate or not. In this regard, it is helpful to keep in mind that investors would not pay for analysts' growth forecasts if they did not find them to be helpful in making stock buy and sell decisions. Similarly, the NYSE and NASD would not have taken steps to address conflicts of interest if investors did not rely on analysts' forecasts in making investment decisions.

D. Dr. Woolridge's Capital Asset Pricing Model

Q. 57 What is the CAPM?

A. 57 The CAPM is an equilibrium model of expected returns on risky securities in which the expected or required return on a given risky security is equal to the risk-free rate of interest plus the security's "beta" times the market risk premium:

Expected return = Risk-free rate + (Security beta x Market risk premium).

The risk-free rate in this equation is the expected rate of return on a risk-free government security, the security beta is a measure of the company's risk relative to the market as a whole, and the market risk premium is the premium investors require to invest in the market basket of all securities compared to the risk-free security.

Q. 58 How does Dr. Woolridge use the CAPM to estimate KAWC's cost of equity?

A. 58 The CAPM requires estimates of the risk-free rate, the company-specific risk factor, or beta, and either the required return on an investment in the market portfolio, or the risk premium on the market portfolio compared to an investment in risk-free government securities. For the risk-free rate, Dr. Woolridge uses the recent average 4.25 percent yield on 30-year Treasury bonds [Woolridge at 41]; for the company-specific risk factor or beta, Dr. Woolridge uses the current Value Line beta for each company [Woolridge at 42]; and for the required return or risk premium on the market portfolio, Dr. Woolridge employs the average 4.68 percent risk premium he obtains from his review of the risk premium literature [Woolridge at 47].

Q. 59 What CAPM result does Dr. Woolridge obtain for his proxy companies?

A. 59 Dr. Woolridge obtains a CAPM result of 7.8 percent for his water utility proxy group and a result of 7.3 percent for his natural gas distribution company proxy group.

Q. 60 Does Dr. Woolridge recognize that the results of his CAPM analysis are unreasonably low?

A. 60 Yes. Dr. Woolridge reports the results of his DCF and CAPM studies in his testimony at page 49 as follows:

	DCF	CAPM
Water Proxy Group	9.3%	7.8%
Gas Proxy Group	8.9%	7.3%

From these results, Dr. Woolridge concludes that KAWC's cost of equity is 9.25 percent. Since Dr. Woolridge's CAPM results are approximately 150 to 200 basis points lower than his recommended 9.25 percent cost of equity, Dr. Woolridge must agree that a CAPM result of 7.8 percent or 7.3 percent is unreasonably low.

Q. 61 Do you agree with Dr. Woolridge's application of the CAPM?

A. 61 No. I agree with Dr. Woolridge that his CAPM results are below a reasonable range of estimates of KAWC's cost of equity.

Q. 62 Why do you believe that the CAPM produces unreasonably low cost of equity results for water and natural gas utilities at this time?

A. 62 I believe there are two reasons why the CAPM produces unreasonably low cost of equity results for water and natural gas utilities at this time. First, as a result of the economic crisis, the U.S. Treasury has kept interest rates on Treasury securities low as part of its effort to stimulate the economy. In addition, the betas of utilities are currently approximately 0.70, and the CAPM tends to underestimate the cost of equity for companies whose equity beta is less than 1.0 and to overestimate the cost of equity for companies whose equity beta is greater than 1.0.

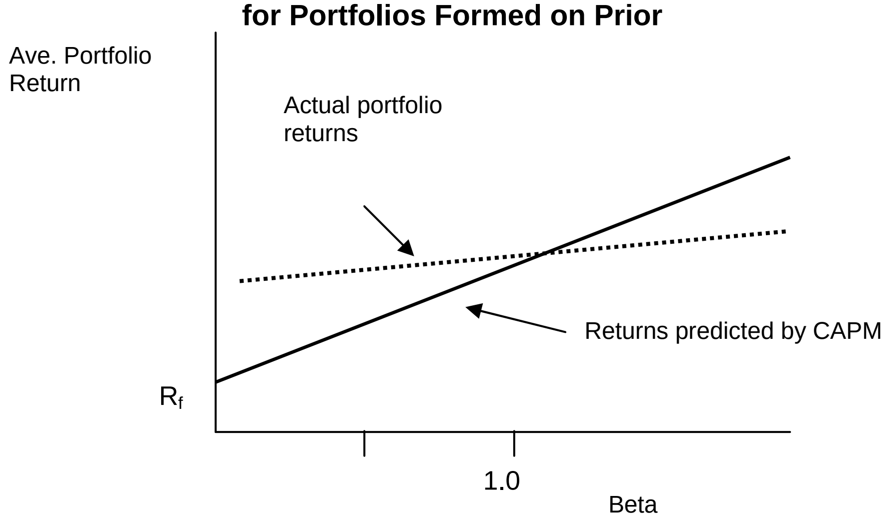
Q. 63 Can you briefly summarize the evidence that the CAPM underestimates the required returns for securities or portfolios with betas less than 1.0 and overestimates required returns for securities or portfolios with betas greater than 1.0?

A. 63 Yes. The CAPM conjectures that security returns increase with increases in security betas in line with the equation

$$ER_i = R_f + \beta_i \left\lfloor ER_m - R_f \right\rfloor,$$

where ER_i is the expected return on security or portfolio *i*, R_f is the risk-free rate, $ER_m - R_f$ is the expected risk premium on the market portfolio, and β_i is a measure of the risk of investing in security or portfolio *i*. If the CAPM correctly predicts the relationship between risk and return in the marketplace, then the realized returns on portfolios of securities and the corresponding portfolio betas should lie on the solid straight line with intercept R_f and slope $[R_m - R_f]$ shown below.

Figure 1
Average Returns Compared to Beta
for Portfolios Formed on Prior



Financial scholars have found that the relationship between realized returns and betas is inconsistent with the relationship posited by the CAPM. As described in Fama and French (1992) and Fama and French (2004), the actual relationship between portfolio betas and returns is shown by the dotted line in the figure above. Although financial scholars disagree on the reasons why the return/beta relationship looks more like the dotted line in the figure than the solid line, they generally agree that the dotted line lies above the solid line for portfolios with betas less than 1.0 and below the solid line for portfolios with betas greater than 1.0. Thus, in practice, scholars generally agree that the CAPM underestimates portfolio returns for companies with betas less than 1.0, and overestimates portfolio returns for portfolios with betas greater than 1.0.

Q. 64 What conclusions do you reach from your review of the literature on the CAPM to predict the relationship between risk and return in the marketplace?

A. 64 I conclude that the financial literature strongly supports the proposition that the CAPM underestimates the cost of equity for companies such as public utilities with betas less than 1.0. Since the CAPM significantly underestimates the cost of equity for companies with betas less than 1.0, and both Dr. Woolridge's and my proxy companies have betas that are significantly less than 1.0, I further conclude that the Commission should give little or no weight to the results of the CAPM at this time.

E. Dr. Woolridge's Comments on the Relationship between Utilities' Rates of Return on Equity and their Market-to-Book Ratios

Q. 65 Does Dr. Woolridge discuss the relationship between rates of return equity, the cost of equity, and market-to-book ratios in his testimony?

A. 65 Yes. Dr. Woolridge asserts that a market-to-book ratio above 1.0 indicates that a company is earning more than its cost of equity:

> As such, the relationship between a firm's return on equity, cost of equity, and market-to-book ratio is relatively straightforward. A firm that earns a return on equity above its cost of equity will see its common stock sell at a price above its book value. Conversely, a firm that earns a return on equity below its cost of equity will see its common stock sell at a price below its book value. [Woolridge at 17.]

Q. 66 Dr. Woolridge reports the results of three regression analyses that he believes support his claim that: (1) companies with market-to-book ratios greater than 1.0 are earning more than their costs of equity; (2) companies with market-to-book ratios equal to 1.0 are earning their costs of equity;

and (3) companies with market-to-book ratios less than 1.0 are earning less than their costs of equity [Woolridge at 18 and Exhibit JRW-6]. Do Dr. Woolridge's regression analyses provide any support for Dr. Woolridge's claim?

A. 66 No. Dr. Woolridge's regression analyses do not support his claim that companies with market-to-book ratios greater than 1.0 are earning more than their costs of equity. Dr. Woolridge claims that the cost of equity for water utilities like KAWC is 9.25 percent. However, the data shown in Exhibit JRW-6 indicate that there are many utilities with costs of equity less than Dr. Woolridge's recommended 9.25 percent but market-to-book ratios greater than 1.0. These data contradict Dr. Woolridge's claim that companies earning less than their cost of equity will have market-to-book ratios of less than 1.0.

Q. 67 Are you surprised by Dr. Woolridge's evidence that most electric, gas, and water utilities have market-to-book ratios greater than 1.0, even if they are earning ROEs less than their cost of equity?

A. 67 No. According to the DCF model, a company's stock price is equal to the present value of the company's expected future dividends, which, in turn, depend on its expected future ROEs. Thus, market-to-book ratios greater than 1.0, at best, imply that investors expect the company to earn more than its cost of equity at some time in the future. There is nothing in the DCF model that allows the analyst to draw inferences about the relationship between a company's historical ROE and its cost of equity from evidence on market-to-book ratios.

F. Rebuttal of Dr. Woolridge's Comments on Vander Weide Direct Testimony

Q. 68 What issues does Dr. Woolridge have regarding your estimate of KAWC's cost of equity?

A. 68 Dr. Woolridge disagrees with my: (1) proxy companies; (2) quarterly DCF model; (3) reliance on analysts' growth forecasts; (4) risk premium estimates; and (5) allowance for flotation costs [Woolridge at 55-56].

1. Proxy Companies

Q. 69 What proxy companies do you use to estimate KAWC's cost of equity?

A. 69 I use the proxy group of Value Line water utilities shown in Schedule 1 of my direct testimony and the proxy group of Value Line natural gas distribution companies shown in Schedule 2 of my direct testimony.

Q. 70 Why does Dr. Woolridge disagree with your choice of proxy companies?

A. 70 Dr. Woolridge claims that my proxy group of natural gas distribution companies is unreasonable because it includes companies such as Energen, EQT, MDU Resources, NiSource, ONEOK, and Questar, that receive a relatively low percentage of revenues from natural gas distribution [Woolridge at 54].

Q. 71 Were each of these companies included in the proxy group you used to derive your cost of equity recommendation in this proceeding?

A. 71 No. As shown in Vander Weide Schedule 2, I did not include Energen and MDU Resources from my initial proxy group because their DCF results, 5.0 percent and 17.6 percent, respectively, were outliers.

Q. 72 Do EQT and NiSource receive a relatively large percentage of revenues from regulated operations?

A. 72 Yes. Dr. Woolridge's Exhibit JRW-13, page 4, shows that EQT receives 74 percent of revenues from regulated natural gas operations. NiSource is a combination electric/natural gas utility that also receives most of its revenues from regulated utility operations.[4]

Q. 73 Does your inclusion of EQT, NiSource, ONEOK, and Questar cause your natural gas company proxy group to be more risky than KAWC and its parent, AWC?

A. 73 No. As discussed above, my natural gas company proxy group is slightly less risky than AWC, as measured by the group's average Value Line Safety Rank and average Standard & Poor's bond rating.

2. Quarterly DCF Model

Q. 74 What are Dr. Woolridge's criticisms of your DCF studies?

A. 74 Dr. Woolridge claims that I should: (1) use the annual rather than the quarterly DCF model to estimate KAWC's cost of equity; (2) use a combination of historical and analysts' growth rates to estimate the growth component of the DCF model; (3) include no adjustment for flotation costs; and (4) give less weight to my water utility DCF results in arriving at my cost of equity recommendation.

Q. 75 What is the major difference between the quarterly DCF model which you use and the annual DCF model employed by Dr. Woolridge?

A. 75 The major difference is that my quarterly DCF model is based on the realistic assumption that dividends are paid quarterly, while Dr. Woolridge's annual DCF

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[4] Value Line reports NiSource's 2009 revenue breakdown as follows: electric, 18%; gas, 72%; corporate and adjustments, 5%; and other, 5%

model is based on the unrealistic assumption that dividends are paid once at the end of each year.

Q. 76 Why do you use the quarterly rather than the annual DCF model to estimate KAWC's cost of equity?

A. 76 As I discuss in my direct testimony, the DCF model assumes that a company's stock price is equal to the present discounted value of all expected future dividends. Since the companies in my proxy group all pay dividends quarterly, the current market price that investors are willing to pay reflects the expected quarterly receipt of dividends. Therefore, a quarterly DCF model must be used to estimate the cost of equity for these firms. The quarterly DCF model differs from the annual DCF model in that it expresses a company's price as the present discounted value of a quarterly stream of dividend payments. The annual DCF model is only a correct expression for the present discounted value of future dividends if dividends are paid once at the end of each year.

Q. 77 Why does Dr. Woolridge disagree with your application of the quarterly DCF model?

A. 77 Dr. Woolridge argues first that an early proponent of the DCF model, Dr. Myron Gordon, stated that the appropriate dividend yield adjustment for growth in the DCF model "is the expected dividend for the next quarter multiplied by four." [Woolridge at 27.] Second, Dr. Woolridge argues that Professor Bower has stated that the conventional DCF calculation does produce a downwardly-biased estimate of the cost of equity, but the annual DCF model provides the most appropriate estimate of the utility's required return on rate base. [Woolridge at 57.]

Q. 78 Is Dr. Gordon's statement in favor of an annual DCF model a reasonable justification for use of the annual DCF model in this proceeding?

A. 78 No. Although Dr. Gordon was certainly a major early proponent of the DCF model, this does not imply that Dr. Gordon is correct in his arguments regarding the quarterly DCF model. As shown in my Appendix 1 (filed with my direct testimony), there can be no doubt that, when dividends are paid quarterly, the quarterly DCF model must be used to estimate the cost of equity.

Q. 79 Do you agree with Dr. Bower's statement that the annual DCF calculation is a downwardly-biased estimate of the market cost of equity when companies pay dividends quarterly?

A. 79 Yes. That is why I use the quarterly DCF model to estimate the cost of equity in this proceeding.

Q. 80 Do you agree with Dr. Bower's argument that the annual DCF model is the appropriate measure of the required rate of return on rate base?

A. 80 No. I believe that it is important to measure the cost of equity for the proxy companies correctly, and then to adjust the cost of equity for differences between the business and financial risks of the proxy companies and those of the regulated utility.

3. Analysts' Growth Forecasts

Q. 81 Dr. Woolridge also criticizes your use of analysts' growth rates in your DCF model. Why do you use analysts' growth rates to estimate the growth component of the DCF model?

A. 81 I use analysts' growth rates because my studies indicate that the analysts' growth rates are highly correlated with stock prices. This evidence provides strong support for the conclusion that investors use analysts' growth rates in making stock buy and sell decisions, and thus the analysts' growth rates should be used to estimate the growth component of the DCF model.

Q. 82 Does Dr. Woolridge agree with your statistical studies of the relationship between analysts' growth rates and stock prices?

A. 82 No. Dr. Woolridge has four criticisms of my statistical studies of the relationship between analysts' growth rates and stock prices. First, he argues that my statistical study is outdated. Second, he argues that my study is misspecified because I used a "linear approximation" to the DCF model rather than a modified version of the DCF model. Third, he argues that I did not use both historical and analysts' forecasted growth rates in the same regression. Fourth, he argues that I did not perform any tests to determine if the difference between historic and projected growth measures is statistically significant. [Woolridge at 69 - 71.]

Q. 83 Do you agree with Dr. Woolridge's assertion that your statistical analysis of the relationship between analysts' growth rates and stock prices is outdated?

A. 83 No. As discussed in my direct testimony, my study was updated in August 2004. The updated study continues to support the conclusion that the analysts' growth rates are more highly correlated with stock prices than historical measures such as those employed by Dr. Woolridge. Furthermore, Dr. Woolridge ignores other studies that have corroborated my results.

Q. 84 Do you agree with Dr. Woolridge's criticism that your DCF model is misspecified because you used a "linear approximation" to the DCF model rather than a modified version of the DCF model?

A. 84 No. Most regression analyses are based on the assumption that the relationship between the variables being studied is linear. As part of my studies, I tested whether the linear assumption was sufficiently close to provide reliable estimates of the model parameters. Applying a first order Taylor-series approximation to the DCF equation, I found that the first order, or linear, approximation was sufficiently close to the true equation to justify using linear regression analysis to study the relationship between price/earnings ratios and growth rates.

Q. 85 Why did you not use a combination of historical and analysts' growth rates in the same regression?

A. 85 I did not use a combination of historical and analysts' growth rates in the same regression because there are an infinite number of such combinations which could be tested. My studies indicate that the relationship between analysts' forecasts and stock prices is so strong compared to the relationship between historical growth rates and stock prices that there would be little advantage to combining historical growth rates with analysts' forecasts to predict stock prices.

Q. 86 Is there a statistically significant difference between historical and projected growth measures in explaining stock prices in your statistical study?

A. 86 Yes. The difference in performance of historical and projected growth rates is both statistically significant and dramatic.

Q. 87 Dr. Woolridge claims in his testimony that "it is well known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased." [Woolridge at 33.] Is he correct?

A. 87 No. Contrary to Dr. Woolridge's claim, the academic literature presents compelling evidence that analysts' EPS forecasts are unbiased—that is, neither optimistic nor pessimistic. As discussed above, I have reviewed nine articles that address whether analysts' growth forecasts are overly optimistic. At least seven of the nine articles reviewed find no evidence that analysts' growth forecasts are overly optimistic. Two find evidence of optimism, but also conclude that optimism is declining significantly over time. Of these two studies, one finds that analysts' forecasts for the S&P 500 are pessimistic for the last four years of the study.

Q. 88 Does some of the later research explain why some earlier studies in the literature conclude that analysts' EPS growth forecasts are optimistic?

A. 88 Yes. Articles by Abarbanell and Lehavy (2003) and Keane and Runkle (1998) recognize that the results of earlier studies are heavily influenced by the presence of large unexpected accounting write-offs and special accounting charges at a small number of sample companies. Analysts' forecasts intentionally exclude the impact of accounting write-offs and special charges because such one-time write-offs and special charges are inherently unpredictable. Unexpected accounting write-offs and special charges have a potentially dramatic impact on conclusions concerning analysts' bias because actual earnings include these items whereas analysts' normalized forecasts exclude them. Thus, a comparison of analysts' forecasts premised on normalized earnings (that is, earnings that exclude the impact of accounting write-offs and special charges) to reported earnings that include the negative effect of accounting write-offs and special charges will bias the results in favor of concluding that analysts are optimistic. These studies demonstrate that, once the distorting effect of unexpected accounting write-offs and special charges are removed from the analysis, there is no evidence that analysts' EPS growth forecasts are optimistic.

This research also highlights the potential impact of high correlation in analysts' forecast errors on study conclusions. Analysts' forecast errors tend to be highly correlated because unexpected industry and economy-wide shocks, such as unexpected increases in oil prices or terrorist attacks, have similar effects on all firms in the same industry. However, typical statistical tests of optimism (such as R-squares and t-statistics) are based on the assumption that analysts' forecast errors are independent, that is, the tests assume that the correlation of the analyst errors is zero. Once the statistical tests of optimism are adjusted to account for the high correlation in forecast errors that generally characterize the data, evidence supports the hypothesis that analysts' EPS growth forecasts are unbiased, and hence not optimistic.

Q. 89 Dr. Woolridge also discusses his study of the relationship between analysts' forecasted growth rates and subsequently achieved growth rates [Woolridge at 61 - 62 and 67 - 69]. Do you have any criticisms of his study?

A. 89 Yes. First, Dr. Woolridge apparently makes no attempt to screen his data for companies that have only one or two analysts' growth forecasts or for companies that have outlier growth forecasts. Although my studies indicate that analysts' growth forecasts are highly correlated with stock prices for large publicly-traded companies that are followed by at least three analysts, they may not be highly correlated for many of the small companies contained in the I/B/E/S data base that have fewer than three analysts' growth estimates and that have outlier growth forecasts. Second, Dr. Woolridge makes no attempt to correct for the statistical problems in studies of analysts' forecasts. For example, Dr. Woolridge makes no attempt to adjust his data for the impact on earnings of unexpected accounting write-offs and special charges. Further, Dr. Woolridge fails to adjust for the high correlation in analysts' forecast errors across companies. Financial researchers have conclusively demonstrated that there is no evidence of analysts' optimism in data sets that are properly adjusted for the impact of one-time accounting write-offs and the correlation in analysts' forecasts errors across companies.[5]

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[5] *See* Jeffery Abarbanell and Reuven Lehavy, "Biased Forecasts or Biased Earnings? The Role of Reported Earnings in Explaining Apparent Bias and Over/underreaction in Analysts' Earnings Forecasts," *Journal of*

Q. 90 Dr. Woolridge also discusses the results of his study of the relationship between analysts' forecasts for utilities and the utilities' subsequent achieved earnings growth rates. [Woolridge at 67 - 68.] Do you have any comments on his study?

A. 90 Yes. First, Dr. Woolridge has misspecified the time frame of his analysts' earnings growth forecasts. In his study, Dr. Woolridge claims that he compares an analysts' forecast made in a particular quarter to the company's realized earnings growth rate in the same quarter four years hence. In making this comparison, Dr. Woolridge fails to recognize that the time frame of the analysts' growth forecast is an indefinite, long-run period that may differ from one analyst to another. Dr. Woolridge has provided no evidence that analysts' growth estimates were intended to forecast actual results for a period exactly four years hence. Second, Dr. Woolridge has not distinguished between normalized and non-normalized earnings. The analysts' forecasts are generally intended to be normalized earnings growth forecasts, meaning that they are forecasts of earnings in the absence of extraordinary events and one-time write-offs. It is likely that a good deal of the forecast deviations in Dr. Woolridge's sample are due to extraordinary events and one-time write-offs rather than to problems with the analysts' forecasts of normalized earnings.

4. Risk Premium

Q. 91 What is the risk premium approach to estimating the cost of equity?

Accounting and Economics, 36 (2003) 105 – 146; Stephen J. Ciccone, "Trends in Analyst Eranings Forecast Properites," *International Review of financial Analysis*, 14 (2005) 1 – 22.

A. 91 The risk premium approach is based on the principle that investors expect to earn a return on an equity investment in KAWC that reflects a "premium" over and above the return they expect to earn on an investment in a portfolio of long-term bonds. This equity risk premium compensates equity investors for the additional risk they bear in making equity investments versus bond investments. Using the risk premium approach, the cost of equity is given by the following equation: cost of equity = interest rate plus risk premium.

Q. 92 How do you estimate the interest rate component of the risk premium approach?

A. 92 I estimate the interest rate component of the risk premium approach using the yield to maturity on A-rated utility bonds.

Q. 93 Does Dr. Woolridge have any criticisms of your use of the yield to maturity on A-rated utility bonds to estimate the interest rate component of the risk premium approach?

A. 93 Yes. Dr. Woolridge argues that my use of the yield to maturity on A-rated utility bonds inflates the required return on equity because long-term utility bonds are not risk free, that is, they are subject to both interest rate risk and credit risk [Woolridge at 75].

Q. 94 Do you agree with Dr. Woolridge's criticism of your use of the yield to maturity on A-rated utility bonds to estimate the interest rate component of the risk premium approach?

A. 94 No. Dr. Woolridge fails to recognize that the risk premium approach does not require that the interest rate be "risk free." Indeed, the only requirement of the risk premium approach is that the same interest rate be used to estimate the interest rate component as is used to estimate the risk premium component. Since the risk premium approach suggests that the cost of equity equals (the interest rate) plus (the required return on equity minus the interest rate), the cost of equity should be approximately the same in a risk premium analysis, no matter what interest rate is used as the benchmark interest rate. Thus, use of the interest rate on A-rated utility bonds in a risk premium analysis will produce a higher interest rate component than use of a government bond interest rate, but this difference will be offset by the correspondingly lower risk premium. The lower risk premium arises because the difference between the return on equity and yield on A-rated utility bonds is less than the difference between the return on equity and the yield on long-term government bonds.

Q. 95 Why do you use the yield on A-rated utility bonds rather than the yield on Treasury bonds in your risk premium studies?

A. 95 I use the yield on A-rated utility bonds rather than the yield on Treasury bonds in my risk premium studies because I believe that utility bond yields are better indicators of utilities' cost of equity than Treasury bond yields. First, because the U.S. dollar is the major currency for international trade, foreign governments tend to hold their currency reserves in U.S. Treasury bonds. Indeed, foreign investors now hold approximately 55 percent of U.S. Treasury debt.[6] Thus, Treasury bond yields are highly sensitive to changes in international economic conditions, whereas the U.S. utilities' cost of equity is not.

[6] Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association, February 4, 2009. http://www.ustreas.gov/press/releases/tg10.htm

Second, since U.S. Treasuries are considered to be the safest investment in the world, investors across the world tend to flock to investments in U.S. Treasuries at times of widespread global economic turmoil. In such periods of turmoil, the required return on risky investments such as utility bonds and stocks increases while the yield on U.S. Treasury bonds declines.

Third, yields on U.S. Treasury bonds are highly sensitive to efforts by the Federal Reserve to stimulate the economy. Although most Federal Reserve monetary policy operations are conducted using short-term U. S. Treasury bills, yields on long-term Treasury bonds frequently move in the same direction as yields on short-term Treasury bills. In addition, the Federal Reserve has recently begun to purchase long-term Treasury bonds in an effort to further reduce long-term Treasury yields.

Fourth, to the extent that there are economic developments that are specific to the utility industry, such as changes in environmental regulations and energy policy, such factors will be reflected both in utility bond yields and the utility cost of equity, but not in U.S. Treasury bond yields. Thus, that utility bond yields reflect utility-specific risks is an argument for—not an argument against—the use of utility bond yields to indicate changes in the utility cost of equity.

Q. 96 How do you estimate the risk premium component of the risk premium approach?

A. 96 I estimate the risk premium component of the risk premium approach in two ways. First, I estimate the difference between the DCF cost of equity for a proxy group of companies over the previous 111 months and the concurrent yield to maturity on A-rated utility bonds in those months, and then adjust the average risk premium to account for changes in interest rates. This estimate is my “ex ante risk premium approach.” Second, I estimate the risk premium from an historical study of stock and bond returns over the period 1937 to the present. This second risk premium approach is my “ex post risk premium approach.”

Q. 97 Why does Dr. Woolridge criticize your ex ante risk premium approach?

A. 97 Dr. Woolridge criticizes my ex ante risk premium approach because it relies on analysts’ forecasts to estimate the required return on equity using the DCF model. [Woolridge at 75 - 76.]

Q. 98 Have you addressed this criticism elsewhere in this rebuttal testimony?

A. 98 Yes, I have. (See Section II, C above.)

Q. 99 Does Dr. Woolridge agree with your use of historical stock and bond returns to estimate the equity risk premium?

A. 99 No. Dr. Woolridge states:

> There are a number of flaws in using historic returns over long time periods to estimate expected equity risk premiums. These issues include: (a) biased historic bond returns; (b) the arithmetic versus the geometric mean return; (c) the large error in measuring the equity risk premium using historical returns; (d) unattainable and biased historic stock returns; (e) company survivorship bias; and (f) the “peso problem—U.S. stock market survivorship bias. [Woolridge at 77.]

Q. 100 Why does Dr. Woolridge believe that historical bond returns are biased?

A. 100 Dr. Woolridge states:

> Historic bond returns are biased downward as a measure of expectancy because of capital losses suffered by bondholders in the past. As such, risk premiums derived from this data are biased upwards. [Woolridge at 77.]

Q. 101 Do you agree with Dr. Woolridge's statement that historical bond returns are biased downward because of capital losses suffered by past bond investors?

A. 101 No. Because of capital gains and losses, historical bond returns may be higher or lower than what investors expected at the time they purchased the bonds. During the period since 1982, for example, historical bond returns have been biased upward as a measure of expectancy because of the large capital gains achieved by bondholders over this period. However, over the entire period considered in my ex post risk premium study (from 1937 to the present), capital gains and losses on bonds have approximately offset each other, and consequently there is no significant bias as a result from either capital gains or losses.

Q. 102 What is the difference between an arithmetic and a geometric mean return?

A. 102 An arithmetic mean return is an additive return that is calculated by summing the achieved return in each time period and dividing the total by the number of periods. In contrast, the geometric mean return is a multiplicative return that is calculated in two steps. First, one calculates the product of (1 plus the return) in each period of the study. Second, one calculates the n^{th} root of this product and subtracts 1 from the result. Thus, if there are two periods, and r_1 and r_2 are the returns in periods one and two, respectively, the arithmetic mean is calculated from the equation: $a_m = (r_1 + r_2) \div 2$. The geometric mean is calculated from the equation,

$$a_g = [(1 + r_1) \times (1 + r_2)]^{.5} - 1.$$

Q. 103 Please describe Dr. Woolridge's concern regarding the use of geometric versus arithmetic mean returns.

A. 103 Dr. Woolridge believes that my ex post risk premium study is biased because I calculate the expected risk premium using the arithmetic mean of past returns, whereas he believes I should have calculated the expected risk premium using the geometric mean of past returns.

Q. 104 Is Dr. Woolridge's criticism valid?

A. 104 No. As explained in Ibbotson® SBBI® Valuation Edition 2009 Yearbook (SBBI®), the arithmetic mean return is the best approach for calculating the return investors expect to receive in the future:

> The equity risk premium data presented in this book are arithmetic average risk premia as opposed to geometric average risk premia. The arithmetic average equity risk premium can be demonstrated to be most appropriate when discounting future cash flows. For use as the expected equity risk premium in either the CAPM or the building block approach, the arithmetic mean or the simple difference of the arithmetic means of stock market returns and riskless rates is the relevant number. This is because both the CAPM and the building block approach are additive models, in which the cost of capital is the sum of its parts. The geometric average is more appropriate for reporting past performance, since it represents the compound average return. [SBBI® at 59.]

A discussion of the importance of using arithmetic mean returns in the context of CAPM or risk premium studies is contained in my direct testimony, Exhibit___(JVW-5), "Using the Arithmetic Mean to Estimate the Cost of Equity Capital."

Q. 105 Dr. Woolridge claims that "the U. S. Securities and Exchange Commission requires equity mutual funds to report historical return performance using

geometric mean and not arithmetic mean returns." [Woolridge at 79.] Does this observation demonstrate that the risk premium should be estimated using geometric mean returns rather than arithmetic mean returns?

A. 105 No. As discussed above, I agree that historical performance should be measured using the geometric mean rather than the arithmetic mean. However, as I demonstrate in Exhibit ___(JVW-1), Schedule 5, in estimating the cost of equity, it is essential to use the arithmetic mean return because it is only the arithmetic mean return that will make an initial investment grow to the expected value of the investment at the end of the investment horizon. Thus, for an investment with an uncertain outcome, the arithmetic mean is the best measure of the forward looking expected risk premium.

Q. 106 Dr. Woolridge also criticizes your ex post risk premium study because it is based on "unattainable and biased historic stock returns." [Woolridge at 80 - 81.] Is he correct?

A. 106 No. Dr. Woolridge bases his allegation on the assumption that stock index returns such as those reported by Ibbotson are "unattainable to investors." Dr. Woolridge's assumption is false: investors, in fact, can attain the returns achieved by stock indices simply by purchasing the stock index.

Q. 107 Do you agree with Dr. Woolridge's criticism that your ex post risk premium study is characterized by "survivorship bias"? [Woolridge at 81.]

A. 107 No. Survivorship bias refers to problems that might arise when data for companies that have failed are excluded from the sample. However, with regard to the U.S. markets that I study, survivorship bias is not a major issue. First, over the period 1937 to the present, there have been relatively few companies in the S&P 500 and the S&P Utilities that have failed. Second, the S&P 500 includes the return on a stock until the day it is dropped from the index, and the effect of a company being dropped from the S&P 500 is generally anticipated by the market well in advance of the delisting. Thus, survivorship is not a material issue with respect to U.S. stocks.

Q. 108 What does Dr. Woolridge mean when he refers to the "peso problem"?

A. 108 Dr. Woolridge uses the term "peso problem" to refer to the fact that U.S. investors have earned higher returns on stock investments than investors in other countries because the U.S. economy has not suffered many of the same economic calamities as the economies of other countries. This criticism of the use of U. S. stock returns in risk premium studies might be appropriate if one were attempting to estimate the expected rates of return on non-U. S. stocks. However, for U. S. stocks, since there is no indication that the U. S. will suffer the economic calamities of other countries, such as hyper-inflation or military invasion, there is no reason why the returns on U. S. stocks would be biased upward. As Morningstar states with respect to "survivorship bias" and the closely-related "peso problem":

> While the survivorship bias evidence may be compelling on a worldwide basis, one can question its relevance to a purely U.S. analysis. If the entity being valued is a U.S. company, then the relevant data set should be the performance of equities in the U.S. market. [SBBI® at 65.]

Q. 109 Dr. Woolridge claims that his market risk premium estimate is reasonable because it is consistent with the 7.27 percent long-term forecasted return on the S&P 500 published in February 2010 by the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters [Woolridge at 47]. Is the Survey of Professional Forecasters a reliable source of cost of equity estimates?

A. 109 No. The economists included in the survey are macro economists who are primarily concerned with forecasting factors such as GDP growth, inflation rates, unemployment rates, job growth, and other macro economic indicators. The 7.27 percent forecast of the long-term expected return on the S&P 500 is inherently unrealistic as an estimate of the required return on the S&P 500 because this expected return as of February 2010 is only 100 basis points more than the 6.25 percent average yield on Baa-rated utility bonds at February 2010. Since equity investments in the S&P 500 are more risky than investments in Baa-rated utility bonds, the required rate of return, or cost of equity, on the S&P 500 must certainly be more than 100 basis points above the yield to maturity on Baa-rated utility bonds.

Q. 110 Dr. Woolridge also claims that his risk premium estimate is reasonable because it is consistent with the risk premium estimate found in the CFO Magazine survey of Chief Financial Officers in March - June 2010 [Woolridge at 47]. Do you agree that surveys of business managers provide useful information on the expected market risk premium?

A. 110 No. Surveys of business managers provide little or no information on the expected market risk premium because: (1) managers have no incentive to take the survey seriously; (2) their responses are not typically based on market transactions or actual investment decisions; (3) their responses may reflect what they think the investigator wants to hear; and (4) the response rate is frequently low. In addition, Dr. Woolridge fails to recognize that managers responding to the CFO survey frequently use hurdle rates for making investment decisions that exceed their estimates of excess returns on the S&P 500.[7]

5. Flotation Costs

Q. 111 Why do you include an adjustment for flotation costs in your DCF analysis?

A. 111 I include an adjustment for flotation costs because, without such an adjustment, KAWC would not be able to recover all the costs it incurs to finance its investments in plant and equipment.

Q. 112 Does KAWC issue equity in the capital markets?

A. 112 No. Although KAWC does not issue equity in the capital markets, its parent must issue equity to provide KAWC the necessary financing to make investments in its utility operations. If the parent is not able to recover its flotation costs through KAWC's rates, it will have no incentive to invest in KAWC.

[7] The authors of the CFO survey note that responses to their survey are not typically based on market transactions or actual investment decisions when they state, "Often their [the CFO's] 10-year risk premium is supplemented so that the company's hurdle rate exceeds their expected excess return on the S&P 500." John Graham and Campbell Harvey, "The Long-Run Equity Risk Premium," Sep. 9, 2005, p. 6.

Q. 113 Does Dr. Woolridge agree with your flotation cost adjustment?

A. 113 No. Dr. Woolridge claims that a flotation cost adjustment is inappropriate because: (1) the company has not presented any evidence that it actually incurs flotation costs when it issues new equity; and (2) it is frequently asserted that a flotation cost adjustment is required to prevent dilution of the company's existing shareholders, but existing shareholders cannot suffer dilution as long as the company's stock price is above book value. [Woolridge at 71 - 73.]

Q. 114 Do you agree with Dr. Woolridge's assertion that the company did not provide any evidence that it incurs flotation costs when it issues new equity?

A. 114 No. In Appendix 3 of my direct testimony, I present evidence that all companies incur flotation costs when they issue new equity securities, that flotation costs represent approximately five percent of the company's pre-issue stock price, and that the company will not be able to earn a fair rate of return on its investment if it does not recover its flotation costs.

Q. 115 Do you justify flotation costs on the grounds that flotation costs are required to prevent dilution of existing shareholders?

A. 115 No. I justify flotation costs on the grounds that the company will not be able to earn a fair rate of return if it does not recover the flotation costs it incurs when it issues new equity. My flotation cost adjustment is unrelated to the company's market-to-book ratio.

III. REBUTTAL OF MR. BAUDINO

Q. 116 What is Mr. Baudino's recommended rate of return on equity for KAWC?

A. 116 Mr. Baudino recommends a rate of return on equity equal to 9.5 percent for KAWC.

Q. 117 How does Mr. Baudino arrive at his recommended 9.5 percent rate of return on equity for KAWC?

A. 117 Mr. Baudino arrives at his recommended 9.5 percent rate of return on equity by applying the DCF model to two groups of proxy companies, a water utility group and a natural gas distribution company group. Although he also applies the CAPM to these companies, he does not rely on his CAPM results to arrive at his recommended cost of equity.

Q. 118 What areas of Mr. Baudino's testimony will you address in your rebuttal?

A. 118 I will address Mr. Baudino's: (1) proxy companies; (2) DCF analysis; (3) growth estimates; (4) CAPM analysis; and (5) comments on my direct testimony.

Q. 119 What proxy companies does Mr. Baudino use to estimate KAWC's cost of equity?

A. 119 Mr. Baudino uses the proxy groups of water utilities and natural gas distribution companies shown in Exhibit__(RAB-5) and Exhibit__(RAB-7).

Q. 120 How does Mr. Baudino construct his proxy group of water utilities?

A. 120 Mr. Baudino begins with my proxy group of water utilities and then eliminates Artesian and Southwest Water, eliminating Artesian because complete data for Artesian is not included in Value Line's expanded edition, and Southwest Water because it has agreed to be purchased by a group of private investors since the time of my direct testimony.

Q. 121 Do you agree with Mr. Baudino's decision to eliminate these companies from the proxy group of water utilities?

A. 121 Yes. Recognizing that complete data for Artesian is not included in Value Line and that Southwest Water has agreed to be purchased since the time I prepared my studies, I believe it is reasonable to eliminate these companies from a proxy group of water utilities. In my studies for my direct testimony, I conservatively included results for Artesian in order to have a larger proxy group. If I had not included Artesian in my studies, I would have obtained an average DCF result equal to 12.3 percent rather than the 12.1 percent reported in my direct testimony.

Q. 122 How does Mr. Baudino construct his proxy group of natural gas distribution companies?

A. 122 Mr. Baudino begins with my proxy group of 12 natural gas distribution companies and then eliminates five companies that, in his opinion, are not considered to be natural gas distribution companies and selects four additional companies that, in his opinion, are considered to be natural gas distribution companies.

Q. 123 Do you agree with Mr. Baudino's decision to eliminate five companies from your group because in his opinion they are not considered to be natural gas distribution companies?

A. 123 No. Mr. Baudino fails to recognize that the companies he eliminates from my proxy group have extensive natural gas distribution operations and are included in both Standard & Poor's and Thomson Reuters' natural gas utility groups.

The Standard & Poor's natural gas utility group, for example, includes the following companies.[8]

TABLE 4
STANDARD & POOR'S GAS UTILITIES

GAS UTILITIES
AGL RESOURCES INC
ATMOS ENERGY CORP
ENERGEN CORP
EQT CORP
LACLEDE GROUP INC
NATIONAL FUEL GAS CO
NEW JERSEY RESOURCES CORP
NICOR INC
NORTHWEST NATURAL GAS CO
ONEOK INC
PIEDMONT NATURAL GAS CO
QUESTAR CORP
SOUTH JERSEY INDUSTRIES INC
SOUTHWEST GAS CORP
UGI CORP
WGL HOLDINGS INC

Q. 124 Why did you not include the four additional companies that Mr. Baudino includes in his natural gas proxy group?

A. 124 I did not include these companies because they failed to meet my selection criterion that a company must have at least two analysts' growth forecasts in the I/B/E/S survey.

Q. 125 Do you agree with Mr. Baudino's opinion that your proxy group of natural gas distribution companies is more risky, on average, than water companies such as KAWC and its parent, AWC?

[8] *See* Standard & Poor's Industry Surveys, "Natural Gas Distribution," July 15, 2010. Standard & Poor's lists NiSource and MDU Resources in the Natural Gas Distribution Survey as "multi-utilities."

A. 125 No. As I discuss above, my proxy group of natural gas distribution companies is slightly less risky than AWC, as measured by the Value Line Safety Rank and Standard & Poor's bond ratings.

A. Mr. Baudino's DCF Analysis

Q. 126 What DCF model does Mr. Baudino use to estimate KAWC's cost of equity?

A. 126 Mr. Baudino uses an annual DCF model of the form, $k = D_0*(1+.5g)/P_0$.

Q. 127 Do you agree with Mr. Baudino's use of an annual DCF model to estimate KAWC's cost of equity?

A. 127 No. Mr. Baudino's annual DCF model cannot be consistently applied to his proxy companies because: (1) the DCF model is based on the assumption that a company's stock price is equal to the present value of the expected future dividends investors expect to receive from owning the stock; and (2) the annual DCF model is not a correct equation for the present value of expected future dividends when dividends are paid quarterly. For companies that pay quarterly dividends, the quarterly DCF model must be used to estimate the cost of equity.

Q. 128 How does Mr. Baudino estimate the expected growth component of his DCF model?

A. 128 Mr. Baudino estimates the expected growth component of his DCF model by calculating the mean values of five sources of forecasted growth for each proxy company, including the Value Line dividends per share ("DPS"), earnings per share ("EPS"), b times r, Zack's EPS, and Thomson Reuters growth forecasts.

Q. 129 Do you agree with Mr. Baudino's use of Value Line's DPS growth forecasts to estimate the growth component of his DCF model?

A. 129 No. I believe that analysts' EPS growth forecasts are the best proxy for investors' growth expectations in the DCF model.

Q. 130 Does Value Line expect the water utilities' dividends and earnings to grow at the same rate over the Value Line forecast period?

A. 130 No. The Value Line average earnings growth forecast for the water utilities is 7.71 percent, while the Value Line average dividend growth forecast for the water utilities is only 3.39 percent (*see* Mr. Baudino's Exhibit__(RAB-5), page 1 of 2). Thus, Value Line expects that the water utilities' dividends will grow by 432 basis points less than their earnings over the Value Line forecast period.

Q. 131 Does Value Line's significantly lower dividend growth forecast compared to earnings growth forecast for the water utilities' indicate that Value Line is forecasting that the water utilities' average dividend payout ratio will decline?

A. 131 Yes. A company's dividend payout ratio is equal to the percentage of earnings that are paid out as dividends. If forecasted dividend growth is expected to be less than forecasted earnings growth, then the forecasted dividend payout ratio is necessarily expected to decline.

Q. 132 Do different dividend and earnings growth rates cause any problems in the application of the DCF Model?

A. 132 Yes. The DCF model is based on the assumption that dividends and earnings will grow at the same rate. If earnings and dividends are expected to grow at diverging rates in the short run, an analyst must decide whether the dividend or earnings growth forecast is the best indicator of long-run future growth.

Q. 133 Is Value Line's forecasted dividend growth rate an important indicator of long-run future growth for water utilities?

A. 133 No. Dividend growth forecasts are, in general, less accurate indicators of long-run future growth than are earnings growth forecasts. When analysts forecast dividend growth, they first must estimate earnings growth and then forecast the percentage of earnings that will be paid out as dividends. Since the percentage of earnings that are paid out as dividends is uncertain, there is an additional element of error present in dividend growth forecasts than is present in earnings growth forecasts.

In addition, Value Line's current average dividend growth forecast for the water utilities is based on its assumption that water utilities are in the process of adjusting to a lower target dividend payout ratio. As shown below, dividends must grow at the same rate as earnings once these companies have achieved their new target dividend payout ratio. Thus, Value Line's forecasted earnings growth rate is a better estimate of long-run dividend growth than its current forecasted dividend growth rate.

Q. 134 Suppose that analysts expect a company's dividends to grow by less than its earnings over the next several years because of the company's transition to a new, lower target dividend payout ratio. Does this situation imply that analysts' earnings growth projections for this company cannot be used to estimate the "g" term in the DCF model?

A. 134 No. To illustrate, suppose that a company's current dividend payout ratio is approximately 75 percent and that the company intends to adjust its dividend payout ratio to 60 percent. Once the company achieves its new dividend payout target, dividends will grow at the same rate as earnings. As long as the transition is relatively short, the earnings growth forecast would still be a good estimate of long-term dividend growth in the DCF Model.[9]

Q. 135 How does Value Line's DPS growth forecast compare to Mr. Baudino's four other indicators of future growth for his water utility proxy group?

A. 135 As shown below, Value Line's average DPS growth forecast for Mr. Baudino's water utility companies is significantly lower than his other growth forecasts.

TABLE 5
COMPARISON OF MR. BAUDINO'S WATER COMPANY GROWTH RATES[10]

DPS GROWTH	EPS GROWTH	B X R	ZACKS	THOMSON
3.39%	7.71%	5.13%	6.44%	8.37%

Q. 136 What DCF result would Mr. Baudino have obtained for his water utility group if he had properly excluded the DPS growth forecast from his calculations?

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9 For any one-year period of time, a company's earnings growth rate is given by the equation:

$$g_E = \frac{E_t}{E_{t-1}}$$

Assuming that the company has achieved its new dividend payout ratio of 60%, its dividend growth rate is given by the equation:

$$g_D = \frac{D_t}{D_{t-1}} = \frac{.6\,E_t}{.6\,E_{t-1}} = \frac{E_t}{E_{t-1}}$$

Thus, once the company achieves its new dividend payout ratio, dividends must grow at the same rate as earnings.

10 While Mr. Baudino reports b x r growth rates for his proxy companies, the DCF results he displays in Exhibit__(RAB-5), page 2 of 2, do not report DCF results using the b x r growth rates.

A. 136 Mr. Baudino would have obtained an average DCF result equal to 11.11 percent rather than 10.07 percent (see Mr. Baudino's Exhibit__(RAB-5), page 2 of 2.

Q. 137 What is the b x r method for estimating growth in the DCF model?

A. 137 The b x r method is identical to Dr. Woolridge's "internal growth" method. As discussed above, the b x r method estimates expected future growth by multiplying a company's retention ratio, "b," times its expected rate of return on equity, "r." Thus, "g = b x r," where "b" is the percentage of earnings that are retained in the business and "r" is the expected rate of return on equity.

Q. 138 Do you agree with Mr. Baudino's b x r method for estimating growth in the DCF model?

A. 138 No. As I discuss in my rebuttal of Dr. Woolridge, I have at least three disagreements with Mr. Baudino's use of the b x r method for estimating growth in the DCF model. First, the b x r method involves circular logic in that it requires an estimate of the expected return in order to calculate the growth rate, and the growth rate is used to calculate the required return. Second, the b x r method fails to recognize that a company can grow by issuing new equity at prices above the company's book value. Third, Mr. Baudino's application of the b x r method fails to recognize that Value Line calculates each company's ROE by dividing net income by year-end equity, whereas most financial analysts calculate ROE by dividing net income by average equity for the year. When equity is increasing, as it normally does, Value Line's method of calculating ROE will underestimate the more conventionally measured ROE.

B. Mr. Baudino's CAPM Analysis

Q. 139 How does Mr. Baudino use the CAPM to estimate KAWC's cost of equity?

A. 139 The CAPM requires estimates of the risk-free rate, the company-specific risk factor, or beta, and either the required return on an investment in the market portfolio, or the risk premium on the market portfolio compared to an investment in risk-free government securities. For the risk-free rate, Mr. Baudino uses the recent average 4.44 percent yield on 20-year Treasury bonds and the recent 2.40 percent yield on five-year Treasury bonds; for the company-specific risk factor or beta, Mr. Baudino uses the current average Value Line beta for his water utility group, 0.72; and for the required return or risk premium on the market portfolio, Mr. Baudino employs both the average risk premiums obtained by applying the DCF model to the Value Line universe of companies and the historical risk premiums obtained from Ibbotson [Exhibit__(RAB-8), Exhibit__(RAB-9)].

Q. 140 What CAPM results does Mr. Baudino obtain?

A. 140 Using his estimated risk premium for the Value Line universe of companies, Mr. Baudino obtains CAPM results in the range 8.89 percent to 9.46 percent. Using historical risk premiums from Ibbotson, Mr. Baudino obtains CAPM results in the range 7.83 percent to 9.21 percent.

Q. 141 Does Mr. Baudino incorporate his CAPM results in his recommended cost of equity in this proceeding?

A. 141 No. Mr. Baudino states that his recommendation is based on the results of his DCF analyses and that his recommendation does not incorporate his CAPM results (Baudino at 3).

Q. 142 Do you agree with Mr. Baudino's decision to not incorporate his CAPM results in his cost of equity recommendation in this proceeding?

A. 142 Yes. As discussed above, there is considerable evidence that the CAPM underestimates the cost of equity for companies such as Mr. Baudino's proxy water and natural gas companies that have betas significantly less than 1.0. Since the average beta for Mr. Baudino's proxy water companies is 0.72, the Commission should also ignore Mr. Baudino's CAPM results.

C. Rebuttal of Mr. Baudino's Comments on My Direct Testimony

Q. 143 What are Mr. Baudino's criticisms of your cost of equity estimates for KAWC?

A. 143 Mr. Baudino disagrees with my: (1) proxy companies; (2) quarterly DCF model; (3) allowance for flotation costs; (4) sole reliance on earnings growth forecasts; (5) use of forecasted interest rates; and (6) risk premium estimates.

Q. 144 What is Mr. Baudino's concern with your proxy companies?

A. 144 Mr. Baudino argues that my proxy group of natural gas distribution companies is more risky than either KAWC or AWC because it includes several companies that in his opinion are not natural gas distribution companies (Baudino at 14 - 15).

Q. 145 Do you address this issue in your rebuttal of Dr. Woolridge?

A. 145 Yes. I demonstrate in my rebuttal of Dr. Woolridge that my proxy group of natural gas distribution companies is slightly less risky than AWC as measured by Value Line Safety Ranks and Standard & Poor's bond ratings. I also note above that these companies are included in several commonly used lists of natural gas distribution companies, such as the classifications published by Standard & Poor's and Thomson Reuters.

Q. 146 What is Mr. Baudino's concern with your use of a quarterly DCF model?

A. 146 Mr. Baudino argues that a quarterly DCF model would over compensate investors because quarterly dividends are already reflected in a company's stock price. [Baudino at 38 - 39.]

Q. 147 Is Mr. Baudino correct?

A. 147 No. The DCF model is based on the assumption that a company's stock price is equal to the present value of the cash flows investors expect to receive from their ownership of the stock. Since the quarterly DCF model is the only DCF model that equates a company's stock price to the present value of the cash flows investors expect to receive from owning the stock, the quarterly model must be used to estimate the cost of equity for companies such as those in Mr. Baudino's and my proxy groups that pay quarterly dividends. Contrary to Mr. Baudino's assertion, it is precisely because investors recognize that dividends pay dividends quarterly that the quarterly DCF model must be used to estimate the cost of equity.

Q. 148 Why does Mr. Baudino disagree with your allowance for flotation costs?

A. 148 Mr. Baudino disagrees with my allowance for flotation costs because, in his opinion, flotation costs are already included in stock prices (Baudino at 39).

Q. 149 Are flotation costs already reflected in stock prices?

A. 149 No. Flotation costs are an expense that are deducted from the proceeds associated with a stock issuance.

Q. 150 If flotation costs are an expense, why do you include them in your calculation of a company's cost of equity?

A. 150 I include flotation costs in my calculation of a company's cost of equity because the company will not be able to earn a fair return on equity if flotation costs are not included in the estimate of the cost of equity.

Q. 151 Can you illustrate why a company will not be able to earn a fair return on equity if flotation costs are not included in the estimate of the cost of equity?

A. 151 Yes. Assume that a company issues $100 in equity, incurs $3 in flotation costs, and that the investors' required rate of return on equity is 10 percent. To satisfy the investors' return requirement, the company must earn a $10 return on the $100 investment in the company. However, because of the flotation cost, the company will have only $97 to invest in rate base. Thus, the company must earn a 10.31 percent return on its $97 investment in order to earn the investors' required $10 return (10.31% x $97 = $10).

Q. 152 Why do you rely on earnings growth forecasts in your DCF analyses?

A. 152 I rely on earnings growth forecasts as the estimate of investors' expected growth in the DCF model because the DCF model requires the use of investors' growth expectations, and my studies indicate that earnings growth forecasts are the best proxy for investors' growth expectations in the DCF model. Furthermore, although earnings and dividends must grow at approximately the same rate in the long run, dividends sometimes grow at a different rate than earnings in the short term because a company is adjusting its dividend payout ratio to a different value. Because dividend growth during the transition to the new target dividend payout ratio will not reflect long-run expected dividend growth, analysts' earnings per share estimates are better estimates of long-run future growth than dividend growth forecasts.

Q. 153 Do you discuss your studies of analysts' growth forecasts in your direct testimony?

A. 153 Yes.

Q. 154 Why do you use forecasted interest rates in your risk premium studies?

A. 154 I use forecasted interest rates in my risk premium studies because the rates in this proceeding should be sufficient to provide KAWC an opportunity to earn its required return on equity during the period in which rates will be in effect.

Q. 155 What is Mr. Baudino's disagreement with your use of forecasted interest rates?

A. 155 Mr. Baudino argues that forecasted interest rates could not possibly be higher than current interest rates because, if they were, investors would adjust current bond yields to avoid or minimize capital losses in the future. (Baudino at 41.)

Q. 156 Do you agree with Mr. Baudino's assertion that forecasted interest rates must be equal to current interest rates?

A. 156 No. If investors always expected forecasted interest rates to be equal to current interest rates, they would be unwilling to pay for economic forecasts from firms such as Consensus Economics, Blue Chip, and others. The fact that numerous firms spend considerable sums to obtain forecasts of interest rates is sufficient evidence that they do not believe that current interests rates are the best forecast of future interest rates.

Q. 157 Why does Mr. Baudino disagree with your risk premium estimates?

A. 157 Mr. Baudino contends that: (1) long-term historical return studies may not reflect investors' current required risk premiums; (2) investors' expectations for utilities may be different than their expectations for the S&P500; and (3) low-risk water companies are likely to have a lower risk premium than the Standard & Poor's utilities. [Baudino at 41 - 42.]

Q. 158 Are historical risk premium studies commonly used to estimate the investor's current required market risk premium?

A. 158 Yes. Although the current required market risk premium is uncertain, long-term historical studies of the returns on stocks compared to bonds are the most frequently used method for estimating the required risk premium.

Q. 159 Does Mr. Baudino himself use historical risk premium data to estimate the required market risk premium in his CAPM analysis?

A. 159 Yes. As I discuss above, Mr. Baudino relies on historical risk premium data from Ibbotson Associates as one of his two methods for estimating the required risk premium on the market portfolio.

Q. 160 In your studies, do you adjust your historical risk premium data for the S&P500 to reflect the risk of utility companies?

A. 160 Yes. As I discuss in my direct testimony, I adjust the historical risk premium data on the S&P500 by calculating a historical risk premium on both the S&P500 and the S&P Utilities and using the average of these two estimates.

Q. 161 Does Mr. Baudino present any evidence to support his assertion that water companies have lower risks and lower risk premiums than companies in the S&P Utilities?

A. 161 No. In addition, I note that the water companies have lower Value Line Safety Ranks than either the Value Line electric or Value Line natural gas distribution companies.

Q. 162 Does this conclude your rebuttal testimony?

A. 162 Yes, it does.

KENTUCKY AMERICAN WATER COMPANY
REBUTTAL SCHEDULE 1
COMPARISON OF WATER COMPANIES'
VALUE LINE SAFETY RANKS AND STANDARD & POOR'S BOND RATINGS[11]

LINE	COMPANY	SAFETY RANK	S&P BOND RATING	S&P BOND RATING (NUMERICAL)
1	Amer. States Water	3	A	4
2	Amer. Water Works	3	BBB+	6
3	Aqua America	3	A+	3
4	Artesian Res. 'A'	2	0.00	0
6	California Water	3	A+	3
7	Connecticut Water	2	A	4
8	Middlesex Water	2	A-	5
9	Pennichuck	3	NA	
10	SJW Corp.	3	A	4
11	York Water	2	A-	5
12	**Average**	**2.6**	**A**	**3.8**
13	**Amer.Water Works**	**3**	**BBB+**	**6**

11 Data from Value Line Investment Analyzer, Standard & Poor's, July 2010.

KENTUCKY AMERICAN WATER COMPANY
REBUTTAL SCHEDULE 2
SUMMARY OF DISCOUNTED CASH FLOW ANALYSIS
FOR PROXY WATER COMPANY COMPANIES
UPDATED TO USE DATA THROUGH JUNE 2010

LINE NO.	COMPANY	D_4	P_0	ANALYST GROWTH FORECAST[12]	VALUE LINE FORECASTED GROWTH	AVERAGE GROWTH	MARKET CAP $ (MIL)	COST OF EQUITY
1	Amer. States Water	0.260	35.555	4.00%	6.50%	5.3%	616	8.6%
2	Amer. Water Works	0.210	21.017	10.25%	NMF	10.3%	3,545	15.1%
3	Aqua America	0.145	17.698	7.50%	11.50%	9.5%	2,445	13.4%
4	Artesian Res. 'A'	0.188	18.170	6.00%	NA	6.0%	121	10.7%
5	California Water	0.298	37.008	5.55%	6.50%	6.0%	730	9.7%
6	Pennichuck	0.180	22.595	9.00%	NA	9.0%	181	12.8%
7	SJW Corp.	0.170	25.373	10.00%	NA	10.0%	423	13.2%
8	York Water	0.128	13.946	6.00%	6.00%	6.0%	175	10.2%
9	Average							11.7%

Notes:

d_0	=	Most recent quarterly dividend.
d_1,d_2,d_3,d_4	=	Next four quarterly dividends, calculated by multiplying the last four quarterly dividends per *Value Line* by the factor (1 + g).
P_0	=	Average of the monthly high and low stock prices during the three months ending June 2010 per Thomson Reuters.
FC	=	Flotation costs expressed as a percent of gross proceeds.
g	=	Average of analysts' and Value Line forecasts of future earnings growth June 2010.
k	=	Cost of equity using the quarterly version of the DCF model shown by the formula below:

$$k = \frac{d_1(1+k)^{.75} + d_2(1+k)^{.50} + d_3(1+k)^{.25} + d_4}{P_0(1-FC)} + g$$

12 Analysts' growth forecasts obtained from Thomson Reuters and Yahoo Finance July 2010.

KENTUCKY AMERICAN WATER COMPANY
REBUTTAL SCHEDULE 3
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THE EFFICACY OF ANALYSTS' EARNINGS FORECASTS

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REBUTTAL SCHEDULE 3 (CONTINUED)
RESEARCH LITERATURE THAT STUDIES
THE EFFICACY OF ANALYSTS' EARNINGS FORECASTS

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COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	**)**	
	)	
THE APPLICATION OF KENTUCKY-AMERICAN	**)**	**CASE NO. 2010-00036**
WATER COMPANY FOR AN ADJUSTMENT OF	**)**	
RATES ON AND AFTER March 28, 2010	**)**	
	)	

REBUTTAL TESTIMONY OF JAMES I. WARREN

BACKGROUND AND INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James I. Warren. My business address is 1700 K Street, N.W., Washington, D.C. 20006.

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

A. I am a tax partner in the law firm of Winston & Strawn LLP ("Winston").

Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT WINSTON.

A. I am engaged in the general practice of tax law. I specialize in the taxation of and the tax issues relating to regulated public utilities. Included in this area of specialization is the treatment of taxes in regulation.

Q. ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?

A. I am submitting this testimony on behalf of Kentucky-American Water Company ("KAWC" or the "Company").

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. I joined Winston in September of 2008. For the five years prior to that time, I was a partner in the law firm of Thelen Reid Brown Raysman & Steiner LLP and resident in its New York office. Before that, I was affiliated with the international accounting firms of Deloitte & Touche LLP (October 2000 – September 2003), PricewaterhouseCoopers LLP (January 1998 – September 2000) and Coopers & Lybrand (March 1979 – June 1991) and the law firm Reid & Priest LLP (July 1991 – December 1997). At each of these professional services firms, I provided tax services primarily to electric, gas, telephone and water industry clients. My practice has included tax planning for the acquisition or transfer of business assets, operational tax planning and the representation of clients in tax controversies with the Internal Revenue Service ("IRS") at the audit and appeals levels. I have often been involved in procuring private letter rulings or technical advice from the IRS National Office. On several occasions, I have represented one or more segments of the utility industry before the IRS and/or the Department of Treasury regarding certain tax positions adopted by the federal government. I have testified before several Congressional committees and subcommittees and at Department of Treasury hearings regarding legislative and administrative tax issues of significance to the utility industry. I am a member of the New York, New Jersey and District of Columbia Bars and also am licensed as a Certified Public Accountant in New York and New Jersey. I am a member of the American Bar Association, Section of Taxation where I am a past chair of the Committee on Regulated Public Utilities.

Q. HAVE YOU TESTIFIED IN ANY REGULATORY PROCEEDINGS?

A. Yes I have. I have testified regarding tax, tax accounting and regulatory tax matters before a number of regulatory bodies including the Federal Energy Regulatory Commission and the utility commissions in Florida, Arkansas, Louisiana, Nevada, Delaware, West Virginia, New Jersey, the District of Columbia, New Orleans, New York, Connecticut, Ohio, California, Maryland, Pennsylvania, Missouri, Illinois, Kentucky, Vermont and Texas.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I earned a B.A. (Political Science) from Stanford University, a law degree (J.D.) from New York University School of Law, a Master of Laws (LL.M.) in Taxation from New York University School of Law and a Master of Science (M.S.) in Accounting from New York University Graduate School of Business Administration.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to certain aspects of the direct testimony of Ralph C. Smith filed on behalf of the Kentucky Office of Attorney General. Specifically, I dispute Mr. Smith's contention that it would be proper for this Commission to import the benefits of tax deductions claimed by companies other than KAWC into the KAWC rate setting process. I therefore oppose his proposal to impose a consolidated tax adjustment ("CTA") in the amount of $1.362 million in this proceeding (page 29, lines 7 - 9). I also dispute his assertion that the Company's FIN 48 amount should be included in its accumulated deferred income tax ("ADIT") balance included in the forecasted test-year thereby serving as a further rate base reduction in excess of that proposed by the Company (page 25, line 16 through page 27, line 20). His proposed treatment of the FIN 48 amount would require that, when faced with two alternative uncertain outcomes, this Commission embrace the less likely of the two rather than the more likely. Such a choice would simply not be logical.

THE CTA ISSUE

The Filing of a Consolidated Federal Income Tax Return and Consolidated Tax Adjustments

Q. IS KAWC PART OF A GROUP OF CORPORATIONS THAT FILES A CONSOLIDATED FEDERAL INCOME TAX REUTRN?

A. Yes it is. KAWC files as part of the American Waterworks Company, Inc. ("AWWC") and Subsidiaries consolidated tax group (the "Group"). It has filed as part of a consolidated group for many years. Recently, RWE has divested its equity holdings in AWWC through a series of Initial Public Offerings in the financial markets. AWWC is now a publicly traded domestic (i.e., U.S.) Company (listed on the NYSE as AWK), and AWWC is the Parent for the consolidated federal income tax group

Q. IS FILING AS PART OF A CONSOLIDATED TAX GROUP AN UNUSUAL SITUATION?

A. No. In fact, based on my more than 30 years experience in taxes, I would say it is the norm. I know of no company whose stock is publicly traded that does not file as part of a consolidated group. This encompasses groups that include utilities as well as those that do not include utilities.

Q. WHY DO AFFILIATED GROUPS OF CORPORATIONS FILE CONSOLIDATED TAX RETURNS?

A. The major reason is that it allows a business enterprise to structure itself for legal and business purposes without having to take into account federal tax implications. For example, if it is important to insulate one specific operation from another (for instance, for legal liability or regulatory reasons), the two operations can be conducted in separate corporations filing a consolidated tax return with virtually the same tax consequences as if it they were divisions of the same corporation. However, were they divisions, they would not have achieved their legal and regulatory goals. The consolidated return mechanism allows structural flexibility without imposing a tax cost.

Q. DOES THE IMPOSITION OF A CTA CONTRAVENE THIS PURPOSE?

A. Yes it does. It imposes a regulatory cost on the utilization of this structural flexibility.

Q. WHAT ARE SOME OF THE TAX CONSEQUENCES OF FILING AS A MEMBER OF A CONSOLIDATED GROUP?

A. Just as would be the case were the separate corporations to be divisions of a single corporation, sales from one member to another member do not produce immediately taxable gains or losses. Tax losses of one member can offset taxable income of another member. Capital losses of one member (which can only be deducted against capital gains) can offset capital gains of another member. There are numerous other consequences, but these illustrate the point.

Q. ON WHAT SINGLE CONSEQUENCE OF CONSOLIDATED FILING DOES MR. SMITH FOCUS?

A. The second one described above – that is, the ability of the tax loss of one member to offset the taxable income of another member. I will refer to this hereafter as "Income Netting." Simply put, the corporate tax rate (generally 35%) is applied to the net taxable income of the entire group – that is, the entire economic enterprise.

Q. IS THIS A BENEFIT OF FILING A CONSOLIDATED TAX RETURN?

A. It can be. There are certainly situations where a member who has not generated any taxable income in the loss carryback period (generally 2 years) could not have used its tax loss to offset taxable income until some time in the future (the carryforward period is 20 years). The ability to Income Net is, in such a case, a benefit when compared to the tax consequences of not filing on a consolidated basis – but, of course, it is not a benefit when compared to the tax consequences of a divisional structure. The perception that a benefit exists at all depends on just what it is you compare consolidated filing to.

Q. WHAT IS THE METHODOLOGY FOR THE CTA PROPOSED BY MR. SMITH?

A. For each of the prior 3 years (2006-2008), Mr. Smith proposes to divide up the tax loss of each of the Group's non-regulated affiliates among all the affiliates having positive taxable income in that year. In each year the amount of the non-regulated tax losses assigned to any positive taxable income company is based on the ratio that each company's positive taxable income bears to the total taxable income of all companies producing positive taxable income. He averages the annual amount so allocated to KAWC over the three year period and "tax effects" (multiplies by 35% [the federal income tax rate]) the average to arrive at his proposed adjustment, $1.362 million. His computation is contained on Exhibit RCS-1, Schedule C-2.

Q. WHAT SUPPORT DOES MR. SMITH OFFER FOR HIS CTA PROPOSAL?

A. The only theoretical basis I can find is where he briefly alludes to the necessity to reflect "actual income taxes paid" (page 30, lines 16-17). Further, he asserts that an adjustment like the one he proposes was accepted by this Commission in Case No. 2004-00103.

Q. WHAT IS YOUR BASIS FOR OPPOSING THIS PROPOSAL?

A. The "actual income taxes paid" axiom is nothing more than a convenient sound bite that has no basis in law or fact. As for this Commission's prior, unique treatment of KAWC, I believe that it was based on the Commission's understanding of a representation allegedly made in one of the RWE change of control cases, which, in any event, involves circumstances which, as Mr. Miller describes in his testimony, no longer exist. Mr. Smith exhorts this Commission to jettison the fundamental regulatory principle of cost responsibility, ignore generally accepted accounting principles, diverge from the vast preponderance of its regulatory brethren, inject the effects of non-regulated operations into ratemaking, and "haircut" the Company's allowed rate of return. It should decline the invitation on all counts. In fact, what Mr. Smith proposes amounts to an unjustified confiscation of valuable shareholder property.

The Role of "Actual Income Taxes Paid" in the Analysis

Q. CAN THE "ACTUAL TAXES PAID" MAXIM POSSIBLY UNDERPIN MR. SMITH'S APPROACH TO TAXES IN THIS PROCEEDING?

A. Not in my view.

Q. WHAT EVIDENCE DO YOU HAVE OF THIS?

A. Mr. Smith proposes multiple adjustments that are flat out inconsistent with any reasonable construction of the concept. Every one of his proposed cost disallowances carries with it an increase to tax expense. For example, Mr. Smith proposes to disallow $786,516 of incentive compensation costs (page 32, line 19 through page 44, line 13). This disallowance is reflected in column C-4 of his Exhibit RCS-1, Schedule C-1, page 1 of 2. Rows 4 and 9 of that column clearly show the two components of the compensation expenditures that Mr. Smith proposes to disallow. Further down that same column, specifically rows 31 and 34, Mr. Smith reflects the tax effects of the disallowance. State tax expense increases by $47,191 and Federal tax expense increases by $258,764.

Q. WHAT IS THE SIGNIFICANCE OF THE INCREASE IN TAX EXPENSE?

A. The increase in tax expense can only have one of two possible explanations. The first is that the disallowed compensation expense will, as a result of being disallowed, not be deductible for tax purposes. The second is that it will still be deductible but that Mr. Smith is not reflecting the tax benefit of that deduction in the setting of KAWC's rates.

Q. ARE DISALLOWED EXPENSES TAX DEDUCTIBLE?

A. The regulatory treatment of an expense has absolutely no bearing on its tax treatment. An otherwise deductible expense remains deductible whether it is allowed or disallowed for regulatory purposes.

Q. WHAT, THEN, MUST BE THE REASON THAT MR. SMITH INCREASES TAX EXPENSE AS A RESULT OF DISALLOWING COMPENSATION EXPENSE?

A. He does it because it is logically required. Shareholders, not customers, bear the cost of any disallowed compensation expenditure and he therefore assigns the tax benefit of that cost to shareholders and not to customers. While I will return to this principle later on in my testimony, the purpose for discussing this now is that it belies his assertion that "actual income taxes paid" are at all relevant to the setting of KAWC's rates. The compensation expenditure will produce a tax deduction and Mr. Smith affirmatively – and properly – ignores that deduction in setting rates.

Q. IS THIS THE ONLY EXAMPLE OF MR. SMITH ACTING INCOMPATIBLY WITH THE "ACTUAL INCOME TAXES PAID" MANTRA?

A. Not at all. He does precisely the same thing with each and every one of his other proposed disallowances. It is abundantly clear from even a cursory review of columns C-5 through C-18 of his Exhibit RCS-1, Schedule C-1 that Mr. Smith is completely consistent. He consistently disregards "actual income taxes paid."

Q. WHAT, THEN, IS THE SIGNIFICANCE OF "ACTUAL INCOME TAXES PAID?"

A. "Actual income taxes paid" has no significance whatsoever. It is, in fact, little more than a sound bite. It is my experience that its adherents tend to be very, very selective in its application.

Q. IN YOUR OPINION, WHAT IS THE PROPER APPROACH?

A. The appropriate undertaking should be to ascertain the level of taxes associated with the provision of KAWC's regulated water service.

Cost Responsibility and the Confiscation of Shareholder Property

Q. PLEASE DESCRIBE HOW A CTA CONFISCATES SHAREHOLDER PROPERTY.

A. Our federal tax system imposes a tax on "taxable income." "Taxable income" is a net number. It is revenue reduced by designated expenses. For a corporation engaged in a business activity, almost all expenses are permitted to reduce taxable income. In fact, the ability to reduce taxable income is an inherent characteristic of a deductible expense. If you incur the expense, you reduce your taxable income. Even individuals experience this phenomenon. Anyone who owns a house and pays mortgage interest and property taxes knows that, as a direct result of making those payments, he or she reduces his or her tax liability. If he or she does not make the payments, there is no tax reduction. The tax benefit cannot be separated from the underlying cost.

Q. IN THE MORTGAGE INTEREST AND PROPERTY TAX EXAMPLE, TO WHOM DO THE TAX BENEFITS OF THE TAX DEDUCTIONS BELONG?

A. I think that any person who makes mortgage interest and property tax payments would rightfully feel aggrieved were the tax reduction resulting from the payment of these items to be assigned to some third party who bore no part of the underlying expenditures nor any risk associated with ownership of the property.

Q. HOW IS THIS RELEVANT TO RATEMAKING?

A. It is the basis for the principle of cost responsibility that is an elemental tenet of most ratemaking. This principle dictates that the party that incurs a cost is entitled to the tax benefit that incurring the cost produces.

Q. HOW IS THE COST RESPONSIBILITY PRINCIPLE MOST OFTEN EVIDENCED IN RATEMAKING?

A. It is most often implicated in the treatment of disallowed costs.

Q. WHAT IS A DISALLOWED COST?

A. A disallowed cost is a cost incurred by a utility that a regulatory commission determines should not be recovered from customers or one that the utility is precluded from recovering by statue or regulation.

Q. WHAT ARE THE TYPES OF COSTS THAT ARE DISALLOWED?

A. Costs that are determined not to be necessary to the provision of service or that do not benefit customers are of this type. Some advertising costs, for example, are expenditures that, in some jurisdictions, are considered of this type. As I have indicated above, Mr. Smith proposes that a number of the Company's costs be disallowed.

Q. ARE DISALLOWED COSTS TAX DEDUCTIBLE?

A. As I indicated earlier in my testimony, the determination that a cost is or is not recoverable in rates has absolutely no bearing on its tax treatment. As with the vast preponderance of expenditures incurred by utilities, most disallowed costs are tax deductible.

Q. WITH RESPECT TO DISALLOWED COSTS THAT ARE DEDUCTIBLE, DO THEY REDUCE THE TAXES PAID TO TAXING AUTHORITIES?

A. Yes, they do because, to the extent a cost is tax deductible, it reduces taxable income. Most often the reduction in tax is immediate. However, sometimes it occurs at a later point in time (as in the case of a disallowed capital cost that is depreciated for tax purposes).

Q. IN YOUR EXPERIENCE, WHERE RECOVERY OF A TAX-DEDUCTIBLE COST IS DENIED, WHAT IS THE REGULATORY TREATMENT AFFORDED THE TAX BENEFIT OF THAT COST?

A. In my experience, the universal treatment afforded the tax benefit of such a cost is that the benefit is allocated to shareholders and not to customers.

Q. ARE YOU AWARE OF ANY REGULATORY JURISDICTION IN WHICH THIS IS NOT THE CASE?

A. No.

Q. AGAIN, WHAT IS THE PRINCIPLE THAT UNDERLIES THIS REGULATORY TREATMENT?

A. It is cost responsibility. The tax benefit is an inherent attribute of the cost. It is, therefore, allocated to whomever bears that cost. In the case of disallowed costs, the tax benefit is allocated to shareholders who bear the cost of the expenditure and not to the customers who do not.

Q. WHAT DOES THE PRINCIPLE OF COST RESPONSIBILITY RECOGNIZE?

A. Just as a person who pays a mortgage and property taxes would feel aggrieved were the tax reduction resulting from the payment to be assigned to some third party having nothing to do with the mortgage, investors who shoulder the burden of a corporate expenditure should rightfully feel aggrieved if the associated tax benefit is provided to customers who had nothing to do with the expenditure.

Q. TO YOUR KNOWLEDGE, IS THIS A CONTROVERSIAL PROPOSITION?

A. To the best of my knowledge, it is not.

Q. DOES MR. SMITH SUBSCRIBE TO THIS PRINCIPLE?

A. He appears to do so. As I indicated when I addressed his "actual income taxes paid" reference, his calculations on Exhibit RCS-1, Schedule C-1 conclusively demonstrate that he assigns the tax benefit of each and every proposed disallowed cost to shareholders - and not to customers.

Q. WHAT DOES THIS MEAN IN TERMS OF HOW MR. SMITH TREATS THE TAX BENEFITS OF HIS PROPOSED DISALLOWED COSTS?

A. His treatment of all proposed disallowances is precisely in accord with the principle of cost responsibility. Customers do not bear the disallowed costs and, therefore, they are not provided with the tax benefits of those costs.

Q. IS THERE AN INCONSISTENCY IN MR. SMITH'S APPLCATION OF THAT PRINCIPLE?

A. There certainly is. Most obviously, his proposal to adjust tax expense by reference to tax losses incurred by non-regulated affiliates, that is, his CTA proposal, is inconsistent with this principle.

Q. CAN YOU PROVIDE AN EXAMPLE OF THE NATURE OF THIS INCONSISTENCY?

A. Yes, I can. Mr. Smith proposes to disallow $4,728 of KAWC's charitable contributions (page 57, line 11). As indicated above, he does not propose to pass the tax benefit of these contributions through to customers. In this context, he respects the principle of cost responsibility and recognizes that shareholders are entitled to the tax benefits of a cost they fund. However, if exactly that same $4,728 of contributions had been made by one of KAWC's loss affiliates, then Mr. Smith would propose to pass some portion of the tax benefit to KAWC's customers through the CTA mechanism. Customer rates would, thereby, be lower because a non-regulated affiliate made a charitable contribution. In this context, he would ignore the principle of cost responsibility.

Q. WHAT JUSTIFIES THIS INCONSISTENCY?

A. In my view, nothing justifies it. In both cases the nature of the expenditure would be precisely the same. In both cases the amount of the expenditure would be precisely the same. In neither case would customers fund the cost. In both cases shareholders would fund the entire cost. However, the regulatory treatment of the tax cost would be dramatically different. This unjustifiable dichotomy is precisely what Mr. Smith is asking this Commission to embrace. He recommends the assignment to customers of tax benefits that are embedded in costs incurred by shareholders.

Q. WHAT JUSTIFICATION DO LOSS COMPANIES HAVE FOR CLAIMING THE BENEFITS OF THE TAX LOSSES THEY PRODUCE?

A. Tax losses just don’t happen. They reflect underlying economic activity. By far the most important element is that each dollar of tax loss represents a dollar expended or a dollar of liability incurred by the tax loss member. In other words, each loss member suffered a substantive change in its economic position to produce the tax loss. By contrast, no member of the consolidated group producing positive taxable income, including the Company, contributed anything whatsoever to the creation of the tax loss.

Q. WHAT ABOUT THE RISKS ASSOCIATED WITH THE UNDERTAKINGS THAT PRODUCED THE TAX LOSSES?

A. This point is a critical one. Through the regulatory process, customers are insulated from the risks of non-regulated undertakings. That is, at least in part, the job of this Commission. The risk of commercial failure in these undertakings is, therefore, exclusively for the account of the shareholders. It is their dollars, not customer dollars, that is at stake. It is inequitable to strip out the tax consequences of taking on those risks and transferring them to the non-risk-takers.

Q. ARE THERE ADDITIONAL ELEMENTS OF THE TAX LOSS MEMBERS' CLAIMS TO THE BENEFITS OF THE TAX LOSSES THEY PRODUCE?

A. Yes, there are. It would be extremely unusual for a company to produce tax losses that it can not use. Such a company could easily engage in any one of a number of tax planning techniques to eliminate such "tax inefficiency." For example, it could moderate its deductible expenditures. Ways of accomplishing this include leasing depreciable assets instead of owning them, extracting the benefits of accelerated tax depreciation through lower lease payments. Such a company could organize along alternative lines. It could operate as a division of a larger corporation or as wholly owned limited liability company (the existence of which is ignored for tax purposes). It could co-venture in partnership form and specially allocated deductible items to a co-venturer that could make efficient use of additional tax deductions in exchange for enhanced ownership terms.

Q. WHAT DOES THIS SUGGEST REGARDING THE TAX LOSS MEMBERS' ENTITLEMENT?

A. This is not to say that any of the AWWC loss affiliates should have avoided their tax losses. However, the fact that it was within the power of many of the tax loss members to recognize the tax benefits (directly or indirectly) in the absence of the Company's or any other member's taxable income is a further indicia of responsibility. This element of control over the recognition of tax benefits supports the notion that the benefit of tax losses is properly assigned to the companies that produced the losses.

Q. WHAT, THEN, DO YOU CONCLUDE REGARDING THE APPROPRIATE ASSIGNMENT OF THE BENEFITS OF A TAX LOSS?

A. The group member that produced the tax loss has by far the higher claim to the benefit than does the group member that generated positive taxable income. The former is an active participant in the production of that benefit. The latter is a mere bystander. The loss member effectively paid for the benefit.

The Tax Rate Imposed On Consolidated Affiliates

Q. WHAT IS YOUR VIEW OF THE BASIS FOR MR. SMITH'S ASSERTION THAT A CTA IS APPROPRIATE?

A. The mathematics of his CTA calculation appear to proceed from the premise that, due to the tax losses incurred by its loss affiliates, KAWC does not pay Federal income tax on its income at the maximum 35% tax rate.

Q. IS THIS PREMISE CORRECT?

A. No it is not. A simple example will illustrate why. Assume that the best deal KAWC can negotiate with a furniture supplier is to purchase the single desk it needs for $2,000. However, the supplier offers to sell KAWC two desks for $3,000. If, under these circumstances, KAWC and an affiliate jointly purchase the two desks, clearly each company should be charged $1,500. The benefit of the volume purchase is appropriately split.

Q. IS THIS ANALOGOUS TO WHAT HAPPENS IN THE FILING OF A CONSOLIDATED INCOME TAX RETURN?

A. Absolutely not. There is no volume discount when it comes to federal tax returns. The tax rate is 35% - no more and no less - on net taxable income. Mr. Smith's fundamental error is that he confuses the effect of Income Netting with a volume discount. They are completely different and distinct situations and, consequently, are subject to differing analyses. I will address these distinctions hereafter.

Q. CAN YOU PROVIDE A MORE ACCURATE ANALOGY FOR CONSOLIDATED TAX FILING?

A. Yes I can. Assume again that the best deal KAWC can negotiate with a furniture supplier is to purchase the single desk it needs for $2,000. Further assume that there is no volume discount available. However, KAWC's affiliate (who also needs a desk) has a $1,000 gift card (or some other type of store credit) with the supplier. Using the credit, KAWC acquires the two desks for $3,000. The economics of this situation are vastly different from the volume discount one. Under no reasonable analysis did KAWC's desk cost $1,500. Yet that is essentially the proposition Mr. Smith urges this Commission to accept. In fact, the non-regulated affiliate tax losses operate much more like store credits than volume discounts.

CTAs And Generally Accepted Accounting Principles

Q. DO THE ACCOUNTING RULES ADDRESS THE ISSUE OF CONSOLIDATED TAX RETURNS?

A. Yes they do. Where a separate financial statement must be produced by a member of a group filing a consolidated tax return, Statement of Financial Accounting Standards No. 109, the standard that prescribes generally accepted accounting principles (GAAP) for income taxes, sets forth rules for the appropriate ways in which consolidated taxes can be allocated.

Q. DO THESE RULES PERMIT THE TAX ALLOCATION METHOD THE COMPANY USES?

A. Yes they do. Paragraph 40 of that standard states:

> This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer meets those criteria.

Q. DO THESE RULES PERMIT A TAX ALLOCATION METHOD THAT IMPORTS THE TAX BENEFITS OF AFFILIATE LOSSES AS DOES A CTA?

A. No they do not. Paragraph 40 of that standard further states:

> Examples of methods that are not consistent with the broad principles established by this Statement include:
>
> …
>
> c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

Q. WHAT IS THE SIGNIFICANCE OF THIS?

A. GAAP financial statements are intended to fairly reflect the underlying economics of the businesses they describe. The fact that FAS 109 accommodates the Company's presentation of its tax expense and explicitly rejects allocation methods that incorporate Mr. Smith's CTA premise should place further doubt upon the validity of his proposal.

<u>CTAs Deny Shareholders the Opportunity to Earn Their Allowed Return</u>

Q. WHAT IS THE EFFECT OF A CTA?

A. A CTA reduces a utility's revenues.

Q. WHAT IS THE IMPACT OF A CTA ON A UTILITY'S NET INCOME?

A. A reduction in revenue with no offsetting decrease in expense can have only one result – a reduction in the utility's net income.

Q. WHAT IS A CONSEQUENCE OF A REDUCTION IN A UTILITY'S NET INCOME?

A. A reduction in net income reduces the utility's earned return.

Q. WILL YOU ILLUSTRATE THIS EFFECT?

A. Yes. Assume that Utility has a $1,000 rate base, a capital structure that consists of 100% equity and that it is entitled to earn 11% on that equity. Assume its only expense is $100 of depreciation and that there is no difference between book and tax depreciation.

Utility's revenue requirement is equal to:

$100 + (($1,000 X 11%)/.65) = $269

This revenue requirement is composed of $100 of depreciation, $59 of tax expense and $110 equity return. If Utility's results of operations precisely match those projected in its rate case, its income statement will appear as follows:

	Revenues	$269
Less:	Depreciation	<u>$100</u>
	Pre-tax Income	$169
Less:	Tax Expense @ 35%	<u>$59</u>
	Earned Return	$110
	Earned Rate of Return	11%

In short, Utility would have earned its allowed return.

Assume, alternatively, that Utility has a non-regulated tax-loss affiliate that produces a CTA that reduces revenue requirement by $23 ($269 - $23 = $246). Again assuming that

Utility's results of operations precisely match those projected in its rate case, its income statement will appear as follows:

	Revenues	$246
Less:	Depreciation	$100
	Pre-tax Income	$146
Less:	Tax Expense @ 35%	$51
	Earned Return	$95
	Earned Rate of Return	9.5%

Utility fails to earn its allowed rate of return.

Q. WHAT, THEN, IS THE OVERALL EFFECT OF IMPOSING A CTA?

A. This Commission sets just and reasonable rates sufficient to afford a utility the opportunity to earn a specified rate of return. If everything that is presumed in the rate case actually comes to pass (that is, all rate case estimates and projections turn out to be completely accurate), the imposition of a CTA would render the achievement of the designated level of return impossible and, thus, would negate the opportunity to earn its allowed return.

Q. IN LIGHT OF THIS, HOW CAN A CTA BE CHARACTERIZED?

A. A CTA can reasonably be viewed as a discount applied to a utility's allowed rate of return. Certainly this will be the way its imposition will be manifested to the entire financial community since the only evidence of its effect is a reduction in utility revenues.

Imputing The Consequences Of Non-Regulated Operations Into Ratemaking

Q. DO CTAS IMPORT THE EFFECT OF NON-REGULATED TRANSACTIONS INTO THE UTILITY RATEMAKING ARENA?

A. They do.

Q. WHAT DO YOU BELIEVE IS THE EFFECT OF THE ADOPTION OF A CTA ON THE TRADITIONAL INSULATION OF JURISDICTIONAL CUSTOMERS FROM THE EFFECTS OF NON-REGULATED OPERATIONS?

A. Where a CTA is imposed, the results of non-jurisdictional operations will have a direct effect on the setting of jurisdictional rates. For example, if, at some point after a CTA is imposed, all of the Company's non-regulated affiliates begin to produce taxable income, the Company's revenue requirement will change – even if regulated operations don't change one iota. Thus, whether a non-regulated affiliate leases or purchases an asset may make a difference to the Company's customers. Whether a non-regulated affiliate claims all the deductions it can, depreciates its assets as quickly as it can, borrows additional amounts or pays down debt all become matters of consequence to the Company's customers. Each one of the laundry list of decisions having tax implications that a non-regulated company makes in the normal course will potentially impact customer rates.

Q. WHAT, THEN, DO YOU BELIEVE REGARDING THE RELATIONSHIP BETWEEN CTAS AND THE WALL BETWEEN REGULATED AND NON-REGULATED?

A. CTAs create a direct cause and effect relationship between the operations of non-regulated group members and utility rates. The directness of this relationship leaves no doubt as to the status of the historical division between regulated and non-regulated operations. CTAs breach the separation. The breach is direct and mathematically demonstrable.

<u>The Widely Prevailing Practice Of Regulators In Other Jurisdictions Is Indicative Of The Flaws Inherent In CTAs</u>

Q. IS THE PRACTICE OF IMPOSING CTAS ONE THAT IS GENERALLY FOLLOWED IN THE REGULATORY COMMUNITY?

A. No it is not. Of the 53 regulatory jurisdictions that I know of (the 50 states, FERC, D.C. and the New Orleans City Council), I am aware of only five jurisdictions that systematically impose CTAs. Consequently, CTAs, as a utility ratemaking policy, represent very much the exception rather than the rule in this country.

Q. WHAT ARE THE FIVE JURISDICTIONS THAT CURENTLY IMPOSE CTAs?

A. The five are Texas, Pennsylvania, New Jersey, West Virginia and Oregon.

Q. DO THE PRACTICES IN THESE FIVE JURISDICTIONS INDICATE THAT THOSE REGULATORS HAVE EXERCISED THEIR DISCRETION IN ADOPTING A "PRO-CTA" POLICY?

A. Not in all cases. In Oregon, the legislature enacted a complex structure for determining the tax element of cost of service that is completely unique. It bears little resemblance to

CTAs in the other four jurisdictions, involving, as it does, an allocation of tax based on sales, payroll and property. In any case, the important aspect of the Oregon CTA is that it is imposed by statute, and leaves no discretion to the regulators. Similarly, the Pennsylvania regulators have no discretion with regard to the imposition of CTAs. In 1985, the Supreme Court of Pennsylvania issued a decision mandating (as opposed to permitting) the imposition of CTAs by the Pennsylvania regulators.[1] Since that decision, *i.e.*, for the past 25 years, Pennsylvania regulators have had no discretion in this matter.

Q. WHAT IS THE PREVALENCE OF "PRO-CTA" POLICIES IN THOSE STATES WHOSE REGULATORS HAVE THE DISCRETION TO IMPOSE OR NOT TO IMPOSE THE ADJUSTMENT?

A. Of the 51 jurisdictions in which regulators have discretion to impose or not to impose CTAs, only three regulatory bodies (New Jersey, Texas and West Virginia) have seen fit to impose them. That represents a strikingly small minority.

Q. DO YOU KNOW OF ANY COMMISSIONS THAT HAVE ISSUED FINAL ORDERS REGARDING THE INITIAL ADOPTION OF A CTA WITHIN THE PAST YEAR?

A. I am aware of only two Commissions, Maryland and D.C., that, within the past year, have issued final orders in which they considered the initial adoption of a CTA.

Q. WHAT WERE THE OUTCOMES OF THESE ORDERS?

[1] *Barasch v. Pennsylvania Public Utility Commission*, 491 A.2d 94 (Sup. Ct. of PA 1985).

A. Both commissions explicitly rejected the imposition of CTAs (*Delmarva Power and Light Company*, Order No. 83085 (December 30, 2009); *Potomac Electric Power Company*, Formal Case No. 1076 (March 2, 2010)).

Q. WHAT DO YOU TAKE FROM THE FACT THAT CTAS ARE ACCEPTED RATEMAKING IN SO FEW JURISDICTIONS?

A. There is a message in the fact that only a handful of regulatory jurisdictions employ CTAs – and that in only three states have regulators affirmatively chosen to do so. While CTAs may be superficially attractive mechanisms to lower rates, the premises that underlie them are weak and unconvincing. The fact that there are so few "takers" among this country's utility regulators bears eloquent testimony to the frailty of their underlying rationale.

<u>The Particular Nature Of Mr. Smith's Proposed CTA</u>

Q. HOW WOULD YOU DESCRIBE THE CTA PROPOSED BY MR. SMITH?

A. It is a particularly virulent and highly questionable type of CTA.

Q. PLEASE DESCRIBE YOUR BASIS FOR THIS CHARACTERIZATION.

A. In the first place, it has the capability of passing to customers the benefits of even short term timing differences with no possibility of restoring the benefits when they reverse. A simple example best illustrates this feature. Assume a consolidated group consisting of only two companies – Parent and Utility. Utility produces taxable income of $100 in each of three years. Parent breaks even in each of the three years. The taxable posture of this group would be:

	Year 1	Year 2	Year 3
Parent	$0	$0	$0
Utility	$100	$100	$100

Obviously, because no member has a tax loss in any year, these results would not give rise to a CTA. Now assume that Parent has an opportunity to accelerate a $60 deduction from Year 2 to Year 1 – a one year timing difference. The taxable posture of the group would now be:

	Year 1	Year 2	Year 3
Parent	-$60	$60	$0
Utility	$100	$100	$100

Mr. Smith's CTA process would allocate Parent's Year 1 $60 tax loss to Utility. In both Years 2 and 3, there would be no loss to allocate. He would average the total tax losses allocated to Utility over the three years ([$60 + $0 + $0]/3 = $20) and then tax-effect the result ($20 X 35% = $7). As a consequence, Utility's tax expense would be reduced by $7 for the simple act of accelerating a tax deduction by one year. The fact that the timing difference reversed in Year 2 is not considered. The money is gone forever. This is simply inequitable.

Q. IN WHAT OTHER WAY IS MR. SMITH'S PROPOSED CTA INEQUITABLE?

A. We need look no farther than his own exhibit, Exhibit RCS-1, Schedule C-2. On that schedule, Column F computes the allocation of losses to KAWC for 2008. The allocation is $0. This is because, in that year, KAWC had no positive taxable income. However, the truth is that, in 2008, KAWC generated a tax loss of $7,444,070. Recall that, where a non-regulated affiliate produces a tax loss, the benefit of its loss is apportioned among other members of the group – that is, *away* from the company that generated the loss. That's the essence of Mr. Smith's CTA. The obvious question is why he doesn't apply precisely the same process when it is KAWC that produces the tax loss. It appears that his CTA is a pendulum that only swings one way.

Q. IS THERE ANOTHER OBVIOUS FLAW IN THE METHODOLOGY OF MR. SMITH'S PROPOSED CTA?

A. Yes there is. Again, the flaw is evident from his Exhibit RCS-1, Schedule C-2. Line 2 on that schedule indicates that, in 2003 (column A), KAWC produced $2,123,369 of taxable income. On line 5 of that same column, Mr. Smith assigns the Company $4,367,619 of tax losses – an amount in excess of its taxable income. Because, in any year, KAWC is only capable of offsetting a quantity of tax losses equal to its positive taxable income, this allocation appears inherently unreasonable.

Q. IS THIS AN ANOMALY?

A. No it is not. The same thing happens in Mr. Smith's calculation for 2006 (column D). In that year, KAWC generated $7,944,883 of taxable income and yet is allocated $8,112,692 of tax losses – again a result that, on its face, defies logic.

Q. WILL THESE EXCESS ASSIGNMENTS OF TAX LOSSES HAVE A MATERIAL EFFECT ON MR. SMITH'S CTA?

A. Because Mr. Smith did not use the 2003 results the effect is not material on his CTA. That, however, is not my point. My point is that any methodology capable of producing unreasonable results such as allocating more tax losses to a company than it has income, is, at the very least, suspect and should not be endorsed by the Commission. This is only one of the odd results of Mr. Smith's adjustment. Others are discussed by Mr. Miller and demonstrate that the CTA, especially as calculated by Mr. Smith, is a very imprecise and unreliable tool that the Commission should not be using to set rates.

THE FIN 48 ISSUE

Q. WHAT IS THE FUNDAMENTAL ISSUE WITH REGARD TO FIN 48?

A. This issue is not conceptually complex. The Company has borrowed money from the federal government. The government makes loans for which it charges interest and ones for which it does not charge interest. The issue is which of these two types of loans the Company has received. The Company has treated its FIN 48 liability as a loan requiring interest. As addressed in Mr. Miller’s rebuttal testimony, Mr. Smith’s invitation for the Commission to study this issue should be declined.

Q. WHAT IS THE DIFFERENCE BETWEEN THE TWO TYPES OF LOANS?

A. The difference is best illustrated by a simple, albeit extreme, example. Assume that a utility builds a plant at a cost of $1 million. On its tax return, it can take the position that the plant is depreciable over 20 years on an accelerated basis. This would be the technically correct tax treatment. The utility would claim accelerated depreciation on its tax return and, by virtue of that fact, reduce its tax liability. The reduction in the tax liability would effect a loan from the government. Indeed, that is the purpose of accelerated depreciation. The loan will be paid back in the later years of the plant's useful life (*i.e.*, after year 20) when it is still supplying water (and, therefore, generating taxable revenue) but no additional tax depreciation (it has all been claimed). Because the loan is repaid by the filing of future tax returns, there is no interest associated with it. It is interest-free as long as it is outstanding. By contrast, if the utility decides to deduct the entire cost of the plant in the year it is placed in service, the deduction will reduce its tax liability for that year. Although this would be an incorrect tax position, it would also effect a governmental loan – one larger than the loan created by "merely" claiming accelerated depreciation. Upon audit, the IRS will disallow the tax deduction to the extent it exceeds the permissible level of depreciation and require the utility to pay back a substantial portion of the loan immediately – with interest. Thus, this latter type of loan is not repaid by filing subsequent tax returns but by receiving an assessment from the IRS relating to a previously-filed tax return.

Q. WHAT ARE THE CRITICAL DISTINCTIONS BETWEEN THE TWO TYPES OF LOANS?

A. Though both loans are extended through the tax system, they are very different. The first loan, the "depreciation" loan, is a creature of the tax law. It is the result of a conscious decision by Congress to subsidize the cost of capital assets by the extension of interest-free loans. The benefit of that subsidy is clearly one that needs to be reflected in the ratemaking process – and it is through the reflection of the loan in the ADIT balance and the reduction of rate base by that balance. The second loan, the "expense" loan, is not part of a Congressional subsidization scheme and will cost the utility a carrying cost. In fact, by reflecting an aggressive tax position on its tax return, the utility simply borrowed money from the government in the same way it could have from a bank (though, admittedly, the formalities are quite different).

Q. IN THE "EXPENSE" LOAN SITUATION, IS THE LOAN INTEREST-FREE UP UNTIL THE IRS REQUIRES REPAYMENT?

A. No. It is never interest-free. The IRS will charge interest on its assessment not from the date of the assessment, but from the date the utility filed its tax return – that is, from the date of the loan itself. In short, there is no period during which such a loan is interest-free.

Q. WHAT IS THE DISAGREEMENT BETWEEN THE COMPANY AND MR. SMITH?

A. The Company believes that its FIN 48 amount is properly treated as a loan of the second type. Mr. Smith implies it should be treated as a "depreciation" loan.

Q. WHAT IS FIN 48?

A. FIN 48 is an accounting pronouncement issued in 2006 by the Financial Accounting Standards Board ("FASB"), the body that establishes the rules that constitute "generally accepted accounting principles." FIN 48 prescribes the way in which companies must analyze, quantify, and display the consequences of tax positions that are technically uncertain. It applies to years beginning after December 15, 2006 — that is, for calendar year 2007 and thereafter.

Q. WHAT IS THE PURPOSE OF FIN 48?

A. Each taxpayer has the responsibility both for reporting how much it owes and for paying that amount. This self-reporting is subject to review (i.e., audit) by the relevant taxing authorities. The tax law is exceedingly complex and contains many provisions that are subject to more than one interpretation. Moreover, it is often possible to view business transactions in more than one way. It is not uncommon for a taxpayer to, either knowingly or unknowingly, interpret the tax law in a way that could be disputed. It is similarly not uncommon for a taxpayer to view a transaction, and, hence, the tax consequences of the transaction, in a way that could be disputed. FIN 48 prescribes a single standard, a single process, and a single disclosure regime for uncertain tax positions

Q. WHAT HAPPENS AS A RESULT OF THE APPLICATION OF FIN 48?

A. FIN 48 requires that the Company identify all of its "tax positions." The definition of a tax position is very broad. It really goes to the way in which an economic action is reflected on a tax return. With respect to those that are uncertain (i.e., subject to dispute by the tax authorities), the extent of the uncertainty must be evaluated.

Q. WHAT IS THE NATURE OF THIS EVALUATION?

A. The evaluation process is extremely rigorous. Not only do the Company's internal tax people analyze the positions and assess the risk levels, the Company's external auditors, most especially their tax experts, thoroughly review the results of the Company's process and often challenge its conclusions. At the end of the process, the Company and its external auditors generally reach a consensus as to the amount of tax at risk with respect to each uncertain tax position (i.e., how much incremental tax is it likely will be paid or recovered).

Q. WHAT WOULD FIN 48 MEAN IN TERMS OF YOUR SIMPLE EXAMPLE SET OUT ABOVE?

A. In the context of that example, one might say that the purpose of FIN 48 is precisely to distinguish between "depreciation" loans and "expense" loans.

Q. HOW IS THE AMOUNT AT RISK REFLECTED?

A. As a general proposition, the amount of tax that the Company expects to pay in connection with uncertain tax positions must be reflected by the Company on its balance sheet as a tax liability. FIN 48 does not permit this amount to be reflected as ADIT.

Q. ARE THERE ANY ADDITIONAL CONSEQUENCES?

A. Yes. Interest must be accrued on any amount recorded as a liability under FIN 48 at the rates imposed by the relevant taxing authorities on tax underpayments. In addition, where appropriate, any applicable penalties must be accrued.

Q. WHAT, THEN, DO FIN 48 ENTRIES ECONOMICALLY REPRESENT?

A. FIN 48 entries represent the incremental quantity of tax that the Company and its auditors have concluded will most likely be owed with respect to previously filed tax returns. These amounts will be payable with interest when they are assessed.

Q. BUT WHAT HAPPENS IF THE DETERMINATION OF THE UTILITY AND ITS AUDITORS REGARDING THE LIKELY TAX OUTCOME TURNS OUT TO BE WRONG?

A. When it becomes less likely than not that the uncertain tax deduction provides cost-free capital, then the FIN 48 entries will be reversed and the amounts can appropriately be treated as zero cost capital.

Q. WHAT IS THE ISSUE WITH FIN 48 THAT THE COMMISSION MUST CONSIDER?

A. Where a utility holds a quantity of capital the cost status of which is uncertain, should this Commission make the presumption that it is cost-free simply because of the mechanical manner in which it was procured (by means of a tax return) or should it give consideration to the analysis of the experts inside and outside of the utility in forming its conclusion as to the capital's cost status.

Q. IS THERE UNCERTAINTY ASSOCIATED WITH THE FIN 48 TAX LIABILITY?

A. Yes there is – and the uncertainty cuts both ways. It is uncertain that the governmental loans will require interest. At the same time, it is uncertain that the governmental loans will be interest-free. Thus, there will be uncertainty regardless of which position is adopted.

Q ARE YOU SUGGESTING THAT IT COMES DOWN TO A CHOICE BETWEEN TWO UNCERTAINTIES?

A. Exactly. And it is my view that the Commission ought to adopt the more certain of the two uncertainties – respecting the FIN 48 characterization.

Q. IN REACHING ITS DETERMINATION, SHOULD THIS COMMISSION ENCOURAGE THE COMPANY TO TAKE UNCERTAIN TAX POSITIONS?

A. Absolutely. The successful assertion of an uncertain tax position has the capacity to produce incremental cost-free capital. Consequently, it is in the customers' best interests for the Commission to encourage such positions. Obviously, when the governmental funds produced by the assertion of an uncertain tax position are treated as cost-free capital without regard to their probable real cost, it becomes contrary to the Company's interest to make the attempt.

Q. WHAT IS THE COMPANY'S POSITION ON THIS QUESTION?

A. The Company maintains that, where of two possible statuses, one is more likely than the other, presuming the less probable of the two in the setting of rates would seem counter intuitive. Certainly it makes much more sense to presume the more likely alternative. In this case, the more likely alternative is the non-cost-free status of FIN 48 amounts.

CONCLUSION

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.