

Commonwealth of Kentucky
Before the Public Service Commission

In the Matter of:

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

ATTORNEY GENERAL'S FILING OF
RESPONSES OF DR J. RANDALL WOOLRIDGE
TO COMMISSION STAFF'S WRITTEN QUESTIONS
With
ATTORNEY GENERAL'S READ1ST NOTICE

The Attorney General in compliance with Numbered Paragraph 14 of the Commission's 3 June 2013 Order of procedure submits Dr. J. Randall Woolridge's responses to the written questions of Commission Staff. In accordance with 807 KAR 5:001 Section 8(5)(a) and Numbered Paragraph 5 of the Commission's 17 December 2012 Order of procedure, the Attorney General provides the foregoing general description of the filing.


Pursuant to 807 KAR 5:001 Section 8(7) and Numbered Paragraph 10 of the Commission's December 17th Order, undersigned certifies that the electronic versions in PDF are true and accurate copies of each document filed in paper medium; that the electronic version of the filing has been transmitted to the Commission; and (in that there are no parties that have been excused by the

Commission from participation by electronic means) the filing is in compliance with 807 KAR 5:001 Section 8(7)(c) and Numbered Paragraph 10(c) of the Order of procedure. Further, the Excel files transmitted to the Commission are true representations of the Excel files submitted with the paper version.

WHEREFORE, the Attorney General submits Dr. J. Randall Woolridge's responses to the written questions of Commission Staff and this Read1st Notice.

Respectfully submitted,

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Notice of Filing, Certifications, and Notice of Service

Undersigned counsel provides the following notice with regard to the filing of this material. Pursuant to the Commission's 17 December 2012 Order of procedure, the Attorney General will file the original version on before 21 June 2013, the 2nd business day following the electronic filing.

Per 17 December 2013 Order of procedure, undersigned counsel certifies that the version in the electronic filing is a true and accurate of the original version filed with the Commission. With regard to the electronic filing, in conformity with 807 KAR 5:001 and the Commission's December 17th Order of procedure, the Attorney General has submitted his electronic copies of the information by uploading the material to the Kentucky Public Service Commission.

The electronic filing took place on 19 June 2013.



Assistant Attorney General

Kentucky Public Service Commission
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Responses of Dr. J. Randall Woolridge to Commission Staff's Written Questions

1. Have you performed an update of your analyses based on the April 19, 2013 edition of Value Line and other more current information? If you have done so, please provide a copy of the update.

Response:

Attached please find an updated set of pages 2-6 of Exhibit JRW-10, Dr. Woolridge's DCF analysis. These pages include updated dividend yields, Value Line historic and projected growth rates, and Zacks, Yahoo, and Reuter's projected EP growth rates. These figures are updated as of May 20, 2013.

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2. a. Are you familiar with the articles shown at Table 3 of Dr. Vander Weide's Rebuttal Testimony which represent "more recent research" regarding the accuracy of analysts' forecasts?

Response for 2(a):

Yes, Dr. Woolridge is familiar with the articles, but he would not label them "more recent research." These articles are dated. Dr. Woolridge's Appendix B provides the most recent research on analysts' EPS growth rate forecasts.

b. Do you agree with the Table's conclusions that analysts are either unbiased or exhibit declining optimism or even pessimism?

Response for 2(b):

No. All of these studies evaluate the accuracy of analysts' quarterly or annual EPS estimates. Both Dr. Vander Weide and Dr. Woolridge use analysts' forecasts of long-term EPS growth rates, and not analysts' forecasts of quarterly or annual EPS estimates. None of the studies cited in Table 3 evaluate analysts'

summary of studies that have assessed analysts' forecasts of (1) quarterly and annual EPS estimates and (2) long-term EPS growth rates.

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3. At page 23 of his rebuttal testimony, Dr. Vander Weide states that your studies and those performed by Lacina, Lee, and Xu suffer from substantial statistical difficulties, namely that they fail to recognize the presence of large unexpected accounting write-offs and special accounting charges; and the impact of high correlation in analysts' forecasts. Do you agree that those studies fail to recognize these factors and that the studies therefore suffer from statistical difficulties?

Response:

No. Analysts' forecasts of long-term EPS growth rate forecasts relate to reported EPS. At the time that an analyst makes a long-term EPS growth rate forecast, that forecast includes all the earnings generated by a company's businesses and assets in place. Accounting write-offs and charges typically reflect asset write-offs (such as a plant closure) and/or charges or expenses associated with shutting down or selling a business division. Since these business and assets were in place at the time of the forecast, the impairment to earnings that occurs due to the subsequent write-off or accounting charges reflects the underperformance of these businesses or assets that were part of the company

when the initial forecast was made. This underperformance is reflected in the reported EPS figures (including the write-offs or charges) and in the Company's stock price. Therefore, analysts' long-term EPS growth rates should focus on reported EPS (including accounting write-offs and special charges) and Dr. Vander Wide's observations on this issue are erroneous.

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4. In your opinion do the rules shown at page 24 of Dr. Vander Weide's rebuttal testimony sufficiently address potential conflicts of interest on the part of analysts?

Response:

No, for two reasons. First, all studies that have evaluated the impact of these new rules and regulations have evaluated the impact on analysts' quarterly or annual EPS estimates and not on analysts' forecasts of long-term EPS growth rates. This is reviewed in Appendix B of Dr. Woolridge's testimony. Second, Dr. Vander Weide develops a market risk premium by applying the DCF model to the S&P 500 and uses a growth rate of 10.3% using analysts' long-term EPS growth rates. As Dr. Woolridge indicates at pages 80-83 of his testimony, such a growth rate is not reflective of historic and prospective earnings and GDP growth in the U.S. Dr. Woolridge shows that historic EPS and GDP growth is about seven percent. This indicates that companies in the U.S. would be expected to: (1) increase their growth rate of EPS by over 50% in the future and (2) maintain that growth indefinitely in an economy that is expected to grow at about one-half of his projected growth rates. Dr. Woolridge also points out the

prospective EPS growth is limited to GDP growth, and projected GDP growth rates are in the range of 4.5% to 5.0%. Hence, despite the changes in rules and regulations, the long-term EPS growth rate forecasts of Wall Street analysts are still overly optimistic and upwardly biased.

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5. Do you agree with Dr. Vander Weide that the results produced by your CAPM analysis are unreasonably low?

Response:

Dr. Woolridge believes that the CAPM results are low due to the historically low interest rates and capital costs in the U.S. Given the low interest rates, it is no surprise the CAPM results are low relative to historic figures. In addition, Dr. Woolridge has given primary weight to his DCF results.

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6. In your opinion, does the CAPM underestimate required return on equity for companies or portfolios with beta less than 1.0?

Response:

No, not necessarily. The studies cited by Dr. Vander Weide do not use adjusted betas. Value Line, the source of the Betas used by Dr. Vander Weide and Dr. Woolridge, adjusts Betas to reflect their historic tendency to regress towards 1.0. This adjustment of Beta increases the estimated equity cost rate for stocks with Betas below 1.0.

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7. At page 42 of Dr. Vander Weide's Rebuttal Testimony, he discusses your disagreement with his use of the forecasts yield to maturity on A-rated utility bonds to estimate the interest rate component of the risk premium approach. Dr. Vander Wiede references economists' projections that future interest rates will be higher than current interest rates.

a. In your opinion, do projections show that future interest rates will be higher than current rates?

Response to 7(a):

The projections cited by Dr. Vander Weide do reflect higher interest rates. However, economists always forecast higher interest rates. In fact, economists have been forecasting higher interest rates for a decade and have consistently been wrong. Dr. Woolridge does not believe that interest rates are an economic factor that can be forecasted. As such, he believes that the best measure of future rates are today's rates since, in setting market prices today, investors' expectations regarding expected future interest rates are taken into account. In addition, with respect to the current monetary actions of the Federal Reserve, Dr. Woolridge believes that, at some point, the Federal Reserve will scale back and ultimately end its policy of providing liquidity to the markets by buying bonds.

Dr. Woolridge believes that such a change in policy is well known in the markets and investors' expectations regarding a change in Federal Reserve Board policy is taken into account in the pricing of securities in the markets.

b. How far in the future are economists projecting that interest rates will begin to rise?

Response to 7(b):

See response to 7 a.

c. Are economists projecting significant increases in interest rates?

Response to 7(c):

See response to 7 a.

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8. On or about May 24, 2013, Standard & Poor's reported that it had upgraded the corporate credit rating on American Water Works Company and certain of its subsidiaries from BBB+ to A- with a stable outlook. Does this report affect your analysis and testimony in this case? If yes, what effect does it have on your analysis and testimony?

Response:

The upgrade of the corporate credit rating ("CCR") of American Water Works Company ("AWK") and certain of its subsidiaries from BBB+ to A- brings the CCR of AWK in line with other water companies and makes Dr. Woolridge's recommended ROE of 8.50% appear even more reasonable.