COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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| THE APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES ON OR AFTER MARCH 28, 2010 | ) ) ) | CASE NO. 2010-00036 |

**LEXINGTON-FAYETTE**
**URBAN COUNTY GOVERNMENT'S BRIEF**

Comes now the Lexington-Fayette Urban County Government ("Lexington"), by counsel, in accordance with the procedural schedule, and submits this Brief in support of its positions in this action.

This case involves Kentucky-American Water Company's ("KAW", or the "company") attempt to obtain a rate increase in excess of $25 million per year and almost 38% on the heels of an 18.1% increase less than 18 months ago. [Application, Statement and Notice (and Exhibits referenced therein); June 1, 2009 Order in Case No. 2008-00427].[1] This would cause the average residential water bill to increase by more than $113 per year. [Application, par. 8].

Lexington, the Kentucky Attorney General (the "Attorney General") and the Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. ("Community Action") were granted full intervenor status.

Each of the intervenors filed testimony in this matter, and a two day hearing concluded on August 11, 2010. A cost of service study was produced in this case by the company through expert witness Paul R. Herbert. [Exhibit No. 36

[1] KAW sought an increase of 32.5%, or more than $18.4 million.

to Application; Direct Testimony of Paul R. Herbert]. There were no significant issues raised as to its conclusions, and no party (or the Commission staff) cross-examined Mr. Herbert.

In addition to filing the expert testimony of Mr. Richard A. Baudino pertaining to the appropriate authorized Return on Equity ("ROE") that KAW should be awarded and other limited matters, Lexington also filed into evidence at the hearing more than 4,300 citizen/ratepayer petitions protesting the magnitude of the proposed increase. [Lexington Hearing Exhibit No. 1].

As further argued below, the Public Service Commission (the "Commission") should deny the application and instead provide the company with the lowest possible rate increase allowed by law.

## I. KAW's Application Should Be Denied

Based upon the record in this case and the applicable law, KAW is not entitled to the rate increase it seeks. The burden of proof in this matter is on the company, and the Commission is in no way bound by the evidence presented by it. KRS 278.190(3); Citizens Telephone Co. v. Public Service Commission, 247 S.W.2d 510, 514 (Ky. App. 1952).

While Lexington admits that KAW is entitled to a "fair, just and reasonable rate", the company's requested increase in this case does not meet that standard. KRS 278.030. Instead, KAW should be granted the lowest possible increase that allows it to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed. See

Commonwealth of Kentucky ex rel. Stephens v. South Central Bell Telephone, 545 S.W.2d 927 (Ky. 1976); Citizens Telephone Co. at 511. That determination is not performed in a vacuum, or without considering appropriate outside factors that may influence how much of an increase is warranted. See e.g., Citizens Telephone Co. at 513.

In providing the company with the lowest possible increase, the Commission should adopt the testimony and evidence presented by the Attorney General and Lexington, instead of that requested by KAW.[2]

### a. Return on Equity

Given the size of KAW's rate base after the inclusion of KRS II, the ROE awarded the company is of paramount importance in determining the amount of the rate increase. According to KAW, a 25 basis point reduction from the 11.5% ROE it seeks in this case reduces the revenue requirement by $659,162. [See KAW Response to Hearing Data Request Question No. 11]. This means that if the Commission correctly reduces the authorized ROE sought by KAW, there will be a sizeable corresponding decrease to the amount of the overall rate increase, and its impact on the ratepayers.

For example, if the Commission limits KAW's authorized ROE to 9.5%, the ratepayers will save approximately $5 Million. (KAW seeks an ROE of 11.5%, while Lexington filed testimony through Mr. Richard A. Baudino indicating that it

[2] To the extent there is not a direct conflict with the arguments made herein, Lexington adopts and incorporates herein the evidence and testimony presented by the Attorney General in this case, and the arguments made in his Brief.

should be 9.5%, and the Attorney General 9.25 %. [See Direct Testimony of Michael A. Miller, p. 15; Direct Testimony of Richard A. Baudino, page 3; Direct Testimony of Dr. J. Randall Woolridge, p. 2]). It is Lexington's position that the authorized ROE recommended by either Mr. Baudino or Dr. Woolridge is appropriate, but in no event should it exceed 9.5%. This is based upon the testimony and evidence presented by the respective experts, as well as Lexington's desire to ensure that the ratepayers pay the absolute lowest amount possible.

The authorized ROE is one of the single most important factors in determining how much of a rate increase is warranted.[3] The testimony of Mr. Baudino and Dr. Woolridge points out the flaws in KAW's proposed ROE, which is greatly overstated and completely inconsistent with the intervenors' testimony, and which will cost the ratepayers several million dollars more per year. [See Testimony of Baudino, pp. 33-44; Testimony of Woolridge, pp. 51-90]. Therefore, for the reasons provided by Mr. Baudino and Dr. Woolridge, the Commission should reject KAW's proposed authorized ROE and instead allow KAW an authorized ROE not to exceed 9.5%, or in the alternative, 9.25%.

More specifically, with respect to the Discounted Cash Flow ("DCF") analysis, the following should be dispositive:

1. Mr. Baudino used widely recognized and accepted sources of investor information to estimate the DCF return for two groups: water companies and natural gas distribution companies [Baudino, page 18];

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[3] Lexington also has no issue with the capital structure and cost of debt proposed by Dr. Woolridge.

2. Dr. Vander Weide used a group of gas companies which included highly diversified operations, which are too risky to include in a group of proxy companies [Baudino, pp. 14, 15];

3. Mr. Baudino utilized three different methods for estimating the cost of equity for the gas distribution group. The results ranged from 8.13% to 8.73% [Baudino, page 24]; and

4. Mr. Baudino utilized two methods for estimating the DCF return for the water company group. The results ranged from 9.34% to 10.07%. [Baudino, page 24].

As a check on his DCF analyses, Mr. Baudino also presented the results for two sets of Capital Asset Pricing Model ("CAPM") analyses. His CAPM analyses considered both forecasted and historical market estimates. [Baudino, page 28]. Baudino's CAPM results ranged from 7.83% to 9.46%. [Baudino, pp. 28-30]. In sum, Baudino's recommended ROE is fully supported by his DCF analyses, and as a check, the CAPM results were even lower than his recommendation. An authorized ROE of 9.50% (or 9.25%) is reasonable, even generous for a low-risk water utility like KAW. [Baudino, page 31].

Furthermore, Mr. Baudino also demonstrated how KAW witness Vander Weide systematically and consistently overstated the investor required returns for a low-risk water utility like KAW. For instance:

1. Vander Weide's analyses contain excessive rates of return for certain companies, which are clearly outliers. [Baudino pp. 36-37];

2. Vander Weide's failure to include forecasted dividend growth biased his results upward. [Baudino, page 38];

3. Vander Weide's use of the quarterly DCF model overstates his results. [Baudino, pp. 38-39];

4. Vander Weide's risk premium is clearly overstated due to the (a) use of a forecasted A-rated bond yield, (b) use of forecasted earnings growth to calculate the DCF return for the gas group, (c) inclusion of flotation costs, and (d) quarterly compounding. [Baudino, page 40]; and

5. Vander Weide's CAPM analyses are skewed upward due to a faulty adjustment to beta and the totally unwarranted inclusion of a size premium. [Baudino, page 43].

Therefore, the Commission should reject the ROE recommendation of Mr. Miller, Dr. Vander Weide and the company, and instead approve a return on equity for the Company that is consistent with the testimony and recommendations presented by Mr. Baudino and Dr. Woolridge. An allowed return on equity in the range of 9.25% - 9.50% balances the interests of shareholders and ratepayers and accurately reflects investor expectations in the current low interest rate environment.

**b. Other Rate Issues**

Lexington fully adopts the testimony of Ralph C. Smith and the arguments of the Attorney General on the remaining rate issues. Given the magnitude and impact of the proposed increase on all customers (especially residential customers) and the current economic climate, the Commission should be extra vigilant in reviewing every aspect of this case to make sure that the company only obtains the least relief legally allowed. This is clearly not the full amount requested by KAW.

As evidenced by more than 4,300 petitions, this rate increase would create a significant financial hardship for many people, and it is exacerbated by the current economic climate and recession. [See Lexington Hearing Exhibit No.

1; Pre-filed Testimony of Jack E. Burch]. The Commission is not precluded from considering these factors, particularly in determining the appropriate return the company should be awarded. See e.g., Citizens Telephone Co. at 514 (Holding that the Public Service Commission can consider external financial conditions as part of its determination of the appropriate rate of return).

In addition, the Commission should adopt the recommendation of Mr. Baudino that the labor-related costs charged to KAW from the American Water Works Service Company be reduced by $2.146 million, as the company has failed to show that they were prudently incurred. [Baudino at pp.44-47]. More specifically, the company's testimony indicates that the labor-related costs are higher than they would have been had those reorganizations and restructurings not taken place. [Baudino, page 45]. KAW's adjustments have nothing to do with increased labor costs and should be rejected, and the failure to include productivity adjustments can be argued to make the difference in labor cost even higher. [see Rebuttal Testimony of Michael A. Miller].

Finally, as also recommended by Mr. Baudino, the company's labor expenses should be reduced by at least $0.211 million to reflect a higher capitalization ratio. [Baudino at pp. 48-50].

As shown by the evidence in this case and the consideration of all of the relevant factors, the company seeks an excessive rate increase, which should be denied by the Commission. The most the Commission should award KAW in this case is the least amount allowed by law.

## II. Hydrants

Lexington currently pays more than $2.5 million per year in public fire hydrant tariffs. [Exhibit 36, Schedule A; Response to Question No. 9 of Lexington's First Set of Data Requests]. KAW proposes, based upon its cost of service study, that the public fire hydrant tariff increase proportionally less than the overall requested rate increase (31.8% versus a 37.7% overall increase)[see par. 8 of Application]. Accordingly, the tariff for public fire hydrants should be based upon the 4% cost of service for hydrants in the study, and if KAW is awarded less than the amount it seeks, the public fire hydrant tariff increase should be reduced consistent with that study, as it is the only evidence in this case as to the appropriate cost of service. [Exhibit 36, Scheduled A and B].[4]

Additionally, it would be reasonable for the Commission to further reduce the burden on Lexington and other public fire hydrant owners by assigning a reasonable portion of the public fire hydrant costs to other customer classes in order to reflect the fact that the entire system benefits from having public fire protection given the benefits that public hydrants provide to all ratepayers (ex. improving the water quality through flushing the water system) and the public safety interest served by firefighting. Therefore, the Commission should order or otherwise encourage KAW, pursuant to KRS 278.170(3), to develop a free or reduced public fire hydrant tariff that can be used in future rate cases.

[4] The appropriate revenue for public fire protection in this case should be determined by multiplying the total sales revenue awarded by the Commission by no more than 4%, and then further reducing this amount by the reasonable amount of the benefit that such hydrants provide to the other customers and the system as a whole. This amount would then be divided by the number of public fire hydrants to determine the rate to be charged.

## III. Demand Management Plan

The hearing on this matter makes clear that KAW needs to provide a new demand management plan once KRS II has been up and running for a sufficient period of time, as it has not provided a new plan since 2001, and its operations have significantly changed during that time. [See e.g., Testimony of Linda C. Bridwell 08-10-10, 14:17-14:19, 14:21:30-14:23:10; KAW Response to Hearing Data Request Question No. 6]. This plan needs to include updated demand forecasts for water use, as well as how the 3 KAW treatment plants will be operated in order to maximize the availability of water at the lowest cost. A demand management plan is vital in determining whether the company will have excess water that it can wholesale without the need for additional treatment plant construction, as well as the direction KAW should take with respect to future planning. Therefore, the Commission should order KAW to produce a demand management plan within a reasonable time of entry of its Order in this case.

## IV. Tiered Rates

It is also clear from the evidence that the Commission should order or otherwise encourage KAW to eventually adopt tiered rates or another satisfactory means of addressing low-income and conservation issues for residential customers. [See Pre-filed Testimony of Jack E. Burch]. This would benefit low income customers, encourage less water consumption and should also reduce the number of shutoffs related to nonpayment. Numerous jurisdictions that regulate American Water companies have already implemented these types of tariffs. [KAW Response to Hearing Data Request Question No. 4]. This could be accomplished through the Commission either opening a proceeding to specifically focus on these issues or requiring KAW to address these issues as part of its next rate case, with involvement from interested parties prior to implementation in either instance.

## V. CONCLUSION

Simply put, KAW's requested increase is too much, and is not supported by the evidence. For all of the reasons stated above, KAW is not entitled to a rate increase in the amount sought, nor should the allocation of any rate increase be unfairly borne by the public fire hydrant classification. Therefore, Lexington respectfully requests that the Commission deny KAW's Application and grant Lexington all of the relief that it has specified above.

Respectfully submitted,

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## FILING NOTICE AND CERTIFICATE

In accordance with Ordering Paragraph No. 5 of the Commission's February 16, 2010 Order, this is to certify that Lexington-Fayette Urban County Government's September 3, 2010 electronic filing of this Brief is a true and accurate copy of the document to be filed in paper medium; that the electronic filing has been transmitted to the Commission on September 3, 2010; that an original and one copy of the filing will be delivered to the Commission on September 3, 2010; and that, on September 3, 2010, notification of the electronic filing will be provided to the Commission and the following via electronic mail:

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