

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY-AMERICAN )  
WATER COMPANY FOR AN ADJUSTMENT OF ) Case No. 2010-00036  
RATES SUPPORTED BY A FULLY )  
FORECASTED TEST YEAR )

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Brief of the Attorney General

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## INTRODUCTION

Kentucky-American Water Company is a well-positioned utility. KAW's regulated water business is in the best shape that it has enjoyed in several decades, if not the best shape ever. The solution to a problem that has been looming over the Company since 1986, namely the inadequacy of water-supply during a severe drought and a lack of adequate treatment capacity, is nearly complete.<sup>1</sup> A protracted battle regarding the condemnation of the utility is now history, and it is no longer necessary for the Company to apply its talent and resource to this issue. The impact of these two developments on the strength and vitality of KAW is difficult to understate.

Kentucky-American Water enjoys strong performance. It "has been able to maintain stable financial results."<sup>2</sup> It "has been able to attract capital, adequately carry out its public service obligation, improve service and address its major cost needs, including the KRS II plant and pipeline project."<sup>3</sup> The reduction in risk consequent to the KRS II plant commencing operation, success in the condemnation effort, and remarkably favorable capital markets will strengthen its position. Simply stated: KAW may be the source of envy for any utility in this Commonwealth.

It is therefore difficult, at least at first glance, to understand, the Company's request for an overall increase in rates of approximately 37.7%.<sup>4</sup> Upon inspection, much

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<sup>1</sup> Application, Direct Testimony, L. Bridwell, page 22, lines 7 to 9.

<sup>2</sup> Rebuttal Testimony, M. Miller, page 3, lines 19 and 20.

<sup>3</sup> Rebuttal Testimony, M. Miller, page 3 lines 22 to 24.

<sup>4</sup> Application, KAW\_APP\_EX7\_022610, page 2 of 8.

of the driving force behind the magnitude of this rate increase is the impact of the KRS II project.<sup>5</sup>

As they always do, “The birds have come home to roost.” The realization of impact of the massive addition of plant is arriving as the full recovery of the KRS II project is now being incorporated into rates. However, the KRS II project is not the only item KAW offers in support of its request for an increase. Upon inspection of the entire request, several KAW proposals require adjustment in order for Kentucky-American Water’s proposal to produce fair, just, and reasonable rates. The Attorney General addresses these items in the following manner.

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<sup>5</sup> Application, Direct Testimony, M. Miller, page 4, lines 15 – 20.

## Section 1 – Income Tax

### 1.1 Major Tax Accounting Change (ADIT)

Seeking favorable tax treatments and obtaining tax benefits is in the best interests of Kentucky-American Water Company. Consistent with this principle, the American Water Works Company (AWWC), Kentucky-American’s parent, filed an IRS Form 3115, Application for Change in Accounting Method, on 31 December 2008.<sup>6</sup> The Company received final approval of the change in February 2010; therefore, the Company may now take a tax deduction for costs that were previously capitalized for tax purposes.<sup>7</sup> In terms of impact, the change will provide a significant incremental increase in the balance of ADIT, Accumulated Deferred Income Taxes.

Unremarkably enough, the Company is required through Financial Interpretation 48 (FIN 48) to identify each uncertain tax position, evaluate the position on its merits, and determine whether the deduction is more-likely-than not to be sustained by the IRS.<sup>8</sup> The Company has taken this action, and, as a consequence, it has created a “reserve for a portion of the capitalized repairs deduction” that is more-likely-than not to be disallowed by the Internal Revenue Service.<sup>9</sup>

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<sup>6</sup> KAW response to OAG 2-122.

<sup>7</sup> KAW response to OAG 2-85, page 20 of 26.

<sup>8</sup> See, for general background, KAW response to hearing data requests, Item #3, page 19 of 39.

<sup>9</sup> Rebuttal Testimony, M. Miller, page 22.

Thus, in terms of FIN 48, KAW has created a reserve; however, FIN 48 is a financial reporting requirement. It is not dependent upon nor does it control the rate-making treatment of the expense.<sup>10</sup> Therefore, there is a rate-making issue to resolve.

In general terms, the increase in accumulated deferred income tax expense is in the nature of an interest-free loan.<sup>11</sup> Thus, the Company has reflected a rate base reduction related to deferred income taxes-capitalize repairs, but the reduction is net of the FIN 48 reserve.<sup>12</sup> The position does not strike the correct regulatory balance.

In particular, once the Company made the change in accounting method, it began realizing the benefit of the change, namely capital with a zero-cost rate. While there is a chance that it may not retain all of the benefit, it is currently enjoying all of the benefit, and there is a chance that there will be no challenge to or loss of the FIN 48 reserve amount. The appropriate rate-making treatment of the FIN 48 reserve is to record it in a regulatory liability account, remove it from rate base, and identify it as a separate line-item on the rate base schedule.

At the moment, it is not clear whether the FIN 48 reserve amount will remain zero-cost capital or whether it will ultimately have an interest cost. In terms of a worse-case scenario, "the current interest rate applicable to underpayments of FIT to the IRS is

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<sup>10</sup> TE 10 August 2010 (J. Warren) 11:20:50 – 11:21:43.

<sup>11</sup> Rebuttal Testimony, J. Warren, page 30, lines 11 to 13.

<sup>12</sup> Rebuttal Testimony, M. Miller, page 23, line 6 to 8.

4% until such time as the IRS notifies the entity of an assessment amount.”<sup>13</sup> Thus, if the IRS disallows the deduction, then the cost rate is 4%, a rate significantly below KAW’s proposed weighted cost of capital, 8.58%.<sup>14</sup> Of course, there is also the possibility that it will remain zero-cost capital. With regard to this latter outcome, in the absence of an adjustment to KAW’s proposal, the Company retains all of the benefits.

In terms of regulatory balance, there should be recognition in rate-making of the fact that the Company’s reception of benefit is current, and speculation regarding the possible disallowance of the FIN 48 reserve should not wall-off the full benefit from ratepayers. Rather, the Commission should utilize a rate-making procedure through which (1) the benefit is recognized with an interest amount for the FIN 48 reserve which is recorded above-the-line in tandem with the recordation of a regulatory liability. If the deduction is not disallowed, then there would be a refund to ratepayers. Alternatively, (2) KAW could record interest below-the-line in tandem with the creation of a regulatory asset. If interest is assessed, then the Company could request recovery of the interest in future rate cases.

Kentucky-American Water indicates that it will not seek to pass along either interest or penalties associated with the accounting change in future rate proceedings.<sup>15</sup>

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<sup>13</sup> KAW response to hearing data requests, Item 2. (“If an entity elects to challenge the IRS assessment the interest rate is 6% per annum from the assessment date forward until such payment is made (assumes entity challenge is unsuccessful).”)

<sup>14</sup> Application, Schedule J-1, page 1 of 2.

<sup>15</sup> TE 11 August 2010 (M. Miller) 11:32:00 – 11:34:18 ( KAW’s position under its proposal. KAW seeks symmetry in the FIN 48 rate-making treatment. The position is qualified accordingly.)

However, it may never incur interest or a penalty, and the Company currently has use of these funds. There is, thus, a lack of symmetry in the KAW proposal.

To the suggestion that the Company would have incurred more short-term debt in the absence of an aggressive tax position (thereby suggesting that ratepayers are already receiving benefit), the Attorney General again points out that the pursuit of favorable tax positions is in the best interests of KAW. Thus, it would have been to the detriment of the ratepayers of Kentucky-American Water if the Company had remained “in neutral” and had not pursued the accounting change given that the overall weighted cost of capital would have been higher, due to additional debt with a cost rate rather than zero-cost capital, in the absence of the change. The pursuit of zero-cost capital, thereby foregoing additional short-term debt, certainly supports the aggressive tax position. The discussion of short-term debt, though, does not end the need to inquire into the proper rate-making treatment for the FIN 48 reserve amount.

## 1.2 Consolidated Tax Savings

The parent company [American Water Works Company, Inc.] and its subsidiaries participate in a consolidated federal income tax return for United States tax purposes. Members of the consolidated group are charged with the amount of federal income tax expense determined *as if* they filed separate returns (emphasis added).<sup>16</sup>

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<sup>16</sup> American Water Works Company, Inc., 10-K filed on 1 March 2010 for period ending 31 December 2009, page 79; OAG cross-examination exhibit 3; TE 10 August 2010 (J. Warren) 11:02:35 – 11:02:55.

Thus, at the outset, it is important to point out that Kentucky-American Water Company does not and cannot file a “stand-alone” federal income tax return.<sup>17</sup> Utilization of a “stand-alone” tax calculation in setting the rates of the KAW is an adjustment which denies this reality. KAW files as part of a consolidated return; rate-making should be based upon the consolidated returns.

Mr. Warren’s arguments on behalf of Kentucky-American Water were presented in Case No. 2004-00103,<sup>18</sup> and they did not carry the day. It remains the case that the ratepayers for the two largest regulated subsidiaries of American Water, and 5 of 20 of them overall, have their rates set using a consolidated tax adjustment.<sup>19</sup> It remains the case that the consolidated tax adjustment proposed by the Attorney General comports with tax normalization rules.<sup>20</sup> It remains the case that American Water Works benefits from including Kentucky-American Water in its consolidated return because it can redistribute the excess created through KAW’s so-called “stand alone” tax burden assignment to other subsidiaries in the consolidated group.<sup>21</sup> In sum, nothing in the regulatory bargain sought by and landscape created by KAW has changed. There is no reason to vary from Case No. 2004-103.

There is a separate, yet equally compelling reason for the continued use of the results of American Water Works’ consolidated federal income tax return for KAW’s

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<sup>17</sup> TE 10 August 2010 (J. Warren) 11:02:55 – 11:04:28 (not possible under the law).

<sup>18</sup> TE 10 August 2010 (J. Warren) 10:53:05 – 10:53:37 (arguments “probably similar”).

<sup>19</sup> TE 10 August 2010 (J. Warren) 10:22:30 – 10:23:00; OAG cross-examination exhibit 3.

<sup>20</sup> TE 10 August 2010 (J. Warren) 11:00:45 – 11:02:25 (rate-making issue only).

<sup>21</sup> TE 10 August 2010 (J. Warren) 10:27:50 – 10:28:54.



rate-making. In Case No. 2004-00103, the Commission observes the following with regard to Kentucky-American Water's pursuit of approval for its acquisition by RWE.

Kentucky-American asserted the creation of TWUS would permit the filing of consolidated U.S. tax returns. The ability to file such a tax return, Kentucky-American argued, benefited the public because it would reduce administrative expense by eliminating the need to file multiple tax returns and permit some tax savings by allowing payment of taxes calculated on the net profits of all entities within the consolidated group.<sup>22</sup>

Thereafter, the Commission further observes:

Having previously indicated the savings resulting from the filing of a consolidated tax filing would be viewed as a merger benefit, subject to allocation, we do not believe that acceptance of the AG's [consolidated tax] proposal represents a radical departure from past regulatory practice. Moreover, Kentucky-American and its corporate parents having previously touted TWUS's filing of consolidated tax returns as a benefit to obtain approval of the merger transaction, have no cause to object if we now act upon their representations. Accordingly, we find that the AG's proposed consolidated income tax is reasonable and have reflected it in our calculation of federal income taxes.<sup>23</sup>

Clearly, KAW's participation in a consolidated tax return is a benefit of the RWE transaction relied upon by this Commission in approving the transaction. Whatever challenge Kentucky-American Water may have had to the above findings and conclusions was waived and defaulted when it agreed to dismiss its request for judicial review in *Kentucky-American Water Company v. Public Service Commission*, Franklin Circuit Court, Case No. 2005-CI-00587.<sup>24</sup> Otherwise stated, the recognition of a benefit

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<sup>22</sup> Case No. 2004-00103, Order, 28 February 2005, page 65.

<sup>23</sup> Case No. 2004-00103, Order, 28 February 2005, pages 65 and 66.

<sup>24</sup> See, for background, *In the Matter of: Adjustment of Rates of Kentucky-American Water Company*, Case No. 2007-00143, Order 29 November 2007, page 3.

through Kentucky-American Water filing a consolidated return is part-and-parcel of the regulatory landscape sought and bargained for by KAW.

To allow Kentucky-American Water Company to revert back to a rate-making process through which it adjusts the actual results of its participation in the consolidated return of American Water in order to create a “stand-alone” basis for setting rates is to allow KAW to claw-back from ratepayers a benefit bestowed upon them in the RWE transaction. The Order approving the divestiture of RWE (the IPO transaction) contains an express release of RWE and Thames GmbH from conditions imposed in Case No. 2002-00317.<sup>25</sup> It does not contain any release of Kentucky-American Water or American Water Works from the continued provision of benefits promised in the RWE transaction.<sup>26</sup> Simply stated: The Commission should continue to hold AWW and KAW to the regulatory promises made while the parties were seeking Commission approval for the RWE purchase and subsequent divestiture of KAW.

For the above-stated reasons, the Commission should continue utilize the consolidated tax calculation in setting KAW’s rates.

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<sup>25</sup> *In the Matter of: The Joint Petition of Kentucky-American Water Company, Thames Water Aqua Holdings GmbH, RWE Aktiengesellschaft, Thames Water Aqua US Holdings, Inc. and American Water Works Company, Inc., for Approval of a Change in Control of Kentucky-American Water Company*, Case No. 2006-00197, Order, 16 April 2007, page 31.

<sup>26</sup> In fact, by conditioning the approval of the IPO transaction upon “neither Kentucky-American nor its ratepayers, directly or indirectly, will incur any additional costs, liabilities, or obligations in conjunction with Thames GmbH and RWE’s divestiture of AWWC,” the Commission’s intent was to keep in place the benefits in existence at the time of the transaction. See Case No. 2006-00197, Order, 16 April 2007, Appendix A of the Order. The IPO transaction did not wash away AWW or KAW’s duties and promises.

### 1.3 Deferred Maintenance (ADIT)

Kentucky-American Water acknowledges that it has not performed an analysis to determine if it has charged labor to deferred maintenance in this proceeding; however, it is the case that company labor has previously been included in the deferred maintenance balance.<sup>27</sup> "To defer payroll expense between rates cases and then amortize those costs, in addition to the normal recurring payroll expense, would artificially inflate forecasted test year operations."<sup>28</sup> KAW has the burden of proof. Utilizing evidence from Case No. 2004-00103, the Attorney General makes the recommendation to reduce the forecasted test year balance of ADIT, Deferred Maintenance by \$17,700.<sup>29</sup>

KAW criticizes this adjustment. The response to this criticism is simple. The Attorney General has presented evidence from Kentucky-American Water that calls into question the legitimacy of the Deferred Maintenance, ADIT balance. Specifically, from Case No. 2008-00427, KAW confirmed that 1.68% of the total deferred maintenance cost balance in that application consisted of the Company's internal labor and labor overhead costs.<sup>30</sup> The Company confirms both its uncertainty regarding the current case as well as its past practice of including labor in the deferred maintenance

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<sup>27</sup> Rebuttal Testimony, M. Miller, page 18, lines 15 and 16.

<sup>28</sup> Case No. 2000-0103, Order on rehearing, 9 May 2001 at page 8.

<sup>29</sup> OAG pre-filed Testimony, R. Smith, P. 21; Exhibit RCS-1, page 16 of 40.

<sup>30</sup> Case No. 2008-00427, KAW response to OAG 1-47; see also OAG pre-filed Testimony (R. Henkes), page 17.

balance. The Attorney General's position is based in fact and reason. More importantly, KAW has the burden of proof which it has not carried.

## Section 2 – Compensation

### 2.1 Incentive Compensation

Expenses, even those having a minimal effect on operating income, must be borne by shareholders unless such expenses are proven to be beneficial to ratepayers in furnishing utility service.<sup>31</sup> With regard to incentive compensation, "the mere existence of such plans is insufficient to demonstrate that they benefit ratepayers and that their costs should be recovered through rates."<sup>32</sup>

The Annual Incentive Plan, the amount of which has grown from \$14,100 in Case No. 97-034<sup>33</sup> to \$786,516<sup>34</sup> in the current case, is weighted, 70%, to the achievement of financial goals.<sup>35</sup> It is clearly driven to enhance value to the *shareholder* through share price and the return to shareholders.<sup>36</sup> In fact, threshold targets tied to the Diluted Earnings Per Share must be met for any funding and award under the AIP.<sup>37</sup> The AIP is for the purpose of enhancing *shareholder* value and return.

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<sup>31</sup> *In the Matter of: Notice of Adjustment of Rates of Kentucky-American Water Company*, Case No. 9482, Order, 8 July 1986, page 22.

<sup>32</sup> *In the Matter of: Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, Order 28 February 2005, page 49.

<sup>33</sup> *In the Matter of: Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 2000-00120, Order, p. 42.

<sup>34</sup> See KAW response to PSC 2-4, page 5 of 7, and KAW response to PSC 2-9, page 15 of 15.

<sup>35</sup> M. Miller, Rebuttal Exhibit MAM-5, page 6 of 19.

<sup>36</sup> M. Miller, Rebuttal Exhibit MAM-5, page 5 of 19.

<sup>37</sup> M. Miller, Rebuttal Exhibit MAM-5, page 6 of 19.

The company has not quantified the alleged benefits of the AIP.<sup>38</sup> The evidence fails to support the assignment of these costs to the ratepayers; accordingly, the costs of the AIP should be eliminated.<sup>39</sup>

## **2.2 Stock-Based Compensation**

The stock-based compensation expense (the “Equity Compensation Plan”) has replaced what was known as the long-term incentive plan, or LTIP.<sup>40</sup> In Case No. 97-034, the amount of the LTIP was \$1,770.<sup>41</sup> In the current case, the amount at issue is an incredible \$206,436.<sup>42</sup> The purpose of the stock-based compensation plan:

The Company believes 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.<sup>43</sup>

Clearly, no studies or attempts at quantification are required. The stock-based compensation plan is, in unmistakably plain terms, for the growth of the company and furthering the economic interests of the participants and stockholders. It is a matter for shareholder funding.

## **Section 3 – Rate Case Expense**

### **3.1 Rate Case Expense for Current Case**

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<sup>38</sup> KAW response to PSC 2-5.

<sup>39</sup> Additionally, the Attorney General points out that KAW’s actual incentive compensation expense has been significantly under the budgeted amount in 2009 and 2010. R. Smith, pre-filed Direct Testimony, page 42 (discussing KAW response to PSC 2-4, page 7). KAW also overstates this expense amount.

<sup>40</sup> KAW response to OAG 2-2.

<sup>41</sup> Case No. 2000-00120, Order, 27 November 2000, page 42.

<sup>42</sup> Rebuttal Testimony, M. Miller, page 26; OAG pre-filed Direct Testimony, R. Smith, pages 46, 47.

<sup>43</sup> KAW response to OAG 1-15, page 25 of 39.

It is appropriate to put the current rate case expense into context. In Case No. 8571, KAW sought to recover rate case expense in the amount of \$120,000, and this Commission found the request grossly overstated and reduced it, by approximately one-third, to \$75,566.<sup>44</sup> By comparison, KAW requests a three-year amortization of \$590,000, the forecasted cost of the current case.<sup>45</sup> The \$590,000 amount does not include the \$42,500 forecasted cost of service study or the \$37,500 forecasted cost of depreciation study also presented in this case (for a total expense amount of \$670,000).<sup>46</sup>

The Attorney General does not seek to arbitrarily reduce Kentucky-American Water Company's rate case expense; however, he does wish to point out that KAW has the burden to demonstrate that the expense amount is reasonable<sup>47</sup> and that the corresponding rate-making treatment strikes the proper regulatory balance. The Attorney General submits that the proper rate-making treatment is to either rebalance the current sharing of rate case costs between ratepayers and shareholders or, alternatively, normalize the rate case expense such that it is no longer an asset.

Additionally, the Attorney General points out that the depreciation study provides just as much benefit to the shareholders as it does the ratepayers. Separate

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<sup>44</sup> *In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After September 17, 1982*, Order, 17 February 1983, pages 13 and 14.

<sup>45</sup> Rebuttal Testimony, M. Miller, page 38, lines 30 and 31.

<sup>46</sup> Rebuttal Testimony, M. Miller, pages 38 and 39.

<sup>47</sup> *In the Matter of: Notice of Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2983, Order, 1 October 1985, pages 29 and 30 (KAW to demonstrate that it is doing "everything possible" to minimize rate case costs).

and apart from the remaining rate case expenses, the depreciation study should be shared 50/50.

### 3.2 Rate Case Expense for Prior Rate Cases

Kentucky-American Water Company agreed to settle the last two rate cases.<sup>48</sup> In each instance there was a stipulation and recommendation concerning an increase in annual revenue. With one notable exception (to be discussed below), both settlements were “black-box” settlements reflecting the compromise or bargain among the parties without specific discussion of calculation of the revenue requirement.

In Case No. 2008-00427, the stipulation and recommendation included specific discussion relating to the amount of and rate-making treatment for a portion of the KRS II project. For this item, the Commission states:

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.<sup>49</sup>

Therefore, even for this item, the Commission did not make a finding regarding the appropriateness of the amount or the treatment but rather remained focused upon the overall, total revenue impact. Thus, with regard to revenue requirement, there were no express nor implicit approvals of any of the underlying adjustments or theories of the Kentucky-American Water Company.

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<sup>48</sup> Case No. 2007-00143 and 2008-00427.

<sup>49</sup> *In the Matter of: Adjustment of Rates of Kentucky-American Water Company*, Case No. 2008-00427, Order, 1 June 2009, page 4.

In the present case, KAW seeks to include in rates recovery for the unamortized expense of the 2007 rate case, the 2008 rate case, and the 2007 depreciation study filed in support of that rate case.<sup>50</sup> For three separate reasons, the pursuit should be denied.

First, there was no request for any specific findings in Case No. 2007-00143 or 2008-00427 that the corresponding expense amounts were reasonable. By not presenting these items at the time of the joint stipulations and recommendations, the Company defaulted its right for continued pursuit.

Second, along the same lines, and as an independent reason, the Company did not seek to obtain (nor did it obtain by way of an Order) treatment of these expenses as regulatory assets (or otherwise to establish deferred debits). Third, each settlement was (except for the KRS II project treatment) a “black-box” settlement, and the process through which past rate case expense is being “clawed back” into the current proceeding represents a rewriting of settlement agreements reviewed and approved by Order of this Commission. Even if it were the situation that Kentucky-American Water had unanimous consent for amending the settlement agreements (which it does not), the Orders are final; those cases are closed.

The request for amortization of the 2007 and 2008 rate case expenses (and 2007 depreciation study) should be denied. It is simply inappropriate for Kentucky-American to raid the “black-box” from each of those cases and now claim recovery for

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<sup>50</sup> Rebuttal Testimony, M. Miller, page 39.



items that were not found reasonable, which did not receive deferral treatment, and which constitute rewriting the agreements and re-litigation of those Orders.<sup>51</sup>

#### Section 4 – Slippage

The development of a “slippage” factor is a relatively recent event. It dates back to Case No. 92-452, Kentucky-American Water Company’s first rate adjustment application based upon a forward-looking test period. With the forward-looking test period, utility plant-in-service was based upon *forecasted* plant additions, and KAW did not incorporate cost variances and timing differences.<sup>52</sup>

Based upon the evidence, the Commission found that Kentucky-American’s specific budget projects “have proven an inaccurate indicator of the utility plant that will be completed and place in service.”<sup>53</sup> Further, it noted that “Kentucky-American’s ‘very best estimate(s)’ of construction spending for specific budgets have not proven accurate,” and have “shown a pervasive pattern of overbudgeting for its construction.”<sup>54</sup> In the absence of a slippage adjustment, rates would have been set to include “a return on utility plant not in service during the forecasted period due to delayed investment.”<sup>55</sup>

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<sup>51</sup> Additionally, as discussed earlier, the depreciation study provides just as much benefit to the shareholders as it does the ratepayers. For this separate reason, the KAW proposal for recovery of the 2007 depreciation study is overstated and inappropriate.

<sup>52</sup> Case No. 92-452, Order, 19 November 1993, page 7.

<sup>53</sup> Case No. 92-452, Order, 19 November 1993, page 7.

<sup>54</sup> Case No. 92-452, Order, 19 November 1993, page 10.

<sup>55</sup> Case No. 92-452, Order 19 November 1993, page 9.

In the absence of a slippage adjustment, the risk of Kentucky-American's over-budgeting was borne solely by ratepayers, who were in no position to balance that risk or otherwise insulate themselves or eliminate the problem (and would have paid a return for plant not in-service). The slippage adjustment was a safeguard for ratepayers who were unable to protect themselves from KAW's over-budgeting. A so-called "reverse-slippage" adjustment is unnecessary; KAW, unlike its ratepayers, is in a position to balance risk and reduce or eliminate any problem.

KAW did not propose a "reverse-slippage" adjustment in its application, and one is not warranted. Slippage was never intended to be a double-edged sword that cuts both ways; rather, the intent of the factor was a scalpel for the purpose of excising the risk associated with Kentucky-American Water's over-budgeting in setting rates.

## **Section 5 – Affiliate Fees**

### **5.1 Baryenbruch Study**

The Baryenbruch Study is, essentially, void of probative evidence regarding the reasonableness of the fees charged to Kentucky-American Water Company by the American Water Works Service Company. Rather than an apples-to-apples comparison, it has the characteristics of an apples-to-footballs comparison.

In lieu of a comprehensive recitation of all of its flaws, the Attorney General points out the following problems in the study. There is no demonstration that the

service company activity reflected in the FERC Form 60 accounts is actually comparable or otherwise approximates the American Water Service Company's activity.<sup>56</sup> The Form 60 information reflects activity that has not been adjusted or reviewed in the context of rate-making.<sup>57</sup> The FERC Form 60 is not a measure of productivity or efficiency.<sup>58</sup> Finally, the Baryenbruch Study is simply in the nature of a template for the American Water family rather than a study tailored to Kentucky-American Water Company.<sup>59</sup> The Commission should disregard the study, and there is a legitimate question as to whether the costs associated with the study should be recovered through rates.

## 5.2 Affiliate Management Fees, Business Development

In the Kentucky regulatory framework, costs are not assigned to ratepayers until proven beneficial.<sup>60</sup> Business development, as recognized by this Commission, clearly advances the interests of KAW's shareholders.

The shareholders of Kentucky-American have benefited from the acquisitions [of Tri-Village and Elk Lake]. Kentucky-American has not only immediately expanded its rate base and thus increased its income, but also increased its potential for expansion into previously unserved area for a larger rate base and greater income resulting from that expansion.<sup>61</sup>

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<sup>56</sup> TE 10 August 2010 (P. Baryenbruch) 9:16:40 – 9:17:15 (for example, not enough detail to determine the exact nature of Regulatory Commission Expenses on FERC Form 60).

<sup>57</sup> TE 10 August 2010 (P. Baryenbruch) 9:18:00 – 9:19:00; 9:20:00 – 9:21:35 (Baryenbruch Study does not deal with reasonableness but rather just considers the absolute numbers; there is no presumption that the numbers are correct or otherwise reasonable).

<sup>58</sup> TE 10 August 2010 (P. Baryenbruch) 9:21:35 – 9:22:18 (Form 60 not detailed enough to look at efficiency).

<sup>59</sup> TE 10 August 2010 (P. Baryenbruch) 9:40:30 – 9:41:50; 9:42:45 – 9:43:40 (KAW results placed into template utilized in other studies).

<sup>60</sup> Case No. 9482, Order, 8 July 1986, page 22.

<sup>61</sup> Case No. 2004-00103, Order, 28 February 2005, pages 9 and 10.

In every sense of the phrase, it places the cart before the horse to ask that ratepayers fund the growth opportunities of Kentucky-American Water when there is no presumption or any certainty that the efforts will ever provide the ratepayers with any benefit. Given the additional fact that the acquisition adjustment process is the arena for determining the assignment of costs as between shareholders and ratepayers (and in view of the fact that the business development activities offer just as much potential enhancement to non-regulated activities<sup>62</sup>), the business development costs should be removed.

#### **5.4 Affiliate Management Fees, Donations and Miscellaneous Expenses**

Kentucky-American Water concedes (or does not challenge) the Affiliate Management Fees – Donations and Miscellaneous Expenses adjustments for the following items: Charitable contributions, community relations expense, company dues, membership deductible and non-deductible, and penalties non-deductible.<sup>63</sup>

With respect to advertising, again, the burden is on KAW. Moreover, with regard to advertising, this expense is afforded a very strict review.<sup>64</sup> By use of the qualifier that the advertising expense at issue is “predominantly made up of advertisements and job placement ads related to hiring employees at AWWSC,”<sup>65</sup> the

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<sup>62</sup> See, for example, American Water – Institutional Investor Meetings, August 2010 (slide presentation, page 7 – attached as Appendix Item) (Investing for long-term growth includes growing the regulated businesses through focused acquisitions and pursuing “regulated-like” opportunities and complementary lines of business).

<sup>63</sup> Rebuttal Testimony, M. Miller, page 52.

<sup>64</sup> See, for discussion of institutional advertising, Case No. 2004-00103, Order, 28 February 2005, pages 58 and 59 (the Commission reviews the specific language of these advertisements).

<sup>65</sup> Rebuttal Testimony, M. Miller, page 53.

Company acknowledges that the expense is not limited to that category. In order to recover advertising expenses, the actual language and purpose is key. The responsibility to demonstrate appropriateness is with KAW.<sup>66</sup>

With regard to membership dues, the Attorney General acknowledges that membership in the Kentucky Bar Association is a legitimate expense for rate consideration in Kentucky. The same cannot be said for membership in the American Bar Association. Not only is ABA membership not required for authorization to practice in Kentucky, the ABA is active in a variety of public policy debates, and KAW's rate-payers should not be compelled to contribute to the ABA (which may have policy views quite different from those of Kentucky-American's ratepayers). The same is true for the U.S. Chamber of Commerce.

These memberships have nothing to do with providing service to Kentucky; the expenses are, accordingly, shareholder matters. With regard to the remaining memberships (the Mayor's Water Council, the ISACA/ITGI, etc.), there is a justified aversion against funding memberships in trade organization in the absence of evidence that demonstrates a real, actual connection between the needs of Kentucky-American Water Company's ratepayers and the resources being developed through such funding. The expenses are not proven beneficial.

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<sup>66</sup> See, Case No. 2004-00103, Order, 28 February 2005, page 59.

Consistent with the Attorney General's position that the Kentucky Bar Association dues are legitimate for rate consideration, the Attorney General, in terms of straight-forward pragmatism, will acknowledge the legitimacy of dues associated with the West Virginia Board of Accountancy. However, Kentucky-American ratepayers should not be called upon to fund the activities of any organization not proven necessary and beneficial to Kentucky-American Water providing service.<sup>67</sup>

The meals issue is troublesome. KAW asserts that it does not permit reimbursement for meals that have no legitimate business purpose.<sup>68</sup> However, there is a grain of salt appropriately connected with such a representation (in view of the fact that there may be a healthy difference of opinion as to what constitutes a legitimate business purpose with regard to rate-making as opposed to merely meeting the Internal Revenue Service standard).

The amount "in-play" is \$20,587. It is not a trivial amount nor is the principle of demonstrating benefit any less applicable. The Attorney General, though, in terms of pragmatism (and the simplification of issues) is reluctant to continue debate on this issue other than to once again point out the assignment of the burden of proof. He adds, though, on a going-forward basis, the Commission should make clear that KAW should adequately and consistently demonstrate that its review of allocations from

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<sup>67</sup> It is quite likely that a substantial number of Kentucky-American Water Company's customers would be offended by the knowledge that their rates would be used to fund some of these groups.

<sup>68</sup> Rebuttal Testimony, M. Miller, page 54, lines 16 to 18.

AWWSC is active and aggressively checked. This should logically include a process through which this particular expense items is monitored.

### **Section 6 – Depreciation**

Kentucky-American Water Company's application includes a depreciation study (prepared by John J. Spanos). Depreciation rates in the study were recalculated to include the cost of plant-in-service as of 31 December 2010 (in response to a Commission Staff request for information).<sup>69</sup>

The Attorney General accepts the results of the study except for one account, Account 333, Services. The Company proposes a negative net salvage value of 100%. This percentage amount stands in stark contrast to the amounts for other accounts in the depreciable group. Its disparity is a red flag warranting further inquiry.

Upon further inquiry, it is the case, in terms of foundation, that data for 1995, 1996, 1997, and 1998 is missing.<sup>70</sup> It is also the case, in terms of the dollar amount of activity, that approximately \$623,000 of the \$1.489 million in regular retirements for the study period<sup>71</sup> (or roughly 42%) took place in 2007 and 2008. In examining the three-year moving averages for this account, we see that for the periods 2005 – 2007, 2006 – 2008, and 2007 – 2009, the net salvage amount percentages are negative 41, negative 17,

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<sup>69</sup> Rebuttal Testimony, S. Miller, page 2 (discussing KAW response to PSC 3-6).

<sup>70</sup> Depreciation Study, 30 November 2009, page III-106 (Account 333 Services, Summary of Book Salvage).

<sup>71</sup> Years 1980 to 2009.

and negative 19 respectively. The percentages corresponding to recent activity are indicative of a much lower negative net salvage value percentage.

Mr. Spanos acknowledges that the range of estimates for Account 333, Services, for other water companies is between negative 20 percent and negative 150 percent.<sup>72</sup> Indeed the negative 20 percent is associated with Kentucky-American Water's corporate sibling Virginia-American Water.<sup>73</sup>

There is a difference between arbitrarily reducing an expense amount (or, alternatively, simply second-guessing an expert) and pointing out the principle that rates must be set based upon reliable, probative evidence. Kentucky-American Water has the burden of proof. With regard to this Office, the Attorney General put KAW on notice in Case No. 2008-00427 that the percent for this account was troublesome. In terms of producing sufficient evidence in this proceeding to justify or quantify the percentage sought, the evidence actually supports a much lower percentage. Accordingly, the Attorney General recommends an adjustment. There is nothing arbitrary about reducing the percentage to an amount consistent with recent history for the account and identified as within the range of estimates for water companies.

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<sup>72</sup> Rebuttal Testimony, J. Spanos, page 3; TE 11 August 2010 (J. Spanos) 13:07:00 – 13:08:33.

<sup>73</sup> TE 11 August 2010 (J. Spanos) 13:14:00 – 13:14:26 (And to the extent that Mr. Spanos asserts that each estimate is based upon independent important factors, TE 11 August 2010 (J. Spanos) 13:14:27 – 13:14:52, the Attorney General notes that the principle, then, operates equally to distinguish the results of Indiana-American and Missouri-American as being persuasive.



## Section 7 – CWIP/AFUDC

Beginning with Case No. 92-452,<sup>74</sup> Kentucky-American Water began supporting its requests for rate adjustments with forward-looking test periods. It is a right afforded under statute that the Attorney General does not question. He does, however, openly question whether the treatment-to-date of Construction Work in Progress (“CWIP”) strikes the correct regulatory balance. In terms of its use, the forward-looking test period permits the company to set rates reflecting its plant-in-service during the future test year, and this allowance is a logical, reasonable aspect of a future test period. Allowing CWIP in rate base with a forward-looking test period, however, extends the time horizon beyond the beyond the end of the test period.<sup>75</sup>

The Attorney General presented these concerns in Case No. 2004-00103, and the Commission addressed them in its 28 February 2010, Order.<sup>76</sup> Given the language in the Commission’s Order in Case No. 2004-00103,<sup>77</sup> the Attorney General did not propose this adjustment in Case No. 2007-00143<sup>78</sup> or Case No. 2008-00427.<sup>79</sup> However, given KAW’s pursuit of a different approach for CWIP in Case No. 2008-00427, the debate on this issue has been renewed.

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<sup>74</sup> *In the Matter of: The Application of Kentucky-American Water Company for an Adjustment of Rates*, Case No. 92-452.

<sup>75</sup> This aspect is in addition to the fact that CWIP in rate base results in a shifting of construction project risks to ratepayers from shareholders as well as the fact that CWIP is associated with a recovery for plant that is not providing service.

<sup>76</sup> Case No. 2004-00103, OAG pre-filed Direct Testimony of A. Crane, pages 19 to 21.

<sup>77</sup> Case No. 2004-00103, Order, 28 February 2005, page 12.

<sup>78</sup> See Case No. 2007-00143, OAG pre-filed Direct Testimony of M. Majoros, Exhibit\_\_(MJM-3), Schedule 1, Page 1 of 1.

<sup>79</sup> See Case No. 2008-00427, OAG pre-filed Direct Testimony of R. Henkes, pages 8 and 9.

As is manifest through the testimony of KAW witness Linda Bridwell explaining the difference in the KRS II project cost projections and actual costs,<sup>80</sup> the debate regarding the inclusion of CWIP in rate base versus the AFUDC methodology is not an academic point but, instead, has material impact on rate-making.

The hybrid methodology utilized for KAW no longer strikes the optimal regulatory balance. If the financial health of Kentucky-American Water was not as robust, then the hybrid methodology would seem a better fit. However, Kentucky-American presently enjoys a remarkable financial position, and the position is sufficient to support a rebalancing of risks through the elimination of CWIP from rate base.

## **Section 8 – Other Income Items**

### **8.1 Capitalization Rates**

The dispute regarding the appropriate payroll capitalization rates centers on the issue of whether Kentucky-American Water Company's capitalization percentage, which fluctuates from year-to-year, will be significantly below the amounts realized during recent years. The capitalization percentage per the Application is 17.34%.<sup>81</sup> Acknowledging that the rate per the application requires an upward adjustment, the Company now recommends a 17.8% capitalization rate.<sup>82</sup> While this is a significant

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<sup>80</sup> TE 10 August 2010 (L. Bridwell) 14:43:01 – 14:44:23; 14:44:35 – 14:44:50.

<sup>81</sup> Rebuttal Testimony, S. Miller, page 8.

<sup>82</sup> Rebuttal Testimony, S. Miller, page 9.

movement, it remains well-below the 19.472% five-year (2005 to 2009) average. The Attorney General recommends use of the five-year average.

## **8.2 KAW Party, Outing, and Gift Expenses**

Kentucky-American Water Company has recorded several expenses above-the-line that are inappropriate for inclusion in rates. As is well-established, expenses for employee awards functions and employee recognitions may benefit the employer/employee relationship, but the shareholders, rather than the ratepayers should bear these costs.<sup>83</sup> The United Way is a fine organization; however, the ratepayers should not be compelled to contribute to it. These employee-related expenses should be removed from operating expenses.

## **8.3 Vacancies and Over-projection of Pay Increases**

“Vacancies occur throughout the year due to terminations, retirements, and creation of new positions to address changing work requirements.”<sup>84</sup> It is, therefore, reasonable to expect some level of vacancies at Kentucky-American Water.

KAW counters that it has coordinated its assignment of a full-employee count with its overtime and temporary employee projections.<sup>85</sup> However, it does not necessarily follow that the items are mirror images of each other (i.e. that the dollar amounts are the same under either scenario). The Attorney General’s proposed

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<sup>83</sup> Case No. 1995-554, Order, 11 September 1996, page 43.

<sup>84</sup> KAW response to OAG 1-35.

<sup>85</sup> Rebuttal Testimony, S. Miller, pages 6 and 7.

adjustment is relatively modest, supported by evidence, and consistent with what will likely occur during the period when the rates are in effect.

Kentucky-American Water Company's pay increases have been lower than budgeted by KAW.<sup>86</sup> The budget variances are significant enough to warrant consideration in the rate-making process. Again, the process is not to arbitrarily lower KAW's request; rather, it is to review the evidence and consider what will likely occur during the period when the rates are in effect. After careful consideration of KAW's rebuttal evidence, the contractual increases (the increases that are known and certain) are reliable in setting rates. Nonetheless, the historical evidence of over-projection warrants an adjustment to the remaining non-contractual increases.

#### **8.5 KRS Lagoon Cleaning Expense**

Kentucky-American Water developed its lagoon cleaning expense by utilizing the average for recent bids as the projected cost.<sup>87</sup> The obvious flaw is that Kentucky-American Water will ultimately accept the lowest, qualified bid rather than the average bid.<sup>88</sup> The evidence demonstrates that the cost is overstated, and it should be capitalized and amortized.<sup>89</sup>

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<sup>86</sup> KAW response to PSC 2-14.

<sup>87</sup> Rebuttal Testimony, K. Cartier, page 2; TE 10 August 2010 (K. Cartier) 15:35:01 – 15:35:23.

<sup>88</sup> TE 10 August 2010 (K. Cartier) 15:35:25 – 13:35:55.

<sup>89</sup> See, for discussion, TE 10 August 2010 (K. Cartier) 15:36:37 – 15:39:00.

## **8.6 Uncollectibles Expense**

KAW did not use its 2010/2011 budget to determine its forecasted test year uncollectible expense. Rather, it used the uncollectible expense to billed-revenue ratio for 2009 and applied it to the pro forma revenues for the forecasted test year.<sup>90</sup> The problem is that the expense amount varies from year-to-year, and picking a “spot” amount that is much higher than recent years other than 2009 is inappropriate. In order to smooth out the factor, the Attorney General recommends using a three-year average for the period 2007-2009.<sup>91</sup>

## **Section 9 – Additional Adjustments**

### **9.1 Acquisition Adjustment Double Count**

The application includes an error regarding the unamortized acquisition adjustment for the Boonesboro acquisition. KAW acknowledges the double-count of the unamortized balance in rate base as well as the need for an adjustment.<sup>92</sup>

### **9.2 Pension and OPEB Expense Correction**

Through the base period update filing of 15 July, the Company incorporates an adjustment to its forecasted test-year expenses to reflect the current pension and OPEB costs.<sup>93</sup> This adjustment is necessary and appropriate.

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<sup>90</sup> OAG pre-filed Testimony, R. Smith, page 78.

<sup>91</sup> OAG pre-filed Testimony, R. Smith, page 79.

<sup>92</sup> Rebuttal Testimony, M. Miller, page 16 (discussing KAW response to PSC 2-41).

<sup>93</sup> Rebuttal Testimony, M. Miller, page 3, lines 19 – 21.

### **9.3 Affiliate Management Fees, Excess Over Current Budget**

Consequent to a revision in the AWWSC budget, the affiliate Management Fees for the 12 months ending 30 September 2011 is lower than the amount in the filing.<sup>94</sup> The Company agrees that an adjustment is in order, and it made an adjustment in its base-year update filing, 15 July 2010.<sup>95</sup>

### **9.4 Secondary Adjustments**

The previous adjustments recommended by the Attorney General are primary in nature. Secondary adjustments to items such as taxes, interest synchronization, and depreciation, resulting from changes consequent to the primary adjustments are, except where noted, assumed.

## **Section 10 – Cost of Capital**

### **10.1 KAW's risk profile supports an equity cost rate between 7.3% and 9.3%.**

The Attorney General offers an assessment of Kentucky-American Water Company's cost of capital through the expert testimony of Dr. J. Randall Woolridge.<sup>96</sup> He indicates that the range for Kentucky-American Water Company's equity cost rate is between 7.3% to 9.3%.<sup>97</sup> The Attorney General recommends a 9.25% equity cost rate.

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<sup>94</sup> KAW response to OAG 1 – 113.

<sup>95</sup> Rebuttal Testimony, M. Miller, page 48.

<sup>96</sup> OAG pre-filed Direct Testimony, J. Woolridge.

<sup>97</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 2.

In rebuttal to the Attorney General's position, KAW submits a schedule containing the most recent authorized return on equity (ROE) rates for 17 regulated subsidiaries of American Water Works.<sup>98</sup> The ROE rates for KAW's corporate siblings are items warranting consideration, and they provide a solid foundation for confirming 9.25% as the appropriate cost rate.

The average ROE for KAW's corporate siblings is 10.29%. As confirmed by KAW, there is certainly a difference in risks, from a financial investment standpoint, among the American Water Works subsidiaries.<sup>99</sup> Interestingly enough, Kentucky-American Water determined that the ROE corresponding to its June 2009 rate increase, consequent to a settlement, was 10.0%.<sup>100</sup> Approximately a year later, there is no reason to suggest that that KAW warrants a greater return. In fact, the opposite is true.

KAW has a history of filing rate cases on a regular basis, it utilizes a forward-looking test period, and it uses weather normalized sales in supporting its rate applications. Each of these items reduces KAW's risks, and this full set of practices is not available for Kentucky-American's corporate siblings.<sup>101</sup> Moreover, Kentucky-American has finally resolved its source of supply and treatment issue, it has repelled efforts for its condemnation, and it has stable financial results.<sup>102</sup> These facts readily support the fact that Kentucky-American Water is less risky than that the "average"

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<sup>98</sup> Rebuttal Testimony, M. Miller, page 9; Rebuttal Exhibit MAM-3.

<sup>99</sup> TE 11 August 2010 (M. Miller) 9:36:27 – 9:36:40.

<sup>100</sup> American Water – Institutional Investor Meetings, August 2010, page 40; Appendix Item.

<sup>101</sup> TE 11 August 2010 (M. Miller) 9:38:00 – 9:41:55.

<sup>102</sup> Rebuttal Testimony, M. Miller, page 3, line 21 (for last point of discussion).

AWW subsidiary equity cost rate of 10.29%. Furthermore, comparison of KAW to its corporate siblings also demonstrates the unreasonableness of the Company's requested equity cost rate of 11.5%.<sup>103</sup>

While the analysis regarding the AWW subsidiaries is a valuable, probative piece of information, the bedrock for the Attorney General's position is the testimony of Dr. Woolridge. "The expected or required rate of return on common stock is a function of market-wide as well as company-specific factors."<sup>104</sup> Dr. Woolridge's testimony is a comprehensive analysis of these factors. In lieu of a step-by-step recitation of evidence that is already present in the record, the Attorney General will focus on a recently-articulated concern regarding his approach.<sup>105</sup>

With regard to a Discounted Cash Flow (DCF) analysis, Dr. Woolridge utilizes a three-stage DCF model, and a depiction of his analysis is provided as Exhibit JRW-10.<sup>106</sup> The equity cost rate for a DCF analysis using a water proxy group is 9.3%. The equity cost rate for a DCF analysis using a gas proxy group is 8.9%. In terms of the growth rate associated with these computations, Dr. Woolridge considered a number of measures of growth for the companies in the proxy groups including both historic growth rates as well as growth rate estimates.<sup>107</sup>

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<sup>103</sup> Application, Direct Testimony M. Miller, page 15, line 5; Direct Testimony J. Vander Weide, page 4, line 18 (range 10.8% - 12.1%).

<sup>104</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 19.

<sup>105</sup> See, for background, *In the Matter of: Application of Louisville Gas and Electric Company for an Adjustment of Electric and Gas Base Rates*, Case No. 2009-00549, Order 30 July 2010, page 33.

<sup>106</sup> OAG pre-filed Direct Testimony, J. Woolridge, Exhibit JRW-10 (DCF Study).

<sup>107</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 29.



While it is true that the analysis contains some negative results,<sup>108</sup> these negative outcomes are appropriate for inclusion in the analysis. If we were to eliminate negative outcomes from the analysis and consider only positive outcomes, then we would have an average higher than the mean of the actual distribution. On this point, we should not factor out of the process the possibility (and expectation) of negative outcomes in assumptions regarding growth.

With regard to Dr. Woolridge's Water Proxy Group, the evidence supports a dividend yield of 3.25% and a DCF growth rate of 6.0%.<sup>109</sup> KAW's equity cost rate, based upon the Water Proxy Group, is 9.3%. By comparison, the authorized ROE for American Water Works per AUS Utility Reports, June 2010, is 9.51%.<sup>110</sup>

Based upon all of the evidence, the appropriate equity cost rate for Kentucky-American Water is 9.25%. In view of the position that Kentucky-American Water now enjoys, it is the rate consistent with adequately and fairly compensating KAW's investors.

## **10.2 Problems with Dr. Vander Weide's approach.**

Dr. Vander Weide relies upon forecasted earnings per share ("EPS") growth rates of Wall Street analysts and *Value Line* to compute his equity cost rate. Empirical

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<sup>108</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 34; Exhibit JRW-10, 3 of 7.

<sup>109</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 38 (summary).

<sup>110</sup> OAG pre-filed Direct Testimony, J. Woolridge, Exhibit JRW-12, page 1 of 3.

evidence demonstrates that these earnings growth rates are upwardly-bias.<sup>111</sup> Per the recently published study, “Equity Analysts: Still Too Bullish”:

Alas, a recently completed update of our work only reinforces this view – despite a series of rules and regulations, dating to the last decade, that were intended to improve the quality of the analysts’ long-term earnings forecasts, restore investor confidence in them, and prevent conflicts of interest. For executives, many of whom go to great lengths to satisfy Wall Street’s expectations in their financial reporting and long-term strategic moves, this is a cautionary tale worth remembering. This pattern confirms our earlier findings that analysts typically lag behind events in revising their forecasts to reflect new economic conditions. When economic growth slows, it increases. So as economic growth cycles up and down, the actual earnings S&P 500 companies report occasionally coincide with the analysts’ forecasts, as they did, for example, in 1988, for 1994 to 1997, and from 2003 to 2006. Moreover, analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent. Over this time frame, actual earnings growth surpassed forecasts in only two instances, both during the earnings recovery following a recession. On average, analysts’ forecasts have been almost 100 percent too high.<sup>112</sup>

The use of upwardly biased forecasts translates into a grossly-overstated cost rate for common equity. Not only is this demonstrated by Dr. Woolridge’s analysis, it is confirmed by Kentucky-American Water Company’s own evidence. The suggestion that KAW’s equity cost rate is 11.5% is absurd on its face.<sup>113</sup>

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<sup>111</sup> OAG pre-filed Direct Testimony, J. Woolridge, pages 58 – 69.

<sup>112</sup> OAG pre-filed Direct Testimony, J. Woolridge, pages 66 and 67 (quoting Goedhart, Raj, and Saxena, McKinsey on Finance (Spring 2010) pages 14 – 17).

<sup>113</sup> The equity cost rate was set at 10.0% in Case No. 2004-00103, Order, 28 February 2005, page 74. KAW indicates an ROE amount of 10.0% consequent to Case No. 2008-00427, American Water – Institutional Investor Meetings, August, 2010, page 40. KAW’s evidence shows a 10.29% average cost rate for American Subsidiaries. Rebuttal Exhibit MAM-3. The suggestion of 11.5% lacks credibility in the face of KAW’s recent history (especially the KRS II project) that manifest KAW’s relatively low-risk.

With regard to the literature reviewed by Dr. Vander Weide per his rebuttal testimony,<sup>114</sup> it is important to point out that the articles referenced are based upon quarter-to-quarter earnings estimates.<sup>115</sup> However, neither Dr. Vander Weide nor Dr. Woolridge rely upon quarter-to-quarter earnings estimates; rather, they rely upon growth rate forecasts. Therefore, as Dr. Woolridge notes, the only relevant research is the research relating to analysts' long-term projected growth rate forecasts.<sup>116</sup> The relevant academic research demonstrates the "overly optimistic and upwardly biased" analysts' long-term EPS growth rate forecasts.<sup>117</sup> Dr. Vander Weide's rebuttal testimony regarding research into quarter-to-quarter earnings estimates is irrelevant, and it does not address, much less rebut, the upward bias in analysts' long-term growth rate forecasts identified by the relevant academic research.

### **Section 11 – Rate Design**

The Attorney General accepts Kentucky-American Water Company's rate design and does not offer any adjustments other than the reductions that correspond to those necessary to match his revenue requirement and cost of capital recommendations. The Attorney General notes, though, that discussions of issues regarding rate design are

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<sup>114</sup> Rebuttal Testimony, J. Vander Weide, page 18, Rebuttal Schedule 3.

<sup>115</sup> See, for examples, KAW N 082410, page 13 of 225, page 53 of 225, page 61 of 225, page 87 of 225, etc.

<sup>116</sup> OAG pre-filed Direct Testimony, J. Woolridge, pages 59 to 62.

<sup>117</sup> OAG pre-filed Direct Testimony, J. Woolridge, page 60.

present in this record. To this extent, he opines that the parties have a mutual interest in aggressively exploring rate design alternatives.

The Attorney General does not seek an Order or instruction from the Commission directing this exploration; each party appears willing to move forward. Still, the Attorney General wishes to make clear that reliance upon the assumption that the demand for water (as measured by its elasticity) will be sufficient to indefinitely sustain rate increases under this rate design is a bit tenuous. It is in the business interest of the utility (in terms of having a reasonable opportunity to earn its return) as well as the customers (in terms of reasonable access to and continuity of water service) to consider other rate design options as one of the means of addressing a concern of growing significance, namely the affordability of water.

#### CONCLUSION

For the foregoing reasons, the Attorney General requests that the Commission adjust Kentucky-American Water Company's application for an increase in rates.

*Notice of Electronic Filing, Filing, and Certificate of Service*

Undersigned counsel provides the following notice with regard to the filing of this Brief, certifications for the filing, and notice of the service of information to the other parties of record. Pursuant to Ordering paragraph 2 of the Commission's 16 February 2010 Order of procedure, the Attorney General files the original and one copy in paper medium and one copy in electronic medium. Per Ordering paragraph 6 of the February 16<sup>th</sup> Order of procedure, undersigned counsel certifies that the electronic version is a true and accurate copy of the material filed in paper medium, the electronic version has been transmitted to the Commission, and notice has been provided to the Commission and the other parties of record, by electronic mail, that the filing has been transmitted to the Commission.

With regard to the electronic filing, in conformity with Ordering paragraph 4 of the February 16<sup>th</sup> Order, the Attorney General has submitted his electronic copies of the information by uploading the material to the PSC's Web Application Portal at [https://psc.ky.gov/psc\\_portal/](https://psc.ky.gov/psc_portal/). With regard to the original and paper copy, the material will be filed at the Commission's offices on the next business day following the electronic filing (consistent with the instruction contained in ordering paragraph 12 of the February 16<sup>th</sup> Order).

The Attorney General has provided notice to the Commission and other parties, by electronic mail, of this filing.

dbarberi@lfucg.com;

lbowman@lexington.ky.gov;

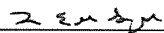
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The electronic filing took place on 3 September 2010 with the filing of the documents in paper medium scheduled for 7 September 2010.

  
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Assistant Attorney General

## APPENDIX

American Water – Institutional Investor Meetings, August 2010 page 7

American Water – Institutional Investor Meeting, August 2010 page 40

Source: <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzkzMzc1fENoaWxkSUQ9Mzk4NDE0fFR5cGU9MQ==&t=1>  
(viewed 2 September 2010)

# Our Strategic Direction

## Realizing Today's Value

- Earn an appropriate rate of return on our investments
- Promote constructive regulatory frameworks
- Attain consistent and predictable financial performance through Regulatory, Weather and Economic Diversity
- Realize operating efficiencies through economies of scale and management of expenses
- Efficiently allocate capital to regulated water and wastewater investments
- Grow Regulated Businesses through focused acquisitions
- Pursue "regulated-like" opportunities & complementary lines of business
- Focus on operating efficiencies



# Rate Case Awards: 2009 through August 3, 2010

	Docket / Case Number	Date Filed	Amount Filed	ROE Requested	Effective Date for new rates	ROE Granted	Increase to Revenue	Rate Base (Approved)
West Virginia	08-0900-W-42T	5/30/2008	\$14.8	11.75%	3/26/2009	10.00%	\$5.2	\$414.7
New Mexico	08-00134-UT	6/30/2008	\$2.2	11.75%	5/20/2009	10.25%	\$1.4	\$30.0
AWWM (NJ)	WR08080550	8/1/2008	\$4.4	11.80%	5/21/2009	10.30%	\$1.6	\$15.1
California (ROE) *	A 08-05-003	5/1/2008	\$2.8	11.50%	5/6/2009	10.20%	\$0.1	N/A
Kentucky	2008-00427	10/31/2008	\$18.5	11.50%	6/1/2009	10.00%	\$10.3	\$301.3
Michigan	N/A	6/22/2009	\$0.2	10.50%	7/1/2009	10.50%	\$0.2	\$2.7
Calif (Monterey Water)	A 08-01-027	1/30/2008	\$35.3	11.50%	5/11/2009	10.20%	\$12.1	\$102.5
California (Monterey WW)	A 08-01-023	1/30/2008	\$1.8	11.50%	7/9/2009	10.20%	\$1.7	\$2.0
California (Gen Office) **	A 08-01-024	1/30/2008	\$6.4	11.50%	5/11/2009	10.20%	\$2.2	N/A
Maryland	Case No 9187	4/30/2009	\$0.8	11.75%	9/10/2009	10.75%	\$0.6	\$11.6
Iowa	RPU-2009-0004	4/30/2009	\$9.4	12.20%	7/27/2009	10.50%	\$6.1	\$82.4
Pennsylvania	R-2009-2097323	4/24/2009	\$58.1	12.00%	11/7/2009	10.80%	\$30.8	\$1,840.2
Texas	2008-0910-UCR	2/21/2008	\$0.9	12.00%	11/30/2009	12.00%	\$0.5	\$5.5
Arizona (multiple)	W-01303A-08-0227	5/1/2008	\$20.0	11.75%	12/1/2009	9.90%	\$8.1	\$154.7
Illinois	Docket No. 09-0319	5/29/2009	\$58.6	12.25%	4/23/2010	10.38%	\$41.4	\$607.4
New Mexico (Edgewood)	Case No. 09-00156-UT	8/21/2009	\$0.7	12.25%	5/10/2010	10.00%	\$0.5	\$4.0
Indiana	Cause No. 43680	4/30/2009	\$46.9	12.00%	5/3/2010	10.00%	\$31.5	\$670.5
Ohio	Case No. 09-391-WS-AIR	5/1/2009	\$8.8	12.20%	5/19/2010	9.34%	\$2.6	\$70.1
Missouri	WR-2010-0131.SR-2010-0135	10/30/2009	\$48.7	11.60%	7/1/2010	10.00%	\$28.0	\$791.8
California (Sac, LA, Lark)	Case No. A 09-01-013	1/23/2009	\$24.0	10.20%	7/1/2010	10.20%	\$14.6	\$179.9
Michigan	N/A	6/24/2010	\$0.2	10.50%	7/1/2010	10.50%	\$0.2	\$2.4
Total General Rate Cases							\$199.7	
Total Infrastructure Surcharges							\$35.7	
Total to August 3, 2010							\$235.4	

\* Application of approved ROE to rate base additions in 2009 after the ROE order resulted in additional revenues of \$0.7 m

\*\* Additional revenue of \$0.8 m granted by commission in response to a company filed Motion for Reconsideration effective 7/1/2010.