COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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

PUBLIC DIRECT TESTIMONY

OF

RALPH C. SMITH

ON BEHALF OF THE

KENTUCKY OFFICE OF ATTORNEY GENERAL

JUNE 11, 2010

TABLE OF CONTENTS

Exhibits and Appendix

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name, position and business address.

A. Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC, 15728 Farmington Road, Livonia, Michigan 48154.

Q. Please describe Larkin & Associates.

A. Larkin & Associates is a Certified Public Accounting and Regulatory Consulting firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorneys general, etc.). Larkin & Associates has extensive experience in the utility regulatory field as expert witnesses in over 400 regulatory proceedings including numerous telephone, water and sewer, gas, and electric matters.

Q. Mr. Smith, please summarize your educational background.

A. I received a Bachelor of Science degree in Business Administration (Accounting Major) with distinction from the University of Michigan - Dearborn, in April 1979. I passed all parts of the Certified Public Accountant ("C.P.A.") examination in my first sitting in 1979, received my CPA license in 1981, and received a certified financial planning certificate in 1983. I also have a Master of Science in Taxation from Walsh College, 1981, and a law degree (J.D.) cum laude from Wayne State University, 1986. In addition, I have attended a variety of continuing education courses in conjunction with maintaining my accountancy license. I am a licensed C.P.A. and attorney in the State of Michigan. I am also a Certified Financial Planner™ professional and a Certified Rate of Return Analyst

("CRRA"). Since 1981, I have been a member of the Michigan Association of Certified Public Accountants. I am also a member of the Michigan Bar Association and the Society of Utility and Regulatory Financial Analysts ("SURFA"). I have also been a member of the American Bar Association (ABA), and the ABA sections on Public Utility Law and Taxation.

Q. Please summarize your professional experience.

A. Subsequent to graduation from the University of Michigan, and after a short period of installing a computerized accounting system for a Southfield, Michigan realty management firm, I accepted a position as an auditor with the predecessor CPA firm to Larkin & Associates in July, 1979. Before becoming involved in utility regulation where the majority of my time for the past 31 years has been spent, I performed audit, accounting, and tax work for a wide variety of businesses that were clients of the firm.

During my service in the regulatory section of our firm, I have been involved in rate cases and other regulatory matters concerning electric, gas, telephone, water, and sewer utility companies. My present work consists primarily of analyzing rate case and regulatory filings of public utility companies before various regulatory commissions, and, where appropriate, preparing testimony and schedules relating to the issues for presentation before these regulatory agencies.

I have performed work in the field of utility regulation on behalf of industry, state attorneys general, consumer groups, municipalities, and public service commission staffs concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Indiana, Illinois, Kansas, Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, Nevada, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, Washington D.C., West Virginia and Canada as well as the Federal Energy Regulatory Commission and various state and federal courts of law.

Q. Have you previously testified before the Kentucky Public Service Commission ("PSC" or "Commission")?

A. No.

Q. Have you previously performed analysis on rate case issues where testimony was submitted by other members of Larkin & Associates before the Kentucky Public Service Commission?

A. Yes. Several years ago, I worked on various Kentucky rate cases as a regulatory analyst where testimony was submitted before the Commission by other Larkin & Associates professionals, such as Hugh Larkin, Jr.

Q. Have you previously testified before other state public utility regulatory commissions?

A. Yes, I have testified before other state public utility regulatory commissions on many occasions.

Q. Have you prepared an attachment summarizing your educational background and regulatory experience?

A. Yes. Appendix A provides details concerning my experience and qualifications.

Q. Have you prepared any exhibits to accompany your testimony?

A. Yes. Exhibit RCS-1 presents Accounting Schedules that quantify the recommendations in my testimony. Exhibit RCS-2 presents selected non-confidential material that is referenced in testimony and schedules. Exhibit RCS-3 presents KAWC's confidential responses to data requests referenced in testimony and schedules.

II. SCOPE AND PURPOSE OF TESTIMONY

Q. What is the purpose and scope of your testimony?

A. On February 26, 2010, Kentucky-American Water Company ("Kentucky-American", "KAWC", "KAW", or "Company") filed for an increase in its base rates for water service of $25,848,286, representing an overall increase of 37.7% over the Company's current revenues. This revenue increase request is based on forecasted operating results for the forward-looking 12-month period ending September 30, 2011.

Larkin & Associates was engaged by the Office of Rate Intervention of the Kentucky Office of Attorney General ("AG") to conduct a review and analysis and present testimony regarding rate base, operating income and revenue requirement aspects of the filing.

The purpose of my testimony is to present to the PSC the appropriate test period rate base, overall rate of return and utility operating income, as well as the appropriate overall revenue requirement and rate increase for the Company in this proceeding.

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

In developing this testimony, I have reviewed and analyzed the Company's February 26, 2010 filing, supporting testimonies, exhibits, filing requirements and workpapers; the Company's responses to initial and follow-up data requests by the PSC Staff, AG and other intevenors; and other relevant financial documents and data.

III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. Please summarize your findings and conclusions in this case.

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

1. The appropriate test period 13-month average rate base amounts to approximately $352.4 million, which is approximately $10.3 million lower than the Company's proposed test period rate base of $362.7 million, as shown on Exhibit RCS-1, Schedule A, line 1 and on Schedule B.

2. The AG's expert rate of return witness, Dr. Woolridge, has recommended an overall rate of return of 7.50%, incorporating a return on equity of 9.25%. In contrast, KAWC

has requested an overall rate of return of 8.58%, including a return on equity of 11.50%, as shown on Exhibit RCS-1, Schedule A, line 2 and on Schedule D.

3. The appropriate test period utility operating income amounts to approximately $18.2 million, which is approximately $2.7 million higher than the Company's proposed test period utility operating income of $15.5 million, as shown on Exhibit RCS-1, Schedule A, line 6 and on Schedule C.

4. The appropriate gross revenue conversion factor ("GRCF") to be used for ratemaking purposes in this case is 1.6515716. This factor is lower than the 1.6522819 used by KAWC because I have used a three-year average as the basis for the Uncollectible Factor component, whereas KAWC has used a higher Uncollectible Factor, based solely on 2009 results. The derivation of the GRCFs used by both the Company and the AG are shown on Exhibit RCS-1, Schedule A, line 8 and on Schedule A-1.

5. The application of the recommended overall rate of return of 7.50% to the recommended test period rate base of approximately $352.4 million produces a required return of approximately $26.4 million, as shown on Exhibit RCS-1, Schedule A, column B, line 3. Compared to the adjusted net operating income of approximately $18.2 million, this represents a deficiency of approximately $8.2 million, as shown on Exhibit RCS-1, Schedule A, column B, line 7. Applying the GRCF of 1.6515716 indicates that the Company has an annual revenue requirement deficiency of approximately $13.6 million, as shown on Exhibit RCS-1, Schedule A, column B, line 11. As shown on Exhibit RCS-1, Schedule A, column C, line 11, this represents a difference of approximately $12.3 million versus the Company's proposed annual revenue deficiency of $25.8 million. The revenue

increase of approximately $13.6 million is an overall increase of 20.0 percent over adjusted revenue at current rates of approximately $81.44 million, as shown on Exhibit RCS-1, Schedule A, lines 11-14.

IV. ORGANIZATION OF ACCOUNTING SCHEDULES

Q. How are AG's accounting schedules organized?

A. AG's accounting schedules are presented in Exhibit RCS-1. They are organized into summary schedules and adjustment schedules. The summary schedules consist of Schedules A, A-1, B, B.1, C, C.1 and D. Exhibit RCS-1 also contains rate base adjustment Schedules B-1 through B-7 and net operating income adjustment Schedules C-1 through C-18.

Q. What is shown on Schedule A of Exhibit RCS-1?

A. Exhibit RCS-1 presents the AG Accounting Schedules and revenue requirement determination. Schedule A presents the overall financial summary, giving effect to all the adjustments I am recommending in my testimony. This schedule presents the change in the Company's gross revenue requirement needed for the Company to have the opportunity to earn the AG's recommended rate of return on the adjusted rate base. The rate base and operating income amounts are taken from Schedules B and C, respectively. The overall rate of return on rate base of 7.50 percent, as presented in the prefiled testimony of AG witness Woolridge, is provided on Exhibit RCS-1, Schedule D for convenience.

Column A of Schedule A replicates KAWC's proposed calculations of the revenue deficiency. Column B of Schedule A presents the AG's determination of the base rate revenue deficiency. Column C shows the differences between KAWC's request and the AG's recommendation.

The operating income deficiency shown on line 7 of Schedule A is obtained by subtracting the adjusted operating income on line 6 (operating income as adjusted) from the required operating income on line 5. Line 9 represents the gross revenue requirement, which is obtained by multiplying the income deficiency by the GRCF.

Q. What is shown on Schedule A-1 of Exhibit RCS-1?

A. Schedule A-1 shows the derivation of the GRCF. The GRCF is used to convert the net operating income deficiency into a revenue deficiency amount.

Q. How does the GRCF recommended by AG compare with the GRCF contained in KAWC's filing?

A. As shown on Schedule A-1, I recommend a GRCF of 1.6515716. This differs from the GRCF of 1.6522819 used in KAWC's filing because I have used a three-year average for 2007-2009 for determining an appropriate Uncollectible Factor, whereas KAWC used 2009. Because the Uncollectible Factor has fluctuated from year to year, without a discernible trend[1], it is more appropriate to use an average.

[1] See, e.g., the discussion in this testimony for AG Adjustment C-17, and the factors for 2007, 2008 and 2009 computed by KAWC on KAWC workpaper WP3-10. A copy of that KAWC workpaper is included in Exhibit RCS-2 for ease of reference.

Q. What is shown on Exhibit RCS-1, Schedule B?

A. Schedule B presents KAWC's proposed adjusted test year rate base and AG's proposed adjusted test year rate base. The beginning rate base amounts presented on Schedule B are taken from the Company's filing for the test year, specifically KAWC Schedule B-1. AG's recommended adjustments to rate base are summarized on Schedule B.1. I have prepared Schedule B.1 for adjustments to KAWC's proposed rate base.

Schedules B-1 through B-7 provide further support and calculations for the rate base adjustments I am recommending.[2]

Q. What is shown on Exhibit RCS-1, Schedule C?

A. The starting point on Schedule C is KAWC's adjusted test year net operating income, as provided on Company Exhibit 37, Schedule C-1. My recommended adjustments to KAWC's adjusted test year revenues and expenses are summarized on Schedule C.1. Each of the adjustments are discussed in my testimony.

Schedules C-1 through C-18 provide further support and calculations for the net operating income adjustments I am recommending.

Q. What is shown on Exhibit RCS-1, Schedule D?

A. Schedule D, page 1, summarizes the capital structure and cost of capital that was proposed by KAWC and the capital structure and cost of capital that is recommended by AG witness Woolridge.

[2] As described in the testimony the adjustment to ADIT for a major tax accounting change has not yet been quantified and Schedule B-7 has been reserved for that adjustment, which is expected to result in a significant decrease to KAWC's proposed rate base.

V. RATE BASE

Q. Have you prepared a schedule that summarizes AG's proposed adjustments to rate base?

A. Yes. As noted above, the adjusted rate base is shown on Schedule B and the adjustments to KAWC's proposed rate base are shown on Schedule B.1. A comparison of the Company's proposed rate base and AG's recommended rate base is presented below:

Rate Base Adjustments				
Adj.	Description		Amount	
B-1	Construction Work in Progress	$	(9,463,931)	
B-2	Acquisition Adjustment Double Count	$	(2,342)	
B-3	Cash Working Capital	$	(980,000)	
B-4	Labor Costs in Deferred Maintenance	$	(45,500)	
B-5	Accumulated Depreciation	$	164,801	
B-6	ADIT - Deferred Maintenance	$	17,700	
B-7	ADIT - Major Tax Accounting Change	$	-	[A]
	Total Rate Base Adjustments	$	(10,309,272)	
	KAWC Proposed Rate Base	$	362,672,028	
	AG Proposed Rate Base	$	352,362,756	
[A]	Not yet quantified			

B-1, Construction Work in Progress

Q. Please explain the adjustment shown on Schedule B-1.

A. This adjustment removes Construction Work in Progress ("CWIP") from rate base. There is a related adjustment to net operating income (adjustment C-3) to remove the Allowance for Funds Used During Construction ("AFUDC") from Other Operating Revenue.

Q. What has KAWC stated concerning the past ratemaking treatment of CWIP in rate base?

A. KAWC's response to data request AG 1-99 states as follows:

> *In has been the practice of the Commission, except in circumstances specially requested by the utility (i.e., the KRS II CWIP in the 2008 rate case), that a 13-month average CWIP be included in rate base, with a corresponding calculation of AFUDC for that CWIP reflected in going-level revenues. The Company has filed its petition consistent with the prior Commission treatment of KAW in prior rate cases.*

Q. How does KAWC accrue a return on construction projects?

A. KAWC accrues a return, representing its financing costs during the construction period, called AFUDC. This AFUDC return accounts for the utility's financing cost during the construction period. Then, when the plant is placed into service, the AFUDC becomes part of the cost of the plant and is depreciated.

Q. What amount of CWIP, and what AFUDC offset, did KAWC include in rate base?

A. As shown in KAWC's attachment to data request PSC 3-8, KAWC included $9,463,931 CWIP in rate base, and included in other operating revenue an AFUDC offset of $646,180.

Q. What AFUDC rate did KAWC use, and how does it compare with previous AFUDC rates?

A. As described in KAWC's response to data request AG 1-102, KAWC used an AFUDC rate of 8.58 percent. That is higher than the rates previously used by KAWC, which are listed in that response. It apparently reflects KAWC's proposed cost of capital in the current rate case. As shown on Exhibit RCS-1, Schedule D, the AG is recommending a lower cost of capital, based on the recommendation of AG witness, Dr. Woolridge. Consequently, an adjustment for AFUDC will be necessary, and is shown in Exhibit RCS-1, on Schedule C-3.

Q. Should CWIP be included in rate base in a future test year?

A. No. CWIP represents costs that are not in service. A future test year already reflects all of the plant in service that the utility projects to occur, on average, during that projected period.

Additionally, KAWC has not demonstrated that including CWIP in rate case is necessary to maintain its financial health in the current case, as may have been the situation when KRS II was being constructed.

For the future test year ending September 30, 2011, KAWC's largest single item of CWIP is $4,471,634 for a project entitled "Business Transformation 2010 – 2014"; however, KAWC has not demonstrated that this has produced any benefits to ratepayers.

Among the other items included in KAWC's CWIP request include new and replaced meters; computers; miscellaneous equipment; transportation equipment; tools, shop and garage equipment; engineering studies; relocations and connections; etc. Including costs for such items in rate base in a future test year as CWIP seems questionable at best.

Of the $160,146,030 of CWIP on KAW's books as of May 31, 2010, the vast majority, which apparently relates to KRS II, has been reflected in the forecast test year as

Plant in Service. Consequently, there would seem to be no compelling need to include an additional balance of CWIP in the rate base for the future test year.

Q. Do you agree with the proposal of KAWC to include CWIP in rate base in the current case?

A. No. In general, I do not favor inclusion of CWIP in rate base unless the utility demonstrates compelling reasons to justify this exceptional ratemaking treatment. For a number of reasons, including the following, I do not support KAWC's request for rate base inclusion of CWIP plant in the current case:

1) Allowing a cash return on CWIP in rate base should be considered an exception, and KAWC has not met its burden of proof showing why it requires such ratemaking treatment in the current case.

2) CWIP, by definition, is plant that is not yet in service. Ratepayers should not pay a return on construction projects that are not providing service.

3) The Company has not demonstrated that its CWlP balance was for non-revenue producing and non-expense reducing plant. Included in KAWC's CWIP balance are costs for new mains, services and laterals, meters which can be related to serving customer growth, and/or can reduce expenses for maintenance. Other components such as transportation equipment, and replacements of existing mains, services and meters could be expense reducing, yet typically the expense reductions do not occur until after the item has been replaced; thus, there is an element of mis-matching costs and benefits.

4) Revenues have not been extended beyond the test year to correspond with customer growth. Hence, including the investment in rate base, without recognizing the incremental revenue it supports, would be imbalanced.

Q. Please elaborate on how including CWIP in rate base should be viewed as an exceptional ratemaking treatment and why the circumstances in this case do not warrant such treatment.

A. CWIP, as the title designates, is not plant that is completed and providing service to ratepayers during the test year. During the future test year, it was not used or useful on average in delivering water service to the Company's customers. The ratemaking process is predicated on an examination of the operations of a utility to insure that the assets upon which ratepayers are required to provide the utility with a rate of return are prudently incurred and are both used and useful in providing services on a current basis. Facilities in the process of being built are not used or useful. Therefore, unless there is a compelling reason to provide for CWIP in rate base, such as a large project that cannot be financed without seriously jeopardizing the utility's financial heath, the ratemaking process should exclude CWIP from rate base until such projects are completed and providing service to ratepayers in the context of a test year that is being used for determining the utility's revenue requirement. In the current KAWC rate case, the future test year is September 30, 2011, and the construction projects the Company seeks to include in rate base were not on average providing service during that period. As a general ratemaking principle, such CWIP should be excluded from rate base.

Furthermore, some of the facilities that are being constructed and are included in CWIP will be used subsequent to the future test year ended September 30, 2011 to serve additional customers. It would not be appropriate to include the investment that will serve those new customers without also including the revenues that would be received from those customers. In other words, allowance of CWIP in rate base would result in a mismatch in the ratemaking process.

Additionally, some of the plant being added, such as main replacements, could result in a reduction to maintenance expenditures which would not be reflected in the test period. The inclusion of CWIP in rate base, therefore, creates an imbalance in the relationships between rate base serving customers and the revenues being provided to the utility from customers who were taking service during the test year. Consequently, CWIP should not be allowed in rate base unless there are very compelling circumstances which would warrant an exception to the general rule. In the current case, KAWC has not demonstrated convincingly that it requires the inclusion of CWIP in rate base. It is not appropriate to include the CWIP in rate base, particularly as the projects may result in additional revenues or cost savings which have not been reflected in the future test year ended September 30, 2011.

Q. How does plant that is placed into service between rate case test years typically get reflected in the regulatory process?

A. If the plant is used to serve new customers, the utility receives revenue from those customers. If the plant helps the utility reduce expenses, such as maintenance, the utility benefits from such cost reductions during the intervening period. Once the plant is recognized in rate base in a test year, and rates are reset, the utility earns a cash return on the plant investment, less accumulated depreciation. The related revenues and expense impacts, including known and measurable expense reductions enabled by the plant, are then also recognized in the ratemaking process.

Q. Are you familiar with how other American Water Works utility operating companies have treated CWIP in terms of inclusion in rate base?

A. I am familiar with the treatment of CWIP in the most recent Illinois-American Water Company ("IAWC") rate case, Illinois Commerce Commission Docket No. 09-0319. I am also familiar with the treatment of CWIP in the most current Arizona-American Water Company rate case, Arizona Corporation Commission Docket No. W-01303A-09-0343.

The Arizona Commission routinely excludes CWIP from rate base, unless there is a compelling reason to do otherwise. In the IAWC rate case, the utility's filing excluded CWIP from rate base. This is shown on ICC's Section 285.2005 filing, Schedule B-1, Second Revised, page 1 of 6, line 4, where Account 105, Construction Work in Progress, is shown at a zero balance for purposes of determining rate base for the forecast 2010 test period. A copy of that schedule is included for ease of reference in Exhibit RCS-2.

Q. Please summarize your recommendation concerning CWIP.

A. As shown on Exhibit RCS-1, Schedule B-1, KAWC's proposed rate base is reduced by $9.464 million to remove CWIP. In a later section of my testimony, I discuss a related adjustment to AFUDC in conjunction with net operating income adjustment C-3.

B-2, Acquisition Adjustment Double Count

Q. Please explain AG Adjustment B-2.

A. This adjustment decreases rate base by $2,342 to remove the double count in KAWC's filing of the unamortized acquisition adjustment for the Boonesboro acquisition. KAWC's response to data request PSC 2-41 admits that KAWC included the unamortized acquisition adjustment for Boonesboro twice in the forecasted rate base as "Utility Plant Acquisition Adjustment" and "Deferred Debits." This adjustment removes the $2,342 double count from Deferred Debits, as shown on Exhibit RCS-1, Schedule B-2.

B-3, Cash Working Capital

Q. How has KAWC determined Cash Working Capital ("CWC")?

A. KAWC determined its proposed test year CWC requirement of $2,634,000 by way of a lead-lag study.

Q. What is causing KAWC to have a CWC requirement?

A. The majority of KAWC's proposed CWC requirement is caused by the inclusion, with a zero-day payment lag, in the Company's lead-lag study of non-cash expense items such as depreciation, amortization and deferred income taxes, and the return on equity component. I do not agree that non-cash items should be included in a lead-lag study with a zero-day payment lag because such non-cash expenses do not require a cash outlay in the lead-lag study period. Nor do I agree with the proposition that the entire return on equity be included in the lead-lag study with a zero-day payment lag based on the assumption that the stockholder is entitled to a return at the exact time that service is rendered. The simple fact is that stockholders receive their return through common dividend payments and any gain in the parent company's stock. This is the mechanism by which the common stockholder is compensated in the real world, and this suggests a payment lag significantly higher than zero days. However, based on my review of prior PSC Orders involving lead-lag studies, including KAWC's lead-lag study in Case No. 2004-00103, I understand that the PSC has consistently allowed non-cash expenses and return on equity in utility lead-lag studies at a zero-day payment lag. In recognition of this, and in an attempt to limit the issues in this case, I have chosen to reflect the inclusion of the non-cash expenses and return on equity at a zero-day payment lag in the calculation of the CWC allowance to be used for purposes of this case.

Q. Are you recommending that adjustments be made to the Company's proposed lead-lag study and associated CWC requirement?

A. Yes. Where applicable, I have replaced the Company's proposed test period expense levels in the lead-lag study with the corresponding test period expense levels that I am recommending.

Q. Should your non-adjustment of KAWC's proposed lag days be construed as an endorsement of those components of the KAWC's lead-lag study?

A. No, it should not.

Q. Have you prepared a schedule showing your recommended CWC requirement based on the application of the previously discussed adjustments?

A. Yes. My recommended CWC requirement and the related calculations are presented on Exhibit RCS-1, Schedule B-3. As shown on that schedule, my recommended CWC requirement amounts to $1.654 million, $980,000 lower than KAWC's proposed CWC requirement of $2.634 million.

Q. Do you have any other comments regarding the CWC requirement?

A. Yes. All component expenses of the lead-lag study should be updated to reflect the Commission's findings in this case.

B-4, Labor Costs in Deferred Maintenance

Q. What is the issue with Deferred Maintenance?

A. In KAWC's last rate case, Case No. 2008-00427, an issue was raised regarding the inclusion by the Company of labor costs in rate base as part of its Deferred Maintenance balance. In that case, KAWC proposed to include $2,951,785 of Deferred Maintenance costs in rate base, and the witness for the AG recommended that approximately 1.68 percent, or $49,590, be removed as relating to KAWC's internal labor and labor overhead costs.

In the current KAWC rate case, KAWC has requested rate base inclusion of $2,708,236 of Deferred Maintenance costs in rate base. Approximately 1.68 percent of this is $45,500. As shown on 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.

Q. Has the Commission ruled on this issue?

A. KAWC's last rate case, Case No. 2008-00427, was settled, so there was no specific Commission ruling on this particular issue. However, on page 8 of its Rehearing Order in KAWC's Case No. 2000-120, the Commission ruled that deferred company labor costs included as part of KAWC's proposed acquisition adjustment in that case should not receive rate recovery:

> *We have, however, removed from the proposed acquisition adjustment deferred company labor expenses of $46,350. To defer payroll expense between rate cases and then amortize those costs, in addition to the normal recurring payroll expense, would artificially inflate forecasted test year operations.*[3]

Removal of KAWC's internal labor costs from Deferred Maintenance costs in rate base appears to be consistent with this prior Commission ruling.

B-5, Accumulated Depreciation

Q. Please explain the adjustment for Accumulated Depreciation.

A. This adjustment reduces the forecasted test year balance of Accumulated Depreciation by $269,724. It also reflects a related impact on Accumulated Deferred Income Taxes

[3] Case No. 2000-120 Order on Rehearing, dated May 9, 2001, at page 8.

("ADIT") of $104,923 for a net increase to forecasted period rate base of $164,801, as shown on Exhibit RCS-1, Schedule B-5. This adjustment is related to the adjustment to forecast test year Depreciation Expense discussed in the operating income adjustments, as AG adjustment C-12.

B-6, Accumulated Deferred Income Taxes – Deferred Maintenance

Q. Please explain the adjustment for Accumulated Deferred Income Taxes – Deferred Maintenance.

A. This adjustment reduces the forecast test year balance of ADIT by $17,700, as a result of my recommended adjustment to Deferred Maintenance, discussed above. The adjustment is shown on Exhibit RCS-1, Schedule B-6, and multiplies the adjustment to Deferred Maintenance by the combined state and federal income tax rate to derive the related impact on ADIT.

B-7, Accumulated Deferred Income Taxes - Major Tax Accounting Change

Q. Did KAWC's parent company, American Water Works, apply for a major tax accounting change?

A. Yes. Data Request AG-2-122 asked KAWC:

> *Has KAW or AWWSC or AWWC changed its income tax accounting for repair and maintenance method?*
>
> *a. If so, when was this done?*
>
> *b. Please identify and provide all related correspondence and estimates.*

KAWC's response stated:

> *Yes, American Water Works Company, Inc. ("AWWC") changed the method of accounting for repairs and maintenance for its regulated subsidiaries.*
>
> *a. AWWC filed Form 3115, Application for Change in Accounting Method on December 31, 2008.*
>
> *b. See attached Form 3115 and attachments filed on December 31, 2008.*

Q. What impact has the change in the income tax accounting for repair and maintenance had on the Accumulated Deferred Income Tax balances as of 12/31/2008 and 12/31/2009 and for each month of the FTY?

A. The method change has increased KAWC's ADIT balance, which is an offset to rate base. KAWC's response AG-2-16(a) references a 2009 FAS 109 Deferred Tax Analysis (Row 170 – "Repairs").

Q. Was the tax accounting change requested by AWWC approved by the Internal Revenue Service?

A. Yes. As described in KAWC's response to data request AG-2-85, page 20 of 26[4],

> *In December 2008, the Company as a member of the consolidated group filed a request with the Internal Revenue Service ("IRS") to change its tax accounting method for repair and maintenance costs on its utility assets. The IRS partially approved the request in October 2009, with the Company receiving final approval in February 2010, allowing the Company to take a tax deduction for costs that were previously capitalized for tax purposes. As a result,*

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[4] Kentucky-American Water Company's Financial Statements for December 31, 2009 and 2008, page 17, Note 9: Income Taxes.

the Company recorded a deferred income tax liability for this temporary difference. In addition, the change in tax accounting method generated a net operating loss which the Company has substantially monetized.

Q. Did American Water Works spend a lot of money to implement this major tax accounting change?

A. In response to data request AG-1-181 CONFIDENTIAL at pages 89 -92 of 107, [**BEGIN CONFIDENTIAL**] [redacted] [**END CONFIDENTIAL**]

Q. How have PricewaterhouseCoopers fees been charged to KAWC?

A. As identified in the response to data request AG-2-130, PricewaterhouseCoopers fees have been charged to KAWC as summarized in the following table:

	KAW		AWWSC	
2007	$	101,038	$	503
2008	$	79,443	$	1,067
2009	$	113,795	$	11,147
Base Period	$	140,507	$	13,738
Forcasted Test Year	$	110,166	$	11,552

It is unclear from the information provided by KAWC how much of these fees charged to KAWC relate to the major tax accounting change described above. However, the response to data request AG-2-129 CONFIDENTIAL states regarding the [**BEGIN CONFIDENTIAL**] [redacted]

[redacted] [**END CONFIDENTIAL**]

Q. What other information has KAWC provided concerning this major change in tax accounting method?

A. In response to data request AG-2-123 CONFIDENTIAL, KAWC provided the following explanations:

[**BEGIN CONFIDENTIAL**]

[redacted]

[redacted]

[**END CONFIDENTIAL**]

Q. What impact on KAWC's rate base does this major tax accounting change have?

A. In general terms, this change should **significantly** increase ADIT and should therefore reduce KAWC's rate base significantly for the forecast test year.

Q. Have you seen this issue arise in other recent utility rate cases?

A. Yes. I am aware of this issue, involving a major change to a utility's tax accounting method, being raised in some recent electric utility rate cases.

Q. What impact did it have in those other recent utility rate cases?

A. In two cases of which I am aware, it had the impact of significantly **increasing** the utility's ADIT balance and, correspondingly, significantly reducing the utility's rate base. ADIT, which is an offset to utility rate base, was significantly increased as a result of the tax accounting change. As a result of reflecting the impact of the change in tax accounting, an adjustment was made to increase ADIT and significantly reduce rate base.

Q. In its response to AG discovery, has KAWC presented its reasons for not making an adjustment in the current KAWC rate case to reflect the impact on ADIT from the major tax accounting change that was implemented by AWWC and its subsidiaries, including KAWC?

A. Yes. In its response to data request AG-2-16(c), KAWC presents the following reasons for not increasing ADIT in the current KAWC rate case:

> *FIN 48 liability (repairs – the FIN 48 liability represents the difference between KAW's position taken on the tax return versus*

> *the position utilizing the "more likely than not standard" as required for US GAAP. Fin 48 recognizes that differences in the interpretation of tax law (i.e. legislation and statutes, legislative intent, regulations, rulings and case law) exist, and seeks to eliminate any uncertain tax benefit from the financial statements until the uncertainty associated with the position has been removed. An uncertainty may be removed by either a) review of the technical merits of the position by the relevant taxing authority, b) expiration of the statute of limitations or c) law change. Consequently, the FIN 48 liability has been excluded because it represents an uncertain liability that does not reduce rate base until the uncertainty has been removed by audit, statute expiration or law change.*

Q. Are those valid reasons for failing to adjust KAWC's ADIT balance in the current KAWC rate case?

A. No. The impact of the major tax accounting change that AWWC paid a large amount of money for has been approved by the Internal Revenue Service and has been implemented by AWWC and its subsidiaries, including KAWC, is known and quantifiable and will in fact be reflected AWWC's audited financial statements. KAWC's statement that it has not yet been audited by the IRS does not present a valid reason for failing to make this adjustment. In fact, none of the income tax balances or the ADIT balance proposed by KAWC for the forecast test year have been audited by the IRS. The state and federal income tax returns corresponding to the forecast test year period have not yet been filed. If it were a valid reason for not reflecting a tax expense or ADIT impact until **after** an IRS audit were conducted, there would be no income tax expense in the forecast test year since there has been no IRS audit of that period. Tax audits typically occur after a tax return is filed, and are sometimes not resolved for several years after a return is filed.

Q. Have you quantified the adjustment for KAWC's rate base related to this major tax accounting change?

A. At this time I have not because KAWC did not provide sufficiently clear information in response to data requests issued by the AG in which to quantify the adjustment.

Q. What do you recommend in the current KAWC rate case?

A. The Commission should order KAWC to provide a detailed analysis of the impact of this major tax accounting change on KAWC's forecast test year ADIT balance. The expectation that the ADIT balance reflected by KAWC in its rate increase application should be substantially increased to reflect the impact of this tax accounting change is supported by the information provided by KAWC in response to data request AG-2-129, and the observed impacts from other cases where this issue has arisen. In particular, the Commission should require KAWC to clearly identify the amount of ADIT that AG-2-129(e) asked them to provide (that is, provide the specific ADIT dollar amount of impact - not just a reference to some document that itself is not very clear) and (2) to also confirm that KAWC did **<u>not</u>** reflect that amount as a deduction to rate base in its filing. I recommend that the Commission require KAWC to reflect the full impact of this known major tax accounting change in the determination of the final rate base. This adjustment should increase the forecast test year ADIT balance and reduce KAWC's proposed rate base significantly.

VI. ADJUSTMENTS TO OPERATING INCOME

Q. Please describe how you have summarized AG's proposed adjustments to operating income.

A. Schedule C summarizes the AG's recommended net operating income. Schedule C.1 presents the AG's recommended adjustments to test year revenues and expenses. The impact on state and federal income taxes associated with each of the recommended adjustments to operating income is also reflected on Schedule C.1. KAWC's proposed adjusted test year net operating income is $15.473 million, whereas AG's recommended adjusted net operating income is $18.215 million, as shown on Exhibit RCS-1, Schedule C, line 40. The recommended adjustments to operating income are discussed below in the same order as they appear on Schedule C.1.

C-1, Income Tax Expense – Interest Synchronization

Q. Please explain AG Adjustment C-1.

A. The interest synchronization adjustment applies the weighted cost of debt to the calculation of test year income tax expense. After adjustments, my proposed rate base differs from the rate base used in KAW's filing. My weighted cost of debt also differs from the weighted cost of debt used in KAW's direct filing. This results in an adjustment to the amount of synchronized interest included in the tax calculation. The calculation of the interest synchronization adjustment is shown on Exhibit RCS-1, Schedule C-1. This adjustment increases income tax expense for KAWC in total by the amount shown on

Schedule C-1. The Company's achieved net operating income is reduced by the amount of the net increase to income tax expense.

C-2, Income Tax Expense – Consolidated Tax Savings

Q. Please explain AG Adjustment C-2.

A. This adjustment reflects the consolidated tax savings that result from KAWC's participation in a consolidated federal income tax return. Based on the three-year period, 2006 through 2008, KAWC's share of the consolidated income tax savings are $1.362 million, as shown on Exhibit RCS-1, Schedule C-2.

Q. How did KAWC compute federal income tax expense for the projected test period?

A. KAWC computed test period federal income tax expense by applying a 35 percent federal income tax rate to the Company's determination of the projected test period's taxable income. This is referred to as the "stand-alone" method, which assumes that the Company files a separate federal income tax return.

Q. Does KAWC actually file a federal return on a stand-alone basis?

A. No. KAWC does not file a separate federal income tax return. Rather, KAWC is part of the consolidated federal income tax return that is filed by American Water Works Company ("AWWC") and its subsidiaries, including KAWC. A consolidated income tax return is filed in order to minimize AWWC's federal income tax liability.

Q. Why does a consolidated income tax return generate tax savings?

A. A consolidated income tax return generates tax savings because some members of the consolidated group generate tax losses. These tax losses are used to offset a portion of the taxable income generated by the other affiliates, including KAWC, to reduce income taxes payable for the entire consolidated entity. Without a consolidated filing, it could take several years under the carry-forward and carry-back provisions of the Internal Revenue Code ("IRC") before the recurring loss companies would be able to fully realize tax savings, and without combining those recurring loss companies into a consolidated tax return with other companies that generate positive taxable income, such savings might not be realized. By filing a consolidated return, the consolidated entity, AWWC, as a whole is able to realize, in the current tax year, the tax benefits generated by the loss companies.

Q. Should KAWC's ratepayers share in the tax savings realized from the consolidated federal income tax filings?

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

Q. How did you calculate the consolidated income tax benefit adjustment for KAWC?

A. As shown on Exhibit RCS-1, Schedule C-2, I used the "effective tax rate" method. First, I considered the combined annual taxable income of all of the consolidated group members (including both regulated and non-regulated group members) with positive taxable income. I examined the six years 2003 through 2008. The information for the years 2003 through 2007 was available from KAWC's last rate case, Case No. 2008-00427. I obtained the 2008 information from AWWC's consolidated federal income tax return (form 1120), which was provided in response to data request AG-1-211.

For each year, I then calculated the ratio of KAWC's positive taxable income to the total of all positive taxable income by consolidated group members. Next, I determined the combined annual taxable losses of all non-regulated[5] group members for each year. I then applied the KAWC ratios to the combined annual tax loss amounts to arrive at the annual tax losses that should be allocated to KAWC in order to calculate KAWC's tax benefits produced by the consolidated income tax return filing.

Finally, I averaged the consolidated tax loss benefits allocated to KAWC and applied the federal income tax rate of 35 percent to the average. This calculation indicates an average normalized consolidated tax savings benefit for KAWC of $1,361,624 on a three-year average basis.

[5] Regulated group members with tax losses were not used in the analysis because such tax losses were not considered to be recurring events.

Q. Is the consolidated tax savings adjustment you used consistent with the methodology used to calculate the consolidated tax savings adjustment that was approved by the Commission in Case No. 2004-00103?

A. Yes. In Case No. 2004-00103, the Commission approved a consolidated tax savings adjustment based on the use of a three-year historic average and the use of the effective tax rate method. My calculation uses the same method and is based on the average of the most recent three years available, 2006 through 2008, to determine the prospective consolidated income tax savings adjustment.

C-3, Allowance for Funds Used During Construction

Q. Please explain AG Adjustment C-3.

A. This adjustment is shown on Exhibit RCS-1, Schedule C-3, and first adjusts AFUDC for the difference between the AG's recommended cost of capital and KAWC's requested cost of capital. The adjustment then removes the adjusted AFUDC amount from other operating revenues, consistent with my recommended adjustment B-1, discussed above, to remove CWIP from rate base. The result of this two-step adjustment is to reduce the amount of AFUDC in KAWC's filing from $646,180 to zero.

C-4, Incentive Compensation Expense - KAWC

Q. Please explain AG Adjustment C-4.

A. This adjustment removes incentive compensation expense from the future test year. As shown on Exhibit RCS-1, Schedule C-4, future test year expense is reduced by $349,529[6] for KAWC employees and by $436,987[7] for incentive compensation included in the affiliated Service Company's management fee for a total adjustment to decrease operating expenses by $786,516. These incentive compensation expenses are also summarized below:

Description	KAWC Employees	Included In Affiliate Management Fee	Total Requested by KAWC
	(A)	(B)	(C)
Annual Incentive Plan	$ 349,529	$ 436,987	$ 786,516
Long-Term Incentive Plan			$ -
Total	$ 349,529	$ 436,987	$ 786,516

Q. Did the Company provide a copy of its incentive compensation plan?

A. A copy of a document entitled "2009 Annual Incentive Plan Highlights Brochure" was provided in response to AG-1-15.[8]

Q. Is that "Highlight Brochure" the most detailed document available for the 2009 AIP?

A. According to KAWC's response to data request AG-2-7(a), it is.

[6] See KAWC's response to data request PSC-2-4, page 5 of 7.
[7] See KAWC's response to data request PSC-2-9, page 15 of 15.
[8] A copy of that document is included in Exhibit RCS-2.

Q. That "Highlight Brochure" is dated February 2009. Is that the most recent document available for the AIP?

A. According to KAWC's response to data request AG-2-7(a), it is.

Q. In KAWC's last rate case, there was a component of incentive compensation for a Long-Term Compensation Plan ("LTIP"). What happened to that?

A. KAWC was asked about this in data requests AG-2-2 and AG-2-3. KAWC's responses indicate that there is no LTIP expense in any of the periods, 2009, 2010 or the future test year "because the LTIP Plan has been replaced by the Equity Compensation Plan." The amounts that KAWC is requesting for stock-based compensation pursuant to the Equity Compensation Plan will therefore be addressed in a separate adjustment, specifically AG Adjustment C-5, which is discussed in the next section of my testimony.

Q. Please briefly discuss the key provisions of the incentive compensation program.

A. According to the 2009 Annual Incentive Plan Highlights Brochure, at page 1:

> *The 2009 AIP is designed to challenge and motivate you to perform at your highest level,* ***and promote the creation of shareholder value.***
>
> (Emphasis supplied.)

Page 2 of that brochure describes "what's changing" in the 2009 AIP as follows:

- *Awards are more closely aligned with the Company's ability to fund the award and with individual performance.*
- ***AIP pool funding is based on overall corporate performance against specific financial goals (as represented by the Corporate Multiplier), then allocated***

> ***across organizational groups/functional areas – at senior management's discretion – depending on organizational group/functional area results.***
>
> - *AIP funding for* ***all employees*** *– regardless of your role or position in the Company – depends on the Company achieving its financial as well as non-financial goals.*
> - ***Financial metrics are updated to reflect Diluted Earnings per Share.***
> - *Individual award payouts will be based on individual performance against specific goals (represented by the Individual Performance Factor) and paid from available organizational group/functional area funding.*
> - *For 2009, the Individual Performance Factor range has been changed from 0%-120% to* ***0%-200%****. Individual payouts will be capped at 200% of AIP target award.*

(Emphasis supplied.)

Among the items that have not changed are that the:

> *Actual payout may be lower or higher than target depending on Company and individual performance against specific goals.*

Page 3 states that:

> *Since the value (****as reflected in our share price and our return to shareholders****) and success of our business depend on the achievement of annual Company and individual performance goals, American Water recognizes the need to differentiate and reward the performance of employees who enable us to reach these goals. The 2009 AIP is designed to ensure that award payouts are directly tied to measurable contributions – both Company and individual – to American Water's success.*

Q. Is the overall AIP funding dependent upon an AWWC shareholder-related financial target?

A. Yes. As described on page 4 of the 2009 AIP Brochure, the Corporate Multiplier is based upon a pre-determined threshold for Company performance **– 2009 Diluted Earnings Per**

Share (EPS) must be at least 90.9% of target. This financial EPS target must be met in order for funding and any award to be provided under the AIP.

Q. What does the 2009 AIP Brochure provide once that AWWC financial EPS trigger has been met?

A. As described on page 5, the Corporate Multiplier is weighted 70 percent based on Financial Metrics and 30 percent based on Non-Financial Metrics.

The Financial Metrics are:

- Diluted Earnings Per Share (35%). This is a measure of financial performance that includes the impact of dilutive securities such as stock options.)
- Operating Cash Flow (24.5%). This reflects the cash generated from operations and is used as an additional measure of profitability.
- Revenue Growth (10.5%). This is a measure of how quickly AWWC's business is growing and reflects the percentage of planned increase in revenues achieved.

The Non-Financial Metrics are:

- Safety (7.5%)
- Environmental (7.5%)
- Customer Satisfaction (7.5%)
- Business Transformation (4.5%)
- Diversity (3.0%).

The non-financial outcomes are based on a combination of surveys, end-of-year results, data and annual reports, as described in the brochure.

Q. Please discuss the Non-Financial Metrics, a/k/a the Operational Components of the AIP.

A. As described in KAWC's response to data request AG-1-15 and PSC-2-5, the Operational Component is based on the following:

Safety Performance: Safety performance is measured on an OSHA Total Recordable Incident Rate ("ORIR") which is defined as the rate of total injuries requiring treatment beyond first aid per 200,000 hours worked. ORIR focuses on total injury reduction which by extension improves Lost Work Day Case Rate ("LWCR") and correlates more closely to workers compensation claims and costs. LWCR will remain a personal performance goal for the Operations and Operational Risk Management functions.

Environmental Compliance (NOV): Environmental Compliance is measured by "Notice of Violation ("NOV") count defined as the number of times an official notice is issued by a primacy agency for failure to comply with a federal, state or local government statute or regulation that is covered under the scope of the American Water Environmental Management Policy.

Customer Satisfaction: Customer satisfaction is based on the results of the annual Customer Satisfaction Survey ("CSS") conducted in the fourth quarter of each year through randomly selected customer contacts in each state.

<u>Business Transformation</u>: Business Transformation will be based on the participation and development of new and improved processes across AWWC that promote more efficient use of resources and work processes.

<u>Diversity</u>: Diversity will be based on training for all key managers, analysis of the pool of new hire candidates, and analysis of supplier/contractor sourcing.

Q. Does page 6 of the 2009 AIP Brochure reinforce that the entire award depends upon the achievement of a minimum amount of corporate earnings per share, i.e., the AWWC corporate financial threshold, as a corporate financial trigger?

A. Yes. The Brochure states at the top of page 6 as follows:

> *The financial and non-financial metrics are added together to determine the Corporate Multiplier. So, even if certain metrics are not achieved, the funding may be reduced, but not eliminated altogether.* ***However, if the Company's financial performance does not meet the threshold, the Corporate Multiplier will be reduced to zero, which would eliminate your award payout …***
>
> (Emphasis supplied.)

At page 13, the Brochure presents the following Question and Answer:

> *Q. Will I receive an award payout if I meet my individual performance goals but the Company does not achieve minimum (threshold) performance?*
>
> ***A. No. Award payouts will be made only if both the Company and the individual have met the minimum (or threshold) performance goals for the year.***

There is no assurance that the award levels included in the Company's proposed expense for the test year will be repeated in future years.

Q. Are each of the "Company" Financial Performance Factors used in the AIP based on the consolidated financial reporting of the Parent Company?

A. Yes. As confirmed in KAWC's response to data request AG-2-6(c), each of the "Company" Financial Performance Factors used in the AIP are based on the consolidated financial reporting of the Parent Company, American Water Works Company, Inc.

Q. Are the AWWC financial results that form the threshold for awarding incentive compensation under the AIP subject to manipulation?

A. Yes. If the Corporate Multiplier does not meet the minimum specified threshold, management can apparently attribute some impact to an "uncontrollable event" and thus enable AIP to be awarded, when the award would otherwise have been zero.

Q. Can you provide some illustrative examples of when and how adjustments for "uncontrollable events" produced an AIP award when such an award would have been zero under the previously specified corporate financial trigger?

A. Yes. This apparently happened in both 2008 and 2009, as described in KAWC's response to data request AG-2-5(b):

> *Taking into account the "uncontrollable events" the Corporate Multiplier for 2009 was 93.21% and AIP award was $22.8 million.* ***Without taking into account "uncontrollable events" the Corporate Multiplier for 2009 and the AIP aware would have been zero.***
>
> *Taking into account the "uncontrollable events" for 2008 the financial payout ratio (there was no Corporate Multiplier for 2008) was 81% for American Water consolidated. The AIP awards for 2008 were $19.4 million for American Water consolidated.* ***Without taking into account the "uncontrollable events" the***

> ***financial payout ratio for 2009 (sic) and the AIP would have been zero for American Water consolidated.***
>
> (Emphasis supplied.)

These results create the appearance that, in any given year, some "uncontrollable event" could be cited by AWWC management and effectively render the pre-established AWWC financial target meaningless.

Q. Was the base salary compensation reduced for the employees who participate in the AIP?

A. No. The Company's response to data request AG-1-39 indicates that during the implementation period for incentive compensation, there were no reductions to base salary made concurrent with initiating eligibility for incentive compensation.

Q. Were the KAW employees who participate in the AIP awarded healthy base salary increases over the past several years?

A. Yes. As documented in KAWC's last rate case, the KAWC employees for which KAWC requested incentive compensation rate recovery in that case had, on average, received the following base salary increases (separate from and in addition to incentive compensation increases) in each year, 2004 through 2008[9]:

[9] See, e.g., KAWC's response to AG-1-108, page 2, from Case No. 2008-00427 and AG witness Henkes' direct testimony at page 38.

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

Given these healthy base salary increases that have already been received by the KAWC employees eligible for incentive compensation in years 2004 through 2008, it would not be reasonable or appropriate to charge ratepayers for additional compensation cost in the form of incentive compensation (or stock-based compensation).

Q. Are the base salaries paid by KAWC and its affiliates intended to be "at market" in terms of the level of compensation?

A. Yes. The AWWC compensation system has been to target base compensation at the 50th percentile of market based compensation. The 50th percentile of market based compensation is considered to be "at market."

Q. Could the AIP-based incentive compensation be viewed as "above market"?

A. Yes. The additional AIP-based compensation in the past had been targeted to permit an employee to achieve compensation at the 65th percentile of market. Thus the AIP is designed to produce compensation above the 50th percentile of market after the parent company corporate financial earnings target is triggered. With the change in the 2009 AIP of the individual employee's AIP award band, from the previous level of 0% to 120% of target, to the broader potential range of 0% to 200% of target, the potential for even higher above-market compensation for individual employees via the AIP is presented.

Q. How has KAWC's budgeted AIP compared with actual for the last two years?

A. The KAWC actual incentive compensation expense has been significantly under the budgeted amount in each year, as shown in the following table:

KAWC's Budget Versus Actual AIP - Last Two Years					
Year	Source	KAWC Actual	KAWC Budget	Difference	Note
2009	[A]	$ 245,403	$ 354,238	$ (108,835)	[1]
2010	[A]	$ 312,153	$ 366,355	$ (54,202)	[2]
Source and Notes:					
[A]	KAWC's response to PSC-2-4, p.7 Actual is based in AIP earned in the previous year and Budget is for the year that matches to the year AIP was earned				
[1]	Mr. Rowe shifted from KAWC to AWWSC and the timing of hiring a number of employees result in them not receiving AIP or only receiving a pro-rata share based on their hire date				
[2]	The 2010 award was lower due to a number of employee vacancies during the year				

Q. Are the factors that caused 2010 to be overstated potentially in existence for the forecasted test period?

A. Yes. There are a number of vacancies included in KAWC's forecast.

Q. Has KAWC or AWWSC performed a study that quantifies the benefits to customers from its incentive compensation?

A. No. PSC-2-5(a) had specifically requested that KAWC:

> *Provide a copy of all studies and analyses that Kentucky-American has performed or commissioned that quantifies the benefits the ratepayers derive from the LIP or AIP.*

KAWC's response to data request PSC-2-5 indicates that the Company has not been able to perform a study that attempts to quantify the benefits to customers of its incentive plans.

Q. Please summarize your recommendation concerning KAWC's incentive compensation expense.

A. I recommend that KAWC's incentive compensation expense, including the incentive compensation allocated to KAWC via the affiliated Management Fee, be removed from future test year expenses. This results in a reduction to test year expense of $786,516, as shown on Exhibit RCS-1, Schedule C-4.

Q. Have some of AAWC's affiliates in other jurisdictions removed 100 percent of incentive compensation expense in recent rate cases because payment is premised on a parent company financial trigger?

A. Yes. As an example, in Docket No. 09-0319, before the Illinois Commerce Commission, Karla O. Teasley, the President of Illinois-American Water Company testified concerning incentive compensation, in conjunction with a forecast 2010 test year, as follows:

> VII. INCENTIVE COMPENSATION
>
> Q28. Has the Company proposed recovery of expense related to payments under an incentive compensation plan?
>
> A. No. In the Docket 07-0507 Order, the Commission **<u>denied recovery of incentive compensation expense due to the presence of a parent company financial trigger</u>**. In recognition of the Commission's concern as stated in Docket 07-0507, IAWC will not propose recovery of this cost. (Emphasis supplied.)

A copy of such testimony is included in Exhibit RCS-2.

A similar parent company financial trigger that caused denial of recovery of incentive compensation expense in Illinois also exists with respect to the AIP plan used by KAWC.

Q. Are there any other reasons why incentive compensation (and other discretionary expenses of KAWC) should be disallowed in this case?

A. Yes. The economy is still struggling to recover from the worst economic downturn since the Great Depression, where ratepayers have been faced with job losses, plunging home values, and decreased value of investments and retirement accounts. It is especially during these continuing very difficult economic conditions that ratepayers need relief from these discretionary costs. This includes, but is not limited to, relief from the incentive compensation expense as well as the stock-based compensation expense, discussed in the next section of my testimony.

C-5, Stock-Based Compensation Expense

Q. Has KAWC included stock-based compensation expense in projected test year operating expenses?

A. Yes. KAWC's response to data request AG-1-47 indicates that KAWC included $27,228 of expense in Account 501713, Incentive Plan-Off-Stock Div for KAWC employees, and another $209,324 of expense for stock-based compensation charged to KAWC in the Management Fee for the future test year. The $209,324 described in that response consists of $102,235 in Account 501716, Compensation Expense-Options, and $107,089 in Account 501718, Compensation Expense-Restricted Stock Options. In a subsequent supplement to its response to AG-1-47, KAWC stated that: "the new forecasted test-year AWWSC AIP awards … now total $179,208 compared to the $209,324 in the original response to this question." That response referenced KAWC's response to data request PSC-2-8, which provided AWWSC allocations of expense to KAWC for "Forecasted Test Year LTIP." Page 3 of KAWC's response to PSC-2-8 states that: "LTIP consists of stock based compensation – Options (account 501716) and Restricted Stock Units (account 501718)." In response to data request AG-2-3(a), KAWC stated that "the LTIP Plan has been replaced by the Equity Compensation Plan." In response to data request AG-2-3(b), KAWC identified the forecasted test year amount as $179,208 and referenced its response to PSC-2-8.

Q. What types of stock-based compensation costs did KAWC record in Account 501716?

A. KAWC's response to data request AG-1-47(b) provides the following description of such costs:

> *Account 501716 – Compensation Expense Options – includes accruals based on the estimated costs related to non-qualified stock option grants. These grants provide the participant with an option to purchase shares of AWW stock at an advantaged exercise price if the performance goals have been satisfied, limited by the expiration date of December 31, 2013. A true-up entry is recorded once the options are exercised.*

Q. What types of stock-based compensation costs did KAWC record in Account 501718?

A. KAWC's response to data request AG-1-47(b) provides the following description of such costs:

> *Account 501718 – Compensation Expense Restricted Stock Units – includes accruals based on the estimated costs related to restricted stock unit grants. These grants provide the participant with rights to shares of Company stock that may be redeemed if the performance goals have been satisfied after vesting date of January 1, 2011. A true-up entry is recorded once the grants are exercised.*

Q. Did KAWC provide a copy of the American Water Works stock-based compensation plan?

A. Yes. KAWC's response to data request AG-1-15 provided a copy of a document entitled, "American Water Works Company, Inc., 2007 Omnibus Equity Compensation Plan" and KAWC's response to other data requests, including AG-2-2 and AG-2-3 reference that as the Equity Compensation Plan that replaced the LTIP.

Q. What is the stated purpose of the AWWC Equity Compensation Plan?

A. The purpose is to provide stock-based compensation to benefit AWWC stockholders by aligning the interests of the participants with those of the stockholders. Page 1 of that Plan document under "Purpose" states as follows:

> *The purpose of the American Water Works Company,…..Equity Compensation Plan ….is to provide (i) designated employees of American Water Works Company, Inc. …. and its subsidiaries and (ii) non-employee members of the board of directors of the Company with the opportunity to receive grants of stock options, stock units, stock awards, stock appreciation rights and other stock-*

> *based awards. The Company believes that the Plan will encourage the participants to contribute materially to the growth of the Company, thereby benefiting the Company's stockholders, and will align the economic interests of the participants with those of the stockholders.*
>
> (Emphasis supplied)

Q. Please discuss the reasons for removing stock-based compensation.

A. Ratepayers should not be required to pay executive or director compensation that is based on the performance of the Company's (or its parent company's) stock price, or which has the primary purpose of benefitting the parent company's stockholders and aligning the interests of participants with those of such stockholders.

Additionally, prior to being required to expense stock options for financial reporting purposes under Statement of Financial Accounting Standards No. 123 Revised (SFAS 123R), the cost of stock options was typically treated as a dilution of shareholders' investments, i.e., it was a cost borne by shareholders. While SFAS 123R now requires stock option cost to be expensed on a company's financial statements, this does not provide a reason for shifting the cost responsibility for stock-based compensation from shareholders to utility ratepayers.

Q. Please explain your recommended adjustment for KAWC's Stock-Based Compensation expense.

A. As shown on Exhibit RCS-1, Schedule C-5, using the corrected amounts identified in KAWC's responses to discovery, this adjustment decreases test year expense by $206,436 to reflect the removal of KAWC's stock-based compensation of $27,228 and the additional $179,208 of stock-based compensation charged to KAWC in the affiliate Management Fee that were included by KAWC in its future test year expenses in the current rate case. The expense of providing stock options and other stock-based compensation to officers and employees beyond their other compensation should be borne by shareholders and not by ratepayers.

Q. Has another AWWC utility operating affiliate recently agreed that stock-based compensation expense should be removed from operating expenses in their current rate case?

A. Yes. Arizona-American Water Company (AAWC) witnesses Broderick and Kiger's rebuttal testimony in that utility's current rate case, Docket No. W-01303A-09-0343, indicates that AAWC agrees that stock-based compensation expense should be removed.[10]

Affiliate Management Fees – General Discussion

Q. What amount of affiliated Management Fee charges has KAWC requested be included in operating expenses in the forecasted test year ending September 30, 2011?

A. KAWC's filing at Exhibit 37, Schedule D-2.3, page 1, line 22, shows $9,028,121 of affiliate Management Fee expense in the forecast test year, referencing KAWC's workpaper WP-3-5. The description provided by KAWC for that amount states that:

[10] A copy of the relevant excerpts from such testimony are included in Exhibit RCS-2.

> *Management Fees expense reflects the forecast charges from the Service Company for services rendered during the forecasted period including costs from the Eastern Region Service Company office, Shared Services Center and the Customer Call Center. Also included are allocations from KAWC to Owenton Sewer, Rockwell Village Sewer, and Bluegrass Station O&M Contract.*

Q. Has KAWC indicated that the affiliate Service Company Management Fee amounts reflected in its filing are no longer accurate?

A. It appears so. KAWC's response to data request AG-1-113 provided an updated Service Company Management Fee summary for the 12 months ending September 30, 2011 that totals to $8,949,064, and stated that:

> *Please note that Service Company 2010/2011 budget was revised shortly after the original Kentucky filing. The amounts presented in the attachment represent the latest revised budget numbers for the 12 months ending September 30, 2011.*

Q. How have you addressed that affiliate Service Company Management Fee budget change?

A. I have reflected the difference between the amount utilized in KAWC's filing and the revised Service Company Management Fee summary for the 12 months ending September 30, 2011, in AG adjustment C-6, discussed below.

Q. Have you been able to thoroughly review the affiliated Management Fee charges to KAWC in the current KAWC rate case?

A. Not in the detail that these affiliated charges deserve. I have asked and reviewed discovery concerning some of the costs that have been included in KAWC's claim for affiliated Management Fees.

Q. Have you uncovered other information on regulatory commission reviews of Service Company charges to other American Water Works operating utilities, similarly situated to AAWC, of which you believe the Commission should be aware?

A. Yes. It has come to my attention that the California Public Utilities Commission ("CPUC") Division of Ratepayer Advocates ("DRA") sponsored and presented a regulatory audit of California-American Water Company's ("Cal-Am") 2009 test year revenue requirement, including a detailed review of General Office ("GO") and affiliated Service Company charges to that water utility. Notably, out of the approximately $16.8 million in General Office expense for the 2009 test year that Cal-Am had requested, the DRA-sponsored detailed audit of such expenses, which included a review of affiliated Service Company charges to Cal-Am (the regulated water utility), recommended adjustments to decrease that expense by approximately $3.6 million, and recommended an adjusted level of approximately $13.2 million. The $3.6 million represented a reduction of approximately 21.5 percent to the $16.8 million that had been requested by Cal-Am for such costs.

Section 6.3 of the CPUC's Decision No. 97-07-021 (July 9, 2009) discusses its review of such charges. The CPUC determined that Cal-Am had not experienced significant customer growth since its last general rate case, and required that Cal-Am "must overcome a heavy burden to establish that the proposed increases will result in reasonable rates." Of those GO and affiliated Service Company adjustments identified by the DRA, the CPUC adopted an allowed amount of approximately $13.6 million, ordering reductions based largely on the DRA-recommended adjustments, and reduced Cal-Am's request by approximately $3.2 million, or approximately 19 percent. The CPUC also determined that that DRA's proposed adjustments brought Cal-Am's overall proposed increase for GO costs into line with a benchmark comprised of inflation and customer growth.

Some of the DRA's recommended adjustments in that recent Cal-Am rate case appear to be for similar costs that are being charged to AAWC by AWWSC, including costs for the AWWSC Business Development, and for concerns regarding the over-allocation of Service Company charges to the regulated utility subsidiaries and corresponding under-allocation to non-regulated businesses owned and operated by American Water Works and its subsidiaries, and increased costs allocated to Cal-Am for the national Service Company's Customer Service Center.

Q. Was there a subsequent modification to the CPUC's Decision No. 97-07-021?

A. Yes. The CPUC allowed Cal-Am to file a petition, which Cal-Am submitted on October 7, 2009, wherein Cal-Am petitioned the Commission to modify Decision 09-07-021 regarding General Office charges. The primary result of that petition appears to have been a correction to an allocation to non-regulated operations, specifically, a reversal of the Commission's allocation of 12 percent of the costs of six National Service Company functions to non-regulated affiliate functions, along with some other allocation corrections of less consequence.

Q. Have the Management Fees of AWWSC been reviewed in other utility rate cases?

A. To some extent, it appears they have. The results appear to vary on a case-by-case basis. Each regulatory jurisdiction that regulates water and wastewater utilities owned by AWWC makes its own determinations as to which costs are allowed or disallowed.

Q. How have you utilized the information you obtained from CPUC Decision No. 97-07-021 in the current AAWC rate case?

A. I used it as a source of background information, and asked KAWC discovery questions to help identify questionable affiliate Management Fee expenses charged to KAWC that perhaps should be the subject of ratemaking disallowances or adjustments. I will be discussing specific adjustments that should be made in the current KAWC rate case in subsequent sections of my testimony.

Q. Please briefly describe the Management Fees that KAWC incurs from affiliates.

A. A considerable amount of KAWC's expenses come from affiliated company Management Fee charges. For the forecast test year, KAWC projected affiliated Management Fees charged to O&M expenses of approximately $9.028 million, per the Company's Exhibit 37, Schedule D-2.3.

Apparently, from KAWC's responses to data requests AG-1-109, AG-1-113, and AG-1-117, the $9.028 million is no longer accurate, as those responses each indicate a revised affiliated Management Fee budget for the forecast test year totaling $8,949,064, and that revised amount is apparently before KAWC allocations to non-regulated operations.

Q. Have you identified any adjustments that should be made to affiliated Management Fee expense?

A. Yes. As described above (in conjunction with AG adjustments C-4 and C-5), the portions of the affiliated Management Fee expense related to incentive compensation and stock based compensation should be removed. Additionally, as described below, a number of other adjustments should be made to the affiliate Management Fees included by KAWC for the forecast test year. These adjustments include:

Adjustment C-6, to revise the amount reflected in KAWC's filing based on the responses to AG-1-109, AG-1-113, and AG-1-117, which suggest that the $9.028 million is no longer accurate, as those responses each indicate a revised affiliated Management Fee budget for the forecast test year totaling $8,949,064.

Adjustment C-7, to remove affiliate business development costs charged to KAWC by affiliates via the Management Fee.

Adjustment C-8, to remove donations and other miscellaneous expenses charged to KAWC by affiliates via the Management Fee that are not appropriate for ratemaking.

C-6. Affiliate Management Fees – Excess Over Current Budget

Q. Was KAWC asked to provide a detailed breakout of the $9.028 million of AWWSC costs included in KAWC's filing (referencing Mike Miller's testimony at page 15), including complete details on the costs included for each AWWSC department and function that has charged or allocated cost to KAWC?

A. Yes. Data request AG-1-106 asked KAWC to provide that information.

Q. What did KAWC's response to AG-1-106 state?

A. It stated in full: *"Please refer to the response to question AGDR 1#113_042640."*

Q. What did KAWC's response to AG-1-113 state?

A. KAWC's response to AG-1-113 stated that the

> *… Service Company 2010/2011 budget was revised shortly after the original Kentucky filing. The amounts presented in the attachment represent the latest revised budget numbers for the 12 months ending September 30, 2011.*

Q. How does the revised Service Company budget indicate that the amount of affiliate Management Fees in KAWC's filing was excessive?

A. The revised AWWSC budget information provided in response to AG-1-113 shows total affiliate Management Fees for the 12 months ending September 30, 2011 of $8,949,064. This is lower than the amount of over $9 million used in KAWC's filing.

Q. Please explain AG Adjustment C-6.

A. This adjustment revised the amount reflected in KAWC's filing based on the responses to AG-1-109, AG-1-113, and AG-1-117, which suggest that the $9.028 million is no longer accurate, as those responses each indicate a revised affiliated Management Fee budget for the forecast test year totaling $8,949,064. As shown on Exhibit RCS-1, Schedule C-6, before allocation by KAWC of affiliate Management Fee charges to non-regulated operations such as Owenton Sewer, Boonesboro Sewer, and Bluegrass Station O&M, KAWC had based its filing on affiliate Management Fees of $9.083 million. After the allocation to non-regulated operations, KAWC's claim for affiliate Management Fees is $9.028 million. Applying the same proportionate allocation to non-regulated operations that KAWC used, the budget revision results in a net decrease to affiliate Management Fees of $133,057, as shown on Exhibit RCS-1, Schedule C-6, column C.

C-7, Affiliate Management Fees – Business Development

Q. Please explain AG Adjustment C-7.

A. This adjustment removes all identifiable affiliate "Business Development" costs included in the affiliate Management Fees for the forecast test year. Expense for KAWC is reduced by $199,546 as shown on Exhibit RCS-1, Schedule C-7. This amount reflects the $223,380 of affiliate business development charges shown in KAWC's response to data requests[11], less the $23,834 already removed in other AG adjustments. After an allocation

[11] See, e.g., KAWC's responses to PSC-2-20, page 9 of 9, and AG-1-113, page 2 of 5.

to non-regulated operations, the adjustment reduces forecast test year expense by $198,342.

Q. Why should the affiliate "Business Development" costs that are included in the Management Fee charges to KAWC be removed?

A. These charges should be removed because they are unnecessary for the provision of safe, reliable and reasonably priced water and wastewater utility service in Kentucky. Similar costs were removed by the CPUC in the most recent California American Water rate case and are being removed, with the concurrence of Arizona-American Water Company witnesses, in that affiliated utility's current Arizona rate case.

C-8, Affiliate Management Fees – Donations and Miscellaneous Expenses

Q. Please explain AG Adjustment C-8.

A. This adjustment removes Charitable Contributions, Advertising, Dues and other Miscellaneous Expenses that are inappropriate for ratemaking.

This adjustment removes all identifiable affiliate Charitable Contributions and Community Relations Expense included in the affiliate Management Fees for the forecast test year. KAWC was asked in data request AG-1-63(c) and (e) to identify the amounts included in the cost of service for the test year for Charitable Contributions and Community Relations. To these requests, KAWC responded: "None." This answer may be inaccurate because KAWC's response to data request AG-1-67(c) and (e) identified costs for these items in the test year that were in the affiliated Management Fee charges to KAWC.

In data request AG-1-67(c) and (e), KAWC was asked to identify the amounts included in the cost of service from the Service Company for the test year for Charitable Contributions and Community Relations. KAWC's response to AG-1-67(c) indicates that $4,026 was included for Charitable Contributions charged to KAWC from the Service Company, and AG-1-67(e) indicates that $2,419 was for Community Relations expenses charged to KAWC, for contributions, print ads and sponsorship of various civic and community organizations such as environmental groups, little leagues, etc. However, KAWC's response to AG-1-89 lists Charitable Contributions and Community Relations Expense charged to KAWC via the affiliate Management Fee as $4,728 and $3,499, respectively. On Schedule C-8, the $4,728 and $3,499 amounts are being removed. The primary purpose of these community organization sponsorship activities is to create goodwill for and enhance the image of American Water. These sponsorships may not even be in the communities served by KAWC.

Other expenses charged to KAWC via the affiliate Management Fee that are being removed on Schedule C-8 include $11,909 of advertising; $1,427 of deductible and non-deductible membership dues; $23,961 of membership dues; $81 of nondeductible penalties; and $20,587 of nondeductible meals expense. The IRS has a rule that certain types of meals and travel activities do not represent reasonable and legitimate business expenses, and, therefore, these expenses cannot be used as a tax deduction. I recommend that the Commission use this federal rule as a guideline and disallow these expenses for ratemaking purposes in this case.

In summary, these expenses do not benefit KAWC ratepayers and should not be recovered from them. These affiliated charges are not necessary for the provision of safe, reliable water service. Additionally, I understand that the Commission has a ratemaking policy to not allow rate recovery for charitable contributions. Moreover, KAWC would apparently record charges for donations in a below-the-line account if incurred directly, and such expenses would not therefore be included in the cost of service.[12]

A total of $65,793 is removed for these affiliated Management Fee charges, as shown on Exhibit RCS-1, Schedule C-8.

C-9, Pension and OPEB Expense Correction

Q. What amount of expense for Pension and OPEBs did KAWC reflect in its filing?

A. As documented in KAWC's responses to data requests AG-1-56 and AG-1-49, the amount of defined benefit plan pension expense included in its filing for the future test year as O&M expense is $1,267,732. Per the response to AG-1-56, the amount of Other Post Employment Benefits ("OPEB") expense included in its filing as O&M expense is $910,398. Those amounts are also documented in KAWC's workpapers provided in response to data request PSC-1-1(a) at W/P3-7, at pages 1-3.

Q. Have those amounts since been subject to revision?

A. Yes. Data request PSC-2-23(a) reference the Company's workpapers at W/P3-7, at pages 1-3, and asked KAWC to:

[12] KAWC's filing at Exhibit 37, Schedule F-7 shows $266,141 for Donations for the forecasted period and $27,703 for Civic Activities.

> *Provide all studies, reports and analyses from Towers Perrin which were used to develop the pension projections for the years 2010, 2011, 2012, 2013 and 2014.*

KAWC's response provided an updated forecast from Towers Watson that reflects lower amounts for pension and OPEBs that would reduce the combined expense for these items in KAWC's filing by $305,468. KAWC's response to PSC-2-23(a) also states that: *"It is the Company's intention to include all known changes to the forecasted test-year in the required updated filing that will occur at the time of updating the base period for actual data through May 2010."*

Q. Please explain AG Adjustment C-9.

A. This adjustment reflects a reduction to KAWC's proposed forecasted test year amounts for Pension and OPEB Expense, per the Company's confidential response to data request PSC-2-23. This downward correction helps alleviate some of the concerns about KAWC's pension and OPEB costs being so much higher than pre-2009 levels. As shown on Exhibit RCS-1, Schedule C-9, forecast year operating expenses are reduced by $305,468.

C-10, Rate Case Expense – Prior Rate Cases

Q. What amount of rate case expense has KAWC requested?

A. As shown on KAWC's responses to data requests AG-1-122 and PSC-1-1a, WP3-8, KAWC has requested the following annual allowance for rate case expense:

Case No. 2008-00427 General Balance	$	138,804
Case No. 2007-00143 Depreciation Study	$	6,000
Case No. 2008-00427 Cost of Service Study	$	3,324
Total for Prior Rate Cases	$	148,128

Q. Were KAWC's last two rate cases resolved by settlements?

A. Yes. Case Nos. 2007-00143 and 2008-00427 were not litigated cases in which the Commission made specific findings regarding specific issues. Rather, both of these cases were resolved through "black box" settlements.

Q. What do you mean by "black box" settlements?

A. This means that the details of individual adjustments and the treatment of specific expenses were not specifically addressed.

In particular, Case No. 2007-00143 was resolved in a "black box" settlement that only made mention of the total agreed upon rate increase amount and an agreed upon overall composite depreciation rate.

Case No. 2008-00427 was also settled in a "black box" settlement, with specifics provided only as to (1) the amount of annual revenue increase; (2) that KAWC's forecasted rate base included $20.2 million of Kentucky River Station II ("KRS II") CWIP without an AFUDC offset; (3) KAWC's tap fees were increased to the level proposed in KAWC's application; (4) KAWC continued to use single tariff pricing; (5) the depreciation rates approved in Case No. 2007-00143 continued in effect; (6) The AG, LFUCG and CAC waived the right to assert in KAWC's next rate case that some portion of KRS II cost be disallowed to avoid "rate shock"; and (7) Beginning in Fiscal Year

2010, KAWC shall increase its contribution to the Help to Others Program to a total contribution of $60,000. Moreover, as stated on page 4 of the Commission's June 2, 2009 Order in that matter:

> *We caution the signatories that our approval of the Settlement Agreement should not be considered as acceptance and approval of any ratemaking methodology or accounting treatment beyond the confines of this proceeding. While the signatories have agreed to the application of certain ratemaking methodologies to reach the agreed revenue requirement, our decision today focuses only on the agreed total revenue requirement that the proposed rates will produce. We make no findings regarding the application of CWIP or AFUDC offset to investor-owned water utilities. Such pronouncement regarding such issues should only come only after a rate adjustment proceeding in which those issues are fully explored and argued.*
>
> *We further place all signatories on notice that, while some signatories have agreed to waive their right to raise certain issues in Kentucky-American's next general rate proceeding, this Commission has not. Kentucky-American should be prepared to address in such proceeding questions from us related to the possible balancing of shareholder and ratepayer interests to prevent the occurrence of "rate shock."*

No level of rate case expense was specifically authorized in either of those settlements. Indeed, in Case No. 2008-00427, the AG had challenged the proposed inclusion by KAWC of prior rate case cost amortizations in the current case.

Q. Do you have any other concerns about including amortizations of prior rate case costs?

A. Yes. I have concerns that the approach of recording rate case cost as an asset that is subsequently amortized applies a single-issue approach to an expense that probably does not deserve capitalization treatment. Additionally, KAWC is using a forecast test year.

The purpose of a forecasted test period is to match rates with the expected revenue requirements for a specific future 12-month operating period. In this case, the 12-month period is October 2010 through September 2011. KAWC used construction and operating expense budgets to forecast its cost of operations for that 12-month period. The rate case costs for the two previous rate cases were incurred in periods prior to the test period. Under a normalization approach, rate case cost is recorded as an expense in the period incurred. A utility, pursuant to Statement of Financial Accounting Standards No. 71 (FAS 71) can record a "regulatory asset" (an expense carried on its books as an asset) if it is probable that the cost will be allowed in rates and the revenue allowed is to recover the previously incurred cost rather than to provide for expected levels for similar future costs. It is questionable whether the costs for two prior rate cases continue to warrant deferred treatment under FAS 71 due to their relative immateriality. KAWC has requested a total rate base of over $362 million (with CWIP). The balance of costs remaining from those two prior rate cases (per KAWC's response to data request AG-1-122) total $256,499. The deferral balance thus represents only 0.071 percent in relation to KAWC's proposed rate base.[13] Additionally, the total expense for those prior rate cases being requested by KAWC is only 0.157 percent of KAWC's total revenue requirement request.[14] This could also be viewed as insufficiently material to warrant special single-issue regulatory asset treatment. By selecting this individual expense to record as an asset to be subsequent recovered, KAWC has, in effect, isolated rate case expense as a single issue.

[13] $256,499 / $362,672,028 = 0.071%. It is noted that KAWC is not requesting inclusion of its unamortized rate case expense balance from those two prior rate cases in rate base (other than as a component of cash working capital). Comparing an asset amount with rate base is a framework for evaluating materiality.
[14] $148,128 / $94,371,912 = 0.157%.

Q. What did the Commission state concerning expense deferrals in its Order in Case No. 2000-120?

A. While addressing other deferrals claimed by KAWC in that case, and not specific to rate case expense, at pages 23-24 of that Order (dated November 27, 2000), the Commission expressed the following general concern with respect to KAWC's practice of deferring expenses as regulatory assets:

> *The Commission is concerned with Kentucky-American's present practice of deferring expenses as regulatory assets. In the future Kentucky-American shall formally apply for Commission approval before accruing an expense as a regulatory asset, regardless of the ratemaking treatment that the Commission has afforded such expense in previous rate case proceedings. The Commission will consider each expense independently and with particular regard to materiality.*

This general concern articulated by the Commission in Case No. 2000-120 can also provide useful guidance as a framework for examining in the current KAWC rate case, the Company's request to load the forecast test year not only with its forecasted expenses for the current rate case but also with continued single-issue focused deferrals and amortizations of the costs of two previous rate cases.

Q. Please explain AG adjustment C-10.

A. As shown on Exhibit RCS-1, Schedule C-10, this adjustment removes the $148,128 which represents the sum of the amounts for prior rate case expense that were included in KAWC's filing. Given these facts, it is inappropriate to assume for ratemaking purposes in the current case that specific prior rate case cost, depreciation study and cost of service study expense amounts with specific amortization periods were decided by the

Commission in either prior case. Since rate case settlements always involve compromises and other "give and take" actions, it is impossible to determine from a "black box" settlement what specific rate treatments are or are not included in the agreed upon rate increase amount. Additional concerns relate to the single-issue focus of KAWC's practice of deferring expenses as regulatory assets, and the relative immateriality of the prior rate case costs to the asset level (measured by rate base) or the total revenue requirement of the current KAWC rate case. Accordingly, the $148,128 for prior rate case costs should be removed from forecast test year expenses to address the concerns identified above.

C-11, Rate Case Expense – Current Rate Case

Q. What has KAWC claimed for current rate case cost?

A. As provided in response to data request AG-1-122, and summarized on Exhibit, RCS-1, Schedule C-11, page 1, columns A through C, KAWC has requested a total rate case cost of $670,000, and an annual amortization of $218,333.

Q. How has KAWC over-projected its actual total costs from its prior two rate cases?

A. As shown on Exhibit, RCS-1, Schedule C-11, page 2, KAWC over-projected the actual cost of Case No. 2008-00427 by $159,005 and over-projected the actual cost of Case No. 2007-143 by $233,258. Both of those rate cases settled. It 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.

Q. Please explain AG adjustment C-11.

A. This adjustment provides for a normalized annual allowance for the cost of the current KAWC rate case of $152,045, as shown on Exhibit RCS-1, Schedule C-11, page 2. KAWC's requested amount of $218,333 is reduced by $66,288.

Q. How would you recommend that the amount of normalized allowance for rate case expense be addressed if it becomes apparent that the current KAWC would not be settled?

A. If it becomes apparent that the current KAWC rate case is not going to be subject to a settlement, this would indicate that approximately one in three KAWC rate cases do not settle and are litigated. The percentage used for purposes of the normalization, in that situation, would likely need to be adjusted, in order to provide for a more representative normalized allowance.

Q. Please explain why you recommend that the Commission prospectively treat the allowance for rate case expense as a normalized amount of O&M expense, rather than an amortization.

A. Prospectively, beginning with the cost for KAWC's current rate case, I recommend that the Commission commence treating the annual allowance for rate case expense as a normalized operating expense amount, rather than an amortization, for several reasons, including the following: Although the amortization treatment afforded rate case expense previously effectively treats the rate case expense as an asset, rate case costs do not meet the criteria for a regulatory asset of volatility and materiality and should not be afforded regulatory asset treatment. The ratemaking treatment of such costs should therefore provide for a normalized expense allowance (similar to other O&M expenses), rather than the establishment of a regulatory asset that is amortized prospectively. The purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably and prudently incurred regulatory expense, rather than to provide the utility with a single-issue focus and what could otherwise become a guaranteed dollar-for-dollar recovery for this cost. Consistent with such normalization treatment of this expense, KAWC should not establish an asset for deferral of the current rate case cost and should not record amortization. After a normalization approach is adopted, any remaining amortization of prior case balances would be replaced by a new representative, normalized rate case expense in KAWC's next rate case.

C-12, Depreciation Expense

Q. Please explain AG Adjustment C-12.

A. This adjustment to Depreciation Expense consists of two components:

(1) to adjust forecast Depreciation Expense based on a recalculation of depreciation rates for all plant in service as of December 31, 2010 and the KRS II costs of $163,891,660, as provided in response to data requests PSC-2-43 and PSC-3-6; and

(2) to adjust Depreciation Expense for the negative net salvage percentage applied to Account 333, Services.

Q. What is the impact of the first part?

A. Per KAWC's response to data request PSC-3-6, this impact reduces Depreciation Expense by $351,080 as shown on Exhibit RCS-1, Schedule C-12, page 1.

Q. What is the impact of the adjustment to Depreciation Expense for the negative net salvage percentage applied to Account 333, Services?

A. Revising the negative net salvage percentage applied to Account 333, Services, to the more reasonable 20 percent, reduces depreciation expense by $302,951, as shown on Exhibit RCS-1, Schedule C-12.

Q. Please explain why an adjustment to the negative net salvage percentage for this account is necessary.

A. KAWC witness Spanos used a negative net salvage percentage for this account of 100 percent, largely based on judgment. As noted in prior AG testimony, this negative salvage ratio proposed by KAWC *"sticks out like a sore thumb when compared to Mr. Spanos' more reasonable future net salvage ratios"*[15] for the other KAWC plant accounts. It is far beyond the negative net salvage ratios used for any other account, and is based on judgment. In contrast to the 100 percent proposed by KAWC, I recommend a negative 20 percent net salvage ratio for Account 333, Services. This is clearly more reasonable on its face, and is closer to the actual recent experience for this account. The calculations shown on Exhibit RCS-1, Schedule C-12, page 2, support the reasonableness of a negative 20

[15] See, e.g., Case No. 2007-00143, Direct Testimony of AG witness Majoros at page 11.

percent estimate, which is consistent with KAWC's actual recent experience for this account.

C-13, Capitalization Rate

Q. What is a capitalization rate?

A. The capitalization rate is the ratio or percentage of labor and benefit costs that is charged to construction projects and other non-O&M expense accounts. The capitalization ratio is typically derived from employees accounting for how their work time was spent, i.e., on capitalized construction projects versus O&M work.

Q. How does the capitalization rate affect forecast test year expenses?

A. In general, the lower the capitalization rate, the more forecasted test year labor and benefits cost is charged to O&M expenses.

Q. What capitalization rate did KAWC use for the forecast test year?

A. KAWC used 17.34%.

Q. How does that compare with prior years?

A. It is much lower than prior years. The following table summarizes KAWC actual and budgeted capitalization ratios from information that KAWC provided in response to data request PSC-2-13:

KAWC Capitalization Rates			
Year	Actual	Budget	Difference
2005	15.54%	12.98%	2.56%
2006	18.84%	19.00%	-0.16%
2007	21.34%	18.06%	3.28%
2008	23.35%	18.12%	5.23%
2009	19.64%	19.96%	-0.32%
Averages:			
2007-2009	21.443%	18.713%	2.730%
2006-2009	20.793%	18.785%	2.008%
2005-2009	19.742%	17.624%	2.118%

Q. Are there concerns regarding KAWC's ability to budget its capitalization rate accurately?

A. Yes. As shown in the above table, KAWC's budgeted capitalization rates have been below actual for the three-year, four-year, and five-year averages through 2009.

Q. Please explain the concern regarding the capitalization ratio that KAWC applied to forecast test year labor and benefit costs.

A. There are two concerns: (1) the capitalization ratio that KAWC applied to forecast test year labor and benefit costs is much lower than prior years; and (2) KAWC has on-average under-projected its actual capitalization ratios (i.e., budgeted a higher percentage of labor hours to expense than has actually occurred).

Q. What explanation has KAWC offered for application of a significantly lower capitalization rate to forecast test period costs?

A. In response to data request PSC-2-13, KAWC explained that the forecast test year includes additional labor for operating the KRS II, and that the added positions would charge about 95 percent of their time to O&M, which would lower KAWC's overall capitalization percent.

Q. Does that explanation resolve concerns regarding the use of a lower capitalization rate?

A. No. New hires are not eligible for some of the more costly employee benefits, like participation in the AWWC defined benefit pension plan. Consequently, the capitalization ratio applied to such costs should not be affected by new hires which are not eligible to receive such benefits. Additionally, the capitalization percentage has fluctuated from year to year, so an average should be used, especially in view of KAWC's propensity to budget capitalization percentages that have been well below actual on average.

Q. Please explain AG Adjustment C-13.

A. This adjustment uses the calculations that KAWC provided in response to data request PSC-3-4 in order to derive an adjustment to adjust forecast test year expenses to reflect the use of a 19.742 percent capitalization rate. The 19.742 percent capitalization rate is the average of actual capitalization percentages for the last five years, 2005-2009, as shown in the table discussed above. Data request PSC-3-4 had asked KAWC to calculate the impact on the forecast test year of using a capitalization rate of 18.742 percent in place of the 17.34 percent that KAWC had used. KAWC provided amounts that showed a reduction to its revenue requirement of $211,276 related to using the 18.472 percent capitalization rate, rather than the 17.34 percent. That information is shown in column A of Schedule C-13. In column B, I have adjusted those impacts to reflect the use of my recommended 19.472 percent capitalization rate. In column C, I have converted the revenue requirement results into operating expense adjustments. In total, operating expenses for the forecast test year are reduced by $358,551.

C-14, KAWC Employee Party, Outing and Gift Expenses

Q. Please explain AG Adjustment C-14.

A. This adjustment removes the Employee Party, Outing and Gift Expenses that KAWC had recorded in above-the-line accounts (account 92620), as listed in Exhibit 37, Schedule F-2.3 in KAWC's filing for the forecast test year. These expenses include award banquets, United Way function, and holiday event. Utility rates should include a reasonable level of costs that are necessary for the provision of safe, adequate and proper utility service. The expenses that I recommend be removed do not meet this standard and should not be borne by the Company's customers; rather they should be funded by KAWC's shareholders. As shown on Exhibit RCS-1, Schedule C-14, this adjustment reduces operating expenses by $25,070. A similar adjustment was recommended by the AG in the prior KAWC rate case.[16]

[16] See, e.g., Case No. 2008-00427, Direct Testimony of AG witness Henkes, at pages 62-63.

C-15, Vacancies and Over-projection of Pay Increases

Q. Please explain the adjustment for vacancies and over-projection of pay increases.

A. This adjustment is shown on Exhibit RCS-1, Schedule C-15, and adjusts for vacancies and over-projection of pay increases.

Q. How has KAWC explained vacancies?

A. KAWC's response to data request AG-1-35 provides the following explanation of vacancies:

> *Vacancies occur throughout the year due to terminations, retirements, and creation of new positions to address changing work requirements. Filling of vacant positions often has a cascading effect as internal candidates move to open positions in the bargaining unit bidding process or the non-union job posting process. More specialized positions may require a longer recruiting period in order to obtain the right candidate for the position.*

KAWC's observation that the filling of vacant positions often has a cascading effect and that specialized positions may require a longer recruiting period indicate that some level of vacancies is to be expected at a company the size of KAWC.

Q. Please discuss KAWC's forecast work force level and how you developed a vacancy rate.

A. KAWC's response also listed vacant positions as of December 31, 2008, December 31, 2009 and as of April 19, 2010. At any point in time, KAWC will likely have a number of vacant positions. This appears especially so for the forecast test year when KAWC is attempting to add several new positions to staff the KRS II plant. KAWC's actual work force is listed at 139 employees in January and February, 2010 and 140 employees in March, 2010, in the Company's response to data request AG-1-32. Then it suddenly jumps to 153 employees for each projected month, April 2010 through September 2011. For the forecast test year, KAWC assumed a work force of 153 employees, as shown in response to data request AG-1-32.

I considered information including the following:

Comparable Information on Work Force and Vacant Positions	
Actual work force at March 2010	140
Projected forecast test year work force	153
Budgeted increase, in number of positions	13
Vacant positions as of 4-26-2010	9
Vacant positions as of 4-26-2010, non KRS II related	3
Vacant positions at end of 2008	3

Although KAWC's vacancy rate is currently much higher than 3 positions, it is reasonable to assume that the KRS II plant would need to be appropriately staffed during the forecast test year. Consequently, a three-position vacancy rate, on average, was selected. KAWC has had that level of vacancies in 2008 and had much higher level of vacancies at year-end 2009.

A three-position vacancy rate (which appears conservative) equates to a 2.0 percent vacancy factor.

Q. Please explain the concern regarding KAWC's over-projection of pay increases.

A. As shown in the Company's response to data request PSC-2-14, KAWC has historically over-projected pay increases. That is, on average, KAWC's actual pay increases have been lower than budgeted by KAWC. Because the payroll expense in the forecasted test year is based on KAWC's forecasts, this historical experience suggests that there is a need to temper KAWC's projected pay increases by making a downward adjustment.

Q. How has KAWC historically over-projected pay increases?

A. The information provided by KAWC in response to data request PSC-2-14 shows actual and budgeted pay increases for union and non-bargaining employees. The information KAWC provided in response to data request PSC-2-14 is summarized on Exhibit RCS-1, Schedule C-15, page 2. On average, for 2007-2009, KAWC over-projected pay increases by 0.5 percent for union and 0.3 percent for non-bargaining (i.e., KAWC's budgeted pay increases averaged that amount higher than average). Similar results occurred when 2010 information is included in the analysis. To address KAWC's demonstrated history of overstating actual pay increases, I have applied a 0.4 percent reduction to forecast test year payroll expense.

Q. Please explain the adjustment shown on Exhibit RCS-1, Schedule C-15, page 1.

A. This adjustment starts with the amount of payroll expense that KAWC included in the forecast test year of $8,039,623. It reduces that amount for the impact of other AG adjustments that affected payroll expense. It applies a 2.4 percent reduction (2.0 percent for an average vacancy rate, and 0.4 percent for KAWC's historic budgeted over statement of pay increase percentages). The reduction to payroll expense is $163,785, as shown on line 7.

The impact on employee benefits is calculated on lines 8-13 using information on benefits loading (i.e., the relationship of forecast test year employee benefits cost to payroll cost) that was provided by KAWC in response to data request AG-1-347. The reduction to forecast test year benefits expense is $83,138, as shown on line 13.

The combined reduction to forecast test year O&M expense is $246,923, as shown on line 16.

C-16, KRS Lagoon Cleaning Expense Normalization

Q. Please explain AG Adjustment C-16.

A. KAWC has included $102,376 in the forecast test year for KRS Lagoon cleaning, as detailed on Company workpaper WP3-4, page 2 of 3, which was provided in response to data request PSC-1-1a. This includes 8 months (October 2010 through May 2011) at $7,693 per month and 4 months (June-September 2011) at $10,208 per month. KAWC estimated that a June 2011 KRS Lagoon cleaning would cost $245,000, and proposes that amount to be capitalized and amortized over a 24-month period. KAWC's response to data request AG-2-62(c) states that:

> *The deferral and two year amortization of the KRS Lagoon has been consistent with prior filings since 2000 and has been accepted by the commission. See the Commission's Order in Case No. 2004-00103.*

Q. What supporting documentation did KAWC provide for the $245,000?

A. Virtually none. KAWC's response to data request AG-2-62(a) states that:

The $245,000 is an estimate for the KRS Lagoon cleaning to be performed June 2011. Since the expense has not been incurred there is no invoice or supporting documentation.

Q. Are there any other concerns about the lack of supporting for KAWC's projected cost?

A. Yes. KAWC stated in its response to data request PSC-2-18(a) that the KRS I sludge Lagoon cleaning project is bid, with the project awarded to the lowest qualifying contractor. No bids or supporting documentation were provided, either in response to that request or in response to data request AG-2-62. In fact, as noted above, KAWC's response to AG-2-62 stated that there was no supporting documentation.

Q. How does KAWC's estimate compare with the cost of prior KRS Lagoon cleanings?

A. It is much higher than any of the costs of prior KRS Lagoon cleanings, which ranged from $144,000 in the fall of 2001 to $202,500 in the fall of 2006, with the most recent cleaning in the summer of 2009 costing $184,627, as summarized in the following table:

Kentucky River Station	
Lagoon Cleaning Cost	
Date	Amount
Fall 2001	$ 144,000
Summer 2004	$ 187,529
Fall 2006	$ 202,500
Summer 2009	$ 184,627
Average	$ 179,664

The average cost of the last four cleanings was approximately $180,000.

Q. What adjustment to you recommend?

A. As shown on Exhibit RCS-1, Schedule C-16, I recommend a normalized expense allowance approach to this expense. Based on the history, a total allowance of $180,000 normalized over a 24 month period, for an annual allowance for this expense of $90,000 per year would be reasonable. KAWC's proposed amount is reduced by $12,376.

Q. Please explain why you recommend a normalized expense approach rather than a capitalization and amortization approach for expenses such as this.

A. I have concerns that the approach of recording periodically recurring operating expenses as an asset that is subsequently amortized effectively applies a single-issue approach to an expense that probably does not deserve capitalization treatment. A utility, pursuant to Statement of FAS 71 can record a "regulatory asset" (an expense carried on its books as an asset) if it is probable that the cost will be allowed in rates and the revenue allowed is to recover the previously incurred cost rather than to provide for expected levels for similar future costs. It is questionable whether the costs for KRS Lagoon cleaning warrant deferred treatment under FAS 71 due to their relative immateriality. KAWC has requested a total rate base of over $362 million (with CWIP). The KRS Lagoon cleaning costs have averaged approximately $180,000 and have occurred approximately every two years. Even if KAWC's unsupported projected amount of $245,000 were to be used as a basis for evaluating whether this should be deferred as an asset under FAS 71 (rather than being expensed when incurred), a deferral of such balance would represents only 0.050 to

0.068 percent to in relation to KAWC's proposed rate base.[17] Additionally, the total expense for being requested by KAWC is only 0.095 to 0.108 percent of KAWC's total revenue requirement request.[18] This could also be viewed as insufficiently material to warrant special single-issue regulatory asset treatment. Additionally, by selecting this individual expense to record as an asset to be subsequently recovered, KAWC has, in effect, isolated KRS Lagoon Cleaning costs as a single issue.

C-17, Uncollectibles Expense

Q. Did KAWC use budgeted information as the basis for its forecast test year claim for Uncollectibles?

A. No. KAWC did not use the 2010/2011 budget to determine its forecasted test year Uncollectible expense. It used a 2009 uncollectible expense to billed revenue ratio applied to the pro forma revenues for the forecasted test year. The Uncollectibles Factor used by KAWC is 0.783590 percent.

Q. How does that compare with the Uncollectibles Factor used in KAWC's past two cases and with recent historical experience?

A. It is much higher than the Uncollectibles Factors employed by the Commission in Case Nos. 2000-00120 and 2004-00103 of 0.45620 percent and 0.50683 percent, respectively. It is also higher than 2007, or 2008 or an average of 2007-2009, which are 0.7654 percent,

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[17] \$245,000 / \$362,672,028 = 0.068%. \$180,000 / \$362,672,028 = 0.050%. Comparing an asset amount with rate base is a framework for evaluating materiality of a cost that KAWC seeks to record as a regulatory asset and amortize.

[18] \$102,376 / \$94,371,912 = 0.108%. \$90,000 / \$94,371,912 = 0.095%.

0.6739 percent and 0.7410 percent, respectively.[19] KAWC's proposed Uncollectibles Factor is higher than any of these comparable reference points.

Q. How has KAWC explained why it proposes using such a high Uncollectible Factor?

A. KAWC's responses to discovery explain why KAWC has used such a high Uncollectible Factor. For example, KAWC indicated that it reviewed its historical Uncollectible ratio experience and concluded that the experience for 2009 was the best indicator of the Uncollectible expense likely to be present in the forecasted test year in this case, given the current and expected economic conditions during the forecast test period.[20]

Q. Do you agree with KAWC's use of the highest Uncollectible Factor that is based only on 2009 results?

A. No. KAWC's Uncollectible percentage has not shown a continual upward trend; rather, as shown on Company workpaper WP3-10, it has fluctuated from year-to-year. Consequently, I recommend using a three-year average for the period 2007-2009, rather than placing undue reliance on any one single year, especially a single year, 2009, that could be viewed as the low point in a recession.

Q. Please explain AG Adjustment C-17.

A. As shown on Exhibit RCS-1, Schedule C-17, this adjustment computes forecasted test year Uncollectibles Expense by applying a three-year average Uncollectible percentage to

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[19] See, e.g., KAWC response to PSC-1-1a, WP3-10, page 6 of 9.
[20] See, e.g., KAWC's response to PSC-3-7.

forecast test year billed revenue. The recommended allowance of $479,823 is $27,589 lower than KAWC's proposed amount of $507,412.

Q. Does the Uncollectibles Factor affect anything else in the Revenue Requirement?

A. Yes. It affects the GRCF. As shown on Exhibit RCS-1, Schedule A-1, I have used the three-year average Uncollectible Factor of 0.7410 percent in computing my recommended GRCF.

C-18, Payroll Tax Expense

Q. Please explain your adjustment for Payroll Tax Expense.

A. As shown on Exhibit RCS-1, Schedule C-18, this adjustment reduces Payroll Tax Expense by $84,155, as a result of adjustments to forecast test year payroll expense.

VII. COMMENTS REGARDING THE BARYENBRUCH "STUDY"

Q. Please comment on the "study" filed by KAWC witness Baryenbruch in this case.

A. I question what, if any, useful purpose it can serve in the current KAWC rate case. In general, it attempts to compare KAWC with electric companies. It fails to compare KAWC with other water companies. It fails to compare KAWC with the other operating affiliates of AWWC.[21] It does not evaluate affiliated Management Fee expenses that are charged to KAWC from a perspective of whether the particular expenses are for costs that

[21] Indeed, KAWC even objected to providing comparable information from which one could compare KAWC's costs on a per-customer basis with other AWWC water operating utilities. One would think a comparison with other water operations, especially ones that are affiliated companies, would provide a more meaningful comparison that attempting to compare KAWC with electric companies.

are appropriate for ratemaking purposes. It does not address forecast test year expenses, which are the basis for KAWC's rate increase request. It does not explain why KAWC's cost per customer are so much higher than the comparable companies cited in data request AG-1-93 or the electric companies cited in AG-1-94. It really provides no useful insight as to whether affiliate Service Company charges to KAWC are reasonable or appropriate for inclusion in operating expenses in the current KAWC rate case.

VIII. COST CAP

Q. In addition to the accounting matters which you have discussed above, are there any remaining concern(s) in the filing?

A. Yes.

Q. Please describe them.

A. In case number 2007-00134 KAW filed an application with the PSC for approval of certain facilities to address its source of supply deficit[22]. As I have been instructed by the AG, he intervened in the matter. He supported the Company's application if, and only if, a

[22] See *In the Matter of: Application of Kentucky-American Water Company, a/k/a Kentucky American Water For Certificate of Convenience and Public Necessity Authorizing Construction of Kentucky River Station II ("KRS II"), Associated Facilities, and Transmission Line* at ftp://162.114.3.166/PSCSCF/2007%20cases/2007-00134/KAW_Application_033007.pdf

"cap" on the construction cost be imposed[23]. Unfortunately, and much to his frustration, it was not accepted in the PSC's final order[24].

Q. Given the PSC's refusal to accept the AG's request, are there any ascertainable, accounting consequences at hand?

A. Yes. In discovery, the AG and Staff requested information pertaining to the Company's projected costs for the construction of the new facilities and those for which the company now seeks approval.

Q. What did that discovery reveal?

A. The Company's responses to Staff data requests PSC-3-10, PSC-3-11, and PSC-3-12 provide a listing of the change orders for the water treatment plant, the pipeline, and the booster pumping station, respectively.[25] For the water treatment plant, KAWC's response to data request PSC-3-10 lists five change orders, netting to a change order total of $1,051,441. For the 42-inch pipeline, KAWC's response to data request PSC-3-10 lists six change orders for Section A and five for Section B, netting to a change order total of $2,484,427 for Section A and $1,514,439 for Section B, for a combined total of $3,998,866 for the pipeline. For the booster pumping station contract and storage tank

[23] See pages 23 through 26 of the AG's brief at ftp://162.114.3.166/PSCSCF/2007%20cases/2007-00134/AG_Brief_032008.pdf.
[24] See pages 37 through 39 of the PSC's order at ftp://162.114.3.166/PSCSCF/2007%20cases/2007-00134/PSC_Order_042508.pdf. This order became final on 5 June 2008 after the PSC denied the petition for rehearing filed by Citizens for Alternative Water Solutions.

[25] Copies of these responses are included in Exhibit RCS-2.

contract, , KAWC's response to data request PSC-3-12 lists four change orders, netting to a change order total of $325,133.

The Company's response to data request AG-1-133 also discusses the change orders and indicates at page 10 of 11, that the cost for KRS II in the current KAWC case is $163,885,837. The originally projected amount was $161,290,000 in the KRS II certification case. The cost overrun reported in data request AG-133, on page 10 of 11, is $529,998, not including additional AFUDC of $2,065,839.

Q. What does this suggest to you?

A. The AG's recommended cost "cap" would have limited these expenses and would have precluded these additional costs now requested in this case.

Q. Does this conclude your testimony?

A. Yes, it does.