BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF KENTUCKY

IN THE MATTER OF THE APPLICATION	)	
OF WATER SERVICE CORPORATION FOR	)	Docket No. 2013-00237
A GENERAL ADJUSTMENT IN EXISTING RATES	)	

DIRECT TESTIMONY OF

ANDREA C. CRANE

ON BEHALF OF

THE OFFICE OF ATTORNEY GENERAL

February 5, 2014

TABLE OF CONTENTS

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Andrea C. Crane and my business address is 90 Grove Street, Suite 211, Ridgefield, CT 06877. (Mailing Address: P.O. Box 810, Georgetown, Connecticut 06829)

Q. By whom are you employed and in what capacity?

A. I am President of The Columbia Group, Inc., a financial consulting firm that specializes in utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and undertake various studies relating to utility rates and regulatory policy. I have held several positions of increasing responsibility since I joined The Columbia Group, Inc. in January 1989. I became President of the firm in 2008.

Q. Please summarize your professional experience in the utility industry.

A. Prior to my association with The Columbia Group, Inc., I held the position of Economic Policy and Analysis Staff Manager for GTE Service Corporation, from December 1987 to January 1989. From June 1982 to September 1987, I was employed by various Bell Atlantic (now Verizon) subsidiaries. While at Bell Atlantic, I held assignments in the Product Management, Treasury, and Regulatory Departments.

Q. Have you previously testified in regulatory proceedings?

A. Yes, since joining The Columbia Group, Inc., I have testified in over 350 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii, Kansas, Kentucky, Maryland, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Vermont, Washington, West Virginia and the District of Columbia. These proceedings involved water, wastewater, electric, gas, telephone, solid waste, cable television, and navigation utilities. A list of dockets in which I have filed testimony since January 2008 is included in Appendix A.

Q. What is your educational background?

A. I received a Master of Business Administration degree, with a concentration in Finance, from Temple University in Philadelphia, Pennsylvania. My undergraduate degree is a Bachelor of Arts in Chemistry from Temple University.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. On September 27, 2013, Water Service Corporation of Kentucky ("WSCK" or "Company") filed an Application with the Kentucky Public Service Commission ("PSC" or "Commission") seeking a rate increase of $228,789, or approximately 10.87% over pro forma water sales revenue at present rates. The Company's filing was based on a test year consisting of the twelve months ending December 31, 2012, adjusted "based on known and measurable changes to actual expenses."[1]

The Columbia Group, Inc. was engaged by the Kentucky Office of the Attorney General ("AG") to review the Company's Application and to provide recommendations to the PSC regarding the Company's revenue requirement and need for rate relief.

III. SUMMARY OF CONCLUSIONS

Q. What are your conclusions concerning the Company's filing and its requested rate increase?

A. Based on my analysis of the Company's filing and data request responses, my review of prior PSC Orders relating to WSCK, and my review of other documentation in this case, my conclusions are as follows:

1. The Company's request for a rate increase of $228,789 should be denied.
2. The Commission should eliminate the post-test year salary and wage increases proposed by WSCK and make associated accounting adjustments to expenses charged to plant, payroll tax expense, and pension and other benefit costs.
3. The Commission should reflect rate case costs for the current case based on an average of the actual costs incurred in the last two WSCK rate proceedings.
4. The Commission should disallow certain indirect costs allocated to WSCK, including costs for corporate labor.

1 Direct Testimony of Mr. Yap, page 5, lines 1-2.

5. The Commission should disallow recovery of certain advertising costs and charitable contributions.

6. The Commission should disallow depreciation expense and interest expense associated with Project Phoenix.

7. The Commission should retain the Company's current depreciation rates.

8. The Commission should reflect an allocation of costs to the City of Clinton ("Clinton") sewer operations based on the actual costs incurred in the test year.

9. The Company's current rates are more than sufficient to meet the Commission's 88% operating ratio margin requirement. In order to bring rates down to the 88% operating ratio margin, a rate reduction of $116,869 would be required (see Schedule ACC-1).

10. I recommend a reduction of $116,869 in WSCK's rates for water service.

IV. DISCUSSION OF THE ISSUES

A. Introduction

Q. Please provide a brief summary of the Company's filing.

A. As described in Mr. Yap's testimony, WSCK provides retail water service to approximately 7,362 customers in Hickman and Bell counties. The Company also provides sewer services to Clinton pursuant to a service agreement.[2] Costs associated with the sewer operation are directly charged to Clinton and are removed from the Company's revenue requirement.

WSCK is a wholly-owned subsidiary of Utilities, Inc. ("UI"). UI owns over 70 small water and/or sewer systems that provide service to approximately 270,000 customers in 15 states. Services are generally provided to subsidiaries through Water Service Corporation ("WSC"), a service company that provides both operational and management services to all subsidiaries. Since December 2012, UI has been owned by Corix Utilities, a limited liability company whose ultimate principal investor is a Canadian investment management company.

Mr. Yap states on page 3 of his Direct Testimony that WSCK is filing for rate relief because it "is not able to meet is operating costs and earn a reasonable return on its investment in the WSCK system."[3] The Company is seeking a rate increase of $228,789 or 10.87% in pro forma water sales revenue, based on a test year ending December 31, 2012.

In calculating its revenue requirement, WSCK utilized the 88% operating ratio method that has been traditionally used by the PSC to regulate WSCK. Pursuant to the formula approved by the PSC, the Company is permitted to set rates that provide an amount sufficient to recover its operating expenses (net of income taxes) plus a 12% margin. This method has been termed the 88.00% operating ratio method since it is based on operating revenues, 88% of which reflect operating expenses, net of income taxes plus a 12% net

2 The response to AG 1-1 states that the Company serves 5,900 customers in Bell County and 607 customers in Hickman County. Thus, it appears that Mr. Yap's customer count includes Clinton sewer customers served pursuant to a service agreement.
3 Lines 12-13.

income margin (after-taxes). The formula also includes a gross-up factor for income taxes and other revenue-related costs, as well as interest on long-term debt.

In the public notice that was published in The Hickman County Gazette, the Company stated that it also sought to implement a Distribution System Infrastructure Charge ("DSIC") Rider and a Purchased Power and Chemical Charge Rider. However, the Company apparently reconsidered their position and stated in response to Staff 2-1 that it was no longer pursuing these two rider mechanisms.

Q. What was the Company's actual test year net income, as reported in the filing?

A. According to Schedule B of the filing, WSCK had net income of $49,994 in the test year. The Company has made a series of pro forma adjustments to the test year that result in an increase to net income of $57,514, for a pro forma net income at present rates of $107,508.

Q. Please summarize the test year adjustments proposed by WSCK in its filing.

A. The Company included the following adjustments in its filing:

1. Revenues – Water sales revenues were annualized based on test year usage and customer counts.
2. Uncollectible Costs – The Company adjusted uncollectible costs, consistent with its adjustment to annualize water sales revenues. WSCK utilized an uncollectible rate of 1.81% and applied that rate to its pro forma water sales revenue to determine its pro forma uncollectible expense.

3. Salaries and Wages – The Company annualized salary and wage costs. In addition, WSCK reflected a 3% post-test year salary and wage increase in its claim.
4. Transportation – The Company annualized certain transportation costs based on average test year costs per vehicle and vehicle allocations to Kentucky operations.
5. Operating Expense Charged to Plant – The Company reflected an increase in the operating expenses charged to plant based on the projected increases in salaries, wages, and benefits.
6. Regulatory Commission Expense – The Company included rate case costs for the current case of $193,477, as well as unamortized rate case costs from the last case of $27,300. WSCK proposed to amortize regulatory commission costs over 3 years.
7. Pension and Other Benefits – The Company annualized certain pension and benefit costs to reflect the impact on pensions and benefits of the salary and wage increase adjustments discussed above.
8. Miscellaneous – The Company removed certain costs related to travel, entertainment and other costs that it is not proposing to recover from ratepayers.
9. Depreciation – The Company annualized depreciation expense based on plant balances at the end of the test year.
10. Amortization of Plant Acquisition Adjustment (“PAA”) – The Company eliminated amortization of a plant acquisition adjustment, consistent with the treatment in prior rate cases.

11. Taxes Other Than Income Taxes – The Company made an adjustment to payroll tax expense consistent with its adjustment to salaries and wages.
12. Expense Reductions Related to Clinton Sewer Operations – WSCK reduced the costs projected to be allocated to Clinton sewer operations.
13. Income Taxes – WSCK made an adjustment to reflect pro forma state and federal income taxes consistent with its other accounting adjustments.
14. Interest on Long Term Debt – The Company reflected interest on long-term debt, based on a debt cost of 6.6% and on a capital structure that contains 52.44% debt.

Q. How did you determine the appropriate revenue adjustment required by WSCK?

A. My analysis began with the Company's pro forma results of operations at present rates, i.e., its test year adjusted for known and measurable changes. I examined each of the test year adjustments being proposed by WSCK to determine if it was reasonable from a ratemaking perspective. I also examined the underlying (unadjusted) test year data to identify costs incurred in the test year that should not be borne by ratepayers. Based on this analysis, I am recommending a series of adjustments to develop recommended pro forma results of operations at present rates. In identifying adjustments, I utilized both prior Kentucky Public Service Commission decisions as well as other regulatory policies that have been adopted in rate cases.

Once I developed pro forma operating results at present rates, I then applied the Commission's 88% operating ratio formula to develop the water revenue adjustment necessary to meet the Commission's operating ratio requirement.

Q. Please summarize the adjustments that you are recommending to the Company's pro forma income claim at present rates.

A. As shown in Schedule ACC-1, I am recommending one reclassification of a cost and several accounting adjustments to the Company's filing. First, I am recommending that uncollectible costs be reclassified as an operating expense, instead of as a reduction to pro forma revenue. I am not recommending any adjustment to the amount of uncollectible costs claimed by the Company. In addition to this reclassification, I am recommending various accounting adjustments relating to salaries and wages, operating expenses charged to plant, regulatory commission expense, pension and other benefit costs, service company allocations of indirect costs, miscellaneous expenses, depreciation, payroll taxes, expenses allocated to the Clinton sewer operation, income tax expense, and interest expense. My adjustments indicate that WSCK has pro forma net income at present rates of $284,248, which exceeds the net income provided for by the Commission's 88% operating ratio test. Accordingly, I am recommending a rate reduction for WSCK of $116,869.

B. Uncollectible Expense

Q. Please describe your first adjustment to reclassify uncollectible costs.

A. While a utility's revenues generally reflect the amount that has been billed by the utility, the utility usually does not collect 100% of the amounts billed to customers. Unfortunately, there are always some customers that either cannot or will not pay their utility bills, and hence the amount of revenues actually received by utilities is generally less than the amount billed. In this case, the Company has calculated uncollectible pro forma costs of $38,028. This amount is based on its pro forma annualized test year water sales revenues of $2,103,813 and on an uncollectible rate of 1.81%, which is the actual test year uncollectible rate. According to the response to Staff 2-4, the actual uncollectible rates were 1.81% in 2012; 1.89% in 2011; 5.72% in 2010; 5.72% in 2009; and 1.70% in 2008. It is my understanding that the 2010 and 2009 rates reflected a change in methodology. The uncollectible rate of 1.81% appears reasonable in light of the actual uncollectible costs incurred by the Company over the past few years, though the trend suggests that a lower rate would also be reasonable.

WSCK reflected uncollectible costs as a reduction to pro forma water sales revenues instead of as an operating expense. It proposed a similar treatment in its last base rate case. In that case, the Commission reclassified uncollectible costs from an operating revenue reduction to an expense increase. In my experience, uncollectible costs are more commonly categorized as an operating expense than as a revenue reduction. In addition, this reclassification simplifies the calculation of the 88% operating ratio since it treats uncollectible costs the same as other operating expenses that must be recovered by the

Company. Thus, on Schedule ACC-1, I have increased Total Operating Revenues by $38,028 and increased Operating Expenses by a similar amount.

C. Salary and Wage Expense

Q. How did the Company develop its pro forma salary and wage expense claim in this case?

A. WSCK has no direct employees but instead receives services from various employees of the Service Company, WSC, who allocate all or a portion of their time to the Kentucky operations. There are three separate categories of employee labor costs shown in the Company's cost of service on Schedule B. First, WSCK has included a Maintenance Expense claim of $519,099 related to operational employees. These are employees that are either 100% dedicated to Kentucky operations or employees that supervise the operational employees. Supervisory employees are charged to WSCK at allocation rates of either 21.68% or 6.98%, depending on their job functions. Second, WSCK has included $37,233 for Customer Service Representatives ("CSRs"). These employees provide services to many different UI utility companies and are allocated to WSKC based on the number of equivalent residential connections, resulting in an allocation of 2.78% to WSCK. Third, the Company has included $134,652 of costs associated with the Northbrook operations, which provides corporate administrative functions to all UI subsidiaries. These employees are also allocated to WSCK based on a ratio of 2.78%. Both the CSR employee costs and the corporate labor costs are included in the Salaries and Wages category under General Expenses.

WSCK has annualized its payroll costs and has included a post-test year increase of 3% for all employee positions. A similar adjustment was proposed by the Company in its last base rate case.

Q. Please describe the adjustment that you are recommending to the Company's salary and wage claim.

A. I am recommending that the 3% post-test year expense adjustment be eliminated. In making this adjustment, WSCK has selectively chosen one component of its revenue requirement to adjust, which distorts the test year concept. Utility rates are based on a test year, which is a twelve month period reflecting normal operating conditions and financial results. In evaluating the test year, it is important that the relationship of the revenue requirement components such as revenues, expenses, and investment be retained in order to properly match the results of test year operations with the resources used to generate those results. In this case, WSCK has annualized its water sales revenues based only on the test year and has generally not gone past the end of the test year to adjust other expense categories. While it is generally permitted to annualize changes that took place within the test year, post-test year adjustments are often disallowed. Therefore, I recommend that the Company's claim for a post-test year 3% salary and wage increase be rejected by the Commission.

Q. Did the Commission reject a similar post-test year adjustment in the Company's last case?

A. Yes, it did. In its Order in Docket No. 2010-00476, the Commission rejected a similar adjustment proposed by the Company in that case. The Commission found that there was "insufficient evidence to support the reasonableness of the proposed adjustment to the test-year expense."[4] WSCK has failed to provide evidence in this case that would justify violating the test year concept by including a post-test year expense adjustment. Therefore, I recommend that the Company's adjustment for a 3% post test year increase be denied.

Q. Did employees actually receive a 3% post-test year increase?

A. No, the actual increases granted to employees in 2013 varied considerably by employee, as shown in the response to AG 1-50. Some employees received increases that were significantly greater than 3% while others received increases that were considerably less.

Q. Did WSCK conduct any studies to determine how its payroll costs compared with prevailing wages in the area, as suggested by the Commission's Order in the last case?

A. No, it did not. In Staff 2-10, Staff requested that the Company provide "all studies and analysis that WSKY or UI have conducted or commissioned on prevailing wages in the Clinton region, the Middlesboro region, or in the state of Kentucky." In its response, the Company simply referred Staff to Mr. Shambaugh's testimony. While Mr. Shambaugh's testimony provides some data on overall labor costs, it does not address the reasonableness of the underlying salary or wage levels. In Staff 2-10, Staff also asked the Company to state

4 Order in Docket No. 2010-00476, page 7.

why the 2013 wage increases were reasonable and appropriate, "in light of the present economic conditions, both locally and nationally". In response, the Company stated that such increases "are necessary to enable WSCK to maintain a skilled and competent workforce so as to continue to provide safe and reliable drinking water to its customers at fair, just and reasonable rates." However, once again the Company provided no documentation supporting the specific salary levels for the employees included in this filing. Staff provided an additional opportunity for the Company to support its salary and wage costs in Staff 3-11. But again the Company provided only general information on labor increases from such sources as the Human Resources Kit for Dummies and publications addressing employee retention in general. Given the fact WSCK has put in no new evidence in this case to justify its specific post-test year salary and wage increases, I recommend that the Company's adjustment for a 3% post test year increase be denied.

Q. How did you quantify your adjustment?

A. The pro forma salary and wage adjustments proposed by WSCK contain several parts, including annualizing payroll increases that took place during the test year, annualizing salary and wage costs for changes in the number of employees, and annualizing the 3% post-test year increase. Since my adjustment is limited to removing only the 3% post-test year increase, I utilized the Company's pro forma salary and wage claims and divided those claims by 1.03 to remove the impact of the 3% salary and wage increases. My adjustments relating to Maintenance Expenses (Operational labor costs) and General Expenses (CSR labor costs) are shown in Schedule ACC-2. My adjustments reduce the Company's pro forma Maintenance Expense by $15,119 and reduce General Expense by $1,084. I did not make an adjustment relating to the post-test year increase in corporate labor costs on Schedule ACC-2, since these costs are the subject of a separate accounting adjustment discussed below.

D. <u>Operating Expenses Charged to Plant</u>

Q. Please explain your adjustment relating to Operating Expenses Charged to Plant.

A. A portion of the Company's operating expenses is capitalized and charged to plant accounts. This has the effect of reducing the Company's revenue requirement. WSCK calculated the amount of operating expenses charged to plant based on its pro forma salary and wage claim. As previously discussed, the salary and wage claim includes a 3% post-test year increase that has previously been disallowed by the Commission and that I am recommending be disallowed in this case. Therefore, it is necessary to make a corresponding reduction to the amount being charged to plant to reflect the fact that my revenue requirement includes a lower salary and wage claim that the claims included in the Company's filing. At Schedule ACC-3, I have made an adjustment to reduce the amount of operating expenses charged to plant, consistent with my recommended salary and wage adjustments, discussed above.

Q. How did you quantify your adjustment?

A. The costs charged to plant are composed of three categories of payroll costs – Maintenance Expenses related to operational costs, General Expenses related to CSR costs, and General Expenses related to corporate labor costs. I have reduced the amounts charged to plant by adjusting the operational costs and the CSR costs by 3% of the Company's claim. This has the effect of eliminating the 3% post-test year increase that the Company included in its claim for those labor costs charged to plant accounts. My recommendation results in a decrease of $3,903 in the amount of labor costs charged to plant accounts.

Q. Did you make any adjustment on Schedule ACC-3 relating to corporate labor costs?

A. No. Corporate labor costs are the subject of a separate adjustment that is discussed is more detail below. Therefore, Schedule ACC-3 does not reflect any adjustment relating to the Company's claim for corporate labor costs charged to plant.

E. Regulatory Commission Expense

Q. How did the Company develop its claim for regulatory commission expense?

A. WSCK's regulatory expense claim is based on total estimated costs for the current rate case of $193,477. This includes $80,000 in external legal costs; $25,000 for consulting fees; $12,000 for newspaper publication and mailings; $72,017 for UI personnel; and $4,460 for travel. In addition, the Company included $27,505 of unamortized costs from its last base rate case, for a total regulatory commission expense of $220,981. The Company is proposing to amortize these costs over three years, for an annual amortization expense of $73,660.

Q. Did the Company solicit competitive bids for rate case services relating to this case?

A. No, it did not. According to the response to AG 1-82, the Company did not issue any Requests for Proposal for services associated with this rate case. Moreover, the Company only has a written agreement with one outside firm, AUS Consulting, for services in this proceeding.[5] WSCK does not have written agreements with either Mr. Baryenbruch or with the law firm of Sturgill, Turner, Barker, and Moloney relating to this rate case.

Q. Are you recommending any adjustment to the Company's claim for regulatory costs?

A. Yes, I believe that the Company's claim is excessive. The estimated costs for the current case are significantly higher than the actual costs incurred in the last three base rate case proceedings, as shown below:[6]

	Rate Case Expense
2010 Case	$141,408
2008 Case	$145,604
2005 Case	$88,660
Average	$125,224

5 Per the response to AG 1-81.
6 Per the response to AG 1-80.

While the 2005 case was significantly less costly than the 2008 or 2010 cases, the last two cases were fully litigated while the 2005 case was settled. Therefore, the 2008 and 2010 rate case costs are a better proxy for costs that are likely to be incurred in this case, assuming full litigation. In order to determine a normalized level of rate case costs, I recommend that the PSC utilize an average of WSCK's costs in its last two base rate proceedings. This recommendation results in a pro forma cost of $143,506 for the current case. I am not recommending any adjustment to the Company's claim for unamortized costs of $27,505 relating to the last case. In addition, I have accepted the Company's proposal to use a three-year amortization period for rate case costs associated with the current proceeding. Accordingly, at Schedule ACC-4, I have made an adjustment to reflect prospective annual costs of $57,004 ((143,506 + $27,505) /3), based on the average costs over the last two rate cases and on a three-year amortization period. This recommendation reduces the Company's pro forma operating expenses by $16,656.

F. Pension and Other Benefits Expense

Q. How did the Company develop its claim for pension and other benefits expense?

A. The Company's claim for pension and other benefits expense includes costs for health insurance, 401K contributions, and other benefits such as life insurance and tuition assistance. With regard to the 401K contributions, WSCK has included a 4% company contribution as well as a 3% 401K matching contribution, for a total of 7% of annualized salary and wage costs. Thus, the costs associated with 401K contributions are directly related to the amount of payroll costs reflected in the filing.

Q. Please explain your adjustment to the Company's claim.

A. Since I am recommending that the 3% post-test year salary and wage adjustment be rejected, I have made a corresponding adjustment to eliminate the 401K contributions associated with the salary and wage costs that I recommend be disallowed. My adjustment is shown in Schedule ACC-5 and reduces the Company's pro forma operating expense by $1,134.

G. Service Company – Allocated Expenses

Q. Please describe the indirect costs allocated to WSCK from the Service Company.

A. WSCK is allocated a portion of costs incurred by WSC, a wholly-owned subsidiary of UI that manages the operations of the individual water and sewer systems. According to the testimony of Ms. Lupton, costs incurred by WSC are directly charged to a utility, if applicable. Costs that cannot be directly assigned are allocated based on the Equivalent Residential Connections ("ERCs") of the subsidiaries that benefit from the function being allocated. WSCK does not receive an invoice related to these costs - instead the charges are automatically booked to WSCK through UI's financial accounting system.[7]

There are three main categories of services provided by WSC, as previously discussed in the payroll section of this testimony. First, WSC provides operational services and all of

7 While Ms. Lupton states that costs can be directly charged to an entity, the response to AG 1-40 states that "Neither Utilities, Inc., nor any other affiliated entity charges costs directly to WSCK."

the personnel providing operational functions are employed by WSC. Most of these costs are 100% allocated to WSCK, although related supervisory costs are allocated to multiple jurisdictions. Second, WSC provides customer service support through its customer service representatives. These costs are allocated to all entities based on ERCs. Third, WSC provides corporate services such as management, administration, accounting, data processing, and regulatory services. These costs are also allocated to all entities based on ERCs.

In prior cases, the PSC has disallowed the corporate labor costs as well as certain other indirect costs that are allocated to WSCK. The Commission found that the Company had not demonstrated that such costs were reasonable. In addition, the Commission noted that the Directors and Officers of WSCK of Kentucky are the same individuals that hold similar positions at other UI subsidiaries. According to the response to AG 1-22 in this case, WSCK has two Directors, Lisa Sparrow and John Stover. Lisa Sparrow is President and CEO of UI while John Stover is Vice President and Secretary. These individuals are also directors and officers of all other subsidiaries of UI. Thus, there is no inherent independent management of WSCK.

The existence of common directors and officers creates potential conflicts of interest, especially when affiliated transactions are involved. In fact, the UI corporate structure does not provide any real local control of WSCK. In the response to AG 2-14, the Company acknowledged that its Board of Directors did not even approve this rate application, stating that “[t]he Company’s rate application filing process does not include the approval by the

Board of Directors." The Company went on to state that "regulatory personnel performs analyses on a regular basis to verify that the Company is operating at the appropriate income level so that it can satisfy the needs of its customers by delivering clean water and reliable service at the lowest reasonable cost. Once it is determined that the Company requires rate relief, the executive team approves the filing of the rate application." This lack of independence requires especially close scrutiny by the Commission of costs allocated from affiliates, especially the allocation of corporate costs.

In the last case, WSCK attempted to justify its corporate labor costs by comparing its costs with costs incurred by a sample of electric utility service companies. This comparison was rejected by the PSC, who found that the Company's study failed "to involve similar type and sized utilities...." [8] The Commission also noted its concerns regarding "an absence of any independent review of the cost allocations by WSKY's management."

Q. **Does the Company have the ability to accept or reject allocated expenses from affiliates pursuant to the service agreement?**

A. No, it does not. The service agreement does not provide for the provision of specific challenges to allocated costs by the member companies, such as WSCK. Instead, the only option available to a subsidiary is to terminate all services from WSC. In Staff 2-14, Staff asked the Company if the service agreement had been modified since the last case "to allow

8 Order in Case No. 2010-00476, page 11.

WSKY to contest the reasonableness of any expense that the Service Company allocates to WSKY." The Company responded that the service agreement has not been modified.

Q. How did the Company attempt to justify the reasonableness of the corporate labor costs in this case?

A. In this case, the Company attempted to justify its corporate labor costs through the testimony of Mr. Shambaugh. Mr. Shambaugh first attempted to justify the corporate labor charges by comparing the average revenues of WSCK with the average revenues in either 2011 or 2012 for twelve Kentucky water systems regulated by the Commission. On page 7 of his testimony, Mr. Shambaugh concludes that WSCK's revenues in 2011 were in the low range of a group he studied, at $25.41 per month. This analysis is flawed in that it provides no information about the reasonableness of the underlying costs allocated to WSCK. In fact, it doesn't provide information about any of WSCK's costs, nor does it provide information about the costs of the other Kentucky systems. Revenues per customer can vary for a number of reasons including the frequency of rate cases, the percentage of fixed vs. variable charges, temperature and rainfall conditions, growth in a particular service territory, and many others.

Mr. Shambaugh then reviewed the salaries and wages of the sample group based on three criteria: 1) reported salaries and wages (excluding officers and directors), 2) salaries and wages for officers and directors, and 3) total salaries and wages including officers and directors. However, once again this macro analysis fails to provide meaningful support for the corporate labor costs being allocated to WSCK in this case. Payroll costs can vary among utilities due to a host of factors, including how the utility is organized, how the utility acquires its supply resources, how efficient a utility is in its operations, how compensation programs are designed, and other factors. Moreover, Mr. Shambaugh's analysis includes operational costs, which are not at issue in this case.

Mr. Shambaugh did examine individual employee salary and wage information for four Kentucky systems in Exhibit E to his testimony, concluding that the per customer cost incurred by WSCK ratepayers for allocated corporate labor costs was less that the per customer cost incurred by ratepayers of the other systems. But again, this does not provide the Commission with information about either the underlying corporate labor costs being allocated to WSCK in this case or about the appropriateness of the allocation methodology. Moreover, it appears that the four companies referenced in Exhibit E are not subsidiaries of a large corporate parent, as is WSCK. While smaller independent systems may not benefit from the economies of scale available to WSCK, such systems are likely to have direct control over their hiring practices and greater local oversight of operations.

While there are undoubtedly some costs being allocated to WSCK that are necessary for the provision of safe and reliable water service, there is nothing in the Company's testimony to identify the specific services needed, or to indicate that the costs for the services actually being provided are reasonable. That was the Commission's concern identified in the last case. While the overall level of costs may be low relative to other companies, it does not follow that the actual costs being proposed by WSCK for the services being provided are reasonable.

Q. Haven't other regulatory commissions approved the allocations contained in the service agreement, which are based on the ERCs of the benefitting subsidiaries?

A. Yes, they have. However, as pointed out in several regulatory Orders from other jurisdictions, such approval does not eliminate the requirement that the utility must justify the reasonableness of its costs in a base rate case. For example, in Staff 3-8, the Company provided an Order from the Virginia State Corporation Commission approving an amended services agreement involving Massanutten Public Service Corporation ("MPSC"), another subsidiary of UI. In approving that agreement, the Commission found that "...MPSC should continue to evaluate services obtained from WSC on a regular basis. Services for which a market exists should be evaluated as to the cost of such services from the market to ensure that MPSC is paying WSC the lower of WSC's cost or the market price for such services. MPSC should bear the burden of proving during any rate proceeding that it paid WSC the lower of cost or market for such services."[9] Similarly, in a case involving Penn Estates Utilities, Inc., the Pennsylvania Public Utility Commission found that "...approval of the agreement does not constitute a determination that the associated costs or expenses are reasonable or prudent for the purposes of determining just and reasonable rates."[10] The existence of a service agreement does not ensure that the underlying costs are reasonable or that the costs meet the regulatory standards for recovery.

9 Order in Case No. PUE-2008-00040, page 3.
10 Letter of August 31, 2010 in Case G-2009-2134767.

Q. What do you recommend?

A. I recommend that the Commission continue to disallow corporate labor costs allocated to WSCK. The Commission excluded these costs from the rates paid by Kentucky ratepayers in at least the past two rate cases, and it should continue to exclude these costs from rates. My adjustment is shown in Schedule ACC-6.

Q. How did you quantify your adjustment?

A. My adjustment consists of three components. First, I eliminated $21,907 in non-labor costs relating to certain memberships, travel costs, fines and penalties, and other costs that were disallowed by the Commission in the Company's last base rate case. Second, I eliminated the Company's claims for corporate labor costs allocated to WSCK, as well as the associated payroll taxes and employee benefit costs. Third, since a portion of the corporate costs was charged to plant in the Company's filing, it was necessary to reverse this allocation in order to avoid double-counting a portion of my adjustment. The net impact of these three adjustments is a reduction in operating expenses of $159,159 as shown in Schedule ACC-6.

H. <u>Miscellaneous Expense</u>

Q. Did the Company include other operating costs in its claim that should not be collected from ratepayers?

A. Yes, it did. The Company included $160 in advertising costs and $340 in charitable contributions that I recommend be disallowed. Advertising costs are generally disallowed by regulators unless a utility can demonstrate a direct benefit to ratepayers. In AG 1-109, we asked the Company to identify its test year advertising expenditures by category, such as educational, conservation, institutional, etc. WSCK was unable to identify the purpose of each advertising expenditure. Accordingly, the Company has not shown that these costs provided a direct ratepayer benefit or were necessary for the provision of regulated water service.

Similarly, I am recommending that charitable contributions be excluded from the Company's revenue requirement. Utility rates should include a reasonable level of costs that are necessary for the provision of safe and reliable utility service. Civic and charitable contributions, while worthwhile expenditures, should not be borne by ratepayers. Civic and charitable contributions are not necessary to the provision of safe and adequate utility service. Furthermore, by including such contributions in utility rates, utilities force ratepayers to indirectly contribute to those organizations selected by utility management, effectively forcing ratepayers to support organizations whose goals and objectives may conflict with those of any specific ratepayer. For these reasons, many regulatory commissions prohibit utilities from recovering any donations or charitable contributions in their utility rates. It is my understanding that the Kentucky Public Service Commission has disallowed charitable contributions in prior cases, finding that such costs "are not essential to the provision of services and are below the line items, the expense of which should be borne by stockholders and not the ratepayers."[11]

At Schedule ACC-7, I have made an adjustment to remove a total of $500 in advertising and charitable contributions from the Company's claim.

Q. Do you have any additional comments regarding miscellaneous expenses?

A. Yes, in developing my miscellaneous expense adjustment, it was not my intent to eliminate costs that may have already been eliminated by WSCK in its filing. As shown on Schedule B to the filing, WSCK did eliminate $12,945 of costs that it believed should not be borne by ratepayers. Based on my review of the data request responses and company workpapers, I do not believe that my miscellaneous expense adjustment is duplicative with the Company's adjustment. Similarly, I do not believe that my earlier adjustment to non-labor indirect costs is duplicative with the Company's miscellaneous expense adjustment. However, if the Company demonstrates that it has already removed any of the miscellaneous expenses or non-labor indirect costs that are the subject of adjustments in my testimony, then I will revise my adjustments accordingly.

I. <u>Depreciation Expense</u>

Q. How did the Company calculate its depreciation expense claim in this case?

11 In the Matter of Adjustment of Rates of Columbia Gas of Kentucky, Inc., Case No. 10498, Order entered October 6, 1989, page 48.

A. The Company based its claim on annualized test year plant balances and various depreciation rates. WSCK used a depreciation rate of 2% for its water plant, a depreciation rate of 25% for vehicles, and depreciation rates ranging from 12.5% to 33.3% for computer and software systems.

Q. Did WSCK propose any changes to its depreciation rates in its testimony?

A. No, it did not. WSCK did not provide a depreciation study in this case nor did it propose to adopt new depreciation rates. However, the Company was asked several questions regarding depreciation expense in the discovery process and appears to now be proposing revised depreciation rates. In the response to AG 2-6, the Company stated that,

> In lieu of the initially proposed composite depreciation rate of 2.0% for its water plant (see Application, Exhibit 12), WSCK is proposing to recover expenses for depreciation that is consistent with the 1979 NARUC Study as suggested by Commission Staff or depreciation rates approved by the North Carolina Utilities Commission where no depreciation rates were presented in the 1979 NARUC Study. Support for these expenses is contained in response to Item 9 of the Commission Staff's Third Information Request.

Q. Did Staff "suggest" revised depreciation rates?

A. To my knowledge, Staff has not suggested that the Company revise its depreciation rates. Staff did refer to a 1979 NARUC study in data request Staff 2-6 and asked the Company to explain its depreciation rates in light of the NARUC guidelines, but it did not recommend that the Company adopt different depreciation rates.

Q. What would be the impact on the Company's revenue requirement if it revised its depreciation rates to reflect either the rates shown in the 1979 NARUC Study or depreciation rates approved by the North Carolina Utilities Commission?

A. As shown in the response to Staff 3-9, this change would increase the Company's revenue requirement by $194,428. Thus, this change would almost double the rate increase being requested by WSCK.

Q. Would you support such an increase at this time?

A. No, I would not. If the Company wanted to change its depreciation rates, it should have conducted a depreciation study and filed that study as part of its testimony in this base rate case. Moreover, there is no evidence that depreciation rates from a NARUC study that is 35 years old are relevant today or are appropriate for WSCK. Nor should the Commission adopt new depreciation rates simply because such rates were approved by the North Carolina Utilities Commission. If any party proposes new deprecation rates, then that party should submit testimony in this case supporting those revised rates. In addition, other parties should have an opportunity to review that testimony and conduct the discovery activities necessary to properly evaluate the proposal. There is no justification at this time for increasing the Company's revenue requirement by $194,428 to reflect new depreciation rates based on the referenced discovery request propounded by Staff. Therefore, I recommend that the Commission continue to utilize the Company's current depreciation rates.

Q. Although you are not recommending any change to the Company's depreciation rates, are you recommending any adjustment to the Company's depreciation expense claim?

A. Yes, I am recommending one adjustment. Specifically, I am recommending that depreciation expense associated with Project Phoenix be excluded from the Company's revenue requirement. This is consistent with prior findings of this Commission.

Q. What is Project Phoenix?

A. As described by Mr. Baryenbruch at page 4 of his testimony, Project Phoenix involved the implementation of new financial and customer systems for the UI family of companies. Specifically, the financial system is the Oracle JD Edwards EnterpriseOne ("JDE") system and the customer system is the Oracle Utilities Customer Care and Billing System ("CC&B"). The financial system went live on December 3, 2007 and the customer system went live on June 2, 2008. The total cost of Project Phoenix was $21.12 million.

Q. What concerns has the Commission raised in the past relating to Project Phoenix?

A. In Case No. 2010-00476, the Commission excluded depreciation expenses associated with Project Phoenix "[i]n light of WSKY's failure to provide convincing evidence as to the reasonableness or need of Project Phoenix."[12] The Commission cited the concerns expressed by the AG asserting that "WSKY has failed to demonstrate the purchase and implementation

12 Order in Case No. 2010-00476, page 13.

of the Project Phoenix systems was reasonable or that the project costs were reasonable....”[13] In that case, the AG argued that WSKY failed to demonstrate that a “reasonable utility of comparable size would spend in excess of a half-million dollars on software similar to that contained in Project Phoenix.” Accordingly, the Commission excluded costs associated with Project Phoenix from the Company’s revenue requirement. The Commission made a similar finding in Case No. 2008-00563.

In its Order in the last case, the Commission also found that “[o]ur review of the record in this proceeding and in WSKY’s last rate proceeding indicates no new evidence that requires us to alter our earlier findings. In the last proceeding, we expressly noted the failure of UI to perform an analysis to show that Project Phoenix benefited WSKY’s ratepayers. ”[14]

Q. Has Mr. Baryenbruch provided sufficient documentation in this case to justify including costs associated with Project Phoenix in the utility’s rates?

A. No, he has not. Mr. Baryenbruch describes the project but provides only a vague rationale as to why the $21.12 million system was required. The Company claims that Project Phoenix was necessary to mitigate certain operational risks associated with the prior systems and/or to address fragmentation of the prior systems that made coordination difficult. However, Mr. Baryenbruch provided no cost-benefit analysis in support of the decision to implement Project Phoenix nor did he identify specific problems that WSCK experienced with the prior

13 Id., page 12.
14 Id., page 13.

system that made replacement necessary. In response to Staff 3-2, the Company stated that "Project Phoenix was cost/benefit-justified because the condition of UI's old financial and customer systems presented serious operability and reliability risks." However, no quantitative analysis was provided to support this contention.

Other than stating that he believes the cost of Project Phoenix to be justified, Mr. Baryenbruch provided no new evidence to support the Company's claim. In Staff 2-19, the Company was asked to provide a copy of the "study" referenced in Mr. Baryenbruch's testimony that purports to support the costs being claimed in this case for Project Phoenix. In response, the Company indicated that there is no "study" but rather Mr. Baryenbruch only conducted a "review." Moreover, this review was based primarily on discussions with Mr. Lubertozzi, UI's Chief Regulatory Officer and on Mr. Baryenbruch's professional experience. In fact, in response to Staff 2-20, the Company acknowledged that "Mr. Baryenbruch's review did not entail an audit or highly detailed data-gathering process."

Q. Has the Company compared Project Phoenix costs against any external benchmarks?

A. No, on page 6 of Mr. Baryenbruch's testimony, he states that "There are no external benchmarks available against which to compare these amounts." While he goes on to state that he believes that the benefits from Project Phoenix justify its cost, there is no quantitative data to support this claim. Nor is there any data regarding other options that may have been available to UI and/or WSCK when it implemented Project Phoenix. The Company has failed to demonstrate that Project Phoenix was necessary for Kentucky ratepayers or that the associated costs are reasonable.

Q. What do you recommend?

A. I recommend that the Commission continue to exclude depreciation expense associated with Project Phoenix from the Company's revenue requirement, consistent with its recent WSCK Orders. My adjustment is shown in Schedule ACC-8. This adjustment reduces WSCK's operating expenses by $76,685.

J. <u>Taxes Other Than Income</u>

Q. Are you recommending any adjustment to the Company's claim for Taxes Other Than Income Taxes?

A. Yes, I am recommending one adjustment. At Schedule ACC-9, I have made an adjustment to eliminate payroll taxes associated with my post-test year salary and wage adjustments for operational and CRS labor costs. This adjustment reduces the Company's pro forma operating expense by $1,240. My payroll tax adjustment does not include the payroll taxes associated with corporate labor costs, since I included those payroll taxes in the adjustment shown on Schedule ACC-6 (Service Company-Allocated Expenses).

K. Expense Reduction Relating to Clinton Operations

Q. Please explain the Company's pro forma adjustment relating to Clinton sewer operations.

A. WSCK provides services to the City of Clinton sewer customers pursuant to a service agreement that was provided in response to Staff 3-6. Under that agreement, WSCK bills Clinton based on its cost plus a profit of 15%. In Schedule B to the filing, WSCK shows actual test year expenses allocated to Clinton of $153,284. These expenses reflect the actual amount billed to Clinton in 2012. WSCK is proposing a test year adjustment of $32,576, resulting in a pro forma expense allocation to Clinton sewer operations of $120,708.

Q. Do you believe that this adjustment is appropriate?

A. No, I do not. There is no reason to anticipate that the costs charged to Clinton in the future will decline relative to those incurred in the test year. Operational labor is the largest component of the costs being charged to Clinton. Even though I have eliminated the Company's proposed post-test year labor adjustment, the annualized operational labor costs that I have included in my revenue requirement are still higher than those incurred in the test year. The Company is not contending that the level of services provided to Clinton in the future will be any less than the level of services provided in the test year. Therefore, there is no reason why the amount of costs charged to Clinton should decline.

I note that the Company proposed a similar adjustment in its last base rate case. In that case, WSCK proposed to reduce the expenses charged to Clinton from $137,459 to

$103,253. However, actual revenue received from Clinton has increased over each of the past three years, from $142,312 in 2010 to $149,393 in 2011, and to $153,285 in 2012. While the Commission accepted the Company's proposed adjustment to Clinton expenses in the last case, actual revenues have increased in the past three years and the company has not provided any evidence or rational for why that trend will not continue.

Q. What do you recommend?

A. I recommend that the Commission set rates that reflect the actual test year level of activity for Clinton sewer operations.

Q. How did you quantify your adjustment?

A. The Company's filing reflects actual test year costs that are equal to the actual test year revenues received from Clinton. Since WSCK includes a 15% profit in its charges to Clinton, I reduced the actual test year revenues by 15% to determine the actual costs that were incurred in the test year to provide services to Clinton. As shown in Schedule ACC-10, this results in actual test year costs of $130,291. I have adjusted the Company's revenue requirement to reflect an expense allocation of $130,291 to Clinton sewer operations. My adjustment reduces the Company's operating expenses by $9,583.

L. Income Tax Expense

Q. Please describe your adjustment to the Company's pro forma state and federal income tax claims.

A. At Schedule ACC-11, I have recalculated the Company's pro forma income tax expense at present rates, based on the accounting adjustments discussed in my testimony. My pro forma income tax expense includes state income taxes at a rate of 6% and federal income taxes at a rate of 34%. These are also the tax rates reflected in the Company's filing.

M. Interest Expense

Q. How did the Company calculate its interest expense claim?

A. WSCK calculated its pro forma interest expense by applying its weighted average cost of debt to its rate base claim. The Company's filing reflects a capital structure consisting of 52.44% debt and 47.56% equity. Its pro forma debt cost is 6.6%. Therefore, its weighted average cost of debt is 3.46% (52.44% X 6.6%). Based on pro forma rate base of $4,961,487, the Company included $171,672 of interest expense in its claim.

Q. Are you recommending any adjustment to the Company's interest expense claim?

A. Yes, I am recommending one adjustment. Since I am recommending that the costs of Project Phoenix be disallowed, as the Commission has previously ordered, it is necessary to make a corresponding adjustment to remove the interest expense associated with the financing of Project Phoenix. Therefore, at Schedule ACC-12, I have calculated the associated interest expense based on the net book value of Project Phoenix and the percent allocated to WSCK. My adjustment reduces the Company's interest expense claim by $7,621.

N. Recommended Rate Change

Q. What is the impact of the adjustments recommended in your testimony?

A. Based on the adjustments recommended in my testimony, WSCK has pro forma net income of $284,248 at present rates, as shown on Schedule ACC-1.

Q. How does the pro forma net income of $284,248 compare with the Company's required net income using the Commission's 88% operating ratio methodology?

A. As shown on Schedule ACC-13, my adjustments result in operating expenses (net of tax) of $1,563,240. Applying the 88% operating ratio, the Company should be authorized to set rates based on net income of $213,169. Therefore, the Company's current rates are more than sufficient to meet the 88% operating ratio requirement. In order to bring utility rates in line with the 88% operating ratio, a rate reduction of $116,869 would be required.

Q. What revenue multiplier did you use to determine the required rate reduction?

A. I used a revenue multiplier of 1.644227. This revenue multiplier is calculated in Schedule ACC-14. It reflects uncollectible costs of 1.81%, a regulatory assessment of .1583%, state income taxes of 6%, and federal income taxes of 34%. These are the rates reflected in the Company's filing.

Q. Does this conclude your testimony?

A. Yes, it does.