COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
APPLICATION OF KENTUCKY-AMERICAN WATER COMPANY FOR AN ADJUSTMENT OF RATES SUPPORTED BY A FULLY FORECASTED TEST YEAR	)	**Case No. 2012-00520**

Direct Testimony of

Stephen M. Rackers

On behalf of

The Kentucky Office of Attorney General
and
Lexington-Fayette Urban County Government

April 3, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9712

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STATE OF MISSOURI	)	
	)	**SS**
COUNTY OF SAINT LOUIS	)	

Affidavit of Stephen M. Rackers

Stephen M. Rackers, being first duly sworn, states the following: The prepared Direct Testimony constitutes the direct testimony of Affiant in the above-styled case. Affiant states that he would give the answers set forth in the Direct Testimony if asked the questions propounded therein. Affiant further states that, to the best of his knowledge, his statements made are true and correct. Further affiant saith not.

Stephen M. Rackers

Stephen M. Rackers

SUBSCRIBED AND SWORN to before me this 3rd day of April, 2013.

Tammy S. Klossner

Notary Public

My Commission Expires March 14, 2015.

TAMMY S. KLOSSNER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Charles County
My Commission Expires: Mar. 14, 2015
Commission # 11024862

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Direct Testimony of Stephen M. Rackers

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Stephen M. Rackers. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation with the firm of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A I graduated with a Bachelor of Science Degree in Business Administration, with a major in Accounting. I have over 30 years of experience in the field of utility regulation. I am also a licensed Certified Public Accountant ("CPA") in the state of Missouri. Additional information is included in Appendix A to my testimony.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A This testimony is presented on behalf of the Kentucky Office of Attorney General ("AG") and the Lexington-Fayette Urban County Government ("LFUCG").

Q PLEASE SUMMARIZE THE ISSUES YOU ARE ADDRESSING IN YOUR TESTIMONY.

A I am recommending several adjustments to the calculation of revenue requirement requested by Kentucky-American Water Company ("KAWC" or "Company"). In total, the adjustments reduce KAWC's proposed revenue requirement by approximately $2.8 million. Where applicable, I have used the cost of capital recommended by AG/LFUCG witness Dr. J. Randall Woolridge to determine the revenue requirement value. Further, using Dr. Woolridge's cost of capital recommendations I have prepared a reconciliation of the KAWC requested and AG/LFUCG proposed revenue requirement, which is contained in Workpaper SMR-9. Listed below is each adjustment with a short explanation discussing the adjustment and the approximate value of the issue:

1. Repairs Tax Deduction – A portion of KAWC's accumulated deferred income tax ("ADIT") balance relates to costs the Company has capitalized on its books, but is allowed to deduct as an expense on its income tax return. Due to KAWC's determination that the Internal Revenue Service ("IRS") may not allow the full deduction, the Company has reduced the ADIT balance, which results in an increase in the rate base and the revenue requirement. I am recommending that this reduction to the ADIT balance be eliminated.

   Approximate Value - $400,000 reduction to revenue requirement[1]

[1]Workpaper SMR-1

2. Working Capital – KAWC has inappropriately included several non-cash expenses and the common equity component of net income in the determination of working capital. I recommend eliminating these items from working capital.

   Approximate Value - $400,000 reduction to revenue requirement[2]

3. Revenues – I recommend that the calculation of the forecast year revenues reflect different customer counts and monthly water use/customer terms than those used by KAWC. This adjustment to increase KAWC's revenues is partially offset by increases in electricity and chemical expenses.

   Approximate Net Value - $2 million reduction to revenue requirement[3]

I will also address the Company's request to establish a Distribution System Improvement Charge ("DSIC") for infrastructure plant additions, and KAWC's proposal to allow trackers for chemical and electricity expense.

I have included a table of contents that lists each issue and the corresponding beginning page for that issue.

REPAIRS TAX DEDUCTION

Q PLEASE EXPLAIN THE REPAIRS TAX DEDUCTION.

A KAWC has made certain capital improvements to its system, which the Company charged to its plant accounts. For calculating net income before income tax on its books, KAWC would recognize depreciation expense over the life of the capital improvement. However, for calculating income tax, KAWC is allowed to classify the capital improvements as repairs and deduct the entire cost currently rather than deducting depreciation. This situation creates a book/tax timing difference. KAWC recorded deferred income taxes to reflect the difference between recognizing a tax deduction based on depreciation expense and repair expense. The cumulative

[2]Workpaper SMR-1
[3]Workpaper SMR-2

amount of the deferred income taxes are included in the ADIT balance, which is used as a reduction to the rate base.

Q BASED ON ITS EVALUATION DOES KAWC BELIEVE THE TOTAL AMOUNT OF THE CAPITAL IMPROVEMENTS IT HAS CLASSIFIED AS REPAIRS WILL BE ACCEPTED BY THE IRS FOR CALCULATING INCOME TAXES?

A No. In accordance with the requirements of Financial Accounting Standards Board Interpretation No. 48 ("FIN 48"), KAWC is required to evaluate positions it has taken regarding the calculation of income taxes. After such an evaluation, KAWC has determined that the repairs deduction the Company recognized in the calculation of income taxes is "more likely than not" to be accepted by the IRS. However, the Company does not believe that the repairs deduction will be accepted in its entirety. As a result of this determination, KAWC has calculated a FIN 48 reserve, which the Company is reflecting as an offset to the ADIT balance included in rate base related to the repairs deduction. The amount of this reserve increases the forecast year rate base, (KAWC Application, Exhibit 37, Schedule B), by $3.9 million (AG 2-13).

Q DO YOU TAKE ISSUE WITH THE AMOUNT OF THE RESERVE CALCULATED BY KAWC?

A No. I am not disputing the amount of the reserve, but rather its recognition as a reduction to the ADIT balance included in rate base. However, I believe that allowing KAWC to reflect a FIN 48 reserve in the determination of revenue requirement provides a definite incentive to the Company to reflect the maximum amount possible.

Q WHAT IS THE EFFECT OF ALLOWING KAWC TO RECOGNIZE THE FIN 48 RESERVE?

A Allowing the Company to include the FIN 48 reserve in rate base increases the revenue requirement by approximately $400,000.

Q WHAT IS YOUR RECOMMENDATION REGARDING THE RECOGNITION OF THE INCREASE IN RATE BASE FOR THE FIN 48 RESERVE?

A I do not recommend including the FIN 48 reserve as an increase to rate base. Recognition of the FIN 48 reserve results in allowing KAWC to retain all the tax benefits associated with the repairs deduction by paying less income tax, while customers pay $400,000 in higher rates as a result of recognizing a larger rate base in the determination of revenue requirement.[4]

Q WHAT IS YOUR SUPPORT FOR THIS RECOMMENDATION?

A The repairs deduction is being normalized, which means that the lower current income tax expense paid by KAWC to the IRS is not reflected in income tax expense included in rates. Deferred income tax expense reflects the difference between income tax currently paid by KAWC and the income tax expense without the repairs deduction. By including both current and deferred income tax expense in the determination of revenue requirement, the total income tax expense included in rates is calculated as though the repairs deduction did not exist. As a result, rates will reflect payment of the taxes should the IRS disallow a portion of the repairs deduction, and require KAWC to pay additional tax. The deferred income tax expense is accumulated in the ADIT balance, which is an offset to the rate base.

[4]The Commission previously ruled in favor of KAWC regarding this issue in Case No. 2010-00036, beginning at page 17 of the December 14, 2010 Order.

This issue deals with the proper treatment of the portion of the ADIT balance which reflects KAWC's estimate of the amount of repairs tax deduction that will not be accepted by the IRS.

I recommend that the ADIT balance offsetting rate base reflect the entire value of the repairs tax deduction. Until the IRS makes a future determination regarding the repairs deduction, KAWC will enjoy the benefits of having the cash in-hand resulting from lower income taxes. Based on its recommended rate of return and revenue conversion factor, KAWC is charging ratepayers 11.45% for each dollar of ADIT associated with the repairs deduction that is not recognized in rate base. However, while KAWC is enjoying the benefit of reduced taxes, it is making no payments to the IRS. At some unknown date in the future, KAWC may have to provide the taxes supplied by ratepayers to the IRS, plus interest. The interest rate currently charged by the IRS for large corporate underpayments is 5%.

Q DO YOU OPPOSE KAWC'S RECOVERY OF THE INTEREST IT MAY OWE REGARDING THIS ISSUE IN THE FUTURE?

A No. If at some unknown date in the future, KAWC owes any interest on tax payments associated with the FIN 48 reserve eliminated from rate base, I am not opposed to the Company's recovery of the associated interest expense.

Q DO YOU BELIEVE YOUR RECOMMENDATION SHOULD CAUSE KAWC TO STOP PURSUING AGGRESSIVE TAX POSITIONS?

A No. My recommendation protects KAWC by providing the tax expense and allowing recovery of interest should the IRS not accept the Company's tax position. In addition, the pursuit of aggressive tax positions provides cash to KAWC for investment and also assists the utility in maintaining lower rates. As a result, KAWC should continue its pursuit of aggressive tax positions.

Q IF THE COMMISSION DOES NOT ACCEPT YOUR PRIMARY RECOMMENDATION, DO YOU HAVE AN ALTERNATIVE?

A If the Commission believes it is appropriate to currently recognize the potential cost resulting from the IRS not accepting the repairs tax deductions at some unknown future date, I recommend the following alternative:

1. Exclude the FIN 48 reserves from the ADIT balance resulting in a reduction to rate base;

2. Include the future potential annual interest cost associated with the FIN 48 reserves, at the current IRS rate, in the cost of service in this case; and

3. Perform a true-up and include recovery or refund of the interest cost in subsequent rate cases based on any resolution or change regarding the FIN 48 reserve that was excluded from rate base in a rate case.

Even though the interest may not have to be paid, this alternative will recognize the potential future outlay of the Company on a current basis.

DISTRIBUTION SYSTEM IMPROVEMENT CHARGE

Q PLEASE EXPLAIN THIS ISSUE.

A KAWC is asking the Commission to approve a surcharge to collect the revenue requirement associated with certain plant additions between rate cases. The plant additions would be limited to: (1) Account 331, Transmission and Distribution Mains, including main rehabilitation (cleaning and lining) and valves; (2) Account 333, Services; (3) Account 334, Meters and Meter Installations; and (4) Account 335, Hydrants. These categories would include main extensions to eliminate dead ends and the unreimbursed costs associated with relocations of mains, services, and hydrants resulting from street or highway construction. The DSIC will only apply to the type of plant described above, which is non-revenue producing and has not previously been included in rate base.

Q HAS KAWC IDENTIFIED THE ADDITIONAL AMOUNT THE COMPANY WOULD SPEND IF THE DSIC WAS APPROVED?

A. Yes. In response to PSC 2-52 and PSC 2-53, KAWC states that it anticipates spending an additional $3 million per year for the next ten years if the DSIC is approved.

Q HAS THE COMPANY IDENTIFIED THE SPECIFIC PLANT PROJECTS THAT WILL BE ADDRESSED BY THE ADDITIONAL SPENDING THROUGH THE DSIC MECHANISM?

A No. On pages 14 and 15 of his direct testimony, Company witness Lance Williams discusses the replacement of all 6” and smaller mains that are 75 years and older. While he states that a DSIC program would help accelerate the replacement of aging mains, there is no identification of specific projects the DSIC will address.

In addition, KAWC currently has no written procedures or policies to rank or prioritize the replacement of aging water mains. Based on the response to PSC 2-100, identification and prioritization of main replacement is performed periodically by KAWC engineers and operations personnel.

Q WHAT EVIDENCE IS KAWC PROVIDING TO SUPPORT ITS NEED FOR INFRASTRUCTURE IMPROVEMENTS AND A DSIC?

A Company witness Gary M. VerDouw cites statistics from a study conducted by the United States Environmental Protection Agency ("EPA Study"). These statistics provide estimates of the needed plant improvements over a 20-year horizon.

Q ARE THE STATISTICS CITED BY MR. VERDOUW COMPARABLE TO THE PLANT KAWC IS REQUESTING RECOVERY OF THROUGH A DSIC?

A No. The EPA Study defines infrastructure as pipe, treatment plants, storage tanks and other key assets. The statistics cited by Mr. VerDouw reflect all of these types of facilities, which include source of supply, treatment, storage, transmission and distribution ("T&D") and other plant. However, the DSIC requested by KAWC only addresses distribution facilities. The need identified by the EPA Study for future distribution facilities is significant, but represents less than 60% of the nationwide amounts cited by Mr. VerDouw. With regard to the Kentucky-specific information in the EPA Study, approximately 70% of the total infrastructure replacement is for distribution facilities.

In addition, comparisons between the EPA Study results and the results from prior years are problematic. Some of the project documentation policies and data collection procedures used in prior years were revised in the current EPA Study to ensure a more comprehensive and consistent approach. In addition, longer term needs were underreported in the 1999 and 1995 studies.

Q WILL APPROVAL OF THE DSIC RESULT IN LOWER COST OR FEWER RATE CASES?

A In the near term KAWC does not expect approval of the DSIC to result in cost savings. KAWC <u>may</u> experience cost savings over the long-term, but the amount, if any, and timing are unknown (PSC 2-51).

In addition, KAWC states that the effect of a DSIC on the frequency of base rate cases is unknown (PSC 2-60). However, approval of a DSIC will require some type of proceeding to implement an annual tariff and perform a reconciliation of the prior year actual investments and revenue collections. Therefore, approval of a DSIC will increase docketed proceedings and the number of tariff changes.

Q HOW DOES THE AMOUNT OF LOST WATER EXPERIENCED BY KAWC COMPARE WITH OTHER AMERICAN WATER COMPANIES?

A KAWC's average water loss percentage during the period 2010 through 2012 due to line breaks and leaks was 11.79%. According to LFUCG 2–10, KAWC is at the lower end of the range when compared to other American Water affiliates.

Q DOES THIS LEVEL OF WATER LOSS INDICATE A SIGNIFICANT WATER LEAK PROBLEM?

A No. Based on a *Survey of State Agency Water Loss Reporting Practices* prepared for the American Water Works Association in 2002, 15% is the most common benchmark for lost water. This survey reported that the Kentucky Department of Energy, Water and Sewer Branch used a standard of 15% for lost water. KAWC's current lost water percentage is below the most widely used standard and does not indicate a significant water loss problem.

Q PLEASE BRIEFLY DISCUSS THE ACCEPTANCE OR REJECTION OF THE DSIC MECHANISM IN OTHER STATES WITH AMERICAN WATER OPERATING COMPANIES.

A A DSIC-like mechanism is currently in place in Pennsylvania, Illinois, Indiana, Missouri, Ohio, New York, Delaware and Connecticut. Pilot programs exist in California and New Hampshire. DSIC mechanisms were specifically rejected in Iowa and West Virginia. As Mr. VerDouw points out, these DSIC-like mechanisms have different names depending on the state.

However more importantly, some of the mechanisms were enacted under different circumstances than are present in this case and have very different terms than those sought by KAWC. In several states including Missouri and Illinois, legislation was enacted specifically allowing the regulatory commissions to approve DSIC-like mechanisms. Pennsylvania, Illinois and Indiana have rate caps of 5%. Illinois and Missouri require the infrastructure plant to be in-service prior to being included in the surcharge. In Illinois, if the utility earned above its authorized return on equity in the previous 12 months, not including revenues from the DSIC-like mechanism, a mechanism cannot be implemented. If the utility earned above its authorized return on equity in the previous 12 months, including revenues from the DSIC-like mechanism, a reduction is required to the rates authorized under the mechanism. In Missouri, the utility is required to file a rate case within three years of establishing rates under a DSIC-like mechanism.

Q HOW DO KAWC'S DSIC TERMS COMPARE TO THE MECHANISMS ENACTED IN OTHER STATES?

A Based on my review, KAWC's request for a 10% cap, future year infrastructure plant additions, no consideration of current earnings levels and no requirement to periodically file a full rate case, are some of the most advantageous terms that have been approved in any state.

Q DOES THE USE OF A DSIC CONSTITUTE SINGLE-ISSUE RATEMAKING?

A Yes. Rate adjustments should only occur after all relevant factors have been examined and considered in the determination of revenue requirement. Considering all relevant factors ensures that rates are not adjusted upward for a single rate component, while other rate components are declining. For example, rates would increase as a result of infrastructure plant additions being addressed by the DSIC, while the cost of service reflected in base rates is declining, due to increases in revenues and/or decreases in expenses. This situation could result in a utility earning above its authorized rate of return.

In addition, the DSIC establishes a second rate base upon which KAWC can earn a return in addition to the rate base established in setting base rates in the most recent rate case. While the DSIC tracks increases in the infrastructure rate base, it ignores the decline in the rate base established in setting base rates. This decline occurs due to the continued build-up of the accumulated depreciation and ADIT reserves associated with the plant in-service balance included in base rates following the effective date of rates from the most recent rate case.

Q DOES THE CURRENT RATE CASE PROCESS ALLOW KAWC TO RECEIVE RATE RECOGNITION OF INFRASTRUCTURE ADDITIONS OCCURRING SUBSEQUENT TO THE EFFECTIVE DATE OF BASE RATES?

A Yes. Through the use of a future test year, KAWC can include the average infrastructure as well as other plant additions estimated to occur during the year following the effective date of base rates. The current rate case process allows

KAWC to receive timely rate recognition of a program to ramp-up replacement of infrastructure plant.

Q ARE YOU SPECIFICALLY FAMILIAR WITH THE DSIC-LIKE MECHANISM ENACTED IN MISSOURI?

A Yes. While a member of the Staff of the Missouri Public Service Commission, the State legislature authorized an Infrastructure System Replacement Surcharge, similar to the DSIC. This mechanism was authorized in response to a significant increase in the number of main breaks and the level of water loss being experienced by Missouri-American Water Company. KAWC has not provided any evidence of a significant main break problem. In addition, as previously discussed, KAWC's water loss percentage is low compared to other American Water affiliates.

Q WHAT IS YOUR RECOMMENDATION REGARDING KAWC'S REQUEST FOR A DSIC?

A I recommend the Commission deny KAWC's request for a DSIC. KAWC seeks the approval of a DSIC so the Company can invest an additional $3 million annually. Yet KAWC is currently not experiencing a significant water loss problem. In addition, KAWC has not specifically identified the projects that will be addressed by the DSIC, it does not have written procedures or policies to rank or prioritize the replacement of aging water mains, and the Company has no expectation of achieving savings as a result of implementing this new regulatory mechanism. Finally, KAWC has provided no assurance that it will file less base rate cases with approval of a DSIC. Therefore, customers will have to endure periodic base rate increases with the same frequency, as well as annual DSIC rate increases. Considering the additional expected investment levels and lack of expected savings, the combined increases in rates will be higher with a DSIC. For all these reasons, the Commission should resist KAWC's attempt to engage in single-issue ratemaking and deny KAWC's request for approval of a DSIC.

Q IF THE COMMISSION IS PERSUADED BY KAWC TO ALLOW A DSIC, DO YOU HAVE ANY RECOMMENDATIONS REGARDING THE STRUCTURE OF THE MECHANISM?

A Yes. If the Commission determines that a DSIC is appropriate, I have the following recommendations regarding the structure of the mechanism:

1. If the utility is currently earning at or above its authorized return on equity, it should not be allowed to implement a DSIC or increase the current DSIC rate.

2. The change in the accumulated depreciation and ADIT reserves associated with the plant previously included in rate base in the most recent rate case should be an offset to the DSIC eligible plant.

3. The accumulated depreciation and ADIT reserves associated with DSIC eligible plant should be an offset to the DSIC eligible plant.

4. Items 2 and 3 should be updated as part of the calculation of the surcharge in each subsequent DSIC filing until reset to zero following a rate case.

5. Property taxes may be included if KAWC can prove taxes will increase. If included, only property taxes that will be paid on DSIC eligible plant during the current calendar year should be included in the calculation of the surcharge

6. KAWC should be required to make its annual filing in a docketed proceeding, at least 120 rather than 90 days prior to implementation of or change to the DSIC, in order to allow more time for review by interested parties.

7. KAWC's annual reconciliation filing should be made in a docketed proceeding in which all interested parties have an opportunity to participate.

8. All parties who participated in the most recent rate case should receive automatic intervention in the dockets for items 6 and 7.

In addition, I believe the size of the rate cap, the use of projected versus in-service plant additions and the time period a DSIC can continue between base rate filings are interrelated and should be defined in the terms of the tariff.

WORKING CAPITAL

Q PLEASE EXPLAIN THIS ISSUE.

A KAWC has overstated rate base by including amounts which even the Company recognizes are non-cash items in the calculation of working capital. In addition, KAWC is including a net income amount that provides a double counting of federal income taxes and inappropriately includes the profit on common equity in working capital. If the following four items: depreciation expense, amortization expense, deferred income taxes and net income are eliminated from KAWC's calculation, the revenue requirement associated with working capital would be immaterial. Therefore, I propose to eliminate the working capital component proposed by KAWC in this case.[5]

Q PLEASE EXPLAIN THE PURPOSE OF THE WORKING CAPITAL COMPONENT PROPOSED BY KAWC.

A As KAWC witness Linda Bridwell discusses on page 25, lines 2-7 of her direct testimony, working capital is necessary to recognize the lag between the collection of funds from ratepayers to pay for the "cash" expenses that are necessary to fund the daily operations of the Company. Therefore, non-cash expenses and common equity profits should not be considered in the analysis of working capital since these items are not cash expenses necessary to fund daily operations.

[5] The Commission previously ruled in favor of KAWC regarding the inclusion of depreciation expense in working capital in Case No. 2004-00103, beginning at page 17 of the February 28, 2005 Order.

Q HAS KAWC RECOGNIZED THAT DEPRECIATION, AMORTIZATION AND DEFERRED INCOME TAXES ARE NON-CASH ITEMS?

A Yes. In response to AG 1-98, Ms. Bridwell recognizes that depreciation, amortization, deferred income taxes and net income are all non-cash items. As a result, Ms. Bridwell states that no expense lag days were associated with these items.

Including non-cash items is an attempt to redefine the purpose of providing working capital. Calculating working capital is designed to determine the funds that are needed on a daily basis for the utility to pay for the costs incurred to provide service to ratepayers.

Q PLEASE EXPLAIN THE FOUR ITEMS YOU CITED AND WHY IT IS INAPPROPRIATE TO INCLUDE THESE ITEMS IN WORKING CAPITAL.

A Depreciation and amortization are not cash outlays. These expenses are recorded in KAWC's books to reflect the allocation of the cost of investments in plant over the useful life of the assets. Depreciation and amortization are fully recovered through the inclusion of these expenses in the cost of service. These items are not cash expenses that are included in the daily payments for the services and/or materials required to provide utility service to ratepayers.

Deferred income taxes are also not cash outlays. These expenses reflect the difference between how certain items are recorded on KAWC's books and how these items are recognized in the calculation of income taxes. Because, in the aggregate, these items reduce taxable income, the associated tax payments are deferred until the future. Deferred income taxes are fully recovered through the inclusion of this expense in the cost of service. However, this item is not a cash expense that is included in the daily payments for services and/or materials required to provide utility service to ratepayers.

The net income amount included by KAWC reflects the residual earnings of the Company, after reductions for operating expenses, interest and preferred dividends, but before the reduction for federal income taxes. The net income after interest and preferred dividends reflects earnings available for common shareholders. Distributions to common shareholders are discretionary payments and should not be included in a working capital analysis. If distributions are made to shareholders, it generally occurs through quarterly dividends and through realized gains when the stock is sold.

Q PLEASE ELABORATE ON THE INAPPROPRIATENESS OF INCLUDING COMMON EQUITY RETURNS IN THE CALCULATION OF WORKING CAPITAL?

A Common equity returns represent the net earnings-profits of the Company. Working capital is a component of the rate base, the investment on which the Company earns a rate of return, which includes a component for common equity-profit. By including a working capital component for common equity-profits in the rate base investment, the Company is requesting another layer of profit, in effect, a profit on profit.

In addition, common equity profits are not included in the daily payments for services and/or materials required to provide utility service to ratepayers. Including common equity returns in an analysis designed to measure the need for cash to fund the daily operations skews the results of the analysis and the associated amount of working capital.

Even if there is an assumed cash working capital requirement associated with the return on equity, this effect should already be incorporated into the equity return required by the common stock investor. Any assumption that the common shareholder is entitled to an equity return on investment at the exact instant that service is rendered is incorrect. Shareholders receive their return through the quarterly payment of dividends and any gain from the sale of the Company's stock. This is how common shareholders are compensated for their stock investments.

Q ISN'T IT TRUE THAT CASH IS USED TO PAY COMMON EQUITY RETURNS TO SHAREHOLDERS?

A Yes. However, the decision to pay dividends is uncertain from year to year and should not be included in working capital as a known payment.

In addition, dividends are usually paid quarterly. Therefore, if a component for common equity returns is included in working capital, an expense lag reflecting the payment of quarterly dividend would be 45.625 days ([365/4]/2) rather than the zero expense lag used by KAWC.

Q IF IT IS DETERMINED THAT A COMPONENT FOR NET INCOME SHOULD BE INCLUDED IN WORKING CAPITAL, HAS KAWC CALCULATED AN APPROPRIATE AMOUNT?

A No. Net income, is the residual amount after all expenses including income taxes. Income taxes are already reflected in the working capital analysis. Therefore, income taxes should not be added back to net income. As a result, if it is determined that a component for net income should be included in working capital, KAWC's forecasted year amount should be $11.5 million rather than $20.2 million, reflecting the elimination of federal income taxes. In addition an expense lag of 45.625 should be assigned to the net income component of working capital to reflect a quarterly dividend payment.

Q HAS KAWC AGREED THAT INCOME TAXES SHOULD NOT BE INCLUDED IN THE NET INCOME THE COMPANY PROPOSES TO INCLUDE IN WORKING CAPITAL?

A Yes. Based on discussions with KAWC personnel, the Company has agreed to revise its calculation of net income for cash working capital to eliminate income taxes.

Q PLEASE SUMMARIZE YOUR TESTIMONY AND RECOMMENDATION REGARDING WORKING CAPITAL.

A I recommend that the Commission eliminate the working capital component of the rate base. The amount of working capital requested by KAWC would be immaterial if the Company appropriately eliminated depreciation, amortization, deferred income taxes and net income for the reasons I previously discussed.

CHEMICAL AND ELECTRICITY TRACKERS

Q PLEASE EXPLAIN THIS ISSUE.

A KAWC is requesting a tracker for increases in chemical and electricity expenses. This mechanism would allow KAWC to defer increases in chemical and electricity cost, in excess of the amount included in rates in the current case, and recover this deferred amount through an amortization in the next rate case.

Q WHAT IS YOUR RESPONSE TO THE COMPANY'S PROPOSAL?

A I recommend the Commission deny KAWC's request to establish these trackers. In general, the use of a tracker, either one that automatically adjusts rates between rate cases or a tracker that adjusts at the time of each new rate case, should be avoided. There are two important reasons to avoid such a mechanism.

First, the use of a tracker allows a utility to pursue single-issue ratemaking. Under single-issue ratemaking, a utility can receive additional revenue in rates due to either an increase in a tracked expense or decrease in tracked revenue without any consideration of whether that utility would simultaneously be receiving offsetting decreases in expenses or offsetting increases in revenues for those expenses and revenues that are not being tracked. Allowing a tracker can skew the relationship between revenues, expenses and rate base, potentially leading to a utility over-recovering its costs. Second, the use of a tracker eliminates the inherent incentive a utility has to minimize expenses and maximize revenues between base rate proceedings, which over time works to keep electric rates lower than they otherwise would be. When a utility is allowed to track an expense, it can become indifferent with regard to minimizing that expense since it knows it will not need to file a new base rate case in order to recover any increases in that expense. Similarly, when a utility is allowed to track a revenue, it can become indifferent with regard to maximizing that revenue since it knows that it will not need to file a base rate case in order to recover any shortfall in that revenue.

Q ARE THE ANNUAL CHANGES IN THESE COSTS SIGNIFICANT ENOUGH TO WARRANT A CHANGE IN THE REGULATORY TREATMENT FOR CHEMICALS AND ELECTRICITY?

A No. The significance of the recently experienced change in expense does not warrant a change in regulatory treatment. Chemical expense has actually declined from 2010 through the 2013 budget year. During that period, the average annual change in chemical cost is approximately 2.9%. This rate of change equates to only a $52,000 annual change in the approximately $2 million of total annual chemical expense (AG 1-85).

The average annual increase in electricity cost from 2010 through the 2013 budget year is approximately 1.14%. This rate of change equates to only a $42,700 annual increase in the approximately $3.7 million of total annual electricity expense (AG 1-100). KAWC should be able to manage these levels of change in annual costs without changing the regulatory treatment for these items through the establishment of trackers.

Q ARE THERE OTHER ALTERNATIVES TO A TRACKER AVAILABLE TO THE COMPANY?

A Yes. If KAWC foresees significant changes in chemical and electric costs, it can file a rate case to capture these items in the cost of service. The Company may also file for authority to create a deferred debit to address significant changes in these costs for possible recovery as part of a future rate case.

Q WHY IS A DEFERRED DEBIT MORE PREFERABLE THAN A TRACKER?

A A tracker establishes a guaranteed recovery of a cost over a future period without regard to other components of the cost of service and the earnings of the utility at the time of the deferral. However, a deferred debit allows for a broader examination of the cost being deferred. In addition, recovery of the expense can be examined during a formal process where all relevant factors affecting the cost of service can be considered.

REVENUES

Q HOW HAS KAWC CALCULATED CUSTOMER USAGE IN THIS CASE?

A As described in the testimony of KAWC witness Linda Bridwell, the Company has annualized revenues based on a usage per customer class that reflected an average of the previous two years of history. The Company then applied a declining use factor to the usage per customer amount to arrive at the forecasted level. The usage per customer was then multiplied by the forecasted level of customers to determine the annualized level of water sales.

Q DO YOU BELIEVE THE COMPONENTS USED IN THE COMPANY'S CALCULATIONS ARE REASONABLE?

A No. Some of the use per customer amounts reflect low levels that have either not been achieved in the past, or were only achieved during the wettest year since 2004. In addition, some of the customer levels used by the Company are below the number of customers currently taking service from KAWC. I recommend several adjustments to the number of customers and usage per customer by class.

Q PLEASE EXPLAIN THE ADJUSTMENTS YOU ARE RECOMMENDING BY CUSTOMER CLASS?

A In determining the need for adjustments to the customer and usage per customer components used by KAWC, I am relying on the data supplied in AG 1-170 for the calendar year period 2005 through 2012. In determining whether the rainfall levels reflect severe conditions, I am relying on information provided by National Oceanic and Atmospheric Administration ("NOAA") as well as the Palmer Drought Severity Index, which is a recognized indicator of the effects of rainfall.

<u>Residential and Commercial</u>

KAWC calculated a monthly usage per customer of 4.5 and 36 thousand gallons for the residential and commercial classes, respectively. Levels this low have only been achieved once during the 2005 through 2012 calendar year period. The Company experienced 4.5 and 36 thousand gallons in 2011. However, in 2011 Kentucky experienced the wettest year in the 2005 through 2012 period. In 2011, record or near record rainfall levels were set throughout the state. I believe it is unreasonable to establish rates based on usage levels that reflect such extreme conditions. Therefore, I recommend the usage per customer actually experienced during 2012 of 4.58 and 37.2 thousand gallons for the residential and commercial classes, respectively. During 2012 rainfall in Kentucky was more close to normal levels. For these rate classes, the forecasted customers used by KAWC appeared to be reasonable and I am not proposing an adjustment to these levels.

<u>Industrial</u>

KAWC's usage per customer appears reasonable for the industrial class and I am not proposing an adjustment to this level. However, KAWC is only reflecting 21 customers in the calculation of annualized water usage, which does not reflect the current situation. During 2012 KAWC began the year serving 23 customers. In April and continuing through December, KAWC added an additional customer. Also, a seasonal customer was served from June through October. Therefore, I recommend using the current full-time level of 24 customers to determine the annualized level of customer sales for the industrial class.

<u>Other Public Authorities ("OPA")</u>

KAWC calculated a monthly usage per customer of 212.4 thousand gallons for the OPA class. A level this low has never been achieved during the 2005 through 2012 calendar year period. The Company experienced 217.2 thousand gallons during the extreme rainfall year 2011, which is still higher than the forecast level of 212.4 thousand gallons proposed by KAWC. Therefore, I recommend the usage per customer actually experienced during 2012 of 229.58 thousand gallons, which is still the lowest level achieved in the 2005 through 2012 period, other than the extreme year of 2011.

Regarding customers, KAWC is only reflecting 531 customers in the calculation of annualized water usage, which does not reflect the current situation. During 2012 KAWC averaged 533 customers. In addition, average customers in this class have increased in all but one year and have experienced an annual growth of 7 customers from 2005 through 2012. Therefore, I recommend using the 2012 average level of 533 customers, together with the 229.58 thousand gallon usage per customer, to determine the annualized level of customer water sales for the OPA class.

<u>Other Wholesale Use ("OWU")</u>

KAWC's usage per customer appears reasonable for the OWU class and I am not proposing an adjustment to this level. However, KAWC is only reflecting 12 customers in the calculation of annualized water usage, which does not reflect the current situation. During 2012 KAWC began serving 13 customers in September of 2011 and has served 13 customers throughout 2012. Therefore, I recommend using the current level of 13 customers to determine the annualized level of customer sales for the OWU class.

Q HOW DO YOUR ADJUSTMENTS TO KAWC'S CUSTOMER AND USAGE PER CUSTOMER LEVELS AFFECT THE AMOUNT OF ANNUALIZED REVENUES?

A My recommended adjustments increase the annualized revenues by $2.2 million as follows:

Class	1,000 Gallons	Revenues
Residential	132,210	$700,765
Commercial	124,463	$600,908
Industrial	75,312	$293,314
OPA	114,935	$487,922
OWU	35,160	$148,000

Q ARE THERE ANY OFFSETS TO THE REVENUE ADJUSTMENTS?

A Yes. To produce the additional water sales, KAWC will incur additional cost for chemicals and electricity. Therefore, to properly reflect the cost associated with the increased level of water sales I am recommending, both chemical and electricity expenses need to be increased. To calculate the increase in these costs, I developed factors based on the Company's annualized water sales and chemical and electricity costs. I then applied these factors to my recommended additional waters sales to calculate the associated additional chemical and electricity cost. These calculations result in approximately $153,000 and $70,000 of additional electricity and chemical expense to produce the additional water sales I am recommending.

Q ARE THERE INCONSISTENCIES IN THE LEVEL OF CUSTOMER NUMBERS THAT HAVE BEEN PROVIDED BY KAWC?

A Yes. For example, the customer numbers provided in response to AG 1-170 for 2012 do not match the level provided in response to PSC 1-03. Company witness Bridwell shows 21 industrial customers during each month of 2012 on page 42 of KAWC's response to PSC 1-03. However, Company witness Cartier shows in industrial customers ranging from 23 to 25 for 2012 on page 11 of KAWC's response to AG 1-170. In addition, in workpaper "averagewaterusage.xlsx," the average usage per customer per month was calculated using 21 industrial customers.

Q DID THE SCOPE OF YOUR REVIEW INCLUDE AN EXAMINATION OF WHETHER KAWC ACTED WITH PRUDENCE REGARDING THE COMPANY'S DECISION TO ADDRESS THE WATER DELIVERY PROBLEMS IN THE NORTHERN DIVISION?

A No. Such an examination was beyond the scope of the assignment for which I was retained.

Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A Yes, it does.

Qualifications of Stephen M. Rackers

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Stephen M. Rackers. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q PLEASE STATE YOUR OCCUPATION.

A I am a Consultant in the field of public utility regulation with the firm of Brubaker & Associates, Inc. ("BAI"), energy, economic and regulatory consultants.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EMPLOYMENT EXPERIENCE.

A I graduated from the University of Missouri in 1978 with a Bachelor of Science Degree in Business Administration, with a major in Accounting. Subsequent to graduation I was employed by the Missouri Public Service Commission. I was employed with the Commission from June 1, 1978 until February 29, 2012.

I began my employment at the Missouri Public Service Commission as a Junior Auditor. During my employment at the Commission, I was promoted to higher auditing classifications. My final position at the Commission was an Auditor V, which I held for approximately 15 years.

As an Auditor V, I conducted audits and examinations of the accounts, books, records and reports of jurisdictional utilities. I also aided in the planning of audits and investigations, including staffing decisions, and in the development of staff positions in which the Auditing Department was assigned. I served as Lead Auditor and/or Case

Supervisor as assigned. I assisted in the technical training of other auditors, which included the preparation of auditors' workpapers, oral and written testimony.

During my career at the Missouri Public Service Commission, I presented testimony in numerous electric, gas, telephone and water and sewer rate cases. In addition, I was involved in cases regarding service territory transfers. In the context of those cases listed above, I presented testimony on all conventional ratemaking principles related to a utility's revenue requirement.

In March of 2012, I joined the firm of Brubaker & Associates, Inc. as a Consultant. The firm Brubaker & Associates, Inc. provides consulting services in the field of energy procurement and public utility regulation to many clients including industrial and institutional customers, some utilities and, on occasion, state regulatory agencies.

More specifically, we provide analysis of energy procurement options based on consideration of prices and reliability as related to the needs of the client; prepare rate, feasibility, economic, and cost of service studies relating to energy and utility services; prepare depreciation and feasibility studies relating to utility service; assist in contract negotiations for utility services, and provide technical support to legislative activities.

In addition to our main office in St. Louis, the firm also has branch offices in Phoenix, Arizona and Corpus Christi, Texas.

Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANIZATIONS TO WHICH YOU BELONG.

A I am a licensed Certified Public Accountant ("CPA") in the state of Missouri.

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