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**

POST-HEARING BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

I. STATEMENT OF THE CASE

A. History of the Proceeding

On January 27, 2010, Kentucky-American Water Company ("Kentucky American Water" or "Company") filed a Notice with the Public Service Commission of the Commonwealth of Kentucky ("Public Service Commission" or "Commission") in conformity with 807 KAR 5:001, Section 10(2), and 807 KAR 5:001, Section 9(1), expressing its intention to file an application for an increase in its rates no earlier than four weeks subsequent to receipt of the January 27, 2010 correspondence. The Notice specifically provided that the application for an increase in rates would be supported by a fully forecasted test year as authorized by Kentucky Revised Statute 278.192.[1]

In keeping with prior practice, simultaneously with the delivery of the Notice of its intention to seek an increase in rates, Kentucky American Water requested the Commission's consideration of continuing to use electronic technology, such as the use of electronic filing procedures and the service of all documents upon parties by only electronic means. The Commission's February 16, 2010 Order granted Kentucky American Water's request and established the procedures for electronic submission.

On February 24, 2010, the Community Action Council of Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. ("CAC") moved for full intervention. By its March 30, 2010 Order, the Commission granted CAC's motion to intervene. CAC waived its right for service by United States Mail on March 31, 2010. On February 26, 2010, the Attorney General ("AG") filed a motion to intervene and agreed to waive his right to service by United States Mail. The Commission granted intervention on March 30, 2010. On March 3, 2010, the

[1] The Notice was subsequently attached to the Application, Statement and Notice filed by Kentucky American Water in Case No. 2010-00036 and marked as Filing Exhibit No. 8.

Lexington-Fayette Urban County Government ("LFUCG') petitioned for full intervention and agreed to waive its right to service by United States Mail. The Commission permitted intervention in its March 30, 2010 Order. Thus, adjudication of this matter has proceeded with three intervenors—CAC, the AG, and LFUCG.

B. Proposed Rate Increase

In its Application, Statement and Notice filed with the Commission on February 26, 2010, Kentucky American Water sought the Commission's approval of an increase in its annual revenues of $25,848,286 by rates to become effective on and after September 30, 2010. In a later filing, the Company revised its requested increase to $25,302,362. Pursuant to the Commission's Order in Case No. 2007-00143, in which implementation of single-tariff pricing was approved, the proposed rates for each customer class are and will be uniform throughout each customer class, regardless of the Kentucky American Water division to which the customer belongs.

By letter dated March 4, 2010, the Executive Director of the Commission informed all parties of record that the Application met the minimum filing requirements and was thus accepted for filing as of February 26, 2010. By Order dated March 17, 2010, the Commission suspended the operation of the proposed rates for a period of six months and established a Procedural Schedule providing for two series of data requests to Kentucky American Water, the filing of intervenors' testimony, one round of data requests to the intervenors, and the filing of rebuttal testimony by Kentucky American Water's witnesses. In its Order on April 6, 2010, the Commission scheduled an evidentiary hearing for this matter beginning August 10, 2010.

With its Application, Kentucky American Water presented the testimonies of Mr. Patrick Baryenburch, Ms. Linda Bridwell, Mr. Keith Cartier, Mr. Paul Herbert, Mr. Michael Miller, Ms. Sheila Miller, Mr. Nick Rowe, Mr. John Spanos, Dr. Edward Spitznagel, Jr., Dr. James Vander

Weide, and Mr. Lance Williams. Subsequent rebuttal testimony was presented from Mr. Keith Cartier, Mr. Michael Miller, Ms. Sheila Miller, Mr. John Spanos, Dr. James Vander Weide, and Mr. James Warren.

The AG presented the testimony of Dr. J. Randall Woolridge and Mr. Ralph Smith. LFUCG presented the testimony of Mr. Richard Baudino and CAC filed the testimony of Mr. Jack Burch.

A hearing on the merits of the proposed increase was held at the Commission on August 10, 2010 and August 11, 2010. The following witnesses from Kentucky American Water were presented and subject to cross examination: Mr. Patrick Baryenbruch, Mr. James Warren, Mr. Nick Rowe, Ms. Linda Bridwell, Mr. Keith Cartier, Ms. Sheila Miller, Mr. Michael Miller, Mr. John Spanos and Mr. Lance Williams. The AG presented Mr. Ralph Smith and Mr. Jack Burch testified for CAC.

Throughout the course of the hearing, numerous data requests were issued to Kentucky American Water. Pursuant to the Commission's Order on August 6, 2010, the Company tendered its responses to these requests on August 20, 2010.

C. Proposed Revenue Changes

In its Application, Statement and Notice, Kentucky American Water requested an increase on an annual basis of $25,848,286, to be allocated among all customer classes pursuant to Kentucky American Water's tariffs. The Company later revised its requested increase to $25,302,362. The increase in annual revenues proposed by Kentucky American Water stands in stark contrast to the $13.6 million increase proposed by the AG. The indicator that best demonstrates the unreasonableness of the AG's position is a review of the financial statements filed with Kentucky American Water's Application, which demonstrate that absent rate relief, the achieved return on equity for 2010 is currently forecasted to be 5.41 percent, and is expected to further diminish to 1.12 percent in 2011. With returns on equity as low as 5.41 percent and 1.12 percent, the Company will be unable to attract the capital necessary to successfully effectuate its public service obligations. This concern is particularly cogent given the extensive capital invested to complete the Kentucky River Station II ("KRS II") project. Rate relief is thus required at this time to restore Kentucky American Water's financial condition to a level that will permit the continued delivery of the safe, reliable service customers have rightfully come to expect.

II. RATE BASE

A. <u>Kentucky American Water's Calculated Rate Base is Reasonable</u>

Kentucky American Water calculated its rate base in accordance with Commission precedent by utilizing a thirteen month average for most items, except for elements calculated using a twenty-four month average pursuant to the Commission's final order in Case No. 1997-034.[2] Further, many of the rate base elements were analyzed from actual, per books data as of November 30, 2009, and later updated to include actual data through May 31, 2010.[3] The thirteen month average accords with the forecasted test period ending September 30, 2011.[4]

Kentucky American Water has proposed $569,054,823 of Utility Plant in Service as a thirteen month average for the forecasted test year.[5] To arrive at this amount, Kentucky American Water first considered the actual level of Utility Plant in Service at May 31, 2010.[6] Kentucky American Water then forecasted its capital expenditures by month from that date through the end of the forecasted test year involving substantial capital investment projects that

[2] Direct Testimony of Sheila A. Miller of February 26, 2010 (Case No. 2010-00036) ("S. Miller Direct") at 10.
[3] *Id.*; *see* Kentucky American Water's base period update filed July 15, 2010.
[4] S. Miller Direct at 10.
[5] Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[6] S. Miller Direct at 10.

have been approved by the Company's Board of Directors.[7] The thirteen month average only reflects the inclusion when the project is complete and in service.[8]

Finally, in order to arrive at an accurate and representative thirteen month average of Utility Plant in Service, all utility plant retirements anticipated to occur during that period were deducted from the balance in the month in which the retirement is expected to occur.[9]

B. Utility Plant Acquisition Adjustment

Kentucky American Water has not acquired the assets of any other utility since its last rate case. The Company, however, was still amortizing the acquisition of the Boonesboro Water Association over a ten year period, pursuant to Commission Order, when its Application was filed. The amount included in the calculation of the thirteen month average, net of amortizations, in rate base is $2,342.[10] This acquisition adjustment was fully amortized as of April 30, 2010, which is reflected in the Company's base period update.[11]

No intervenor objected to this adjustment.[12]

C. Accumulated Depreciation

The Company developed the amount of accumulated depreciation to be included in rate base in the same manner in which the Utility Plant in Service was calculated.[13] After beginning with the actual balance at November 30, 2009, the balance was adjusted by month for forecasted depreciation expense and forecasted retirements.[14] Kentucky American Water utilized the depreciation rates approved by the Commission in Case No. 2007-00143 to forecast depreciation

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7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.* at 11.
11 *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
12 As explained in Kentucky American Water's Response to Staff 2-41, the Company inadvertently included the acquisition adjustment in the forecasted rate base in Utility Plant Acquisition Adjustment and Deferred Debits. As such, Kentucky American Water's proposed forecasted rate base was reduced by $2,342. This did not affect other schedules and is properly reflected in the base period update filed July 15, 2010.
13 S. Miller Direct at 11.
14 *Id.*

expenses through September 2010.[15] From October 2010 through the end of the test period, the depreciation rates proposed by John Spanos in this proceeding were employed.[16] The thirteen month average of accumulated depreciation being deducted from rate base is $110,017,434.[17] The accumulated depreciation includes an annual amount of unrecovered reserve that Kentucky American Water seeks to amortize over a five-year period, with a yearly amortization of $321,377.[18]

The AG's witness, Mr. Ralph C. Smith, objected to Kentucky American Water's calculation of accumulated depreciation, seeking to reduce the forecasted test year balance by $269,724.[19] Mr. Smith proposed this reduction because of his adjustment to the forecasted test year depreciation expense,[20] which is an operating income adjustment that will be discussed in a later section of this brief. As Kentucky American Water objects to the depreciation expense adjustment on which this reduction to accumulated depreciation is based, the Company also objects to this reduction.

D. <u>Construction Work in Progress</u>

Kentucky American Water has requested the inclusion in rate base of $9,438,488 of construction work in progress ("CWIP").[21] As with the other forecasted rate base elements, the Company began by examining the actual balance as of May 31, 2010, and then added forecasted expenditures by month and then deducted amounts transferred to Utility Plant in Service.[22]

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[15] *Id.*
[16] *Id.*
[17] *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[18] Kentucky American Water's Response to Staff 3-6, page 6 of 94.
[19] Direct Testimony of Ralph C. Smith of June 11, 2010 (Case No. 2010-0036) ("Smith Direct") at 20.
[20] *Id.* at 21.
[21] S. Miller Direct at 11-12; Application Exhibit B-1, page 2 of 2; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.

[22] S. Miller Direct at 12; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.

When a project achieves in-service status, the funds associated with that project are transferred from CWIP to Utility Plant in Service.

The AG's witness, Mr. Smith, has objected to the inclusion of CWIP in rate base, asserting that CWIP should not be included in rate base when a utility files a rate case utilizing a forecasted test year.[23] Mr. Smith asserts that Kentucky American Water "has not demonstrated that including CWIP in rate base is necessary to maintain its financial health in the current case…"[24] Mr. Smith appears to misunderstand the Commission's historical treatment of CWIP, as the Commission has never adopted the "necessary to maintain its financial health" standard by which Mr. Smith attempts to constrain Kentucky American Water. In fact, the Commission has permitted CWIP to be included in Kentucky American Water's rate base in every case it has filed using a forecasted test year.[25]

In Case No. 2004-00103, the last Kentucky American Water rate case not ending in settlement, the AG objected to the inclusion of CWIP in a forecasted test year[26]—the very same argument advanced by the AG's witness in this proceeding. The Commission rejected the AG's position, stating that "find[ing] no merit to the AG's argument that CWIP should be eliminated because of Kentucky-American's use of a forecasted test year."[27] The Commission explained its "hybrid approach," which:

> [A]llows Kentucky-American to include all CWIP in rate base while accruing AFUDC on projects taking longer than 30 days to complete. [Internal citation omitted] Under this approach, AFUDC revenue is reported "above the line." This approach eliminates the effects of including AFUDC bearing CWIP in rate base. It further allows Kentucky-American to accrue AFUDC as part of an asset's

[23] Smith Direct at 12.
[24] *Id.*
[25] *See* Case No. 92-452, November 19, 1993 Order; Case No. 95-554, September 11, 1996 Order; Case No. 97-034, September 30, 1997 Order; Case No. 2000-120, November 27, 2000 Order; Case No. 2004-00103, February 28, 2005 Order.
[26] Case No. 2004-00103, February 28, 2005 Order at 11.
[27] *Id.* at 12.

> cost where appropriate and to earn a return on CWIP where AFUDC is not accrued.[28]

Kentucky American Water has diligently abided by the approach outlined in the Commission's Order in calculating the appropriate inclusion of CWIP and AFUDC in the Company's rate base and operating income, respectively.

At hearing, the AG, through its witness, Mr. Smith, attempted to advance the argument that because Kentucky American Water sought to include KRS II CWIP without an AFUDC offset in Case No. 2007-00143 (the Company's last rate case), Kentucky American Water had effectively "waived" its right to seek CWIP per the Commission's order in Case No. 2004-00103.[29] Kentucky American Water's position on the inclusion of CWIP without an AFUDC offset in Case No. 2007-00143 was in perfect accordance with its position in the KRS II certificate case that it would seek to recover its KRS II costs in two rate cases to minimize the impact to its customers. The AG's argument turns that well-founded position on its head. The Company only sought a different CWIP treatment in Case No. 2007-00143 due to the fact that it was undertaking the single largest capital project in its history. The Company now seeks only to return to the long-standing treatment of CWIP. The AG's position amounts to a punitive measure in response to the Company's efforts to gradually seek recovery of these prudently incurred expenditures. Further, it is unclear on what grounds the Company could "waive" application of Commission precedent.

Despite Kentucky American Water's adherence to Commission precedent, the AG again seeks to disallow the inclusion of CWIP in rate base, basing its argument solely on Mr. Smith's testimony, which proffers no authority in support of his unsubstantiated position. While Mr.

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[28] *Id.* at 11.
[29] VR: 8/11/10; 14:14:00-14:15:16.

Smith, in fact, may "not favor inclusion of CWIP in rate base unless the utility demonstrates compelling reasons,"[30] his personal belief is not a compelling reason to reverse well-established and reasoned Commission precedent. Kentucky American Water has complied with the Commission's mandated procedure regarding the inclusion of CWIP in rate base. As the AG has failed to provide the Commission with any credible evidence for deviating from this well-established practice, Kentucky American Water respectfully requests that the Commission reject the AG's removal of CWIP from rate base.

E. <u>Cash Working Capital</u>

Kentucky American Water has proposed to include $2,141,000 of cash working capital in its rate base.[31] Cash working capital is the amount of investor-supplied resources that fund the daily operations of the Company.[32] This item also includes the funds required to offset the delay in the recovery of certain expenses from customers.[33] This latter item is calculated by utilizing a lead/lag study prepared for this proceeding.[34] The study was based on revenue and expense information for the twelve months ending May 31, 2010.[35]

The AG's witness, Mr. Smith, objected to Kentucky American Water's calculation of its cash working capital. Mr. Smith asserted that due to his adjustment to items included in the cash working capital calculation, several revisions to the calculation were necessary.[36] The cash working capital calculation is derived from all of the Company's operating expenses and thus all of Mr. Smith's adjustments to these expenses affected the calculation. The adjustments principally responsible for Mr. Smith's proposed reduction to cash working capital are his

[30] Smith Direct at 13.
[31] *Id.* at 12; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[32] S. Miller Direct at 12.
[33] *Id.*
[34] *Id.*
[35] M. Miller Direct at 28; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[36] Smith Direct at 18.

consolidated tax adjustment, adjustment to payroll expense, and proposed reduction in Service Company charges allocated to Kentucky American Water.[37] Each of these proposed adjustments are contested by Kentucky American Water and is discussed at length in the portion of this brief pertaining to operating expenses. The net effect of these revisions reduces the amount of cash working capital to $1,654,000, which is $487,000 less than the amount the Company proposed pursuant to the lead/lag study it performed.[38]

Kentucky American Water objects to the adjustments Mr. Smith has proposed for the various items that were considered in the calculation of cash working capital. As the Company objects to the adjustments upon which this reduction is based, Kentucky American Water similarly objects to this reduction to rate base.

F. <u>Contributions in Aid of Construction</u>

Also included in Kentucky American Water's forecasted test year rate base is an amount for Contributions in Aid of Construction.[39] To calculate the appropriate amount for the test year, the Company began by examining the actual balance as of May 31, 2010 and then forecasted an increase in these contributions based upon: (1) direct contributions from developers, businesses, or government agencies; and (2) increases in the account as a result of transfers from Customer Advances after ten year agreements expire.[40] The forecasted thirteen month average balance is $49,781,990.[41]

The Company's calculation includes the impact of Kentucky American Water's proposed revision to the tap fee tariff, which will result in increases from developers or other parties.[42]

No intervenor objected to this adjustment to rate base.

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[37] *Id.* at Exhibit RCS-1, Schedule B-3, page 2 of 3.
[38] *Id.* at 19.
[39] S. Miller Direct at 12.
[40] *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[41] S. Miller at 13; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[42] S. Miller Direct at 13.

G. Customer Advances

Using the same methodology as with Contributions in Aid of Construction, Kentucky American Water calculated its customer advances for the forecasted test period to reflect forecasted receipts and refunds of customer advances and the transfer of customer advances to the contributions account each month through the end of the test period.[43] The forecasted receipts were calculated following discussions with local developers, and refunds were forecasted based upon an examination of historical trends.[44] The forecasted thirteen month average balance is $19,881,239.[45]

H. Deferred Income Taxes

Pursuant to prior practice, deferred income taxes were included as a reduction to Kentucky American Water's forecasted thirteen month average rate base.[46] The forecasted amount in rate base is $40,098,238.[47] Included in the deferred income taxes, and pursuant to the Commission's approval in prior cases, were deferred taxes associated with Utility Plant in Service, Deferred Maintenance and Deferred Debits.[48] Further, Kentucky American Water has incorporated SFAS 109 – Accounting for Income Taxes in both the rate base deduction for income taxes and forecasted federal and state income tax expense.[49]

The AG's witness, Mr. Smith, has objected to Kentucky American Water's calculation of its deferred income taxes. First, Mr. Smith has proposed adjustments to Kentucky American Water's calculation of its accumulated depreciation and deferred maintenance, which has a

[43] *Id.*
[44] *Id.*
[45] *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[46] S. Miller Direct at 13.
[47] *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[48] S. Miller Direct at 13.
[49] *Id.* at 14.

corresponding effect on the amount of forecasted deferred income taxes.[50] The Company objects to Mr. Smith's adjustments to accumulated depreciation and deferred maintenance, and similarly objects to the inclusion of those adjustments in his proposed revision to the Company's deferred income tax calculation.

Mr. Smith has also raised concerns regarding the appropriateness of Kentucky American Water's calculation of its deferred income tax due to an accounting change in the manner in which American Water Works ("AWW"), Kentucky American Water's parent company, accounts for repairs and maintenance for its regulated subsidiaries to the Internal Revenue Service ("IRS").[51] While the IRS approved AWW's application to change its accounting method for repairs and maintenance, there is significant uncertainty surrounding the deduction the Company has made. While AWW, along with other utilities across the country, has effectuated the accounting change, the appropriate deduction is unclear as the IRS has yet to define a critical component of the deduction calculation. As the extent of the deduction is not yet delineated, the deduction the Company has taken falls within FIN 48, which describes the manner in which companies must analyze, quantify and display the consequences of uncertain tax positions.[52]

FIN 48 requires companies to identify all of its tax positions and evaluate the degree of uncertainty associated with each position.[53] If the Company has taken tax positions for which it is more likely than not that the entire deduction, or a portion thereof, will be disallowed by the IRS, the Company records the amount it expects to pay the IRS as a liability on its balance sheet. Kentucky American Water, after thorough review by its internal and external auditors, reasonably expects that a portion of the deduction taken in connection with the accounting

[50] Smith Direct at 20-21.
[51] *Id.* at 21-22; *see* Kentucky American Water's Response to AG 2-85.
[52] Rebuttal Testimony of James I. Warren of July 19, 2010 (Case No. 2010-00036") ("Warren Rebuttal") at 32.
[53] *Id.* at 33.

change will be disallowed by the IRS, which will require Kentucky American Water to remit the disallowed portion to the IRS, with interest. The Company will continue to record the amount as a liability until the uncertainty surrounding the deduction is removed. There are various means by which the uncertainty could be removed, including a formal IRS audit or expiration of the statute of limitations.[54] If the uncertainty is removed without requiring the Company to remit additional amounts to the IRS, the appropriate FIN 48 entries will be reversed and will be treated as cost-free capital.[55]

In juxtaposition to the Company's reasoned and prudent accounting for the FIN 48 entries is Mr. Smith's aggressive and impetuous adjustment, which would require Kentucky American Water to transfer the entire balance of FIN 48 entries attributable to the tax accounting change to the Company's rate base through addition to accumulated deferred income taxes. Mr. Smith's proposal contravenes the parameters of FIN 48, which does not permit the transfer to deferred income taxes until the uncertainty has been removed.

Mr. Smith attempts to support his adjustment by asserting his awareness of the issue "being raised in some recent electric utility rate cases."[56] In response to Staff 1-5, Mr. Smith initially provided three decisions from other jurisdictions allegedly addressing the FIN 48 issue. A review of the decisions demonstrates that none of the cases supports the position Mr. Smith has taken on this issue. First, in *Washington Utilities and Transportation Commission v. Puget Sound Energy, Inc.*, a recent case before the Washington State Utilities Transportation Commission,[57] an intervenor proposed to include the full amount of the deduction the utility had

[54] Rebuttal Testimony of Michael M. Miller of July 19, 2010 (Case No. 2010-00036) ("M. Miller Rebuttal") at 24.
[55] Warren Rebuttal at 34.
[56] Smith Direct at 25.
[57] Dockets UE-090704 and UG-090705 (consolidated) Order, April 2, 2010.

taken in its accumulated deferred income taxes.[58] The utility objected to the adjustment, arguing that the amount of the deduction that would be approved was uncertain because "the IRS has not yet audited the Company's implementation of the methodology."[59] The commission accepted the utility's position, rejecting the increase to accumulated deferred income taxes because the "final disposition with the IRS is not known."[60] The commission, in keeping with Kentucky American Water's position in the instant proceeding, held that the utility "should implement an increase in deferred income taxes in a future case if the IRS approves its methodology for treatment of repair costs following an audit."[61] Thus, the commission recognized the prudence of awaiting IRS determination before requiring the utility to transfer the balance of the deduction into the utility's deferred income tax account.

The second of the three decisions Mr. Smith initially provided in response to Staff 1-5 was a recent decision by the Public Service Commission of the District of Columbia involving the Potomac Electric Power Company.[62] While the decision is quite long and highly detailed, there is no discussion of a tax accounting change or an increase in deferred income taxes due to an accounting change. The only possible reference to the issue is found on page three of the order, under the heading of "Rate Base – Unopposed Adjustments" in which various adjustments are listed, one of which is "Reflection of New Method-Repair Categorizations."[63] It is unclear from the record whether this refers to the accounting change at issue in this proceeding or if FIN 48 was involved. Further, if this adjustment does refer to the issue, it was an unopposed adjustment and there is no description in the order, or in Mr. Smith's testimony, explaining either

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[58] *Id.* at 69.
[59] *Id* .at 70.
[60] *Id.*
[61] *Id.*
[62] Formal Case No. 1076, *In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, Order No. 15710, March 2, 2010.
[63] *Id.* at 3.

the utility's position or the intervenors' positions on the matter. It is consequently unclear why this decision was included as being responsive to the Staff's question, as it provides no insight into other jurisdictions' treatment of this issue.

The final case initially provided was a decision issued by the Public Service Commission of Utah involving Rocky Mountain Power.[64] The parties to the proceeding were litigating several issues relating to various concerns with the utility's ratemaking accounting of its taxes. The parties entered into a unanimous settlement that described changes to the utility's tax accounting, one of which discussed the effect of the change in the method of accounting for repairs.[65] Due to the brevity of discussion regarding the issue, it is unclear what position the parties to the proceeding had taken on the issue. The parties agreed upon an amount that would be added to the utility's accumulated deferred income taxes that would be a consequent reduction to rate base.[66] Ostensibly due to the uncertainty surrounding the amount the IRS would ultimately permit to be deducted, the parties agreed to several hold harmless provisions that provided protection to the utility if the IRS consequently approved less than the amount the utility was adding to its accumulated deferred income taxes.[67] If that occurred, the utility was authorized to record the additional amount as a liability, with recovery from ratepayers occurring over an amortization period.[68] The commission's order approving the settlement did not discuss the merits of the terms in any particularized manner, instead merely noting that no parties

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[64] *In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of Its Proposed Electric Service Schedules and Electric Service Regulations; In the Docket on Rocky Mountain Power's Deferred Income Tax Normalization Method*, Docket No. 09-035-23 and Docket No. 09-035-03, Order, December 8, 2009.

[65] *Id.* at Stipulation, paragraph 11.

[66] *Id.* at Stipulation, paragraphs 12-13.

[67] *Id.*

[68] *Id.*

expressed opposition to the settlement.[69] Neither the settlement nor the order mentioned the applicability of FIN 48.

The three decisions Mr. Smith initially provided in response to Staff 1-5 further support the Company's position on the issue, as none of the cited commissions imposed the punitive adjustment Mr. Smith has proposed in this proceeding. One commission expressly rejected a similar adjustment, while all parties to another proceeding reasoned that if a utility should be forced to include a significant portion of the claimed deduction in deferred income taxes, a mechanism must be available to allow the utility to recoup additional funds from ratepayers, if necessary, once the uncertainty surrounding the amount of the deduction is resolved.

On August 6, 2010, the AG updated its response to Staff 1-5, providing another commission decision that addressed FIN 48 and deferred income taxes in relation to the change in the accounting for repairs. The decision was issued by the Public Service Commission of the State of Missouri and involved the Union Electric Company, doing business as AmerenUE.[70] The staff had proposed adjustments that would require the utility to treat all of its uncertain tax positions as deferred income taxes.[71] One such uncertain tax position involved the appropriate amount of the deduction the utility had taken pursuant to the change for accounting for repairs. In accordance with FIN 48, the utility treated as a liability the portion the company ultimately expects to pay the IRS in taxes, including interest.[72]

The Commission noted that ratepayers benefit from the utility's pursuit of uncertain tax positions with the IRS, and because ratepayers benefit from aggressive deductions, "[t]he best way to encourage AmerenUE to continue to take uncertain tax positions is to treat the company

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[69] *Id.* at 4.
[70] *In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service*, Case No. ER-2008-0318, Tariff Nos. YE-2008-0605, Order, January 27, 2009.
[71] *Id.* at 54.
[72] *Id.* at 55.

fairly in the regulatory process."[73] The commission then rejected the staff's adjustment, holding "AmerenUE should not be required to recognize as deferred taxes the amount of its uncertain tax positions it ultimately expects to pay with interest to the IRS…Therefore, the Commission will exclude from the deferred taxes account the amount of AmerenUE's FIN 48 liability."[74] Thus, in the latest decision provided in response to Staff 1-5, a commission rejected the precise adjustment Mr. Smith has proposed to impose upon Kentucky American Water.

Thus, in two of the four cases provided, a commission rejected a similar adjustment, finding it unfair to punish a utility for taking uncertain tax positions that, if approved, would ultimately benefit ratepayers. Neither the AG nor Mr. Smith was able to provide to this Commission a single decision in which the severe adjustment proposed in this proceeding was imposed in another jurisdiction. To the contrary, jurisdictions have uniformly rejected Mr. Smith's proposed adjustment.

While Mr. Smith characterizes the impact of the "major tax accounting change" as "known and quantifiable," he did not initially propose an adjustment related to this issue because he alleged that "KAWC did not provide sufficiently clear information in response to data requests issued by the AG in which to quantify the adjustment."[75] Despite his reticence in proposing an adjustment, on August 9, 2010, the eve of the hearing, the AG communicated to the parties that Mr. Smith had quantified his proposed change to Kentucky American Water's rate base due to his proposal to transfer all of the FIN 48 account pertaining to the Company's accounting change to its deferred income taxes. Mr. Smith would require Kentucky American Water to add $2,392,803 to its deferred income taxes.[76]

[73] *Id.*
[74] *Id.* at 56.
[75] Smith Direct at 27.
[76] Smith Revised Exhibit RCS-1, Schedule B-7.

The Company objects to any addition to its deferred income taxes at this time because of the uncertainty surrounding the ultimate amount of the deduction that will be permitted and the amount, if any, Kentucky American Water will be required to remit to the IRS, with interest. The Company is simply asking the Commission to await final determination from the IRS on this issue before increasing its deferred income taxes. At hearing, the Company committed that if additional interest or penalties were required to be paid exceeding the amount in FIN 48 reserved for the issue, Kentucky American Water would not seek recovery for those amounts from ratepayers.[77]

Simply, the Company has taken an advantageous tax position that is designed to benefit ratepayers. Kentucky American Water certainly believes the benefits of the tax accounting change should inure to its customers, but asks the Commission to allow the Company to receive a final determination from the IRS before the Company's deferred income taxes are increased. Kentucky American Water's position bears no financial risk to customers, as the Company has agreed to not seek recovery from ratepayers if any interest or penalties are ultimately required. For these reasons, Kentucky American Water respectfully requests that the Commission deny Mr. Smith's adjustment.

I. <u>Deferred Income Tax Credit</u>

Kentucky American Water, in accordance with established practice, continued the amortization of its 3 percent deferred investment tax credit.[78] The actual balance at the end of

[77] VR: 8/11/10, 11:32:10-11:33:15.
[78] S. Miller Direct at 14.

November 2009 was $87,160[79] with a forecasted test year average balance of $76,952.[80] The latter amount has been reduced from Kentucky American Water's rate base.[81]

No intervenor objected to this adjustment to rate base.

J. <u>Deferred Maintenance</u>

Kentucky American Water calculated the forecasted thirteen month average for deferred maintenance based upon both actual projects deferred and projects that are forecast to be deferred.[82] Ms. Miller's direct testimony provided examples of the projects included in this account, such as the repainting and repairs of water storage tanks.[83] The types of expenses included in deferred maintenance expenses have been afforded rate base treatment in prior Commission proceedings.[84] The forecasted thirteen month average, adjusted for amortizations, for these deferred maintenance items is $2,708,236.[85]

The AG objected to Kentucky American Water's deferred maintenance calculation, specifically the component of the calculation comprising labor costs. The AG's witness, Mr. Smith, proposes to remove a portion of labor costs from the calculation because in Kentucky American Water's last rate case, "the witness for the AG recommended that approximately 1.68 percent….be removed as relating to KAWC's internal labor and labor overhead costs."[86] After stating that this adjustment was proposed by the AG in the Company's last rate proceeding, Mr. Smith listed the amount Kentucky American Water had calculated for deferred maintenance and then summarily asserted that "[a]pproximately 1.68 percent of this is $45,500. As shown on

[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[86] Smith Direct at 19.

Exhibit RCS-1, Schedule B-4, rate base is reduced by $45,500 to remove estimated internal labor costs from KAWC's claim for Deferred Maintenance."[87]

Mr. Smith provides no further support for this adjustment, other than the AG's past practice of proposing this recommendation. While it is certainly common for parties to propose the same adjustment in multiple rate case proceedings, it is unusual for a witness to simply rely upon a calculation from a prior rate case to quantify an adjustment in a later rate case without making any effort to ensure that the calculation remains appropriate. At hearing, Kentucky American Water's counsel confirmed through cross examination that Mr. Smith did not perform an independent calculation to arrive at the 1.68 adjustment he has proposed.[88] Instead, Mr. Smith continued to reiterate, as opposed to simply admitting that he did not perform an independent calculation, that the 1.68 percent remained accurate because the last case settled and the data was not sufficiently different as to warrant a revised calculation. A review of the Company's filed amount of deferred maintenance in this case, as opposed to the last rate case, demonstrates the fallacy of Mr. Smith's position. While Kentucky American projected a thirteen month average of $2,708,236 in deferred maintenance during the forecasted test period in this proceeding,[89] it sought to include $2,951,785 in its last rate case.[90] The variance in these numbers demonstrates that contrary to Mr. Smith's assertion at the hearing, there is a significant difference among deferred maintenance in the last proceeding and in this case.

Further, while a witness for the AG did propose a similar adjustment in the Company's last rate case, the direct testimony of the AG's witness in that proceeding noted that the removal

[87] *Id.* at 19-20.
[88] VR: 8/11/10; 14:18:05-14:20:10.
[89] Application, Exhibit 37, Schedule B-1, page 2 of 2.
[90] *In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company Effective on and After November 30, 2008* (Case No. 2008-00427) Exhibit 37, Schedule B-1, page 2 of 2.

of the 1.68 percent was strongly contested by Kentucky American Water.[91] More importantly, Kentucky American Water's last rate case settled, and neither the Commission's Order approving the settlement, nor the parties' settlement itself, approved the 1.68 percent removal of labor costs.[92] In short, while Mr. Smith attempts to justify his failure to perform any analysis, calculation, or other means of support explaining his removal of 1.68 percent from the Company's deferred maintenance, his decision to merely duplicate a prior witness' calculation should not be deemed sufficiently credible to merit Commission approval. For these reasons, Kentucky American Water respectfully requests that the Commission deny Mr. Smith's adjustment to deferred maintenance.

K. <u>Deferred Debits</u>

Kentucky American Water is requesting an additional $1,700,474 in rate base for various deferred debit items.[93] These amounts are offset by corresponding deferred income taxes.[94] The Company developed its thirteen month average for deferred debts in accordance with the practice previously recognized by the Commission.[95]

No intervenor objected to this adjustment to rate base.

L. <u>Other Rate Base Elements</u>

The final adjustment Kentucky American Water has proposed to its rate base is an adjustment for other rate base elements.[96] In Case No. 2004-00103, the Commission reduced the Company's rate base for Contract Retentions, Unclaimed Extension Deposit Refunds,

[91] Direct Testimony of Robert J. Henkes of February 23, 2009 (Case No. 2008-00427) at 17.
[92] *See* the Commission's June 1, 2009 Order in Case No. 2008-00427 and Appendix A.
[93] S. Miller Direct at 14; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[94] S. Miller Direct at 14.
[95] *Id.*
[96] *Id.* at 15.

Retirement Work in Progress, Deferred Compensation and Accrued Pension.[97] Pursuant to this precedent, Kentucky American Water has calculated a rate base reduction of $2,161,475 for these items.[98]

No intervenor objected to this adjustment.

III. FORECASTED TEST YEAR REVENUES

A. Residential Consumption

Provided as Exhibit 37, Schedule M-3.2, page 1, to Kentucky American Water's Application shows $48,172,874 in anticipated revenues based upon a projected 1,333,336 residential customer bills. The forecasted revenue was calculated by employing the rates proposed in this proceeding.

In calculating the projected revenues, Kentucky American Water relied upon the study conducted by Dr. Edward L. Spitznagel, Jr. Dr. Spitznagel estimated the amount of water that will be utilized by residential customers during the forecasted test period, from October 2010 to September 2011.[99] To calculate the projected water consumption, Dr. Spitznagel utilized ten years of Kentucky American Water's monthly consumption data spanning from January 2000 to December 2009.[100] Dr. Spitznagel analyzed variations in temperature and precipitation and then examined how those variations affect water consumption in residential and commercial customers.[101] Dr. Spitznagel also incorporated into his study other, non-meteorological, predictors, such as the effect of water-conserving appliances, in forecasting water

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[97] *Id.*; Order, February 28, 2005 (Case No. 2004-00103) at 38.
[98] S. Miller Direct at 15; Kentucky American Water's base period update filed July 15, 2010 at Schedule B-1, page 2 of 2.
[99] Direct Testimony of Edward L. Spitznagel, Jr. of February 26, 2010 (Case No. 2010-00036) ("Spitznagel Direct") at 1.
[100] *Id.*
[101] *Id.*

consumption.[102] Dr. Spitznagel's multivariate model utilized calendar month, year, drought severity index and cooling degree days as predictors.[103]

After conducting his extensive inquiry, Dr. Spitznagel projected that each residential customer will consume 155.67 gallons of water per customer each day in the forecasted test period.[104] No intervenor objected to Dr. Spitznagel's projection.

B. <u>Commercial Consumption</u>

Provided as Exhibit 37, Schedule M-3.2, page 2, to Kentucky American Water's Application shows $23,401,316 in anticipated revenues based upon 108,701 commercial customer bills. The forecasted revenue was calculated by employing the rates proposed in this proceeding.

Dr. Spitznagel employed the same methodology in estimating water consumption by Kentucky American Water's commercial customers during the test period as for the Company's residential customers. Dr. Spitznagel has forecasted that each commercial customer will utilize 1,205.10 gallons of water each day during the test period.[105] No intervenor objected to Dr. Spitznagel's projection.

IV. ADJUSTMENTS TO OPERATING REVENUES AND EXPENSES

Kentucky American Water's Application and supporting materials set forth and explain the adjustments the Company has made to its operating revenues and expenses. The proposed expenses, to the extent possible, ensure the values contained in the forecasted test period in this proceeding represent an accurate and representative level of revenues and expenses. Exhibit 37 to Kentucky American Water's Application contains the schedules that set forth the adjustments

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[102] *Id.* at 2.
[103] *Id.* at 3.
[104] *Id.* at 5-6.
[105] *Id.* at 6.

in rates supported by the forecasted test period. Further, the Company provided a base period update on July 15, 2010, that provides updated information for the twelve months ended May 31, 2010.

Only the adjustments to operating revenues and expenses that were contested by the Company or intervenors to the proceeding are discussed below.

A. <u>Labor Expense</u>

In calculating the appropriate labor expense for the forecasted test period, Kentucky American Water analyzed the wages of each individual employee.[106] The Company adjusted each employee's wages to the level that would be paid during the forecasted test period, beginning with the actual wages the employee was receiving in 2010.[107] Employees' working hours were segregated and consequently apportioned between work performed for operation and maintenance duties and capital projects.[108] The expected number of hours worked during the forecasted test period is 2,088.[109] Kentucky American Water also projected the number of forecasted overtime hours for the same time period.[110] The Company eliminated from the filing the number of hours that employees devote to sewer operations.[111]

Kentucky American Water's Application utilized a capitalized percentage of 17.34, which is used to apportion the budgeted wages between operation and maintenance and capital accounts.[112] The Company revised its capitalized percentage to 17.80 percent to reflect the transfer of three positions from Kentucky American Water to American Water Works Service

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[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] *Id.*
[112] *Id.*

Company ("Service Company").[113] The 17.80 percent of total labor expense attributable to capital projects was excluded from the calculation of operation and maintenance labor expense.[114] The resulting amount of operation and maintenance labor expense for the forecasted test period is $7,784,856.[115]

The AG's witness, Mr. Smith, has objected to Kentucky American Water's calculation of its labor expense, specifically the capitalization percentage the Company has used. Mr. Smith's objection to the Company's use of the 17.34 percent capitalization rate is that the rate is "much lower than prior years."[116] Mr. Smith's argument implies that because the capitalization rate is lower than the rate proposed by Kentucky American Water in its last base rate case, the capitalization rate is too low. The LFUCG's witness, Mr. Richard Baudino, advanced a similar objection.[117]

This characterization of yearly variations in capitalization ratios is simply incorrect. As explained in Kentucky American Water's response to Staff 2-13, the level of capitalized labor depends on a host of factors, including the construction budget, the number of main breaks that are expensed in capital accounts and the number of developer main extensions. In this same response, Kentucky American Water explained that the capitalization ratio was lower principally because of the addition of seven new positions to operate KRS II.[118] The Company further demonstrated that six of those positions would only be charging time to operation and maintenance accounts, as those employees would be responsible for the daily operation of the

[113] Rebuttal Testimony of Sheila A. Miller of July 19, 2010 (Case No. 2010-00036) ("S. Miller Rebuttal") at 9.
[114] S. Miller Direct at 6.
[115] *Id.*; base period update filed July 15, 2010 at Schedule C-2, page 1 of 1.
[116] Smith Direct at 68. When Mr. Smith filed his testimony, Kentucky American Water had not yet updated its capitalized percentage, and as such, Mr. Smith objected to the 17.34 percentage.
[117] Direct Testimony of Richard A. Baudino of June 11, 2010 (Case No. 2010-00036) ("Baudino Direct") at 48.
[118] Response to Staff 2-13.

treatment plant.[119] The final position (plant supervisor) is expected to allocate ninety-five percent of his time to operation and maintenance accounts.[120] The cumulative effect of the addition of these positions is to increase the portion of labor expense budgeted to operation and maintenance accounts due to the job performance these positions require.

While the Company thus explained why the capitalization rate utilized in calculating labor expense was lower than in the last rate case, Mr. Smith continues to object. He has proposed an adjustment to normalize Kentucky American Water's capitalization ratio through employing a five-year average.[121] Mr. Baudino has also proposed use of the five-year average.[122] Mr. Smith provides scarce reasoning for his significant adjustment, as the Company's capitalization ratio has never been normalized. In his direct testimony, he states that "the capitalization percentage has fluctuated from year to year, so an average should be used…"[123] Normalization adjustments have been infrequently approved by the Commission and have been approved only for expenses for which projections are difficult to create due to the randomness of the subject matter. The most prevalent examples of normalization adjustments involve storm damages and injuries, both occurrences demonstrating no discernible trend.

In light of the rarity with which normalizations are approved, Kentucky American Water inquired as to why Mr. Smith believed a normalization adjustment is appropriate for the Company's capitalization ratio. Certainly, Kentucky American Water can accurately project the number of employees it expects to add during the forecasted test period and can reasonably estimate the duties associated with those positions. Mr. Smith, however, did not sufficiently

[119] Response to Staff 2-13.
[120] *Id*.
[121] Smith Direct at 70-71.
[122] Baudino Direct at 50. Mr. Baudino's reasoning and limited justification closely parallel's Mr. Smith's. As such, one explanation addressing both adjustments is presented.
[123] Smith Direct at 70.

address the basis of his adjustment. In discovery, the AG merely stated, "Mr. Smith believes there is a specific concern with the capitalization rate...and has therefore proposed an adjustment to address this."[124] Mr. Smith ignored entirely Kentucky American Water's assertion that the capitalization ratio was comprised of sufficiently known variables to render a normalization adjustment inappropriate.

Perhaps as disconcerting as the adjustment itself is Mr. Smith's calculation. As mentioned, the capitalization ratio represents the percentage of labor expected to be performed on capital projects. Labor can be only be allocated among capital projects and operation and maintenance expenses. Thus, although a simplistic example, if twenty percent of labor is allocated to capital, then eighty percent of labor is consequently allocated to operation and maintenance accounts. By applying this same principle, it becomes evident that if an adjustment is proposed to *increase* the capitalization percentage, then there must be a corresponding *decrease* in the amount of operation and maintenance labor, as the sum cannot exceed one hundred percent.

Mr. Smith did not adhere to this basic formula, as he removed $358,551 from the Company's revenue requirement for operation and maintenance labor costs he believes to be overstated.[125] Despite removing this amount from the Company's operation and maintenance expenses, Mr. Smith admitted at hearing that he did not add that amount back into the Company's capitalized labor costs in its rate base.[126] When questioned as to whether this amount should have been added to the Company's rate base, Mr. Smith admitted that "you could make a case" that a portion of the removed operation and maintenance expenses should be included in

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[124] AG's Response to Kentucky American Water 1-25.
[125] VR: 8/11/10; 14:35:00-14:36:09.
[126] VR: 8/11/10; 14:36:00-14:36:52.

rate base.[127] Mr. Smith attempted to argue that only half of the removed expenses should be included in rate base by making an untenable argument that only half should be included because rate base was calculated on a forecasted test year.[128] This is inapposite, as the $358,551 he removed from the revenue requirement was equally based upon a forecasted test year. Despite admitting that a portion of the removed amount should be added back into rate base, Mr. Smith failed to do so. The effect of his adjustment was to simply remove $358,551 from the Company's overall labor expense, instead of recategorizing the amount. Neither Mr. Smith, nor any other intervenor, has alleged that Kentucky American Water's forecasted labor expenses are unreasonable or excessive. Although the cumulative amount of labor remains uncontested, Mr. Smith, under the guise of transferring labor expenses from operation and maintenance accounts to capital accounts, simply removed a significant portion of labor expense. If the Commission accepts Mr. Smith's proposed adjustment that Kentucky American Water's capitalized ratio is too low, the full amount of labor expenses removed from the revenue requirement must be added back to the Company's rate base. If not, a portion of labor expense will be disallowed, even though no intervenor proposed such adjustment.

While Kentucky American Water's capitalization ratio is lower than in the last proceeding, the Company has clearly explained that the change in the ratio is attributable to the addition of the seven employees necessary for the daily operation of KRS II. The AG has failed to provide any reasoned basis for his proposed normalization adjustment, other than that the capitalization rate is lower in this proceeding. In prior cases in which the ratio was higher, no such adjustment was proposed, thus demonstrating that the AG's adjustment is selective and merely attempts to arbitrarily decrease Kentucky American Water's operating expenses. The

[127] VR: 8/11/10; 14:36:00-14:36:50.
[128] VR: 8/11/10; 14:37:12-14:37:22.

basic mathematical premise underlying the reduced capitalization ratio cannot be refuted: labor expenses can only be allocated between either operation and maintenance expenses or capital expenditures. If seven new employees are to devote essentially all of their time to operation and maintenance expenses, a contention that has not been disputed, the percentage of operation and maintenance expense must increase. If operation and maintenance expense increases, capital must decrease correspondingly.

The AG and LFUCG have failed to provide the Commission with any compelling reason to deviate from its prior practice and, as such, Kentucky American Water respectfully requests that the AG's and LFUCG's proposed adjustment to normalize the capitalization ratio be denied.

B. Payroll Expense

Another labor-related adjustment Mr. Smith has proposed seeks to adjust the vacancies for which the Company has sought recovery, as well as a reduction in Kentucky American Water's projected pay increases. Before addressing Mr. Smith's arguments, an overview of the Company's treatment of employee vacancies may prove useful. When Kentucky American Water files a base rate case using a forecast test year, it must treat employee vacancies by one of two methods. Under the first method, which was utilized by Kentucky American Water in this proceeding, the Company projected its salaries and wages for the forecasted test year assuming that all employee positions would be filled.[129] Although the Company recognizes that vacancies will occur throughout the year, the job requirements associated with those vacancies are not eliminated simply because the position is unfilled for a period of time. Under this method, the Company's forecast salary and wage expense is the expected expense for all employees during the forecast test year, assuming a zero vacancy rate.[130]

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[129] S. Miller Rebuttal at 6.
[130] *Id.*

The second, and more complex, method in which to determine the appropriate salary and wage expense is to estimate the average number of vacancies expected throughout the forecast period and then attempt to quantify the amount of temporary and overtime labor that will be necessary to perform the job responsibilities associated with each vacant position.[131] As briefly explained above, when a position is vacant, the responsibilities associated with this position remain. The Company will either hire temporary employees to perform the tasks associated with the vacant position, or existing employees will be required to work overtime to execute the additional tasks. Calculating the appropriate amount of temporary and overtime labor necessary to adequately cover the vacant responsibilities is not only cumbersome, but may result in a higher labor expense due to the presence of overtime labor. As such, the Company forecasts its salary and wage expense by utilizing the first method, in which a full complement of employees is assumed.[132] This is the most accurate method of anticipating the going-forward level of salary and wage expense.

Mr. Smith's proposed adjustment is in stark opposition to the Company's reasoned approach to calculating salary and wage expense. Mr. Smith decided upon a "vacancy rate" of three positions, which resulted in a two percent vacancy factor.[133] Mr. Smith has proposed to reduce the Company's projected salary and wage expense by that amount. While seeking to disallow payroll expense for the average number of vacancies Mr. Smith estimates throughout the test year, Mr. Smith failed to add back into salary and wage expense a single dollar for the additional temporary and overtime labor that will be necessary to ensure that the responsibilities

[131] *Id.*
[132] *Id.*
[133] Smith Direct at 73. When Mr. Smith's direct testimony was filed, Kentucky American Water expected to have 153 employees. As explained in Ms. Miller's rebuttal testimony, three employees were transferred to the Service Company, reducing the number of Kentucky American Water employees to 150. To calculate the vacancy factor, Mr. Smith divided his three-position vacancy rate by the number of Kentucky American Water employees, which at 153 employees, resulted in a vacancy factor of 1.96 percent, which Mr. Smith rounded to two percent. With the number of employees reduced to 150, the vacancy factor is exactly two percent.

associated with the vacant positions are adequately satisfied. Interestingly, Mr. Smith advances no argument that the Company's projected number of employees is excessive or inaccurate. While Mr. Smith does not contest the number of employees Kentucky American Water has projected that it needs for the provision of safe and reliable water service, Mr. Smith unreasonably seeks to punitively disallow a portion of the Company's salary and wage expense because of vacancies that will periodically occur throughout the test year.

Further, Mr. Smith has also proposed an adjustment to reduce the amount of projected pay increases the Company has requested.[134] Mr. Smith has contended that Kentucky American Water's actual pay increases have been lower than the Company's budgeted amount.[135] Mr. Smith, relying solely upon historical data, proposed a 0.4 percent reduction in the Company's projected pay increases.[136] In order for Mr. Smith to have proposed a valid adjustment, the Company's pay increases for the test year would have to have been based upon budgeted, as opposed to actual, amounts.[137] As explained in Ms. Miller's rebuttal, the pay increases for union employees is pursuant to an existing contract and is thus certain and fixed.[138] Mr. Smith ignores the preexisting obligation that is the basis for the pay increases, instead relying solely upon historical data in an effort to disallow a portion of the established pay increases.

Kentucky American Water has calculated its payroll expense for the forecasted year based upon the most accurate information available to the Company while utilizing the most reasoned method of calculation. While the Company's payroll expense is based upon quantifiable salary and wage increases, Mr. Smith's relies upon incomplete calculations and

[134] *Id.* at 73-74.
[135] *Id.* at 73.
[136] *Id.* at 74.
[137] S. Miller Rebuttal at 7.
[138] *Id.*

historical data. For these reasons, the Company respectfully requests the Commission deny Mr. Smith's adjustments to payroll expense.

C. Rate Case Expenses

In keeping with well-established Commission precedent, Kentucky American Water has proposed to amortize the expenses incurred in preparing and litigating this proceeding.[139] The forecasted rate case costs, including actual expenses through August 18, 2010, are $553,121.43.[140] Kentucky American Water is seeking to amortize the rate case expense and cost of service study expenses over a period of three years, while amortizing the depreciation study expense over a five-year period.[141]

The AG's witness, Mr. Smith, has objected to the Company's calculation of its projected rate case expense.[142] Mr. Smith argues that Kentucky American Water's rate case expenses should be normalized because "[i]t appears fairly normal, based on recent experience, for KAWC to settle its rate cases and incur significantly less than the estimated forecast amounts it proposes for ratemaking purposes."[143] While the Company endeavors to settle rate cases when practicable, this current proceeding demonstrates that settlement is not a certainty.

The AG proposed this adjustment in a prior Kentucky American Water rate case proceeding, Case No. 2004-00103.[144] The Commission denied the adjustment, holding that "introducing additional projected cost estimates into Kentucky-American's rate proceedings through normalization would only result in additional litigation in future rate cases…"[145] Despite the Commission's clear rejection of normalizing rate case expenses, the AG has again

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139 S. Miller Direct at 7.
140 Response to Hearing Data Request 20.
141 S. Miller Direct at 7.
142 Smith Direct at 64.
143 *Id.* at 64-65.
144 Order, February 28, 2005 (Case No. 2004-00103) at 20.
145 *Id.*

proposed this adjustment, neither mentioning the Commission's prior rejection nor providing any sound basis for accepting the unsupported adjustment.

Further, Mr. Smith acknowledges that a normalized amount of rate case expenses will be unjust to Kentucky American Water in rate case proceedings such as this one, which do not result in settlement.[146] Mr. Smith proposed that when it becomes apparent that a rate case is not going to settle "the percentage used for purposes of normalization…would likely need to be adjusted, in order to provide for a more representative normalized allowance."[147] This acknowledgement demonstrates the inappropriateness of Mr. Smith's adjustment. A normalization adjustment will not capture differences in the complexities of rate cases and is unable to reflect variables, such as whether a new depreciation study has been completed in connection with the proceeding.

Perhaps more alarming, a normalization adjustment that utilizes prior rate case expenses will likely always result in Kentucky American Water being able to recover less than its actual expenses, as a simple average based on historical costs will not reflect inflationary increases in legal, accounting, and other related costs Kentucky American Water must incur in preparing and litigating a base rate case. For example, as noted in Kentucky American Water's response to Staff 2-24, the Consumer Price Index currently assumes annual price increases of 2.5 percent each year. By utilizing historic data, Mr. Smith's adjustment would never reflect price increases and would instead employ data that was outdated by several years. As there have been no allegations that Kentucky American Water's rate case expenses have been imprudent or excessive, the punitive adjustment Mr. Smith has proposed is neither warranted nor reasonable.

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[146] Smith Direct at 65.
[147] *Id.*

Finally, as in regard to the Company's capitalization ratio, it is unclear why Mr. Smith asserts that rate case expenses are suitable for normalization. Rate case expenses can be reasonably forecasted, as consulting and related costs can be determined prior to the filing of the Company's Application. Mr. Smith provides no explanation as to why normalization is appropriate, instead arguing that rate case expenses do not warrant regulatory asset treatment and consequent amortization.[148] Mr. Smith's unsupported position is in contravention of well-established and long-held Commission precedent.[149] As the AG has not provided the Commission with any compelling reason to depart from its longstanding practice of amortizing rate case expenses over a period of three years, Kentucky American Water respectfully requests that the Commission reject this adjustment.

In addition to proposing an adjustment to normalize all future rate case expenses, Mr. Smith also objects to Kentucky American Water's amortization of rate case expenses from the Company's 2007 and 2008 rate cases.[150] Mr. Smith contends that amortization of the Company's expenses in those proceedings was inappropriate because the settlements in those cases did not specifically address rate case expense recovery.[151]

In justifying his recommendation, Mr. Smith interjects a host of inapposite ratemaking terms, such as "FAS 71" and "single issue rate making."[152] Mr. Smith, as explained in Mr. Miller's rebuttal testimony, is attempting to assert that Kentucky American Water should be

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[148] *Id.*

[149] *In the Matter of: The Application of Cedarbrook Treatment Plant for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Case No. 93-327) Order, June 1, 1993; *In the Matter of: Proposed Adjustment of the Wholesale Water Service Rates of the City of Owenton, Kentucky* (Case No. 98-283) Order, February 22, 1999; *In the Matter of: Adjustment of Rates of the Goshen Utilities, Inc., Sewer Division* (Case No. 93-482) Order, June 17, 1994; *In the Matter of: Application of West Oldham Utilities, Inc. for a Rate Adjustment Pursuant to the Alternative Rate Filing Procedure for Small Utilities* (Case No. 89-136) Order, February 16, 1990; *In the Matter of: Application of Kenergy Corporation for Review and Approval of Existing Rates* (Case No. 2003-00165) Order, April 22, 2004.

[150] Smith Direct at 59-61.

[151] *Id.*

[152] *Id.* at 61-62.

prohibited from recovering the amount of its prior rate case expenses that have yet to be amortized because such amortization was not expressly authorized in the settlements in those proceedings.[153] At the same time, however, Mr. Smith implies that prior rate case expenses were comprised *in total* in the agreed-to settlements in those cases, even though the provision is not contained in the settlements. The direct contradiction in Mr. Smith's position is astounding: he argues that Kentucky American Water should not recover its prior expenses because the settlements do not mention the expenses, while arguing that the revenue requirements agreed to in those settlements contained the full measure of those costs. Kentucky American Water urges the Commission to ignore Mr. Smith's obfuscating arguments. Quite simply, Kentucky American Water is merely seeking to recover its expenses from its prior rate cases in accordance with the aforementioned Commission precedent.

D. Consolidated Tax Adjustment

In calculating its tax expense for the forecasted test year, Kentucky American Water calculated its tax liability on the "stand-alone" method, consistent with not only the Company's internal practice, but equally in accordance with the Commission's long-standing precedent for all utilities subject to its jurisdiction. The AG, through its witness, Mr. Smith, has again attempted to impose a consolidated tax adjustment on Kentucky American Water, in keeping with its prior efforts to force the Company and other utilities to adopt its minority position. Specifically, Mr. Smith wishes to confiscate $1.362 million from Kentucky American Water because the Company is a part of a consolidated filing group.[154]

[153] M. Miller Rebuttal at 40-41.
[154] Smith Direct at 29.

As a subsidiary of AWW, Kentucky American Water participates in a consolidated tax filing group with AWW and its other subsidiaries.[155] Although Kentucky American Water files as part of a group for tax purposes, for regulatory purposes, Kentucky American Water, along with other utilities subject to the Commission's jurisdiction, calculates its tax liability for regulatory purposes on the stand-alone method. Under the stand-alone method, Kentucky American Water calculates its tax liability based upon its own taxable income, as opposed to considering the tax liability of AWW and its affiliates. Mr. Smith has proposed to divide up the tax losses of non-regulated affiliates among all the affiliates having positive taxable income.[156] Mr. Smith examines AWW's returns for 2006, 2007 and 2008, and then averages the annual amount allocated to Kentucky American Water over the three year period.[157]

In support of his adjustment, Mr. Smith provides two bases: (1) a brief mention of an actual income taxes paid standard;[158] and (2) reliance on the Commission's decision in Case No. 2004-00103.[159] As to the first justification, this Commission has never relied on this standard to justify imposition of a consolidated adjustment.

Mr. Smith's second justification for a consolidated tax adjustment is the Commission's order in a prior Kentucky American Water proceeding, Case No. 2004-0013. In that proceeding, the AG proposed a consolidated tax adjustment based upon the Company's consolidated filing with Thames Water Aqua U.S. Holdings, Inc.[160] The AG argued that the tax loss benefits generated by other subsidiaries should be shared among other members of the consolidated group, serving to reduce the effective federal tax rate.[161] The Commission did accept the AG's

[155] Warren Rebuttal at 4.
[156] Smith Direct at 30-31.
[157] *Id.*
[158] *Id.* at 30.
[159] *Id.* at 32.
[160] Order, February 28, 2005 (Case No. 2004-00103) at 63.
[161] *Id.*

adjustment, but, notably, not on the basis the AG had put forth. While the AG's position was that a consolidated tax adjustment was appropriate for *all* utilities that filed as part of a consolidated group, the Commission imposed a consolidated tax adjustment based upon alleged statements by Kentucky American Water in the change of control proceeding involving Thames Water Aqua U.S. Holdings, Inc. and its ultimate parent, RWE.

In Case No. 2002-00317, which was the proceeding in which the Commission permitted an intermediate holding company, Thames Water Aqua U.S. Holdings, Inc. to hold the stock of Kentucky American Water and other affiliates,[162] Kentucky American Water explained it would file its income taxes as part of the Thames Water Aqua U.S. Holdings, Inc. group.[163] The Commission's interpretation of the Company's position in that proceeding was that the consolidated tax filing "benefited the public because it would reduce administrative expenses by eliminating the need to file multiple tax returns and permit some tax savings by allowing payment of taxes calculated on the net profits of all entities within the consolidated group."[164] The Commission then accepted the consolidated tax adjustment, finding that "Kentucky-American and its corporate parents having previously touted TWUS's filing of consolidated tax returns as a benefit to obtain approval of the merger transaction, have no cause to object if we now act upon their representation."[165]

In Case No. 2002-00317, Kentucky American Water consistently maintained that the Company would not realize tax savings due to a consolidated filing and would continue to utilize the stand-alone method—even though the parent company may realize tax savings.

[162] *Id.* at 64-65.
[163] *Id.*
[164] *Id.* at 65.
[165] *Id.* at 65-66.

The distinction regarding the tax savings the Company referred to in that proceeding is demonstrated by Kentucky American Water's Joint Motion and Petition to Modify Order, which was filed on August 28, 2002.[166] In the Motion and Petition, Kentucky American Water explained that a German foreign transaction law had changed, rendering it financially advantageous for Thames Water Aqua US Holdings, Inc., an intermediate holding company, to be created.[167] The beneficial change in the law allowed Thames Water Aqua US Holdings, Inc. to file a consolidated tax return which would include all of its United States holdings, principally the AWW businesses.[168] The Motion and Petition explained that the consolidated filing may "result in potential future benefits in that it may be possible to recognize for tax purposes losses that otherwise might not have been recognized. It is this future opportunity for tax savings together with the current administrative cost savings that led to the financial desirability of this action."[169] Importantly, Kentucky American Water made clear that any tax savings resulting from the consolidated tax filing would inure to Thames Water Aqua US Holdings, Inc. and not Kentucky American Water, as the Motion and Petition then states, "There will be no effect on Kentucky-American either in the form of additional costs or tax savings. Because Kentucky-American generates taxable income, and its tax expense is calculated on a stand alone basis for ratemaking purposes, the filing of a consolidated return at the parent level will have no effect on Kentucky American's rates." [170] This section clarifies that while the consolidated filing may result in tax savings to Thames Water Aqua US Holdings, Inc., Kentucky American Water never promised that it would receive tax savings due to its participation.

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[166] Motion and Petition to Modify Order (Case No. 2002-00317), August 28, 2002.
[167] *Id.* at 4-5.
[168] *Id.* at 5.
[169] *Id.* at 5.
[170] *Id.* at 6.

Kentucky American Water has reviewed the entire record in Case No. 2002-00317 to ensure that its statements in that proceeding were consistent with the Motion and Petition that initiated the case. The Company's position throughout the case emphasized potential administrative savings, but assiduously maintained that Kentucky American Water would not receive tax benefits from the transaction, as the tax method for the Company would not be impacted. For example, in the AG's initial requests for information, the AG inquired as to the "impact on Kentucky-American Water Company from expanding the group with which it will be consolidated for tax purposes."[171] The Company explained in its response that for tax purposes "Kentucky-American will not be impacted, since its rates are set on a stand-alone tax basis."[172]

Another intervenor to the proceeding, LFUCG, also inquired as to the impact of the transaction on the Company's taxes, as it asked the Company to "provide all analyses performed by any of the Applicants that describes or quantifies the benefits to be achieved by any of the Applicants through the formation of TWUS."[173] Kentucky American Water responded by explaining that "[o]ther than the benefit of filing a consolidated tax return discussed in Mr. Smith's testimony, no such analyses have been performed."[174]

The Mr. Smith to whom the response refers is Stephen Smith, the Director of Tax and Accounting for Thames Water, Plc, who filed testimony in the proceeding.[175] Mr. Smith's testimony explained that "from an overall management perspective, there would be no change at all from the present situation. This is because American has historically filed a consolidated tax return, as TWUS proposes to do, while Kentucky-American's income tax calculation for

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[171] Attorney General's Initial Request for Information Dated September 23, 2002 (Case No. 2002-00317), Item No. 15.
[172] Response to Attorney General's Initial Request for Information Dated October 1, 2002 (Case No. 2002-00317), Item No. 15.
[173] LFUCG's Initial Request for Information Dated September 23, 2002 (Case No. 2002-00317), Item No. 5.
[174] Response to LFUCG's Initial Request for Information Dated October 1, 2002 (Case No. 2002-00317), Item No. 15.
[175] Direct Testimony of Stephen Smith of September 18, 2002 (Case No. 2002-00317).

ratemaking purposes has historically been computed on a 'stand-alone' basis."[176] The testimony later stated that "Kentucky-American will continue to make its stand-alone tax payments to American, as it has done for many years."[177]

Both the AG and LFUCG inquired further as to transaction's effect on Kentucky American Water's taxes in supplemental data requests. The AG inquired as to whether "Kentucky-American's tax liabilities [would] be impacted by liabilities of unregulated companies?"[178] The Company reaffirmed in its response that "Kentucky-American's tax liability will continue to be calculated on a stand-alone basis. Therefore results from unregulated operations will have no impact on Kentucky-American's tax liability."[179] Perhaps most directly on point was a supplemental data request issued by LFUCG asking the Company to "state whether tax savings realized as a result of the filing of a consolidated tax return will be included in merger savings to be reported to the Commission in Case No. 2002-00277."[180] Kentucky American Water, in its response, explained that "Kentucky-American will continue to be treated on a stand alone basis for taxes. Accordingly, any theoretical tax savings (e.g. growing out of losses experienced by another of TWUS' subsidiary's having losses) would not impact Kentucky-American."[181]

At the hearing conducted in that matter on November 21, 2002, Stephen Smith again made clear there was no expectation of tax benefits for Kentucky American Water. When asked whether the Company and other joint petitioners would "be willing to share the advantage or

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[176] *Id.* at Q9.
[177] *Id.* at Q10.
[178] Attorney General's Supplemental Requests for Information Dated October 7, 2002 (Case No. 2002-00317), Item No. 9.
[179] Response to Attorney General's Supplemental Requests for Information Dated October 14, 2002 (Case No. 2002-00317), Item No. 9.
[180] LFUCG's Supplemental Requests for Information Dated October 7, 2002 (Case No. 2002-00317), Item No. 5.
[181] Response to LFUCG's Supplemental Requests for Information Dated October 14, 2002 (Case No. 2002-00317), Item No. 5.

benefit [of the consolidated tax adjustment] with Kentucky-American Water Company and its customers," Mr. Smith replied that the "advantages that will come from the filing of a tax return in the short term are very much administrative and relatively small."[182] When pressed further on whether any future tax benefit arising from the consolidated filing would be passed on to Kentucky American Water's customers, Stephen Smith explained that "[w]e're not willing to commit that we move away from the current position, which is that Kentucky-American files its tax return for ratemaking purposes on a stand-alone basis."[183]

Thus, at hearing, the Company made clear that while small administrative benefits may inure to Kentucky American Water, there would be no tax savings for the Company because of its continued adherence to the stand-alone method. In sum, in its Motion and Petition, responses to requests for information, and at hearing, Kentucky American Water maintained that no tax savings would be realized due to the proposed transaction.

Further, since the 2004 rate case proceeding in which the adjustment was granted, RWE has divested itself of AWW. Complete divestiture occurred in November 2009.[184] AWW is now a publicly traded, domestic corporation, of which Kentucky American Water and other affiliates are members. In the proceeding in which RWE divested itself of AWW and Kentucky American Water, no tax savings were promised. Even if the Commission still maintains that Kentucky American Water promised tax savings for Kentucky ratepayers in the 2002-00317 proceeding, which it did not, the corporate governance change that was the premise for that concept has again changed such that imposition of a consolidated tax adjustment is no longer warranted.

In addition to Kentucky American Water's changed corporate structure and parent company, since imposition of the consolidated tax adjustment in 2004 the Commission has

[182] Transcript of Evidence, Hearing of November 21, 2002 (Case No. 2002-00317) at page 50.
[183] *Id.* at page 51.
[184] VR: 8/10/10; 13:13:00-13:13:31.

affirmed its commitment to use of the stand-alone methodology for utilities subject to its jurisdiction. In the Commission's recent final orders in Case No. 2009-00548 and 2009-00549, which were rate cases involving Louisville Gas and Electric Company and Kentucky Utilities Company, the Commission rejected the AG's proposed consolidated tax adjustment.[185] The Commission stated,

> The Commission is not persuaded by the AG's arguments in this case on this issue any more than in Case No. 2003-00434. Acceptance of the adjustment would preclude KU from the opportunity to earn its authorized rate of return; would violate the "stand-alone" rate-making principle that the Commission has long employed; and would result in cross subsidization of KU and its ratepayers by its unregulated affiliates.[186]

Thus, this Commission recently articulated three reasons for denying consolidated tax adjustments. The first reason, which is that a utility cannot earn its authorized rate of return if a consolidated tax adjustment is imposed, is applicable to all utilities subject to this Commission's jurisdiction. The Commission was correct in noting that a utility's return will always be less than the amount to which it has been authorized due to the significant reduction in revenue that accompanies a consolidated tax adjustment. In the rebuttal testimony of Mr. James Warren in this proceeding, which was filed prior to the release of the orders in the Louisville Gas and Electric Company and Kentucky Utilities Company rate cases, Mr. Warren makes this very argument, entitling a section "CTAs Deny Shareholders the Opportunity to Earn Their Allowed Return."[187] Mr. Warren, in keeping with the Commission's orders, noted that the practical effect of a consolidated tax adjustment is a "discount applied to a utility's allowed rate of return."[188]

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[185] *In the Matter of: Application of Louisville Gas and Electric Company for an Adjustment of Electric and Gas Rates* (Case No. 2009-00549) Order, July 30, 2010 at 24-25; *In the Matter of: Application of Kentucky Utilities Company for an Adjustment of Electric Rates* (Case No. 2009-00548) Order, July 30, 2010 at 22-24.
[186] *In the Matter of: Application of Kentucky Utilities Company for an Adjustment of Electric Rates* (Case No. 2009-00548) Order, July 30, 2010 at 24.
[187] Rebuttal Testimony of James I. Warren of July 19, 2010 (Case No. 2010-00036) ("Warren Rebuttal") at 20.
[188] *Id.* at 22.

As the Commission has recently acknowledged that a consolidated tax adjustment irrevocably prohibits a utility from earning its authorized rate of return, Kentucky American Water submits that it, too, should not be subject to such a punitive measure, as there is no reason that Kentucky American Water should be barred from earning its Commission-approved rate of return.

The second basis for the Commission's recent denial of the AG's proposed consolidated tax adjustment was its continued adherence to the stand-alone method, which is the method Kentucky American Water is requesting be approved in this proceeding. Since imposing a consolidated tax adjustment on Kentucky American in Case No. 2004-00103, the Commission has denied all of the AG's subsequent attempts to impose this adjustment on other utilities. For example, the Commission has twice denied consolidated tax adjustments in cases involving Louisville Gas and Electric Company and Kentucky Utilities Company.[189] Also during this time, the Kentucky Court of Appeals has noted that the stand-alone method is the "Commission's methodology" for the computation of tax liability.[190] Given the Commission's stated adherence to the stand-alone method, there is no reasonable basis to treat Kentucky American Water differently than the other utilities in the Commonwealth.

The Commission's stated preference for the stand-alone methodology is well supported by the majority of public service commissions across the United States. As noted in Mr. Warren's testimony, only five jurisdictions systematically impose consolidated tax adjustments.[191] Mr. Smith's response to a Staff data request indicated that he was aware of seven

[189] *In the Matter of: Application of Louisville Gas and Electric Company for an Adjustment of Electric and Gas Rates* (Case No. 2009-00549) Order, July 30, 2010 at 24-25; *In the Matter of: Application of Kentucky Utilities Company for an Adjustment of Electric Rates* (Case No. 2009-00548) Order, July 30, 2010 at 22-24; *In the Matter of: An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company* (Case No. 2003-00434) Order, June 30, 2004 at 52-55; *In the Matter of: An Adjustment of the Electric Rates, Terms, and Conditions of the Kentucky Utilities Company* (Case No. 2003-00433) Order, June 30, 2004 at 45-47.
[190] *Com., ex rel. Stumbo v. Kentucky Public Service Comm'n,* 243 S.W.3d 374, 384 (Ky. Ct. App. 2007).
[191] Warren Rebuttal at 24.

states, Kentucky included, that had ever imposed a consolidated tax adjustment.[192] At hearing, the AG implied that because AWW operates in New Jersey, West Virginia and Pennsylvania, each of which has imposed a consolidated tax adjustment, it is proper for a consolidated tax adjustment to be imposed on Kentucky American Water.[193] Currently, AWW operates in thirty-five states across the country; the significant majority of those states do not impose consolidated tax adjustments. Further, in none of the states in which AWW operates and consolidated tax adjustments have been approved was an AWW subsidiary involved in the state's initial approval of the adjustment.

The small minority of states recognizing consolidated tax adjustments is in stark contrast to the overwhelming majority of state commissions do not impose consolidated tax adjustments. For example, the Public Service Commission of Maryland recently rejected a consolidated tax adjustment, stating that "[i]n order to adopt the Staff's recommended CTA, we would have to depart substantially from prior Commission decisions on this issue and join a very small minority of commissions."[194] Further, the Public Service Commission of the District of Columbia also recently held that "the Commission has decided to adhere to our traditional stand-alone approach regarding federal and district tax expense, which is widely followed by the majority of Commissions throughout the country."[195] These cases, decided within the last year, demonstrate that the stand-alone approach, consistent with this Commission's precedent, is greatly favored by a substantial majority of jurisdictions.

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[192] AG's Response to Staff 1-10(a).

[193] VR: 8/10/10; 10:21:51-10:23:55.

[194] *In the Matter of the Application of Delmarva Power and Light Company for an Increase in Its Retail Rates for the Distribution of Electric Energy*, Public Service Commission of Maryland (Case No. 9192) Order No. 83085 at 22 (Dec. 30. 2009).

[195] *In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service* (Case No. 1076) Order No. 15710 at 92 (March 2, 2010)

In addition to this Commission's adherence to the stand-alone method and the continued national trend of rejecting similar adjustments, authoritative treatises also support rejecting consolidated tax adjustments. The text Accounting for Public Utilities by Robert L. Hahne and Gregory E. Aliff, which is widely accepted as an authoritative source in public utility accounting matters, states that the "only approach that is consistent with standard ratemaking principles that prohibit cross-subsidization between utility and non-utility activities is to put the regulated operation on a 'stand-alone' basis and to assign the full tax burden to the taxable gain source and a tax benefit to the loss source."[196] At hearing, Mr. Smith attempted to refute Hahne and Aliff's standing as an authoritative source. A review of filings and orders from this Commission demonstrates that in prior proceedings both the Commission and the AG have relied upon the treatise as an authoritative text, including prior proceedings involving Kentucky American Water.[197] More specifically, the AG has recently referred to the publication as an "authoritative source."[198] As the Commission and the AG have relied upon the text for support in prior proceedings, the Company submits that the authors' discussion of the consolidated tax adjustment is further credible evidence demonstrating the appropriateness of the stand-alone method.

The third basis for the Commission's rejection of consolidated tax adjustments is the concern for cross-subsidization between Kentucky ratepayers and nonregulated affiliates. Cross-

[196] Hahne and Aliff, *Accounting for Public Utilities* § 7.08[3].

[197] For example, in *In the Matter Of: Adjustment of the Rates of Kentucky American Water Company* (Case No. 2004-00103), in the Commission's First Set of Information Requests to the Attorney General, the Staff quoted from Hahne and Aliff, asking an AG's witness whether she agreed with the principle contained therein. Later, in the Commission's final order in Kentucky American Water's rate case, the Commission again cited to the text approvingly as the basis for its decision on a specific matter. Similarly, in *In the Matter of: The Proposed Adjustment of the Shelbyville Water and Sewer Commission's Wholesale Water Service Rate to West Shelby Water District* (Case No. 99-265) the Commission Staff cited to Hahne and Aliff as the "general rule" for a particular issue.

[198] In responding to data requests in *In the Matter of: Application of Atmos Energy Corporation for an Adjustment of Gas Rates* (Case No. 2006-00464), the AG stated "[a]nother authoritative source is the well-known publication 'Accounting for Public Utilities' by Robert L. Hahne and Gregory E. Aliff…"

subsidization is prohibited pursuant to KRS 278.2201, which states that a "utility shall not subsidize a nonregulated activity provided by an affiliate or by the utility itself." The statute further requires utilities to maintain records demonstrating the separateness of accounts and cost allocations.[199] The purpose of this statute is to protect Kentucky ratepayers from the business and financial risks of nonregulated activities. Statutory prohibitions on cross-subsidization insulate ratepayers from the effects of the utility's affiliates and subsidiaries and provide assurance that ratepayers' rates will not be affected—either positively or negatively—from nonregulated business operations. Imposition of a consolidated tax adjustment inevitably eliminates the protection ratepayers currently enjoy from the business outcomes of non-jurisdictional operations. The adjustment creates a mathematical certainty that the financial performance of nonregulated businesses will impact the rates of Kentucky ratepayers.

Mr. Smith's proposal would have Kentucky American Water's ratepayers share in the tax losses of unregulated affiliates, even though the Company's customers have not borne the financial risks associated with those investments. Notably, Mr. Smith would never agree that Kentucky American's ratepayers should help pay a tax liability incurred by a nonregulated affiliates. Despite the conspicuous contradiction, Mr. Smith steadfastly asserts it is proper for Kentucky ratepayers to enjoy the benefits at the expense of the same nonregulated affiliates.

Kentucky American Water is mindful of the Commission's decision in Case No. 2004-00103, in which a consolidated tax adjustment was imposed. The Company has reviewed the basis for that decision and has sought to demonstrate that Kentucky American Water did not anticipate any tax savings from the use of an expanded consolidated filing group. The Company has provided the relevant portions of the record from that proceeding so that the Commission can review Kentucky American Water's pleadings and testimony to better understand the Company's

[199] KRS 278.2201.

position. Further, RWE has since divested itself of AWW and its subsidiaries, including Kentucky American Water.

In addition to the changes in Kentucky American Water's corporate governance since imposition of the consolidated tax adjustment in Case No. 2004-00103, the Commission has issued four decisions rejecting consolidated tax adjustments proposed by the AG. The most recent decisions were issued in July 2010, with the Commission providing three reasons for its rejection of consolidated tax adjustments. The three bases on which the Commission relied: inability of the utility to earn its authorized rate of return, the Commission's adherence to the stand-alone method, and the prohibition of cross-subsidization of unregulated affiliates, are universally applicable to all utilities subject to Commission jurisdiction. For these reasons, Kentucky American Water respectfully requests that the Commission deny the AG's proposed consolidated tax adjustment.

E. Incentive Compensation and Stock-Based Compensation

Included in Kentucky American Water's forecasted labor expense for the test period was incentive compensation expense for the Company's employees, as well as incentive compensation expense for certain Service Company employees, allocated pro rata among the states those employees serve. Mr. Smith seeks to disallow *all* incentive compensation expense for both Kentucky American Water and Service Company employees.[200] Additionally, Mr. Smith also seeks to disallow all of Kentucky American Water's stock-based compensation expense, as well as stock-based compensation charged to the Company in affiliate management fees in its future test year expenses.[201] The financial impact of this adjustment is significant; these adjustments constitute 9.5 percent of the total labor cost the Company has requested.[202]

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[200] Smith Direct at 33.

[201] *Id.* at 47-48. Mr. Smith has proposed a variety of adjustments to Kentucky American Water's affiliate

Before addressing Mr. Smith's contentions, a brief summary of the role of incentive compensation[203] in the Company's compensation structure may be beneficial for a better understanding of Kentucky American Water's position. In designing the Company's compensation, Kentucky American Water conducted a study of salary wage bands to determine the market-based salary range for all of its non-hourly positions.[204] The purpose of the study was to ascertain the mid-point salary range for each position, such that the Company could effectively target its base compensation at the fiftieth percentile of the wage band.[205]

Base compensation at the fiftieth percentile is vitally augmented by the incentive compensation plan, which permits high-performing individuals to receive compensation beyond the fiftieth percentile.[206] Incentive compensation is currently governed by the 2010 Annual Incentive Plan ("AIP") Brochure, which defines the parameters of the plan, as well as identifies the various components that determine an employee's eligibility for an award and the amount thereof. The award criteria have changed since the Company's last rate case; most notably, neither AWW's, nor the Eastern Division's financial results, determine any portion of each employee's incentive compensation award.[207] The performance of AWW is only relevant to the determination of the overall amount of AIP compensation available each year.[208]

Beginning with incentive compensation, Mr. Smith's primary objection to the expense is the presence of a so-called "shareholder-related financial target."[209] Various components of AWW's performance, including financial and non-financial metrics, determine the pool of

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management fees. The remaining adjustments will be discussed at length in a later section.

[202] M. Miller Rebuttal at 26.

[203] Note that the Tennessee Valley Authority ("TVA"), a high performing federal utility, also uses incentive compensation to further align its employees' interests with TVA's goals.

[204] Response to Staff 2-4, page 2 of 7.

[205] *Id.*

[206] *Id.*

[207] M. Miller Rebuttal at 29.

[208] *Id.* at 29-30.

[209] Smith Direct at 35.

available incentive compensation each year.[210] Mr. Smith attempts to equate the presence of a financial target with an incentive plan that is purely purposed on increasing shareholder value. Quite simply, it would be fiscally irresponsible to award incentive compensation if a company was underperforming financially. In adhering to this fundamental principle, the overall financial performance of AWW does determine, in part, the available pool of incentive compensation. Non-financial metrics also play a critical role in determining the overall pool of available AIP funds. Safety, environmental goals, customer satisfaction, business transformation, and diversity are all included in the calculation.[211] Although Mr. Smith acknowledges that non-financial metrics comprise thirty percent of the calculation, he refers to this initial determination as the "AWWC financial EPS trigger."[212] Mr. Smith's characterization is misleading in that there are five non-financial metrics involved in determining the overall pool of available incentive compensation.

Once the overall pool of incentive compensation is determined, the financial and non-financial metrics of AWW, the Eastern Division or other regulated subsidiaries have no effect upon each employee's individual award.[213] Each employee's award is solely based on the employee satisfying or exceeding individual performance goals pertaining to specific areas of responsibility for the employee.[214] Mr. Smith does not address this component of the plan, despite the fact that an individual employee's performance determines if that employee receives *any* incentive compensation. Mr. Smith's continued assertion that the current AIP centers around a financial trigger designed to promote shareholder value misstates the purpose and effect of the program. For Kentucky American Water's employees who strive daily to conduct their

[210] M. Miller Rebuttal at 29-30.
[211] Smith Direct at 36.
[212] *Id.*
[213] M. Miller Rebuttal at 27.
[214] *Id.*

job performance efficiently and productively, the financial and non-financial metrics that determine the available pool of compensation merely provides the opportunity to receive an at-risk portion of their overall compensation. The consequent award, if any, is solely attributable to job performance, irrespective of any other consideration.

Mr. Smith's second objection to inclusion of incentive compensation expense in the Company's labor costs is that the expense does not benefit customers.[215] Specifically, Mr. Smith asserts that the "Company has not been able to perform a study that attempts to quantify the benefits to customers of its incentive plans."[216] Mr. Miller's testimony on this issue at the hearing demonstrates the inaccuracy of Mr. Smith's contention. Since the Commission issued its decision in Case No. 2004-00103, the Company has endeavored to find the most accurate means by which to quantify the host of benefits customers receive due to the AIP. As explained by Mr. Miller in his testimony at hearing, Kentucky American Water initially planned to employ a third-party vendor to conduct a study quantifying the benefits of the AIP, but the Company has been unable to locate a provider that has performed a comparable study.[217]

Once this was determined, the Company assessed its internal capabilities and decided that it could produce a study that identified and quantified the benefits that inure to ratepayers pursuant to the incentive compensation plan. The study, attached as an exhibit to Mr. Miller's rebuttal testimony,[218] demonstrates that since 2005, Kentucky American Water's increases in operation and maintenance costs per customer have consistently been below those of the consumer price index.[219] This demonstrates that the Company has successfully been able to resist cost increases more successfully than others. Kentucky American Water's ability to

[215] Smith Direct at 43.
[216] *Id.*
[217] VR: 8/10/10; 10:56:10-56:20.
[218] M. Miller Rebuttal at Exhibit MAM-6.
[219] *Id.* at page 1 of 3.

contain costs is not accidental; efficiency and productivity are central components of many employees' performance goals under the AIP.

The study further demonstrates that substantially all of Kentucky American Water's key performance indicators have demonstrated significant improvement from 2007 to 2009.[220] For example, overall customer satisfaction has increased from 86 percent to 89 percent during this period, and service quality satisfaction has rise from 83 percent to 89 percent. For several employees, customer satisfaction and service quality satisfaction are critical components of the employee's review, which determines both whether the employee will receive incentive compensation and the amount of any resulting award. Allowing those employees to receive additional compensation for exemplary performance in these areas is beneficial to customers, and the increase in customer satisfaction demonstrates that customers are directly benefiting from incentive compensation and are cognizant of the improved service. For other key performance indicators, the benefit to customers is apparent: Kentucky American Water's ratepayers benefit when 99.60 percent of customer appointments are timely met and 99.30 percent of service orders are completed as scheduled.[221] When employees are financially motivated to excel in these areas, customers indeed benefit.

Finally, Mr. Smith's overriding characterization of the incentive compensation plan must be addressed. Simply put, incentive compensation is not a "bonus," but instead is the at-risk portion of eligible employees' overall compensation. The distinction between these two viewpoints is significant. While Mr. Smith's deems incentive compensation a bonus—thus rendering it discretionary—the Company, and its employees, consider incentive compensation non-discretionary, but simply not guaranteed. The critical impact of this distinction is that if

[220] *Id.* at page 3 of 3.
[221] *Id.*

incentive compensation is disallowed, the Company will then have to increase the salaries of its employees, as Kentucky American Water will not be able to retain the highly skilled employees if it is unable to pay compensation beyond the fiftieth percentile. Many of those employees possess incomparable institutional knowledge and experience. The Company has made the decision to make a portion of employees' compensation at-risk in order to foster enhanced performance, which ensures that customers are not funding salaries that are not commensurate with the services received. The Company's current performance-driven compensation structure ensures ratepayers receive superior service from Kentucky American Water's employees at the lowest cost to the customer.

In addition to proposing to remove all incentive compensation from the test year, Mr. Smith has also sought disallowance of stock-based compensation for Kentucky American Water employees, as well as stock-based compensation charged to Kentucky American Water in management fees for the future test year.[222] Stock-based based compensation permits high-performing Kentucky American Water employees to receive grants of stock options, stock awards and other stock-based awards.[223] Mr. Smith has vehemently objected to the purpose of the stock-based compensation, which he construes to benefit the parent company's stockholders.[224] To reach this conclusion, Mr. Smith must ignore the portion of the "Purpose" of the "American Water Works Company, Inc., 2007 Omnibus Equity Compensation Plan" that explains the "Plan will encourage the participants to contribute materially to the growth of the Company…"[225] Contrary to Mr. Smith's assertion, the purpose of the program is to incentivize enhanced performance by permitting employees to increase their personal investment in the

[222] Smith Direct at 44.
[223] *See* Kentucky American Water's Response to AG 1-15.
[224] Smith Direct at 47.
[225] *See* Kentucky American Water's Response to AG 1-15, page 25 of 39.

Company. Reasonably, individuals considering themselves stakeholders in the Company will strive to perform in such a way as to maximize the success of the Company through efficiency, productivity, and cost containment. Kentucky American Water's customers benefit when these values are exhibited.

For these reasons, Kentucky American Water respectfully requests that the Commission deny Mr. Smith's adjustments to incentive compensation and stock-based compensation.

F. Affiliate Management Fees

As a member of AWW, Kentucky American Water is able to receive services provided by Service Company. The purpose of the Service Company is to provide shared services to AWW's subsidiaries, including Kentucky American Water.[226] In keeping with the model utilized by most utility holding companies, consolidating executive and professional services into a single service company results in purchasing economies, operating economies of scale, continuity of service, maintenance of corporate-wide standards, improved governance and retention of personnel.[227] The Service Company performs its functions from several locations, such as the corporate office, national call centers, and various regional offices.[228] When services are performed for Kentucky American Water, the consequent charges are billed to the Company through either direct charges or allocated charges.[229] A direct charge occurs when a Service Company task or expense is incurred in support of only one operating subsidiary.[230] An allocated charge occurs when the work performed by the Service Company benefits more than one operating subsidiary.[231]

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[226] Direct Testimony of Patrick Baryenbruch of February 26, 2010 (Case No. 2010-00036) ("Baryenbruch Direct") at Report, page 3.
[227] *Id.* at Report, page 3.
[228] *Id.* at page 4.
[229] *Id.* at Report, page 5.
[230] *Id.*
[231] *Id.*

Mr. Smith, a witness for the AG, objected to various components of the Service Company charges for which Kentucky American Water is seeking recovery in this proceeding. Specifically, Mr. Smith has proposed five adjustments that would eliminate several components of the Service Company expense. First, Mr. Smith eliminated the entire amount of incentive compensation for Service Company employees allocated to Kentucky American Water.[232] Kentucky American Water objects to this adjustment for the reasons discussed earlier in this brief. The second adjustment Mr. Smith proposed was to accept Kentucky American Water's revised affiliate management fee for the forecast test year.[233] As this adjustment reflects the information contained in its base period update, the Company does not object to this adjustment.[234]

The third adjustment Mr. Smith proposed is to remove affiliate business development costs charged to Kentucky American Water.[235] Mr. Smith provides scarce support for his adjustment, merely asserting that business development costs are "unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Kentucky" and that [s]imilar costs were removed by the CPUC in the most recent California American Water rate case."[236] In addition to failing to provide a sound justification for his proposed adjustment, Mr. Smith provides no quantification for his significant adjustment that would disallow almost $200,000 from the Company's allocated portion of Service Company expense.[237] Mr. Smith appears to have made no effort to determine what comprises business development costs and has

[232] Smith Direct at 53.
[233] *Id.*
[234] *Id.*
[235] *Id.*
[236] *Id.* at 56.
[237] *Id.* at 55. Mr. Smith removed $199,546 from Kentucky American Water's revenue requirement, which represents the $223,380 of business development charges, less the $23,834 already removed in other adjustments.

thus performed no independent analysis to determine if the business development activities benefited Kentucky American Water's customers.

Had Mr. Smith inquired as to the nature of the business developments costs, he would have quickly learned that business development costs have directly benefited all of Kentucky American Water's customers. Some of the business development expenses include a portion of a Lexington, Kentucky based Service Company employee's salary, whose job responsibility is to develop customer and business growth for Kentucky American Water and Tennessee American Water.[238] This employee's time and expense constitute a significant portion of the business development costs Mr. Smith has attempted to eliminate.[239] The efforts of this employee, along with the administrative support received from other Service Company employees, has provided invaluable research and financial modeling that has led to successful business proposals.[240]

The direct results of these efforts have been both immediate and substantial. These include an increase in revenue from a new LFUCG billing contract, along with the addition of new customers as a result of acquisitions in Boonesboro, Tri-Village, Elk Lake and Owenton.[241] The billing contract will provide $364,000 in annual revenues, which results in a dollar-for-dollar reduction in the Company's revenue requirement.[242] Expansion of the customer base benefited existing Kentucky American Water customers because fixed costs are now spread among a greater number of customers.[243] These acquisitions were significantly beneficial to the acquired customers who received significant improvements in the quality of their water service, as a myriad of prior service issues were remedied by the Company.[244]

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[238] M. Miller Rebuttal at 51.
[239] *Id.*
[240] *Id.*
[241] *Id.* at 50.
[242] *Id.* at 51.
[243] *Id.*
[244] *Id.*

At the hearing, when asked whether he was familiar with these significant advantages that were the direct result of the business development expense he seeks to disallow, Mr. Smith was admittedly unaware of these beneficial outcomes.[245] While not inquiring into the activities comprising the business development expense, Mr. Smith attempted to assert that business development was primarily focused upon efforts for nonregulated entities;[246] this is entirely inaccurate. Mr. Smith has provided no reasoned basis for disallowing the business development expense in this proceeding. In attempting to refute the Company's thorough accounting of the benefits associated with this expense, he offers only a vague reference to a decision in another jurisdiction. As Kentucky American Water has clearly demonstrated the significant benefits associated with its business development expense, and Mr. Smith has provided no credible evidence or reasoned basis for his adjustment, the Company respectfully requests the Commission deny the proposed adjustment.

The fourth adjustment Mr. Smith proposed was to remove several miscellaneous expenses from the Service Company fee.[247] Of the various expenses Mr. Smith removed, the Company has chosen not to rebut the removal of charitable contributions, community relations expense, company dues, membership deductible and non-deductible, and penalties non-deductible.[248]

One of the expenses Mr. Smith has attempted to remove is the advertising expense.[249] Mr. Smith provides no independent justification for elimination of this expense, instead attempting to demonstrate why several expenses should be removed through the use of one nonspecific objection, which is that "these expenses do not benefit KAWC ratepayers and should

[245] VR: 8/11/10; 14:22:53-14:25:38.
[246] VR: 8/10/10; 14:22:00-14:22:37.
[247] Smith Direct at 56.
[248] M. Miller Rebuttal at 52.
[249] Smith Direct at 57.

not be recovered from them" and the "charges are not necessary for the provision of safe, reliable water service."[250] Had Mr. Smith examined the uses of the advertising expense, he would have learned that the expense predominantly consisted of job placement advertisements for available positions.[251] Mr. Smith's contention that advertising expense is not necessary for the provision of reliable water service is inaccurate, as the maintenance of proper staffing levels is certainly imperative in ensuring the uninterrupted delivery of water service.[252] Further, Mr. Smith has not challenged the appropriateness of rate recovery for expenses Kentucky American Water has incurred in advertising, thus demonstrating the selective nature of this adjustment.

Mr. Smith has also attempted to eliminate the portion of Service Company membership dues allocated to Kentucky American Water.[253] In proposing this adjustment, Mr. Smith has contended that Service Company employees' memberships in organizations such as the Kentucky Bar Association and the American Institute of CPAs do not benefit ratepayers and are unnecessary to the delivery of water service.[254] Both of these contentions are wholly inaccurate.

To illustrate the error in Mr. Smith's argument, consider the position of in-house counsel at Kentucky American Water, whose job responsibilities include filing and litigating rate cases, responding to formal service complaints brought to the Commission, managing litigation in which the Company is involved, and a host of other regulatory issues. Although performing these tasks for Kentucky American Water, in-house counsel is classified as a Service Company employee. Pursuant to the rules of the Kentucky Supreme Court,[255] an attorney practicing law in the Commonwealth of Kentucky must be a member of the Kentucky Bar Association. Thus, the

[250] *Id.* at 58.
[251] M. Miller Rebuttal at 53.
[252] *Id.*
[253] *Id.* at 57.
[254] *Id.* at 53.
[255] SCR 3.030(1) states that "All persons admitted to the practice of law in this state shall be, and they are, members of the association upon completion of the prerequisites under Rule 2.100."

in-house counsel at Kentucky American Water—whose everyday job performance benefits ratepayers and is necessary to providing water service in accordance with administrative requirements—*must* be a member of the Kentucky Bar Association. This position is only one illustrative example of the compulsory membership dues Mr. Smith seeks to eliminate from rate recovery. Notably, as with advertising expense, Mr. Smith does not seek to disallow membership dues for Kentucky American Water employees, while seeking to eliminate parallel expenses for Service Company employees. Mr. Smith's adjustment lacks a reasonable basis, as it is imperative that Service Company employees working on behalf of Kentucky American Water be permitted recovery for continuation of their professional licenses.

The final miscellaneous Service Company expense Mr. Smith seeks to disallow is non-deductible meals.[256] To justify removal of this expense, Mr. Smith has proposed that the Commission adopt the IRS guidelines, thus rendering all non-deductible meals inappropriate for rate recovery.[257] This Commission has never employed IRS guidelines in determining whether an expense is appropriate for ratemaking. As explained more fully in Mr. Miller's rebuttal testimony, Mr. Smith's interpretation of the IRS rules regarding whether employee meals are deductible is inaccurate.[258] Mr. Smith has misconstrued a tax option the Company has elected to pursue with a claim that the meals were not for legitimate business purposes. Neither Kentucky American Water nor the Service Company internally permits reimbursements for meals lacking a legitimate business purpose and thus would not seek recovery for those expenses in a rate case proceeding. For these reasons, Kentucky American Water asks this Commission deny Mr. Smith's proposed adjustment.

[256] Smith Direct at 57.
[257] *Id.*
[258] M. Miller Rebuttal at 54.

In addition to Mr. Smith's proposed adjustments to the Service Company expense, a witness for LFUCG, Mr. Richard Baudino, also proposed to eliminate a portion of the Service Company expense, albeit on a different basis.[259] Mr. Baudino has proposed an adjustment that would remove $2.145 million from the requested Service Company expense because "KAWC has not shown that the labor costs charges from AWWSC have been prudently incurred."[260]

Mr. Baudino's testimony fails to mention either Mr. Baryenbruch's direct testimony or the extensive report attached to Mr. Baryenbruch's testimony, focused solely upon the reasonableness of the Service Company expenses. Further, the Company has provided highly detailed analyses and information regarding Service Company expenses pursuant to data requests issued by the Commission Staff and other intervenors. The LFUCG and Mr. Baudino had access to this ample information, yet still made the unsubstantiated claim that the Company did not demonstrate the reasonableness of the Service Company expense. Instead of responding to Mr. Baryenbruch's testimony and report, Mr. Baudino has simply ignored this information. Due to the vague and indefinite nature of Mr. Baudino's objection to the prudency of the Service Company expense, Kentucky American Water finds it challenging to respond more definitively to this objection other than by referring the Commission to the plethora of information the Company has provided through its testimony, responses to data requests and at hearing addressing the reasonableness of the Service Company expense.

The amount of Mr. Baudino's proposed reduction in Service Company expense is based upon the amount he contends would not have occurred but for reorganizations at the Service Company.[261] In order to make this assertion, Mr. Baudino again must ignore the quantification of benefits the Company provided in this proceeding which demonstrate that the

[259] Baudino Direct at 44.
[260] *Id.*
[261] *Id.* at 45.

"reorganization" to which Mr. Baudino refers, through which additional responsibilities were delegated to the Service Company, has resulted in lower costs to Kentucky American Water's customers. Mr. Baudino does not challenge the prudency of any specific task the Service Company performed, or any procurement the Service Company incurred, yet Mr. Baudino suggests that $2.145 million of the fee is unreasonable. The only means by which this could be accurate would be to assume that the additional tasks and expenses would not have occurred but for the shift in responsibilities; this is inaccurate.

Mr. Miller's rebuttal testimony provides a clear example of this situation. Included in the Company's forecast test year Service Company expense are fees associated with the purchase of necessary Information Technology Systems equipment and software.[262] No party to the proceeding has challenged the prudency of this expense. Had Kentucky American Water purchased these items on its own, the expense would have been included in rate base, which would have provided a return of and on those assets.[263] The entire cost of the expense would have been borne solely by Kentucky American Water customers. In contrast, when the software and equipment is purchased by the Service Company, the Service Company finances the debt associated with the expense and Kentucky American Water, and consequently its customers, is only billed for its proportionate share of the overall cost.[264] There are direct and immediately quantifiable financial benefits to Kentucky American Water customers through these purchasing and operating economies of scale. This is one of many examples refuting Mr. Baudino's unsubstantiated assertion that the shift in responsibilities to the Service Company resulted in an imprudent level of expenditures. For these reasons, the Company respectfully requests the Commission deny Mr. Baudino's adjustment.

[262] M. Miller Rebuttal at 58.
[263] *Id.*
[264] *Id.*

G. Employee Related Expenses

Mr. Smith has asked the Commission to eliminate several employee-related expenses, including costs incurred for employee recognition awards, a recognition banquet, and a United Way function.[265] The recognition banquet and corresponding awards are provided to employees achieving service milestones, as well as to employees that have performed extraordinarily, such as remedying a crisis or greatly helping a customer.[266] Kentucky American Water believes that recognition of employee achievements among peers enhances employee motivation.[267] The United Way function to which Mr. Smith has objected is a small event that marks the commencement of the annual United Way Fund Drive.[268] The event, designed to promote employee participation and contribution, is important to the communities Kentucky American Water serves, as many of the Company's customers receive direct benefits from this organization.[269]

H. Depreciation Expense

Accompanying Kentucky American Water's Application in this proceeding is a depreciation study performed by Mr. John Spanos that recommends new accrual rates for which the Company is seeking approval.[270] The depreciation study calculated accruals pertaining to utility plant as of November 30, 2009.[271] The Company calculated its depreciation expense through September 2010 based upon the currently-approved depreciation rates, while from

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[265] Smith Direct at 71.
[266] M. Miller Rebuttal at 72.
[267] *Id.*
[268] *Id.*
[269] *Id.*
[270] Direct Testimony of John J. Spanos of February 26, 2010 (Case No. 2010-00036) ("Spanos Direct") at 6.
[271] *Id.* at 7.

October 2010 through the end of the test period, the depreciation rates proposed by Mr. Spanos in this proceeding were employed.[272]

Mr. Smith, a witness for the AG, proposed two adjustments to the Company's calculation of depreciation expense. First, Mr. Smith seeks to adjust depreciation expense based upon the recalculation the Company performed at Staff's request for all plant in service as of December 31, 2010, using $163,891,660 as the cost of KRS II.[273] The Company does not object to this adjustment.

The second adjustment Mr. Smith proposed was to revise the negative net salvage percentage applied to Account 333, Services from the negative 100 percent Mr. Spanos proposed to negative 20 percent.[274] Despite the highly technical nature of depreciation rates, Mr. Smith provides no mathematical basis for this adjustment, instead relying on a statement by a witness for the AG in a prior proceeding that the negative 100 percent "sticks out like a sore thumb when compared to Mr. Spanos' more reasonable future net salvage ratios."[275] Mr. Smith then recommends using negative 20 percent for this account because that amount is "clearly more reasonable on its face."[276] Mr. Smith did not provide any analysis, calculation, or other supporting documentation which demonstrates either that Mr. Spanos' calculation is inaccurate or that his recommended rate is plausible. Kentucky American Water issued a data request to the AG asking for all workpapers and documents Mr. Smith relied upon in recommending the negative 20 percent.[277] Mr. Smith failed to attach a single page demonstrating how he arrived at his calculation, instead referring to the schedule attached to his direct testimony, which merely

[272] S. Miller Direct at 11.
[273] *See* Kentucky American Water's Response to Staff 2-43 and Staff 3-6.
[274] Smith Direct at 67.
[275] *Id.*
[276] *Id.*
[277] *See* Kentucky American Water's request 1-22 to AG.

denotes the change.[278] He also referred the Company to the testimony of Michael Majoros from Case No. 2007-00143 as justification for the adjustment, again quoting Mr. Majoros' "sore thumb statement."[279]

The Company respectfully asserts, as is best illustrated by the substantial data contained in Mr. Spanos' testimony and attached study, that depreciation rates cannot be determined by picking numbers that appear "reasonable." Instead, depreciation rates are calculated through completion of sophisticated modeling utilizing thousands of data entries. As noted by Mr. Spanos, simply comparing rates between other plant accounts with significantly varying life characteristics and retirement costs is a meaningless exercise.[280]

To address the reasonableness of Mr. Spanos' calculation of negative 100 percent, it is important to understand the current depreciation rate for this account, which is negative 120 percent.[281] Thus, Mr. Spanos' recommendation actually lowers the depreciation rate for this account. Further, Mr. Spanos analyzed data from 1980 through 2009 for this account and found that the net salvage amount over this period was negative 106 percent, further demonstrating this reasonableness of his recommended negative 100 percent. [282] Mr. Spanos has provided the Commission a clear and detailed accounting of the process and information involved in his recommended depreciation rates. In contrast is Mr. Smith's proposed adjustment, which primarily relies on an anecdotal statement by a prior AG witness in a prior rate case. Mr. Smith's adjustment is not purposed upon establishing accurate depreciation rates; it is designed to decrease the Company's depreciation expense. For these reasons, Kentucky American Water respectfully requests the Commission deny Mr. Smith's proposed adjustment.

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[278] AG's Response to Kentucky American Water 1-22.
[279] *Id.*
[280] Rebuttal Testimony of John J. Spanos of July 19, 2010 (Case No. 2010-00036) ("Spanos Rebuttal") at 2.
[281] *Id.* at 1.
[282] *Id.* at 3.

I. Lagoon Cleaning

Kentucky American Water routinely contracts with a third-party vendor to clean its KRS I sludge lagoon approximately once every three years. Kentucky American Water expects to have the lagoon cleaned in June 2011 and has thus sought recovery for the expected expense in this proceeding. In keeping with prior practice, the Company estimated the expected expense associated with the cleaning. Kentucky American Water anticipates the cost to be $245,000. Mr. Smith has proposed an adjustment that would prevent the Company from providing the Commission with its most accurate estimation of the expense, as Mr. Smith has sought to normalize the expense by averaging the cost of the last four lagoon cleanings.[283]

In responding to Mr. Smith's adjustment, Kentucky American Water provided the bids submitted by four contracting companies. The bids for the June 2011 cleaning ranged from $180,000 to $635,000, with an average of $339,836.[284] One bid among the four submitted was a significant outlier at $635,000.[285] After removing the outlier bid, the Company recalculated the average of the submitted bids, which was $241,448, a difference of less than $4,000 from the Company's estimate. The accuracy of Kentucky American Water's anticipated cost as compared to the actual bids received validates the reasonableness of the Company's filed position in this case.

The accuracy with which the Company has estimated the lagoon cleaning expense demonstrates that Mr. Smith's normalization adjustment is unnecessary. There are several concerns with Mr. Smith's approach, the first of which is the unneeded degree of complication normalization would require. When the Commission rejected the AG's proposed normalization of rate case expenses in a previous Kentucky American Water proceeding, the Commission held

[283] Smith Direct at 76.
[284] Rebuttal Testimony of Keith Cartier of July 19, 2010 (Case No. 2010-00036) ("Cartier Rebuttal") at 2.
[285] *Id.* at 2.

that "introducing additional projected cost estimates into Kentucky-American's rate proceedings through normalization would only result in additional litigation in future rate cases…"[286] Similarly, normalizing lagoon cleaning expenses—which Mr. Smith admits is a very minor element of the Company's revenue requirement,[287] would introduce the same projection estimates that the Commission found unnecessary with regard to rate case expenses.

Further, Mr. Smith's proposed adjustment appears to rely solely upon historical data, with no consideration for inflation or other cost increases. As lagoon cleaning occurs approximately every three years, simply relying upon the average cost of the four prior lagoon cleanings will utilize cost estimates that are at least twelve years old. Also, Mr. Smith's adjustment relies upon an inaccurate assumption; he has presumed that the scope and extent of the cleaning is identical each time it is performed.[288] The scope of the planned June 2011 cleaning reveals the error in this contention as the Company plans to conduct an engineering study of the dewatering area at KRS I prior to the cleaning which may lead to significant alterations in the cleaning process, including structural changes.[289] Mr. Smith's normalization adjustment is unable to reflect these modifications, while the Company's current approach of providing an estimate based upon the known scope of the project, along with the actual bids received, provide the most accurate representation of the lagoon cleaning expense. For these reasons, the Company requests the Commission deny Mr. Smith's proposed adjustment.

V. RETURN ON EQUITY

A. Kentucky American Water's Requested Return on Equity

[286] Order, February 28, 2005 (Case No. 2004-00103) at 20.
[287] Smith Direct at 77.
[288] Cartier Rebuttal at 3.
[289] *Id.*

Kentucky American Water has asked this Commission to approve a return on common equity ("ROE") of 11.5 percent,[290] which is within the 10.8 percent to 12.1 percent range recommended by the Company's expert witness, Dr. James Vander Weide.[291] Dr. Vander Weide's direct testimony supports this requested ROE through his analyses that involved a host of equity estimation methods, including the discounted cash flow ("DCF") model, the risk premium method, and the capital asset pricing method ("CAPM") to groups of comparable risk companies.[292]

The DCF method is premised upon the assumption that the current market price of a firm's stock is equal to the discounted value of all expected future cash flows.[293] The DCF model thus replicates the timing, magnitude, and relative risk of the expected cash flows of the investment.[294] Within this framework, there are different variations of the DCF model that may be applied. One variation significant to this proceeding is whether the calculation assumes dividends are paid quarterly or annually.[295] As Dr. Vander Weide explains, the quarterly DCF model is appropriate for estimating Kentucky American Water's ROE because the companies in his proxy groups pay dividends quarterly.[296] Another determination significant to the DCF model is how the growth component is calculated. Dr. Vander Weide used both the average analysts' estimates of future earnings per share ("EPS") growth as reported by I/B/E/S Thomson Reuters and the estimate of future earnings per growth share as reported by Value Line.[297] Dr. Vander Weide also included an allowance for flotation costs in his DCF analysis, which are costs

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[290] M. Miller Direct at 15.
[291] Direct Testimony of Dr. James H. Vander Weide of February 26, 2010 (Case No. 2010-00036) ("Vander Weide Direct") at 44-45.
[292] *Id.* at 3.
[293] *Id.* at 11.
[294] *Id.* at 13.
[295] *Id.* at 14.
[296] *Id.*
[297] *Id.* at 16.

such as underwriters' commissions, legal fees and printing expenses that are withheld from the price of the stock, but nevertheless must be incurred by the company.[298] Dr. Vander Weide's proxy groups included a group of publicly-traded water utilities and a group of publicly-traded natural gas utilities.[299] The results of Dr. Vander Weide's analysis resulted in a conservative ROE of 12.1 percent for water companies and 11.4 percent for natural gas distribution companies after eliminating the highest and lowest outliers.[300]

Dr. Vander Weide next performed the risk premium approach, which is based on the premise that investors expect to earn a ROE that reflects a premium above the return the investor expects to earn on an investment portfolio of less-risky long-term bonds.[301] Dr. Vander Weide performed both the ex ante risk premium method and the ex post risk premium method.[302] In performing the ex ante risk premium method, Dr. Vander Weide arrived at a cost of equity estimate of 11.2 percent.[303] The ex post risk premium method resulted in a ROE estimate of 10.8 percent.[304]

The CAPM is an equilibrium model of the security markets in which the expected or required return on a certain security is equal to the risk-free rate of interest, plus the company equity "beta," multiplied by the market risk premium.[305] Dr. Vander Weide used the forecast yield on twenty-year Treasury bonds for his estimate of the risk-free rate.[306] When performing the CAPM analysis, Dr. Vander Weide obtained a CAPM estimate of 9.6 percent.[307] Dr. Vander Weide gave less emphasis to the CAPM results because the model underestimates the necessary

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[298] *Id.* at 20.
[299] *Id.* at 22.
[300] *Id.* at 44.
[301] *Id.* at 29.
[302] *Id.*
[303] *Id.* at 31.
[304] *Id.* at 37.
[305] *Id.* at 38.
[306] *Id.*
[307] *Id.* at 40.

ROE when the average Value Line beta for the proxy groups is significantly less than 1.0, as it is in this case.[308] Further, the CAPM tends to underestimate the cost of equity for small market capitalization companies, such as the water companies in Dr. Vander Weide's proxy group.[309]

B. AG's Position on Kentucky American Water's Return on Equity

Both the AG and LFUCG filed direct testimony regarding the appropriate return on equity, through witnesses Dr. J. Randall Woolridge and Richard A. Baudino, respectively. Dr. Woolridge applied the DCF and CAPM methods to two proxy groups of publicly-held water companies and gas distribution companies.[310] Dr. Woolridge contends that his analyses indicate an equity cost rate between 7.3 percent and 9.3 percent is appropriate.[311] His recommendation for Kentucky American Water's ROE in this proceeding is 9.25 percent, with an overall rate of return of 7.50 percent.[312]

Beginning with Dr. Woolridge's application of the DCF model, his estimated equity cost rate for his water proxy group was 9.3 percent and 8.9 percent for his gas proxy group.[313] These results are significantly lower than Dr. Vander Weide's DCF results, which was a conservative ROE of 12.1 percent for water companies and 11.4 percent for natural gas distribution companies after eliminating the highest and lowest outliers.[314]

Dr. Woolridge correctly identifies the two principal reasons for the divergence in results: (1) the appropriate dividend yield and (2) the estimation of the expected growth rate.[315] Beginning with the dividend yield, Dr. Woolridge utilized an annual DCF model to estimate Kentucky American Water's cost of equity, while Dr. Vander Weide employed a quarterly DCF

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308 *Id.* at 3.
309 *Id.* at 41.
310 Direct Testimony of J. Randall Woolridge of June 11, 2010 (Case No. 2010-00036) ("Woolridge Direct") at 2.
311 *Id.* at 2.
312 *Id.*
313 *Id.* at 38.
314 Vander Weide Direct at 44.
315 Woolridge Direct at 3.

model.[316] As explained by Dr. Vander Weide, all of the companies comprising Dr. Woolridge's proxy groups pay dividends quarterly, meaning that a quarterly DCF model must be utilized to reasonably estimate the cost of equity.[317] Use of the annual DCF model renders useless the purpose of the DCF model, which is based on the assumption that a company's stock is equal to the present value of the expected future dividends associated with investing in the company's stock. This method is implausible when the proxy companies pay dividends quarterly.[318] While Dr. Woolridge acknowledges that assumptions contained in the different variations of the DCF model's input must be recognized,[319] he makes no attempt to reconcile his version of the DCF model with the properties of the companies he selected for his own proxy groups.

The second difference among Dr. Vander Weide and Dr. Woolridge's application of the DCF model is their estimations of the expected growth rates,[320] which is an integral component of the analysis. Dr. Woolridge estimates the expected future growth by considering 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.[321] Dr. Woolridge's use of historical growth rates to estimate future growth is inappropriate, because historical growth rates are inherently inferior to analysts' forecasts.[322] While historical growth rates are intrinsically limited by backward-looking information, analysts' forecasts incorporate all relevant information, including historical growth rates, while being attuned to current market conditions and future expectations.[323] Dr. Woolridge also relies on the internal growth method, which is

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[316] Rebuttal Testimony of Dr. James Vander Weide of July 19, 2010 (Case No. 2010-00036) ("Vander Weide Rebuttal") at 8.
[317] *Id.* at 8.
[318] *Id.*
[319] *Id.* at 9.
[320] Woolridge Direct at 3.
[321] Vander Weide Rebuttal at 9.
[322] *Id.* at 10.
[323] *Id.*

inappropriate because the calculation requires the user to estimate the expected rate of return on equity—the very variable the DCF model is supposed to estimate—to calculate internal growth.[324] For regulated entities such as Kentucky American Water, the allowed rate of return on equity is set to correspond to the cost of equity,[325] allowing Dr. Woolridge to input the very growth measure he ultimately intended to find.

Studies have long indicated that investors rely upon analysts' earnings growth forecasts when deciding to buy and sell stock, as opposed to historical or internal growth rates such as those presented by Dr. Woolridge.[326] This is significant, as the purpose of regulatory ratemaking is to mimic the market-driven process to establish a fair ROE. If ratemaking is to mimic the market, the Commission should most heavily rely upon the information used by investors. Thus, in evaluating the appropriate ROE for Kentucky American Water, the Company urges the Commission to consider the deficiencies within Dr. Woolridge's application of the DCF model. By utilizing an annual DCF model and relying on historical and internal growth rates, Dr. Woolridge presented a cost of equity estimate that does not replicate investors' actual expectations.

Dr. Woolridge's application of the CAPM, which resulted in an estimation of equity for his water utility proxy group of 7.8 percent and 7.3 percent for his natural gas distribution company proxy group,[327] is equally flawed. On its face, Dr. Woolridge's CAPM results are substantially lower than those from any other estimation model. Dr. Woolridge appears to have

[324] *Id.* at 11.
[325] *Id.*
[326] *Id.* at 10.
[327] *Id.* at 26.

discounted the results of his CAPM analyses, as he recommended a ROE of 9.25 percent, approximately 150 to 200 basis points higher than the results of his CAPM models.[328]

As briefly discussed, Dr. Vander Weide submits that the CAPM currently produces an unreasonably low cost of equity for water and natural gas utilities at this time. First, CAPM is an equilibrium model that seeks to determine the amount of risk required above the risk-free rate of interest. The security used to measure the risk-free rate of interest is the U.S. Treasury security. As a result of the current economic crisis, the U.S. Treasury has kept interest rates on U.S. Treasury securities low as part of its efforts to stimulate the economy.[329] Further, investors have sought safety in U.S. Treasury securities due to their low risk, further depressing the consequent interest rates. Due to these unique economic conditions, the CAPM is currently an unreliable method of estimating the cost of equity. At least one other state's Public Service Commission has noted that the CAPM approach may provide less reliable estimates regarding a return on equity due to the current condition of the capital markets.[330] Further, as explained by Dr. Vander Weide, empirical studies have long demonstrated that when the beta values of the proxy group companies are below 1.0, CAPM will underestimate the cost of equity.[331] The beta values of utilities are currently approximately 0.70.[332]

Thus, the AG's recommended ROE of 9.25 is based upon flawed applications of the DCF model and use of the CAPM approach, which is currently an unreliable indicator of the cost of equity. For these reasons, Kentucky American Water respectfully requests the Commission not

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[328] *Id.* at 26.
[329] *Id.* at 27.
[330] *See* Staff Recommendation for Docket No. 080677-E1 – Petition for Increase in Rates by Florida Power & Light Company, at p. 280 (December 23, 2009).
[331] Vander Weide Rebuttal at 27.
[332] *Id.*

approve the AG's recommended ROE, which would prevent the Company from earning a fair return.

C. LFUCG's Position on Kentucky American Water's Return on Equity

Mr. Baudino, on behalf of LFUCG, filed testimony addressing his recommended ROE for Kentucky American Water. Mr. Baudino's results were based upon his application of the DCF model for two proxy groups, one comprised of regulated water utilities and the other comprised of regulated natural gas distribution utilities.[333] Mr. Baudino also performed two CAPM analyses utilizing the same proxy groups, but Mr. Baudino did not incorporate the results of the CAPM analysis into his ultimate recommendation.[334] The results of Mr. Baudino's DCF model for the water utility proxy group range from 9.34 percent to 10.07 percent.[335] For the gas utility proxy group, Mr. Baudino performed three different calculations based upon differing average growth rates. The calculations resulted in averages of 8.60 percent, 8.25 percent, and 8.73 percent.[336] Based upon his DCF analyses, Dr. Baudino has recommended a ROE of 9.50 percent.[337]

Similar to Mr. Woolridge's DCF application, Mr. Baudino has also utilized an annual DCF model.[338] As explained by Dr. Vander Weide, the annual DCF model is inappropriate because the annual DCF analysis is not a correct calculation for the present value of expected future dividends when dividends are paid quarterly.[339] In order to provide the most accurate estimation of the cost of equity, Mr. Baudino should have utilized the quarterly DCF model. Mr. Baudino's use of the annual DCF model renders his resulting estimates unreliable.

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[333] Baudino Direct at 3.
[334] *Id.*
[335] *Id.* at 24.
[336] *Id.* at 24-25.
[337] *Id.* at 3.
[338] Vander Weide Rebuttal at 55.
[339] *Id.*

Another deficiency in Mr. Baudino's DCF model is the manner in which he estimated the expected growth component of the equation.[340] Mr. Baudino estimated the expected growth component by calculating the average values of five sources of forecasted growth for each company in the proxy groups, including the Value Line dividends per share, earnings per share, Zack's earnings per share, and Thomson Reuters growth forecasts.[341] It was improper for Mr. Baudino to consider Value Line's dividends per share growth forecasts because the earnings per share growth forecasts conducted by analysts is the most accurate and current approximation of investors' expectations. The difference in considering dividend growth forecasts instead of earnings growth forecasts is significant; the Value Line dividend growth forecast for water utilities is only 3.39 percent, while the Value Line average earnings growth forecast for water utilities is 7.71 percent.[342] The differences among these values means that Value Line expects water utilities' dividends to grow by 432 basis points less than its earnings over the same period.[343] This is of significant concern, as the DCF model is based upon the premise that dividends and earnings will grow at the same rate.[344] Had Mr. Baudino properly excluded dividends per share growth forecasts, the resulting average DCF result would have been 11.11 percent, as opposed to 10.7 percent.[345]

Importantly, and consistently with Dr. Vander Weide's contention, Mr. Baudino did not rely upon his CAPM analysis to recommend a ROE for the Company.[346] Mr. Baudino acknowledged "controversy surrounding the use of the CAPM."[347] He further noted that "the DCF is a superior tool in the cost of capital toolbox, and I recommend that the Commission place

[340] *Id.*
[341] *Id.*
[342] *Id.* at 56.
[343] *Id.*
[344] *Id.*
[345] *Id.* at 58-59.
[346] Baudino Direct at 25-28.
[347] *Id.* at 27.

primary reliance on it in this proceeding."[348] Dr. Vander Weide agrees with Mr. Baudino on this issue, providing further reason for the Commission to discount Dr. Woolridge's CAPM analyses in this proceeding.

VI. RATE ALLOCATION AND RATE DESIGN

A. Cost of Service and Rate Design

In order to ensure that the proposed increase was fairly allocated among Kentucky American Water's customer classes, Mr. Paul Herbert performed a cost of service allocation and rate design study for the Company.[349] The cost of service study allocated the total costs among the residential, commercial, industrial, public authority, sales for resale, private fire protection and public fire protection customer classes.[350] The result of the allocations results in the relative cost responsibilities for each class of customers.[351]

No intervenor objected to Mr. Herbert's rate design or cost of service allocation.

B. Kentucky American Water's Tariffs

Kentucky American Water has proposed two changes to its tariffs, neither of which has been objected to by any intervenor. The first tariff change is a proposed increase in tap fees, which is attributable to the significant increases in installation costs since 2008.[352] The Company has proposed tap fee increases for each of the three types of meters Kentucky American Water installs.[353] The proposed tariff, which delineates the proposed fees, can be found at Application Exhibit 2, on page 5 of 8. As briefly mentioned, significant increases in contractor costs since 2008, along with substantial increases in the cost of raw materials,[354] have

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[348] *Id.*
[349] Direct Testimony of Paul Herbert of February 26, 2010 (Case No. 2010-00036) ("Herbert Direct") at 3.
[350] *Id.*
[351] *Id.*
[352] Bridwell Direct at 3.
[353] *Id.*
[354] *Id.*

necessitated increases in tap fees. These cost increases have been exacerbated by the sharp drop in the number of new services installed during 2008 and 2009, which consequently raised the proportionate cost of each service.[355] As Kentucky American Water recognizes the recent decline in installed services is partially attributable to the significant economic challenges during the last two years, the Company calculated the proposed tap fees by utilizing a five-year average, as opposed to the typical three-year average, to lessen the impact of the recession's effects on the cost of installation.[356] No intervenor objected to this proposed tariff.

The second tariff change the Company has proposed would permit Kentucky American Water to meter municipal and private fire protection lines, and if necessary, charge the customer for usage unrelated to fire protection.[357] The proposed change affects two tariffs, which is the tariff pertaining to fire protection lines and the tariff pertaining to fire protection hydrants.[358] The proposed tariffs were attached to the Company's Application as Exhibit 2 at pages 6 through 8. Through conducting routine fire hydrant and fire protection line maintenance, the Company became aware that usage was occurring for some fire services unrelated to fire fighting.[359] This usage may indicate a leak, or may implicate some form of illegal usage.[360] Currently, Kentucky American Water does not have the ability to meter fire protection lines to determine the cause of the unaccounted for use. If the Company believes that water is being used for purposes unrelated to fire fighting, the proposed tariffs permit Kentucky American Water to install a meter and

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[355] *Id.*
[356] *Id.*
[357] Cartier Direct at 7.
[358] Application at Exhibit 2, pages 6-8.
[359] Cartier Direct at 7.
[360] *Id.*

monitor usage.[361] The tariffs permit the Company to charge for any use of water unrelated to fire fighting.[362] No intervenor objected to this proposed tariff.

While no intervenor specifically objected to either of Kentucky American Water's proposed tariff changes, Mr. Jack Burch, on behalf of CAC, encouraged the Company to implement a tiered or graduated rate structure, with the price of water increasing with customer usage.[363] Mr. Burch notes that such a structure would "especially [benefit] those on low or fixed incomes."[364] Kentucky American Water has long been acutely concerned with difficulties its low income customers often face, including the customers' ability to afford water service. The Company, in a prior rate case, attempted to further assist its low income customers by proposing a tariff that provided a discount on its service charge for qualifying customers. The AG objected to the proposed discount, asserting that it violated the statutory mandate of equality in rates within a customer class, to which the Commission agreed. At this time, the Company does not believe that it can implement a rate structure designed to benefit low income customers and comply with the statutory limitations that were implicated in the prior proceeding.

Kentucky American Water believes the best solution is to collaborate with CAC, the AG, Commission Staff, and other interested parties to work toward achieving a legislative solution that would permit the Company to again propose a tariff designed to benefit customers that face significant challenges in fulfilling their basic needs, including affording sufficient water service.

VII. CAPITAL STRUCTURE AND THE COST OF DEBT

A. <u>Capital Structure</u>

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361 Application at Exhibit 2, pages 6-8.
362 *Id.*
363 Direct Testimony of Jack Burch of June 10, 2010 (Case No. 2010-00036) ("Burch Direct") at 13.
364 *Id.*

Both the AG and LFUCG, through its witnesses, Dr. Woolridge and Mr. Baudino, respectively, used Kentucky American Water's filed thirteen-month average capital structure for the forecasted test year without adjustment.[365]

B. Short-Term and Long-Term Debt

Dr. Woolridge has proposed to adjust Kentucky American Water's short-term and long-term debt rates.[366] Specifically, Dr. Woolridge proposed a lower short-term debt interest rate, as well as a lower long-term debt interest rate on Kentucky American Water's $25.0 million long-term debt financing planned for November 2010.[367] Dr. Woolridge altered the short-term debt interest rate by analyzing the average spread between the Company's short-term debt rates for the six months ended November 2009 and the federal funds rate, then applying that figure to the current federal funds rate.[368] This adjustment only considers the current federal funds rate, as Dr. Woolridge makes no attempt to determine a reasonable short-term debt rate for the forecasted test year, despite the accessibility of financial forecasts.

Kentucky American Water, in contrast, continued to revise its short-term debt rates throughout the proceeding as information became available. As part of its update to the base year, filed with the Commission on July 15, 2010, the Company analyzed the average spread between Kentucky American Water's short-term debt rates for the twelve months ended June 2010 to the federal funds rate.[369] The Company took the resulting average spread and added it to the forecasted federal funds rate for 2011, as provided by Value Line on May 28, 2010.[370] This

[365] M. Miller Rebuttal at 4.
[366] *Id.* at 5.
[367] *Id.*
[368] Woolridge Direct at JRW-5, page 4 of 4; M. Miller Rebuttal at 6.
[369] M. Miller Rebuttal at 6.
[370] *Id.*

resulted in a short-term interest rate of 1.9004 percent, which the Company recommends be used for its short-term debt rate for the Weighted Average Cost of Capital.[371]

Dr. Woolridge's adjustment to the Company's long-term debt rate suffered from the same deficiency as his adjustment to the short-term debt rate, as he made no attempt to analyze a reasonable debt rate at November 2010, which is when the long-term debt is planned.[372] Dr. Woolridge's adjustment relied upon a meager five weeks of actual data, ending June 4, 2010, without consideration of forecast data for the time period during which the bond will be issued.[373] Mr. Miller's rebuttal testimony contained an analysis of a reasonable long-term taxable interest rate for the bond, finding that thirty-year bond rates in the range of 6.200 percent to 6.387 percent are reasonable.[374]

Mr. Baudino did not object to the short-term or long-term debt rates proposed by the Company.[375]

VIII. CONCLUSION

Kentucky American Water, with this Commission's approval, has undertaken the largest capital construction project in its history so that its customers will have reliable and safe water service even during challenging weather conditions. This rate proceeding represents the final inclusion into rates of the costs associated with this significant and vitally important construction project. As demonstrated throughout this proceeding, the construction of KRS II, which has progressed remarkably within budget projections, comprises the significant majority of Kentucky American Water's requested revenue increase.

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[371] *Id.*
[372] *Id.*
[373] *Id.*
[374] *Id.* at 7.
[375] *Id.* at 5.

Intervenors to this proceeding, especially the AG through its witness, Mr. Smith, have proposed adjustments that would inappropriately disallow a significant portion of the annual increase in revenues justifiable from the record of evidence. Mr. Smith has proposed unsupported adjustments lacking in precedent and reason. The AG's answer to a data request issued by the Company is most telling; when Kentucky American Water sought to discover the basis of one of Mr. Smith's radical adjustments, the AG objected to the form of the question and then inappositely asserted that the Company, and not the AG, had the burden of proof in this proceeding.[376] Kentucky American Water agrees that it has the burden of proof to demonstrate the reasonableness of its requested increase and believes the record of evidence reflects that it has sufficiently met that burden. The AG, when asked to provide the authority for his adjustments, however, asserted that he was under no obligation to prove the reasonableness of his adjustments. This overarching position provides the most appropriate context by which to consider the adjustments Mr. Smith has proposed. Despite the AG's contention, he was obligated to offer adjustments that were fair, just and reasonable. He did not.

Kentucky American Water thus requests its proposed rate increase be approved. The Company undertook the historic endeavor of addressing a water supply concern that had long plagued central Kentucky. This rate proceeding represents the Company's final inclusion in rates of the prudently incurred costs associated with the construction of KRS II. Kentucky American Water respectfully requests that the Commission approve the requested increase in rates to ensure that the Company is afforded the fair, just and reasonable rates to which it is entitled.

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[376] See the AG's Response to Kentucky American Water 1-11.

Respectfully submitted,

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CERTIFICATE

In accordance with Ordering Paragraph No. 6 of the Commission's February 16, 2010 Order, this is to certify that Kentucky-American Water Company's September 3, 2010 electronic filing is a true and accurate copy of the documents to be filed in paper medium; that the electronic filing has been transmitted to the Commission on September 3, 2010; that an original and one copy of the filing will be delivered to the Commission on September 7, 2010; and that, on September 3, 2010, electronic mail notification of the electronic filing will be provided to the Commission and the following:

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