

WEST VIRGINIA-AMERICAN WATER COMPANY

CASE NO. 08-0900-W-42T

DIRECT TESTIMONY

OF

ANDREA C. CRANE

On Behalf of the  
CONSUMER ADVOCATE DIVISION  
of the  
Public Service Commission  
of West Virginia

DATED: November 6, 2008

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1 **I. STATEMENT OF QUALIFICATIONS**

2 **Q. Please state your name and business address.**

3 A. My name is Andrea C. Crane and my business address is 199 Ethan Allen Highway,  
4 Ridgefield, Connecticut 06877. (Mailing Address: PO Box 810, Georgetown, Connecticut  
5 06829)

6  
7 **Q. By whom are you employed and in what capacity?**

8 A. I am President of The Columbia Group, Inc., a financial consulting firm that specializes in  
9 utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and  
10 undertake various studies relating to utility rates and regulatory policy. I have held several  
11 positions of increasing responsibility since I joined The Columbia Group, Inc. in January  
12 1989.

13  
14 **Q. Please summarize your professional experience in the utility industry.**

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

20  
21 **Q. Have you previously testified in regulatory proceedings?**

22 A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 300

1 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii,  
2 Kansas, Kentucky, Maryland, New Jersey, New Mexico, New York, Oklahoma,  
3 Pennsylvania, Rhode Island, South Carolina, Vermont, West Virginia and the District of  
4 Columbia. These proceedings involved electric, gas, water, wastewater, telephone, solid  
5 waste, cable television, and navigation utilities. A list of dockets in which I have filed  
6 testimony is included in Appendix A.

7  
8 **Q. What is your educational background?**

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

12  
13 **II. PURPOSE OF TESTIMONY**

14 **Q. What is the purpose of your testimony?**

15 A. On May 30, 2008, West Virginia American Water Company (“WVAWC” or “Company”)  
16 filed an Application with the West Virginia Public Service Commission (“PSC” or  
17 “Commission”) seeking a rate increase of \$14.76 million, or approximately 12.4% above  
18 going-level revenue at present rates. The Company subsequently updated its revenue  
19 deficiency to \$15.88 million although I understand that it is only requesting a rate increase of  
20 \$14.76 million per its original filing. While the Company is not seeking the full increase of  
21 \$15.88 million, I have shown that claim in my schedules as the Company’s position because

1 my adjustments are based on an analysis of the Company's claimed deficiency at present  
2 rates.

3 The Columbia Group, Inc. was engaged by the Consumer Advocate Division  
4 ("CAD") of the West Virginia Public Service Commission to review the Company's  
5 Application and to provide recommendations to the PSC regarding the Company's revenue  
6 requirement claim. In addition, CAD is also sponsoring the testimony of Byron Harris on  
7 certain policy issues; of Randy Short on cost of capital issues; and of Scott J. Rubin on  
8 management fees from American Water Works Service Company ("AWWSC" or "Service  
9 Company"). In developing my overall revenue requirement recommendation, I relied upon  
10 Mr. Short's cost of capital testimony and upon Mr. Rubin's recommendations with regard to  
11 AWWSC management fees.

12  
13 **Q. What are the most significant issues in this rate proceeding?**

14 A. The most significant issues driving WVAWC's rate increase request are: 1) the Company's  
15 request to use a terminal rate base value for many of its plant accounts; 2) the inclusion in  
16 rate base of \$4 million of post-test year projects; 3) the Company's claim for a return on  
17 equity of 11.75%; 4) the Company's proposed adjustment relating to declining residential  
18 usage; 5) proposed salary and wage increases through March 31, 2010; 6) increases in  
19 employee benefit costs including pension costs; 7) increases in chemical costs; and 8)  
20 increases in uncollectible costs.

21

1 **III. SUMMARY OF CONCLUSIONS**

2 **Q. What are your conclusions concerning the Company's revenue requirement and its**  
3 **need for rate relief?**

4 **A.** Based on my analysis of the Company's filing and other documentation in this case, my  
5 conclusions are as follows:

6 1. The twelve months ending December 31, 2007, is an acceptable test year to use in  
7 this case to evaluate the reasonableness of the Company's claim.

8 2. Based on Mr. Short's testimony, WVAWC has an overall required cost of capital of  
9 7.28%, as shown on Schedule ACC-2.<sup>1</sup>

10 3. WVAWC has a going-level rate base of \$410,122,050, as shown in Schedule ACC-3.

11 5. WVAWC has going-level operating income at present rates of \$32,367,964 as shown  
12 in Schedule ACC-10.

13 6. WVAWC has a going-level revenue surplus at present rates of \$3,119,123 as shown  
14 on Schedule ACC-1. This is in contrast to WVAWC's claimed deficiency of  
15 \$15,877,765.<sup>2</sup>

16

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1 Schedules ACC-1, ACC-36, and ACC-37 are summary schedules. Schedule ACC-2 is a cost of capital schedule. Schedules ACC-3 to ACC-9 are rate base schedules. Schedules ACC-10 to ACC-35 are net operating income schedules.

2 As discussed, the Company is only seeking an increase of \$14.76 million in this case.

1 **IV. INTRODUCTION**

2 **Q. Before discussing your specific recommendations, do you have any general comments**  
3 **about the Company's filing?**

4 A. Yes, I do. It should be noted that WVAWC has requested, and received, significant rate  
5 increases over the past few years. Since 1992, the Company has received rate increases of  
6 over \$65 million, including an increase of \$14.75 million in March 2008, only eight months  
7 ago.

8 In spite of these increases, WVAWC continues to experience very high levels of non-  
9 revenue water ("NRW"), a situation that is resulting in higher operating costs. In spite of the  
10 Company's failure to adequately address this issue, WVAWC is proposing to reward  
11 shareholders by requesting a dramatically higher return on equity in this case. Moreover, the  
12 Company's claim is being made as many ratepayers are facing significant financial hardship.  
13 The PSC should be mindful of the broader picture facing ratepayers, as well as the history of  
14 the Company with regard to rate increases, as its evaluates WVAWC's claim in this case that  
15 it has a revenue deficiency of \$15.88 million.

16  
17 **Q. What were the major differences between the Company's original filing requesting a**  
18 **rate increase of \$14.76 million and its updated request for an increase of \$15.88**  
19 **million?**

20 A. The increase of \$1.12 million in the Company's claim was largely the result of increases in  
21 chemical expenses. According to the testimony of Mr. Miller, since its initial filing the  
22 Company has received bids for new contracts for its chemical purchases. As a result,

1 WVAWC increased its going-level claim for chemical costs by \$1.18 million in its revised  
 2 filing. In addition, the Company increased its overall weighted cost of capital, from 8.57% to  
 3 8.60%. This increase in the cost of capital claim increased the Company's going-level  
 4 revenue requirement by approximately \$132,000. The Company also included payroll and  
 5 related costs for an employee that had been on active duty in the Middle East but has since  
 6 returned to the Company. These increases were offset by decreases in fuel and purchased  
 7 power costs, elimination of a non-recurring AWWSC management fee expense, and a  
 8 reduction in the going-level state income tax rate from 8.75% to 8.50%.

9  
 10 **V. CAPITAL STRUCTURE AND COST OF CAPITAL**

11 **Q. What is the capital structure and cost of capital that the Company is requesting in this**  
 12 **case?**

13 **A. The Company utilized the following capital structure and cost of capital in its filing:**

	Percent	Cost	Weighted Cost
Long Term Debt	57.03%	6.52%	3.72%
Short Term Debt	1.98%	3.85%	0.08%
Preferred Stock	0.52%	8.65%	0.04%
Common Equity	40.48%	11.75%	4.76%
Total			8.60%

14  
 15  
 16 **Q. What is the cost of capital and capital structure that CAD is recommending?**

17 **A. As discussed in Mr. Short's testimony, CAD is recommending the following capital structure**  
 18 **and cost of capital:**



	Percent	Cost	Weighted Cost
Long Term Debt	54.46%	6.52%	3.55%
Short Term Debt	4.85%	3.50%	0.17%
Preferred Stock	0.52%	8.63%	0.05%
Common Equity	40.17%	8.75%	3.51%
Total			7.28%

As shown on Schedule ACC-2, I have utilized an overall cost of capital of 7.28% to develop my revenue requirement recommendation.

## **VI. RATE BASE ISSUES**

**Q. What test year did the Company utilize to develop its going-level rate base in this proceeding?**

**A.** The Company selected the test year ending December 31, 2007. In addition, the Company's going-level utility plant-in-service claim includes a post-test year adjustment of \$4 million relating to replacements of small diameter mains and services.

### **A. Utility Plant-in-Service**

**Q. How did the Company develop its going-level utility plant-in-service in this case?**

**A.** WVAWC began with its utility plant-in-service balance at December 31, 2006. It then made several going-level adjustments, to reflect test year plant additions and retirements, and determined a 13-month average utility plant-in-service balance for each account. However, as described by Company witness Jerry Ware, WVAWC is requesting that the terminal value, instead of the average test year balance, be used for certain plant accounts. WVAWC is

1            requesting the use of a terminal value “for known and measurable investments that are non-  
2            revenue producing/non expense reducing or that were incurred to extend quality service to  
3            unserved or ill-served areas.”<sup>3</sup> In addition to requesting the use of a terminal value for certain  
4            accounts, the Company is also proposing to include in rate base \$4 million of post-test year  
5            plant additions relating to replacement of small diameter mains and services. WVAWC  
6            states that these capital expenditures are necessary in order to reduce its NRW levels. The  
7            Company has proposed corresponding adjustments to reduce its going-level chemical and  
8            purchased power costs by 1.5% to reflect a reduction in NRW.

9  
10    **Q.    Are you recommending any adjustment to the Company’s going-level utility plant-in-**  
11    **service?**

12    A.    Yes, I am recommending several adjustments. Specifically, I am recommending the use of  
13    average utility plant-in-service balances for all accounts instead of the terminal values  
14    proposed by WVAWC. I am also recommending that the Commission reject the Company’s  
15    proposed \$4 million post-test year rate base addition. Finally, I have included adjustments to  
16    capitalized overhead costs allocated to WVAWC from the Service Company and I have  
17    corrected a small error in Account 391 identified by the Company in response to discovery.

18  
19    **Q.    Please discuss your first adjustment.**

20    A.    It is my understanding that Rule 42 of the Commission’s Tariff Rules requires rate base to be  
21    developed based on 13-month average balances over the test year. This rate base represents

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<sup>3</sup> Testimony of Mr. Ware, page 8.

1 the actual average investment that was used to serve customers during the test year.  
2 Moreover, it properly matches the test year investment to the revenues and expenses during  
3 the same 12-month period. In certain cases, the PSC has permitted known and measurable  
4 adjustments to the average rate base, including the use of a terminal value for certain  
5 accounts. However, the PSC has generally required that any such adjustments 1) be known  
6 and measurable, 2) be non-revenue producing, non-expense reducing, and 3) not violate the  
7 matching principle.

8 Moreover, the PSC has also required that utilities demonstrate the “need, prudence,  
9 and reasonable certainty of construction expenditures” for such adjustments in cases where it  
10 is requesting an adjustment to the average rate base.

11  
12 **Q. Has the Company justified deviating from Rule 42 in its filing in this case?**

13 A. No, it has not. The Company has not provided any testimony regarding the specific projects  
14 for which it is requesting terminal rate base value. It has not demonstrated that these projects  
15 conform to the criteria that the PSC has adopted in certain circumstances with regard to the  
16 inclusion of terminal value in rate base. The Company’s workpapers identify the plant  
17 accounts for which it is seeking the use of a terminal value in this case, but there is no  
18 detailed description of the specific projects and no explanation as to why each of these  
19 projects should be given special treatment in this case.

20 In fact, the Company’s testimony largely ignores the requirements of Rule 42 that an  
21 average rate base be employed. Based on this requirement, the PSC’s inclusion of a terminal  
22 value in certain cases represents an exception that should be properly supported by the

1 Company. No such support was provided in this case. In fact, in response to CAD 1-B-3,  
2 the Company acknowledged that the plant accounts for which it is seeking the use of a  
3 terminal value “are normal recurring construction and replacements...”. I do not believe that  
4 an exception to Rule 42 should be made for normal recurring construction and replacement  
5 projects. Rather, these projects are the core of the Company’s investment, which Rule 42  
6 states should be reflected in rate base at the 13-month average value. Accordingly, I  
7 recommend that the Company’s adjustment to reflect a terminal value for certain plant  
8 accounts be rejected. My adjustment decreases going-level utility plant-in-service by  
9 \$5,753,707 as shown in Schedule ACC-4.

10  
11 **Q. Please discuss your adjustment relating to the Company’s \$4 million post-test year**  
12 **plant addition.**

13 A. The Company is requesting a deviation from normal ratemaking treatment for \$4 million of  
14 post-test year costs intended to “address the increased investment in main and service  
15 replacement efforts recommended in the Water Loss Study.”<sup>4</sup> The Water Loss Study was  
16 conducted as a result of the Stipulation entered into in the Company’s last base rate case,  
17 Case No. 07-0998-W-42T. The Stipulation in that case required the Company to “engage an  
18 independent consultant to study and submit a written report with recommendations for a  
19 comprehensive plan to reduce unaccounted for water, and the report shall include estimates

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4 Testimony of Mr. Miller, page 49.

1 of capital expenditures necessary to achieve quantifiable improvement (“Water Study and  
2 Report”).”<sup>5</sup> The Water Loss Study was submitted to the PSC in May 2008.

3 The Water Loss Study found that NRW has shown a general increasing trend over the  
4 last 11 years.<sup>6</sup> The Water Loss Study made several recommendations. While an annual main  
5 replacement program was one of the recommendations included in the Water Loss Study, the  
6 study also contained other recommendations such as implementing a leak detection survey,  
7 monitoring existing District Metering Areas (“DMAs”), and managing pressures. CAD  
8 witness Byron Harris provides a further discussion of the Water Loss Study in his testimony.  
9

10 **Q. Is water loss management an integral component of running a regulated water utility?**

11 **A.** Yes, it is. Water loss management is an integral component of running a regulated water  
12 utility. It is incumbent upon the utility to provide regulated service in a cost effective  
13 manner. This includes managing the level of NRW. Moreover, while the management of  
14 NRW may have become even more critical for water utilities over the past few years, due to  
15 increases in chemical costs, purchased water costs, and purchased power costs, as well as the  
16 general movement toward resource conservation, regulatory commissions have historically  
17 examined NRW levels and made adjustments to a utility’s revenue requirement, as  
18 appropriate. As discussed in the Water Loss Study, WVAWC has shown an increasing  
19 trend in NRW for many years. This is not a new topic for the Company or this Commission.  
20

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5 Amended Joint Stipulation in Case No. 07-0998-W-42T, page 6.

6 Water Loss Study, Executive Summary, page 1.

1 **Q. How should costs relating to decreasing the level of NRW be treated for ratemaking**  
2 **purposes?**

3 A. Capital costs relating to managing NRW levels should be treated in the same manner as other  
4 capital costs. Therefore, I recommend that when a water utility files a base rate case, such  
5 costs should be included in rate base based on the actual 13-month average balance for those  
6 capital additions that have been completed and booked to plant-in-service. There is no  
7 rationale for permitting the Company to reflect projected or budgeted capital additions in rate  
8 base, in violation of sound ratemaking principles. Moreover, managing NRW levels is a  
9 normal, on-going and integral component of running a water utility and therefore such costs  
10 should not be given extraordinary rate base treatment.

11 Similarly, operating expenses relating to managing NRW levels should be based on  
12 actual test year costs, unless a utility provides sufficient justification for a known and  
13 measurable going-level adjustment.

14  
15 **Q. Based on your recommendation regarding the ratemaking treatment for capital costs**  
16 **relating to managing NRW, have you made an adjustment to the Company's claim?**

17 A. Yes. At Schedule ACC-5, I have made an adjustment to eliminate the Company's claim for a  
18 post-test year adjustment of \$4 million. There is no rationale for treating these costs  
19 differently from other capital improvements and therefore these costs should be given the  
20 same regulatory treatment as other routine capital expenditures.

21

1 **Q. Is CAD recommending any utility plant-in-service adjustments relating to AWWSC**  
2 **management fees?**

3 A. Yes, as described in the testimony of Mr. Rubin, CAD is recommending a rate base  
4 disallowance of \$22,943 relating to the overhead component of certain capitalized costs.  
5 Since I am recommending the use of a 13-month average for utility plant-in-service, I have  
6 made an adjustment to reduce rate base by one-half of this amount, or \$11,472, to reflect the  
7 impact of Mr. Rubin's recommendation. My adjustment assumes that the costs were  
8 capitalized consistently throughout the year and therefore I have assumed that the average  
9 test year balance amount would be equal to one-half of the total test year amount. This  
10 adjustment is shown in Schedule ACC-6.

11

12 **Q. Are you recommending any other utility plant-in-service adjustment?**

13 A. Yes, I am recommending one final adjustment. In response to CAD 3-B-13, WVAWC  
14 indicated that its initial and revised filings contained an error in the calculation of its 13-  
15 month average balance for Account 391. The effect of this error was to overstate its average  
16 balance in the amount of \$27,549. On Schedule ACC-7, I have made an adjustment to  
17 correct this error. This adjustment is consistent with my recommendation that a 13-month  
18 average utility plant-in-service balance be used for all plant accounts.

19

20 **B. Cash Working Capital**

21 **Q. What is cash working capital?**

22 A. Cash working capital is the amount of cash that is required by a utility in order to cover cash

1 outflows between the time that revenues are received from customers and the time that  
2 expenses must be paid. For example, assume that a utility bills its customers monthly and  
3 that it receives monthly revenues approximately 30 days after the midpoint of the date that  
4 service is provided. If the Company pays its employees weekly, it will have a need for cash  
5 prior to receiving the monthly revenue stream. If, on the other hand, the Company pays its  
6 interest expense quarterly, it will receive these revenues well in advance of needing the funds  
7 to pay interest expense.

8  
9 **Q. Do companies always have a positive cash working capital requirement?**

10 A. No, they do not. The actual amount and timing of cash flows dictate whether or not a utility  
11 requires a cash working capital allowance. Therefore, one should examine actual cash flows  
12 through a lead/lag study in order to accurately measure a utility's need for cash working  
13 capital.

14  
15 **Q. Did the Company provide a lead /lag study in support of its cash working capital claim?**

16 A. Yes, it did. A summary of the lead/lag study was provided in Statement B, Revised,  
17 Schedule 7. The lead/lag days used in the Company's cash working capital claim were  
18 developed in 2002. These lead/lag days have not been updated by WVAWC. In response to  
19 CAD 1-B-8, the Company indicated that it "knows of no material changes in billing or  
20 payment schedule since the 2002 lead/lag study that would require updating the study."



1 **Q. Are you recommending any adjustment to the Company's cash working capital claim?**

2 A. Yes, I am recommending several adjustments, relating to the lead/lag in the payment of  
3 AWWSC management fees, the revenue lag days used by WVAWC, and the actual level of  
4 costs included in the study.

5  
6 **Q. What revenue lag did the Company include its cash working capital claim?**

7 A. The Company's claim is based on a revenue lag of 45.23 days, as shown in the response to  
8 CAD 1-B-7, Attachment page 1. This revenue lag reflects a service median of 14.54 days, a  
9 billing lag of 1.5 days, and a payment lag of 29.19 days.

10  
11 **Q. What adjustment are you recommending to the Company's revenue lag?**

12 A. I am recommending that its revenue lag be revised to reflect a payment lag of 20 days instead  
13 of the 29.19 days used by WVAWC. This adjustment will reduce the Company's overall  
14 revenue lag to 36.04 days (14.54 day service lag + 1.5 billing lag + 20 day payment lag).

15  
16 **Q. What is the basis for your adjustment?**

17 A. In Case No. 03-0353-W-42T, the PSC approved the Company's request to implement a  
18 penalty charge of 10% of any balances that remain unpaid 20 days after a bill is mailed to the  
19 customer. This penalty charge fully compensates WVAWC for any working capital  
20 requirement associated with delayed payments. WVAWC earns its overall rate of return on  
21 its working capital requirement, but it earns considerably more than its overall cost of capital  
22 on unpaid balances. For example, the Company's claim is based on an overall rate of return

1 of 8.60%, which equates to a rate of 0.71% (8.60% / 12 months) per month. However, it is  
2 my understanding that the penalty charge is 10% per month, resulting in significantly more  
3 being earned by the Company than its overall cost of capital. Therefore, the Company is  
4 already being fully compensated for any cash working capital requirements associated with  
5 late payments. Accordingly, the PSC should reflect a payment lag of no more than 20 days in  
6 the Company's cash working capital requirement. My adjustment to use a total revenue lag  
7 of 36.04 days, including a payment lag of 20 days, is shown in Schedule ACC-8.

8  
9 **Q. How did the Company determine the lead/lag days associated with the management**  
10 **fees paid by WVAWC to the Service Company?**

11 A. The AWWSC Management Agreement provides for payment of estimated monthly charges  
12 to the Service Company on a current basis, i.e., as soon as practicable after the close of each  
13 month, the Company is billed estimated charges for the current month as well as a true-up  
14 relating to the prior month. Therefore, the Service Company charges are, on average, billed  
15 in advance of WVAWC receiving the associated services. As shown in the Company's  
16 workpapers provided in response to CAD 1-B-7, the 1.34 expense lead is the result of  
17 prepayments made each month as well as the prior month's true-up.

18  
19 **Q. Are you recommending any cash working capital adjustment associated with the**  
20 **AWWSC management fees?**

1 A. Yes, I am. I am recommending that the PSC adopt an expense lag of 12.0 days for charges  
2 from the Service Company. This is the expense lag associated with WVAWC direct labor  
3 costs.

4 The purpose of AWWSC is to centralize those services that are required by multiple  
5 corporate entities so that these entities can share costs for common support services,  
6 therefore lowering costs to all subsidiaries. The utility should not be required to pay for  
7 these services any more rapidly than it would pay for the services if they were performed  
8 internally. If these services were performed directly by WVAWC, the Company would not  
9 be in the position of pre-paying for the majority of these costs. Instead, there would be some  
10 average lag between the time that services were provided to WVAWC and the time that  
11 payment for those services was required. For example, WVAWC does not prepay its  
12 employees. Instead, employees are paid every two weeks, five days after the midpoint of the  
13 service period. This results in an expense lag of 12.0 days (14 days / 2 plus 5). While there  
14 are some costs that are incurred by WVAWC in advance of service being provided, such as  
15 insurance costs, the vast majority of costs are paid after the midpoint of the service period.  
16 The use of an expense lead of 1.34 days for AWWSC management fees suggests that  
17 payment is provided, on average, 1.34 days prior to the midpoint of the service period.

18 Ratepayers should not be burdened with higher than necessary cash working capital  
19 requirements because of the centralized Service Company structure. Therefore, I recommend  
20 that the PSC adopt an expense lag of 12.0 days for AWWSC management fee costs. I am  
21 recommending the use of a 12.0 day lag because labor costs are the largest single component  
22 of AWWSC management fees. Therefore, I believe that it is reasonable to reflect the labor

1 expense lag in calculating the cash working capital requirement generated by AWWSC  
2 management fee costs. My adjustment is shown in Schedule ACC-8.

3  
4 **Q. Are you recommending any other adjustment to the Company's cash working  
5 capital claim?**

6 A. Yes. I have updated the Company's cash working claim to reflect the impact of the other  
7 revenue, expense, and tax adjustments that I am recommending in this case. This update is  
8 also included in Schedule ACC-8. Moreover, it should be noted that the operating and  
9 maintenance costs included in the Company's cash working capital claim, shown in  
10 Statement B-Revised, Schedule 7, differ from the total operating and maintenance costs  
11 shown in Statement A-Revised, Schedule 2 of the filing. In CAD 5-B-17, I asked the  
12 Company to update its cash working capital claim to reflect the operating and maintenance  
13 costs that it is requesting in this case, or to explain the discrepancy between its cash working  
14 capital claim and its overall level of operating and maintenance costs. In response, the  
15 Company stated that its rate case costs and certain insurance costs were intentionally  
16 excluded from its calculation. In addition, the Company indicated that it discovered certain  
17 errors in its Excel formula that impacted its cash working capital claim. My cash working  
18 capital calculation is based on adjustments to the calculation relied upon by the Company to  
19 determine the going-level cash working capital requirement included in its filing. However,  
20 an additional adjustment may be required to my cash working capital recommendation if the  
21 Company's files a formal revision to its cash working capital claim. In any case, the PSC

1 should update the final cash working capital allowance to reflect the level of costs that it  
2 finds appropriate in determining the Company's revenue requirement.

3

4 **Q. What is the impact of the cash working capital adjustments that you are**  
5 **recommending?**

6 A. As shown in Schedule ACC-8, my adjustments reduce the Company's going-level cash  
7 working capital by \$3,047,580.

8

9 **C. Other Rate Base Components**

10 **Q. Are you recommending any adjustments to rate base components, other than those**  
11 **discussed above?**

12 A. Yes. As discussed above with regard to utility plant-in-service, I am recommending that the  
13 Company's rate base be based on 13-month average balances. In developing its rate base  
14 claim, the Company used terminal values for certain utility plant-in-service accounts. In  
15 addition, WVAWC used terminal values for some, but not all, of its other rate base  
16 components. Specifically, WVAWC used terminal values for material and supplies,  
17 prepayments, other deferred debits, accumulated deferred income taxes, and accumulated  
18 deferred investment tax credits ("ITC"). In addition, the Company made an adjustment to its  
19 claim for accumulated depreciation to reflect the use of terminal values for some of its plant-  
20 in-service accounts. The Company used 13-month average balances, instead of terminal  
21 values, for retirement work in progress, contributions in aid of construction, and advances for  
22 construction.

1           Since I am recommending the use of 13-month average balances, instead of terminal  
2 values, for all utility plant-in-service accounts, I have made corresponding adjustments to  
3 reflect 13-month balances for materials and supplies, prepayments, other deferred debits,  
4 accumulated deferred income taxes, accumulated deferred ITC and accumulated  
5 depreciation. These adjustments are shown in Schedule ACC-9. These adjustments will  
6 increase rate base by \$1,401,363.

7  
8           **D. Summary of Rate Base Adjustments**

9           **Q    What is the net impact of the rate base adjustments recommended by CAD?**

10          A.    My rate base adjustments will result in going-level rate base of \$410,122,050 as summarized  
11 on Schedule ACC-3. These recommendations reflect a reduction of \$11,438,944 to the  
12 Company's rate base claim of \$421,560,994.

13  
14          **VII. OPERATING INCOME ISSUES**

15          **Q.    Please describe the format that you have used for each of your revenue and expense**  
16               **adjustments.**

17          A.    My revenue and expense adjustments are attached as Schedules ACC-11 through ACC-31.  
18 For each adjustment, I have also calculated the applicable tax impact so that each Schedule  
19 portrays the impact of the adjustment on operating income. The total going-level operating  
20 income of the Company is compared, on Schedule ACC-1, to the required income, based on  
21 the going-level rate base and Mr. Short's recommended return, to determine if a rate increase  
22 or decrease is necessary.

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**A. Going-Level Residential Revenue**

**Q. Are you recommending any adjustments to the Company’s claim for going-level revenue?**

A. Yes, I am recommending an adjustment to the Company’s claim for going-level residential sales revenue.

**Q. How did the Company determine its going-level revenue claim in this case?**

A. As described in the testimony of Mr. Ware, WVAWC generally based its revenue claim on actual test year sales, adjusted to reflect the rate increase granted in March 2008. However, the Company reduced residential test year sales by 68.5 million gallons to reflect what it claims is a declining trend in residential usage. WVAWC also made going-level revenue adjustments relating to unbilled revenues, to revenue-based taxes, and to miscellaneous revenues.

**Q. Are you recommending any adjustment to the Company’s revenue claim?**

A. Yes, I am recommending that the PSC reject the Company’s proposed adjustment to reduce its going-level residential sales by 68.5 million gallons.

**Q. What is the basis for your recommendation?**

A. There are several reasons why the Company’s proposed adjustment should be rejected. Consumption from year-to-year, especially among residential customers, is impacted by

1 several factors. The most notable factor influencing annual consumption is the weather.  
2 Thus, variations in temperature and rainfall generally have a major influence on consumption  
3 from year-to-year. For that reason, many regulatory commissions average consumption over  
4 a multi-year period in order to mitigate fluctuations that occur in usage from year-to-year due  
5 to weather. In evaluating usage trends, WVAWC has ignored the impact of weather on its  
6 consumption patterns and in fact the Company stated in response to CAD 3-D-4 that it does  
7 not even retain temperature and rainfall data for its service territory.

8 Second, the Company's proposed adjustment does not constitute a known and  
9 measurable change to the test year. The Company's adjustment to reduce residential  
10 consumption by 68.5 million gallons is speculative and does not meet any known and  
11 measurable standard. While the Company argues that residential consumption has been  
12 trending downward, average annual usage per customer actually increased in the test year,  
13 according to the Company's workpapers.<sup>7</sup> Thus, the Company's proposed adjustment is  
14 speculative and is not based on actual results.

15 Third, according to the response to Staff-22, total water sales were up 4.75% during  
16 the first seven months of 2008 relative to the test year. Given the fact that actual water sales  
17 have increased, given that residential consumption per customer increased in the test year,  
18 and given that the Company's adjustment is speculative and does not meet the test for a  
19 known and measurable change, the PSC should reject the Company's proposed adjustment  
20 and instead use the actual test year sales to determine going-level consumption. My  
21 adjustment is shown in Schedule ACC-11.

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<sup>7</sup> See page 38 of the Company's Operating Revenue workpapers.



1

2 **Q. How did you quantify your adjustment?**

3 A. To quantify my adjustment, I increased going-level residential revenue to reflect an  
4 additional 68.5 million gallons of consumption, priced at the current rate of \$8.8077 per  
5 thousand gallons. This is the same rate that WVAWC used in its residential revenue  
6 adjustment. I also included the impact of increased revenue-related taxes. As shown on  
7 Schedule ACC-11, my adjustment increases going-level revenue by \$603,364.

8

9 **Q. Did you also make an adjustment to reflect increased variable costs associated with**  
10 **these increased sales?**

11 A. Yes, I did. I reflected increased chemical and purchased power costs as part of my  
12 adjustment relating to NRW, discussed in further detail below.

13

14 **B. Uncollectible Expense**

15 **Q. How did the Company determine its claim for uncollectible accounts?**

16 A. The Company's claim is based on a three-year average of charge-offs, net of recoveries,  
17 resulting in an average uncollectible rate of 1.555%. The three-year average rate of 1.555%  
18 was then applied to the Company's going-level revenue claim of \$119,265,598 to determine  
19 the going-level uncollectible expense claim of \$1,854,580.

20

21 **Q. Are you recommending any adjustment to the Company's claim?**

22 A. Yes. I am recommending two adjustments. First, since I am recommending an increase to

1 going-level residential revenue, as discussed above, it is necessary to make a corresponding  
2 adjustment to include uncollectible costs associated with this incremental residential revenue.  
3 In addition, I am recommending an adjustment to the uncollectible rate proposed used by  
4 WVAWC. Both of these adjustments are shown in Schedule ACC-12.

5  
6 **Q. What adjustment are you recommending to the uncollectible rate?**

7 A. As noted, the Company used a three-year average of charge-offs net of recoveries. An  
8 uncollectible rate based on a multi-year average is frequently used in order to mitigate  
9 fluctuations that occur from year-to-year. However, in this case, the uncollectible rate has  
10 steadily declined, from a rate of 1.847% in 2005, to 1.520% in 2006, and finally to 1.308% in  
11 2007.<sup>8</sup> Thus, uncollectible costs have exhibited a steady decline over the past three years.  
12 Charge-offs net of recoveries have declined from \$1,889,962 in 2005, to \$1,548,684 in 2006,  
13 to \$1,381,346 in the test year. Therefore, in this case, it appears that the use of a three-year  
14 average will overstate the Company's going-level uncollectible costs.

15  
16 **Q. Why do you believe that uncollectible costs are declining?**

17 A. One possible explanation for the decline is the implementation of a penalty charge, which  
18 took effect as a result of the 2003 base rate case. As noted earlier, ratepayers are now subject  
19 to a 10% penalty for amounts that are unpaid twenty days after the bills are mailed. I would

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<sup>8</sup> Note that the Company's uncollectible O&M workpaper, page C-333, indicates that the three-year average is based on the 2004-2006 period. However, the supporting detail shows that the time period used by the Company was actually 2005-2007. This was confirmed in a follow-up response, CAD 3-E-23.

1 expect this penalty to have a significant impact on the payment patterns of the Company's  
2 ratepayers.

3  
4 **Q. What uncollectible rate do you recommend be used by the PSC?**

5 A. I recommend that the PSC utilize an uncollectible rate of 1.308%, which is the actual test  
6 year rate. While the uncollectible rate may continue to decline, at this time any further  
7 decline is speculative and does not represent a known and measurable change. Therefore the  
8 actual test year rate should be used. At Schedule ACC-12, I have made an adjustment to the  
9 Company's uncollectible claim based on the test year uncollectible rate and the going-level  
10 revenues that I am recommending. My adjustments reduce the Company's going-level  
11 uncollectible expense by \$286,694.

12  
13 **C. Salaries and Wages**

14 **Q. How did the Company determine its salary and wage claim in this case?**

15 A. The Company's claim for union employees reflects projected salary and wage costs for the  
16 twelve months ending March 27, 2010, based on contractual increases through that date.<sup>9</sup>  
17 Payroll costs for non-union employees were adjusted to reflect payroll increases effective  
18 April 1, 2008, as well as a projected increase of 3% on April 1, 2009. Payroll costs for non-  
19 union employees were also annualized based on the twelve months ending March 27, 2010.

20 The Company's claim is based on a projected level of 322 employees, which

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<sup>9</sup> While Mr. Ware's testimony states that the twelve months ending March 25, 2010 was used for union payroll, the Company's workpapers show that the twelve months ending March 27, 2010 was used.

1 represents an increase of 13 employees over the number of 309 that the Company states was  
2 included in its 2007 base rate case.

3

4 **Q. Are you recommending any adjustment to the Company's salary and wage claim?**

5 A. Yes, I am recommending two adjustments. First, I am recommending that the PSC limit the  
6 post-test year increases for non-union employees to the actual 2008 increases. Second, I am  
7 recommending that the PSC include an adjustment for vacant positions. These adjustments  
8 are shown in Schedules ACC-13 and ACC-14.

9

10 **Q. What is your rationale for limiting the Company's non-union salary and wage  
11 adjustment to the 2008 increases that have already occurred?**

12 A. The Company has included non-union increases estimated to occur on April 1, 2009, fifteen  
13 months beyond the test year in this case. In addition, WVAWC has included the impact of  
14 these increases through March 27, 2010, reaching more than two full years past the end of the  
15 test year. Such increases are speculative and do not meet the known and measurable criteria  
16 for post-test year adjustments. The Company is under no contractual obligation to award  
17 these increases. Moreover, including adjustments that extend this far out past the end of the  
18 test year violates the matching principle, which requires the components of the regulatory  
19 triad to be matched at a point in time. Therefore, the 2009 increases included by the  
20 Company should be rejected by the PSC. As shown on Schedule ACC-13, this adjustment  
21 reduces the Company's going-level expenses by \$187,433.

22

1 **Q. Have you also made an adjustment to eliminate the 2009 union increases included in**  
2 **the Company's filing?**

3 A. No. I have not. I understand that similar union increases have been accepted in the past by  
4 the PSC due to the contractual nature of the union agreements. For this reason, I have not  
5 included any adjustment to the post-test year union increases reflected in the Company's  
6 filing.

7 However, while I have not included such an adjustment in this case, I do recommend  
8 that the PSC reconsider this issue. These union increases go well beyond the end of the test  
9 year. Including union increases that take place as late as September 2009, almost two years  
10 past the end of the test year in this case, violates the matching principle. Moreover, the fact  
11 that these increases are contractual does not, in my view, require them to be included in the  
12 Company's revenue requirement in this case.<sup>10</sup> By excluding the impact of such increases,  
13 the PSC would not be attempting to overturn the contractual terms of the agreement, it would  
14 merely be making a regulatory determination regarding the appropriate time period in which  
15 to reflect known and measurable changes to actual test year results. I believe that sound  
16 ratemaking principles would permit, and indeed require, the PSC to eliminate the impact of  
17 the 2009 union increases that have not yet occurred. This adjustment would further reduce  
18 my revenue requirement recommendation by approximately \$230,000.

19

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<sup>10</sup> I am not an attorney and my testimony on this issue is not intended as legal opinion but rather represents my opinion as an expert witness who has testified extensively in regulatory proceedings throughout the United States.

1 **Q. Are you recommending any adjustment relating to employee positions?**

2 A. Yes, I am. I am recommending an adjustment to reflect the fact that the Company does not  
3 have a full complement of employees at any given time.  
4

5 **Q. How many employees did the Company include in its revenue requirement claim?**

6 A. The Company's claim includes costs for 322 employees. According to Mr. Morgan, this  
7 represents an increase of 13 employees over the number included in the Company's last case.  
8 Four of these additions are employees that formerly worked for the Service Company but are  
9 being transferred to the payroll of WVAWC, since they provide services primarily to the  
10 Company. WVAWC is also seeking additional employees related to leak survey activities  
11 and other efforts to reduce its NRW. Other new positions include an administrative assistant  
12 for communications, a planning engineer, a maintenance service supervisor and a SCADA  
13 supervisor.  
14

15 **Q. Have you included these positions in your revenue requirement recommendation?**

16 A. Yes, I have included these positions in my revenue requirement recommendation. In some  
17 cases, these employees have already been hired by WVAWC. Moreover, some of these  
18 positions will enhance efforts to reduce the high levels of NRW being experienced by the  
19 Company. Therefore, I am not recommending any adjustment to these proposed positions  
20 and I have included costs for these specific positions in my revenue requirement  
21 recommendation.

1           However, I recognize that it is unlikely that WVAWC will have a full complement of  
2           322 employees at any given point in time. Therefore, I am recommending an adjustment to  
3           reflect the fact that it is normal and customary to have vacancies throughout the year.  
4           Ratepayers should not be required to fund payroll costs for unfilled positions.

5  
6           **Q.    What has been the Company's experience with regard to employee vacancies?**

7           A.    As shown in the response to CAD 3-E-27, the number of actual employees has generally  
8           been below the number authorized. For example, in 2005, WVAWC had, on average, 281  
9           employees, or 9.6% less than authorized. In 2006, WVAWC had, on average, 300  
10          employees and a 3.5% vacancy rate. In the test year, the Company had, on average, 303  
11          employees and a vacancy rate of 2.7%.

12  
13          **Q.    How should the PSC treat these vacant positions?**

14          A.    If the PSC provides funding for vacant employee positions, utility rates will be higher than  
15          necessary and the Company will be collecting costs for expenses that it will not actually  
16          incur. Therefore, in determining the Company's revenue requirement, the PSC should  
17          recognize that it is normal and customary to have a number of employee vacancies at any  
18          given point in time, due to employees leaving for other jobs, retiring, dying, etc. Thus, it is  
19          reasonable for the PSC to make an adjustment to recognize that it is normal for a certain  
20          number of employee vacancies to exist at any given time.

1 **Q. How did you quantify your adjustment?**

2 A. My adjustment is based on a vacancy rate of 2.7%, which is the actual test year rate. At  
3 Schedule ACC-14, I have made an adjustment to reduce going-level payroll by 2.7%, to  
4 eliminate costs associated with vacant positions. I have applied my 2.7% adjustment to  
5 going-level costs that already exclude the 3% non-union payroll increase for 2009 discussed  
6 above, in order to avoid double-counting the impact of my two salary and wage adjustments.  
7 As shown in Schedule ACC-14, this adjustment reduces going-level expenses by \$400,998.

8

9 **D. Incentive Compensation Costs**

10 **Q. Please describe the Company's incentive compensation program.**

11 A. The Company participates in the American Water Annual Incentive Plan ("AIP"), which  
12 provides incentive payments for all full-time management, professional, and technical  
13 employees. The plan provides for incentive payments based on three criteria: financial,  
14 operational, and individual goals.

15 While the weighting of these goals differs somewhat depending on employee  
16 position, no payment is made unless a certain level of operating income is achieved. Thus,  
17 operating income is the threshold parameter that determines whether or not any award will be  
18 made. For purposes of determining whether the threshold is reached, the operating income  
19 component includes both corporate and regional financial results. For example, in 2007, the  
20 AIP description stated that "more than 70% of the Operating Income target must be achieved



1 before any payment will be made on any component of the Plan for the entire Company  
2 (including regional financial, operational and individual components.)”<sup>11</sup>

3

4 **Q. How much is included in the Company’s going-level expense relating to incentive  
5 compensation plans?**

6 A. As stated in the Company’s response to CAD 1-E-11, the Company expensed \$250,961 of  
7 WVAWC incentive costs in 2007, as well as costs allocated from the AWWSC that are  
8 discussed in the testimony of Mr. Rubin.

9

10 **Q. Do you believe that it is appropriate to recover all of these incentive compensation  
11 costs from regulated ratepayers?**

12 A. No, I do not. I have several concerns about these types of programs, most of which are  
13 based, at least in part, on a utility’s ability to achieve certain earnings goals. Providing  
14 employees with a direct financial interest in the profitability of the Company is an objective  
15 that benefits shareholders, but it does not benefit ratepayers. Incentive compensation awards  
16 that are based on earnings criteria may violate the principle that a utility should provide safe  
17 and reliable utility service at just and reasonable rates. This is because these plans require  
18 ratepayers to pay higher compensation costs as a consequence of higher corporate earnings,  
19 generating an upward spiral that does not directly benefit ratepayers, but does directly benefit  
20 shareholders, as well as the management personnel responsible for establishing such  
21 programs -- to whom much of the incentive compensation is granted.

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<sup>11</sup> Response to CAD 1-E-12, Attachment, page 3.

1           Incentive compensation plans tied to corporate performance result in greater  
2           enrichment of company personnel as a company's earnings reach or exceed targets that are  
3           predetermined by management. It should be noted that it is the job of regulators, not the  
4           shareholders or company management, to determine what constitutes a just and reasonable  
5           rate of return award to shareholders in a regulated environment. Regulators make such a  
6           determination by establishing a reasonable rate of return award on rate base in a base rate  
7           case proceeding.

8           Allowing a utility to charge for additional return that is then distributed to employees  
9           as part of a plan devised to divide extraordinary profits violates all sense of fairness to the  
10          ratepayers of the regulated entity. It is certain to result in burdensome and unwarranted rates  
11          for its ratepayers, and also violates the principles of sound utility regulation, particularly with  
12          regard to the requirement for "just and reasonable" utility rates.

13  
14   **Q.    What would be the appropriate response by the PSC if the earnings of WVAWC were**  
15   **in excess of its authorized rate of return?**

16   **A.    If the PSC determined that these excess earnings were expected to continue, the appropriate**  
17   **response would be to initiate a rate investigation, and, if appropriate, to reduce the utility's**  
18   **rates.**

19  
20   **Q.    Are WVAWC employees being well compensated, separate and apart from these**  
21   **employee incentive plans?**

22   **A.    Yes, they are. Over the past six years, the Company's non-union employees received salary**

1 increases ranging from 3.02% to 3.80% annually. Moreover, there is no indication that  
2 WVAWC is having difficulty attracting quality non-union employees to its workforce. The  
3 Company's salary and wage levels appear reasonable, even if the incentive compensation  
4 plans are not taken into account.

5 Moreover, the incentive compensation payments are represented as "bonuses" by the  
6 Company. The description of the plan provided to employees, which was provided to the  
7 parties in response to CAD 1-E-12, refers to "your bonus plan" in several sections. The plan  
8 description discusses "target bonuses" and the "maximum bonus" that can be achieved. The  
9 plan also permits the Company to modify awards based on "uncontrollable events". As  
10 stated in the 2007 plan, such events include weather conditions, impact of the movement in  
11 foreign exchange rates, disposal and acquisition of other businesses, and other factors. It is  
12 clear from the plan description that the AIP is a bonus plan dependent upon the level of  
13 operating income, and that it does not represent the same Company obligation as other  
14 payroll commitments.

15  
16 **Q. Based on your review of the plan, are you recommending any adjustments to the**  
17 **Company's claim for its incentive compensation plan costs?**

18 A. Yes, I am recommending that the PSC deny the Company's request to recover these costs  
19 from ratepayers. The plan is a bonus plan driven by operating income benchmarks.  
20 Moreover, the prospective incentive plan payments are not known or measurable, since they  
21 are based on future levels of operating income and other variables that cannot be quantified  
22 with certainty until the end of each year. My recommendation will require the Company to

1 establish incentive compensation plans that shareholders are willing to finance. As long as  
2 ratepayers are required to pay the costs of these incentive plans, then there is no incentive for  
3 the Company to control these costs. This is especially true since the management of the  
4 Company and its stockholders are primary beneficiaries of such plans. Therefore, I  
5 recommend that the PSC reject the Company's claim to recover these incentive  
6 compensation costs from ratepayers. My adjustment, which is shown in Schedule ACC-15,  
7 reduces going-level expenses by \$250,961. An additional adjustment relating to incentive  
8 compensation plan costs at AWWSC is included in Mr. Rubin's testimony.

9  
10 **Q. Have other states rejected claims for incentive compensation costs?**

11 A. Yes. New Jersey-American Water Company ("NJAWC") has a rate case pending in New  
12 Jersey before the New Jersey Board of Public Utilities ("BPU"), which has denied recovery  
13 of incentive compensation costs in the past. In a 2000 base rate case involving Middlesex  
14 Water Company, Board Staff argued in its Initial Brief that,

15 Staff is persuaded by the arguments of the RPA that, at this time,  
16 the incentive compensation expenses should be not be recovered  
17 from ratepayers. According to the record, incentive compensation  
18 expenses have tripled since 1995. In addition, the record also  
19 indicated that the bonuses are significantly impacted by the  
20 Company achieving financial performance goals. These facts  
21 lend strength to the RPA's position that it is inappropriate for  
22 the Company to request recovery of bonuses in rates at this time.<sup>12</sup>

23  
24 While the Administrative Law Judge ("ALJ") in that case recommended that Middlesex be  
25 permitted to recover 50% of its incentive compensation costs in rates, the BPU rejected the

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12 I/M/O the Petition of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Charges, BPU Docket No. WR00060362, Staff Initial Brief, page 37.

1 ALJ's recommendation and instead ordered that 100% of these costs be disallowed.<sup>13</sup>

2 In an earlier decision, the BPU found that including employee incentives in utility  
3 rates is especially troublesome during difficult economic times, finding that,

4 We are persuaded by the arguments of Staff and Rate Counsel  
5 that, at this time, the incentive compensation or "bonus" expenses  
6 should not be recovered from ratepayers. The current economic  
7 condition has impacted ratepayers' financial situation in numerous  
8 ways, and it is evident that many ratepayers, homeowners and  
9 businesses alike, are having difficulty paying their utility bills  
10 and otherwise remaining profitable. These circumstances, as well as  
11 the fact that the bonuses are significantly impacted by the Company  
12 achieving financial performance goals, render it inappropriate for the  
13 Company to request recovery of such bonuses in rates at this time.  
14 Especially in the current economic climate, ratepayers should  
15 not be paying additional costs to reward a select group of Company  
16 employees for performing the job they were arguably hired to perform  
17 in the first place.<sup>14</sup>

18 It is indisputable that ratepayers are once again facing very difficult economic  
19 conditions. Consumers and regulators are examining management bonus plans with renewed  
20 interest. Now, more than ever, ratepayers deserve relief from costs that are designed to  
21 benefit the Company and its shareholders, but which may not provide a direct benefit to  
22 ratepayers.

23  
24 **Q. If the PSC rejects your proposal to disallow 100% of the incentive compensation costs,**  
25 **should it consider making a partial disallowance of these costs?**

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13 I/M/O the Petition of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Charges, BPU Docket No. WR00060362, Order Adopting in Part/Modifying in Part/Rejecting in Part Initial Decision at 25-26 (June 6, 2001).

14 I/M/O the Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions, BRC Docket No. ER91121820J, Final Decision and Order Accepting in Part and Modifying in Part the Initial Decision at 4 (June 15, 1993).

1 A. Yes. As stated above, the entire award is dependent upon American Water achieving a  
2 threshold level of operating income, including both corporate and regional entities.  
3 However, once that threshold is met, then the actual amount of individual incentive awards is  
4 dependent upon several factors, such as corporate financial performance, regional financial  
5 performance, operational performance, and individual performance. Various weightings are  
6 given to these criteria depending upon the level of the employee. However, in general, 30-  
7 40% of the resulting individual awards are directly tied to corporate and regional financial  
8 parameters. Thus, if the PSC rejects my recommendation to eliminate 100% of the incentive  
9 compensation costs, it should at least disallow that portion of the individual incentive awards  
10 that is directly tied to financial performance. In that case, I would recommend that the PSC  
11 disallow an average of 35% of the claimed incentive compensation costs. This would reduce  
12 going-level expenses by \$87,836 for WVAWC, in addition to a reduction in similar costs at  
13 AWWSC.

14

15 **E. Payroll Tax Expense**

16 **Q. Have you made an adjustment to the Company's payroll tax expense claim?**

17 A. Yes, I have made an adjustment to eliminate the payroll taxes associated with my  
18 recommended adjustments relating to salary and wage costs and incentive compensation  
19 costs. To quantify my payroll tax adjustment, I utilized the statutory social security and  
20 medicare tax rate of 7.65%. I then multiplied this rate by my recommended adjustments to  
21 the Company's salary and wage expense and to the incentive compensation program. My  
22 adjustment reduces going-level tax expense by \$64,214, as shown in Schedule ACC-16.

1

2 **F. Pension Costs-Defined Contribution Plan**

3 **Q. Please describe the Company's pension plans.**

4 A. WVAWC has two pension plans -- a defined benefits plan and a defined contribution plan.

5 Benefits under the defined benefits plan are frozen for most union employees hired on or

6 after January 1, 2001. Moreover, non-union employees hired on or after January 1, 2006 are

7 not eligible for benefits under the defined benefits plan. Union and non-union employees

8 who are not eligible for the defined benefits plan instead participate in a defined contribution

9 plan. Under the defined contribution plan, the Company contributes 5.25% of base pay into

10 the plan on behalf of eligible employees.

11

12 **Q. Are you recommending any adjustment relating to either of the Company's pension**  
13 **plans?**

14 A. I am not recommending any adjustment to the Company's claim for the defined benefits plan.

15 However, since I am recommending an adjustment to the Company's salary and wage claim,

16 it is necessary to make a corresponding adjustment to reduce its defined contribution plan

17 costs.<sup>15</sup>

18

---

15 It should be noted that Adjustment 21 to the Company's filing is titled "Defined Benefit Plan", as are the associated workpapers. However, this adjustment clearly relates to the defined contribution plan, not the defined benefit plan. The defined benefit plan adjustment is shown in Company Adjustment No. 18 and is titled "Employee Benefit Costs."

1 **Q. How did you quantify your adjustment?**

2 A. My salary and wage adjustment consists of two parts, a reduction to eliminate certain post-  
3 test year payroll increases and an adjustment to eliminate costs for vacant positions. In order  
4 to make the associated adjustment to the Company's defined contribution plan costs, it was  
5 necessary to examine the two components of my payroll adjustment individually, since my  
6 payroll adjustment included some employees that are not included in the defined contribution  
7 plan. Therefore, in calculating the associated adjustment to the defined contribution plan  
8 costs, I considered only that portion of my payroll adjustment relating to vacant positions.  
9 As shown on Schedule ACC-17, I have reduced the Company's defined contribution plan  
10 claim by 5.25% of my recommended payroll adjustment relating to vacancies. My  
11 adjustment reduces going-level expenses by \$21,052.

12 To be conservative, I have not made any adjustment to the defined contribution plan  
13 costs associated with my recommended adjustment to eliminate the 2009 payroll increases  
14 for non-union employees, since the majority of these employees do not participate in the  
15 defined contribution plan. To the extent that some current non-union employees are  
16 participants in the defined contribution plan, my pension adjustment is understated.  
17 However, I would not expect defined contribution plan pension costs for these employees to  
18 have a material impact on my revenue requirement recommendation.

19  
20 **G. Post-Retirement Benefits**

21 **Q. Did the Company make any changes in its post-retirement benefit coverage over the**  
22 **last several years?**



1 A. Yes, it did. As described in the response to CAD 3-E-41, employees hired after January 10,  
2 2003 are not eligible for post-retirement health care benefits. However, the Company does  
3 make an annual contribution to a defined contribution plan of \$500 per employee for those  
4 employees hired after January 10, 2003. These contributions are funded to a Voluntary  
5 Employee Beneficiary Association (“VEBA”) account.<sup>16</sup>

6 In its filing, WVAWC included costs of \$500 for each of the affected employees,  
7 including proposed future employees whose salary and wage costs are included in the  
8 Company’s claim. While the response to CAD 3-E-41 does not state that VEBA  
9 contributions are limited to union employees, the Company’s workpapers appear to limit  
10 its claim for VEBA costs to union employees.

11

12 **Q. Are you recommending any adjustment to the VEBA costs included in the filing?**

13 A. Yes, since I am recommending a salary and wage adjustment to reflect employee  
14 vacancies, it is necessary to make a corresponding adjustment to remove the VEBA  
15 contributions for these new hires. My adjustment, which is shown on Schedule ACC-18,  
16 reduces the Company’s going-level expenses by \$1,797.

17

18 **Q. How did you quantify your adjustment?**

19 A. Since VEBA contributions are based on a fixed amount per employee, it was necessary to  
20 determine the number of positions associated with my proposed vacancy adjustment. Since  
21 the Company’s workpapers only address union employees, I applied the test year 2.7%

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<sup>16</sup> These costs are identified as “VEPA” costs in the Company’s filing.

1 vacancy rate to the going-level claim for union employees. This resulted in an adjustment of  
2 5 employees. As shown on Schedule ACC-18, I reduced the Company's claim by \$2,500,  
3 reflecting the elimination of costs for 5 employees at \$500 per employee.  
4

5 **H. 401K Contribution Costs**

6 **Q. How did the Company determine its claim related to 401K contributions in this case?**

7 A. According to the Company's workpapers, the Company's employees have a 77.52%  
8 participation rate in the 401K matching plan. The Company's 401K claim was developed by  
9 applying this 77.52% participation rate to employee base wages. For participating  
10 employees, the Company provides a 50% match on 5% of base employee wages. WVAWC  
11 then applied a 71.88% expense factor to develop the going-level claim for 401K costs.  
12

13 **Q. Are you recommending any adjustment to the Company's claim?**

14 A. I am not recommending any adjustment to the participation rate or matching rate included in  
15 the Company's claim. However, since I am recommending an adjustment to the Company's  
16 payroll cost claim, it is necessary to make a corresponding adjustment to reduce the payroll  
17 base costs to which the 401K contribution rates are applied. Accordingly, at Schedule ACC-  
18 19, I have made an adjustment to reduce the Company's 401K cost claim consistent with my  
19 recommended salary and wage adjustments. My adjustment reduces the Company's going-  
20 level expenses by \$8,197.  
21

1           **I.       Group Insurance Costs**

2           **Q.     Are you recommending an adjustment to the Company's claim for group insurance**  
3           **costs?**

4           A.     The Company's claim for group insurance costs includes costs for medical insurance, dental  
5           and prescription coverage, life insurance, and disability insurance. Since I am recommending  
6           an adjustment relating to employee vacancies, it is necessary to make a corresponding  
7           adjustment to reduce the Company's group insurance cost claim.

8  
9           **Q.     How did you quantify your adjustment?**

10          A.     As shown in the Company's revised workpapers, its total expense claim for group insurance  
11          costs is \$2,878,932. This claim includes costs for 322 going-level employees. This results  
12          in a per employee cost claim of \$8,941.

13                 To quantify my adjustment, I applied the test year vacancy rate of 2.7% to the  
14          Company's claim for 322 total employees, resulting in 8.69 vacant positions. Therefore, I  
15          eliminated group insurance costs for 8 employees at the average rate of \$8,941 per employee.  
16          My adjustment, which reduces going-level expense by \$71,526, is shown in Schedule  
17          ACC-20.

18  
19           **J.       Workers Compensation Costs**

20           **Q.     How did the Company determine its workers compensation expense claim in this case?**

21           A.     According to the Company's workpapers, the Company's workers compensation claim is  
22           based on an average workers compensation rate of 3.89% of payroll. This rate was derived

1 from the two most recent workers compensation invoices from the Company's insurance  
2 carrier.

3  
4 **Q. Are you recommending any adjustment to the Company's claim?**

5 A. I am not recommending any adjustment to the workers compensation rate included in the  
6 Company's claim. However, since I am recommending an adjustment to the Company's  
7 payroll cost claim, it is necessary to make a corresponding adjustment to reduce the payroll  
8 base costs to which the workers compensation rate is applied. Accordingly, at Schedule  
9 ACC-21, I have made an adjustment to reduce the Company's workers compensation costs  
10 consistent with my recommended payroll and incentive compensation adjustments. My  
11 adjustment reduces the Company's going-level expenses by \$32,652.

12

13 **K. Employee Relocation Costs**

14 **Q. What level of employee relocation costs did the Company include in its claim?**

15 A. The Company's claim includes relocation costs of \$137,837, which are the actual relocation  
16 costs incurred during the test year. It is my understanding that these costs do not include  
17 relocation costs allocated as part of the AWWSC management fee. Those relocation costs  
18 are discussed in the testimony of Mr. Rubin.

19

20 **Q. Are you recommending any adjustment to the Company's claim?**

21 A. Yes, I am. As demonstrated in the response to CAD 3-E-35, the actual test year relocation  
22 costs were high relative to costs in prior years. Moreover, relocation costs can vary

1 significantly from year- to-year, depending upon the number of relocations that occur and the  
2 complexity of each move. Following are the relocation costs incurred by WVAWC over  
3 each of the past three years:  
4

<u>Year</u>	<u>Relocation Costs</u>
2007	\$137,837
2006	\$3,026
2005	\$7,296

5  
6 Given the variation that can occur in these costs from year-to- year, and the high level  
7 of costs included in the test year, I am recommending an adjustment to reflect a three-year  
8 average of relocation costs. This adjustment will mitigate fluctuations that occur from year-  
9 to-year and provide a more representative level of costs in rates than the actual test year  
10 relocation expenditures. My adjustment, which reduces going-level expenses by \$88,451, is  
11 shown in Schedule ACC-22.  
12

13 **L. Non-Revenue Water**

14 **Q. Has NRW been a serious and persistent problem for the Company?**

15 A. Yes, it has. WVAWC has a problem with high levels of NRW, i.e., water that is produced by  
16 the Company but which is not recorded as sold to the end users. A small portion of such  
17 water is used by the Company in its internal operations. Water that is used for fire service is

1 also generally not metered and therefore is included in NRW. A significant amount of NRW  
2 results from leaks in the distribution system.

3 The Company distinguishes between NRW, i.e., water that is not billed to customers,  
4 and unaccounted-for water. The Company considers water that is lost to known leaks within  
5 the system to be NRW but not unaccounted-for water.

6  
7 **Q. Do you agree with this distinction made by the Company between NRW and**  
8 **unaccounted-for water?**

9 A. No, I do not. Both NRW and unaccounted-for water is water that the Company produces but  
10 does not sell to customers. In my opinion, the Company is attempting to confuse the issue by  
11 distinguishing NRW from unaccounted-for water. However, to the ratepayers, there is no  
12 distinction.

13  
14 **Q. Why is NRW an important problem?**

15 A. NRW is important because the Company incurs costs to produce this water but there is no  
16 corresponding revenue stream. As a result, the rates of all customers must be raised in order  
17 to pay for the costs of producing water that never reaches end-use customers. The variable  
18 costs of producing water are primarily purchased power and chemical costs. In some water  
19 utilities, purchased water is also a significant variable cost although that is not the case in  
20 WVAWC.

21

1 **Q. Have various parties addressed the issue of NRW in the past?**

2 A. Yes, they have. I understand that in Case No. 06-0597-W-PC, a 2006 proceeding relating to  
3 the sale of stock, the Stipulation required WVAWC to file reports annually detailing how it  
4 purposed to bring the Company into compliance with the PSC's rules for unaccounted-for-  
5 water. Moreover, I further understand that the PSC has adopted a goal of 15% as an  
6 acceptable level of unaccounted-for water.<sup>17</sup> This percentage is in line with percentages used  
7 by other regulatory commissions. As a result of the Stipulation in the Company's last base  
8 rate case, Case No. 07-0998-W-42T, the Company agreed to engage a consultant to  
9 undertake a study of its NRW levels, and that study was filed with the PSC in May 2008. As  
10 noted in that study, the Company's NRW levels have increased from 25% to 34% since  
11 1997.

12  
13 **Q. What level of NRW did the Company experience in the test year?**

14 A. As shown in the response to Staff 1-13, during the test year the Company experienced NRW  
15 levels of 35.76%. Company use and identified leaks accounted for about 46% of the NRW.  
16 Company-use water represents a very small percentage of the Company's total delivery,  
17 about 2.15% in 2007 according to the response to Staff 1-14 and Staff 1-15. Thus, the vast  
18 majority of NRW is directly attributable to leaks on the Company's system or is classified  
19 simply as unaccounted-for water.

20

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<sup>17</sup> Section 5.6 of the Commission's *Rules and Regulations for the Government of Water Utilities*, 150 C.S.R. Series 7, paragraph 5.6.

1 **Q. Did the Company make any adjustment to NRW in its filing?**

2 A. Yes, as discussed on page 50 of Mr. Miller's testimony, the Company has reduced its  
3 historical test year NRW by 1.5% to reflect improvements anticipated as the result of its  
4 proposed \$4 million of post-test year capital improvements.

5  
6 **Q. What is the Company's most recent experience with regard to the NRW percentage?**

7 A. As shown in the response to CAD 3-T-1, on a 12-month rolling average, the Company's  
8 internal use was about 2.0%, while its total NRW was 34.1%. About 16.1% of total system  
9 delivery was attributed by the Company to identified leaks and the remaining 18.0% is  
10 termed unaccounted-for water by the Company.

11  
12 **Q. Are you recommending any adjustment relating to NRW?**

13 A. Yes, I am recommending that the PSC adopt an adjustment to reflect a more reasonable level  
14 of NRW. There is no reason why the PSC should treat the amount of water that the  
15 Company estimates is associated with identified leaks any differently than it treats  
16 unaccounted-for water. Both result in higher production costs due to water that never  
17 reaches the customers' meters. Therefore, I am recommending that the PSC include in rates  
18 costs that reflect a NRW level of 20%. While this percentage is somewhat higher than the  
19 15% standard established by the PSC, it reflects significant movement toward the PSC goal  
20 of 15%. Moreover, gradually moving the Company to the 15% standard will provide  
21 WVAWC with time to implement any leak detection programs in a manner that is consistent  
22 with sound ratemaking principles. Adopting a 20% NRW level in this case will represent a



1 good first step and will put the Company on notice that the PSC expects its 15% objective to  
2 be meet in a reasonable period of time. Therefore, while my recommended NRW level of  
3 20% is higher than the PSC's current goal, it is more reasonable than the adjusted test year  
4 result incorporated into the Company's going-level expense claim.

5 As shown on Schedule ACC-23, I have also made an adjustment to reduce the  
6 Company's chemical and purchased power costs to reflect my recommendation regarding  
7 NRW. To quantify my recommendation, I began with the level of sales that I am  
8 recommending in this case, which reflects an adjustment to the residential sales claimed by  
9 WVAWC. I then made an allowance for 3% company use and for 20% other NRW,  
10 including both identified leaks and unaccounted-for water. I then used the average rate per  
11 thousand gallons for chemicals and purchased power to determine the incremental costs  
12 associated with my proposed sales and NRW level. While ratepayers will still be paying to  
13 produce water that is not ultimately sold to consumers, my adjustment will eliminate a  
14 significant percentage of the production costs for water that never reaches ratepayers.

15  
16 **Q. What is the impact of your NRW recommendations?**

17 **A.** My recommendations reduce going-level expenses by \$1,389,706, as shown in Schedule  
18 ACC-23.

1           **M.     Waste Disposal Costs**

2           **Q.     Please describe the Company's adjustment with regard to waste disposal costs.**

3           A.     In its filing, the Company included a going-level adjustment (Adjustment No. 8), to increase  
4           its waste disposal costs. To the best of my knowledge, the Company did not provide any  
5           testimony on this issue, nor did the Company provide any supporting workpapers for this  
6           adjustment.

7  
8           **Q.     Did CAD request additional information on this adjustment from the Company?**

9           A.     Yes, in CAD 5-E-49, we asked the Company to provide supporting documentation for its  
10          waste disposal expenses. In response, the Company stated that this adjustment "relates to  
11          additional fees the Company will be charged in 2009 regarding the land application permits  
12          for the Company's treatment plant residuals." WVAWC did not explain how its claim was  
13          quantified or provide any supporting documentation for the Company's waste disposal  
14          expense adjustment.

15  
16          **Q.     What do you recommend?**

17          A.     Given the lack of supporting information provided to date, I am recommending that the  
18          Company's waste disposal expense adjustment be denied. If the Company subsequently  
19          provides information showing that this increase is known and measurable, then I will review  
20          any additional documentation provided by the Company and revise my adjustment, if  
21          necessary. My adjustment is shown in Schedule ACC-24. My adjustment reduces the  
22          Company's going-level expense by \$23,362.

1

2 N. Rate Case Costs

3 Q. How did the Company determine its claim for rate case costs?

4 A. WVAWC's claim is based on estimated costs for the current case of \$754,000. The  
5 Company has requested a two-year amortization of these costs, for an annual cost of  
6 \$377,000. In addition, WVAWC has included unamortized costs of \$123,680 relating to the  
7 last rate case, for a total claim for going-level regulatory commission expenses of \$500,680.

8

9 Q. Are you recommending any adjustments to the Company's claim?

10 A. Yes, I am recommending two adjustments. First, with regard to the current case, I am  
11 recommending a three-year amortization period for these costs. It is my understanding that  
12 the PSC has traditionally utilized a three-year recovery period for rate case costs.  
13 Accordingly at Schedule ACC-25, I have made an adjustment to reflect a three-year  
14 amortization period instead of the two-year period requested by WVAWC.

15 In addition, I have eliminated costs from the prior case that WVAWC is seeking to  
16 recover in this case. It is my understanding that the PSC has generally not included claims  
17 for past rate cases in current regulatory commission expense. In its Order in Case No. 06-  
18 0960-E-42T, the PSC stated that,

19 Although parties, and even the Commission, often refer to  
20 a rate case allowance as being an "amortization" of rate case  
21 expenses over some period of time, the Commission  
22 has historically allowed an increment for rate case expenses  
23 not subject to deferral or amortization. The term amortization  
24 has become a common usage for an averaging of rate case  
25 expense over some period of time.... Whether we allow an  
26 increment for rate case expenses based on an average of

1 three years, five years or any other period, we do not  
2 authorize the Companies to defer rate case expenses  
3 and amortize these expenses.<sup>18</sup>  
4

5 Thus, on Schedule ACC-25, I have also made an adjustment to eliminate the Company's  
6 claim for unamortized costs relating to its prior rate case. My adjustments reduce the  
7 Company's going-level expenses by \$249,347.  
8

9 **O. Miscellaneous Expense Adjustments**

10 **Q. Did the Company include any advertising costs in its claim?**

11 A. Yes, it did. According to the response to CAD 1-E-9, the Company incurred \$162,600 of  
12 advertising costs in the test year. WVAWC classifies the vast majority of this advertising as  
13 "informational". In fact, \$138,843 of its total advertising costs are categorized as costs for  
14 "informational" advertising.  
15

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

17 A. Yes, I am. Based upon my review of the advertisements provided in response to CAD 1-E-9,  
18 I am recommending that the PSC disallow all costs for informational, promotional, and other  
19 advertising, with the exception of costs associated with the AWW web page. The vast  
20 majority of the advertisements presented in that response relate to efforts to promote the  
21 Company's corporate image and the PSC should disallow these costs for ratemaking

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18 PSC Order in Monongahela Power Company and the Potomac Edison Company both dba Allegheny Power, Case No. 06-0960-E-42T, page 18.

1 purposes. My adjustment is shown in Schedule ACC-26 and it reduces the Company's  
2 going-level expenses by \$143,910.

3  
4 **Q. Can you provide some examples of the advertisements that you believe promote the**  
5 **Company's corporate image?**

6 A. Yes. One advertisement quotes Secretary of State Condelezza Rice, stating that "Our  
7 Greatest Achievements Are Yet to Come." The ad goes on to state that "As the oldest and  
8 largest water provider in the state...it's a legacy we can pass on for generations to come."  
9 The ad also announces that WVAWC President Deborah Herndon was the recipient of the  
10 2007 YMCA Women of Achievement Award. While this is a notable accomplishment,  
11 ratepayers should not be required to fund these types of advertisements.

12 Other advertisements discuss the amount that WVAWC has invested in the system  
13 and states that the Company "is proud to deliver clean, dependable water to people across the  
14 state at less than a penny a gallon." This ad appears to be promoting the water utility as a  
15 reasonably-priced supplier. Another ad announces that the Company maintains 3,200 miles  
16 of pipeline, or the "Distance from L.A. to Bangor, Maine."

17 These advertisements are directed toward promoting the corporate image and  
18 therefore the associated costs should be disallowed by the PSC. They are not necessary for  
19 the provision of safe and reliable water utility service and therefore these costs should not be  
20 borne by ratepayers. For the same reasons, I am recommending elimination of costs for  
21 advertising characterized as promotional. I am also recommending disallowance of costs for

1 "other" advertising on the basis that the Company has not demonstrated that these costs  
2 benefit ratepayers.

3 I am not recommending any adjustment to costs for legal/employment, educational,  
4 flushing, or safety advertising since these types of adverting programs generally do provide  
5 benefits to regulated ratepayers.

6  
7 **Q. In addition to the advertising costs discussed above, are there other costs included in**  
8 **the Company's claim that are not necessary for the provision of safe and adequate**  
9 **water utility service?**

10 A. Yes. In response to CAD 1-E-8, the Company identified net costs of \$33,955 in various  
11 penalties and fines that it incurred during the test year. WVAWC did not make any going-  
12 level adjustments relating to these fines and penalties. Thus, these actual test year charges  
13 are included in the Company's going-level expense claim in this case.

14 Fines and penalties are costs that should be borne by the Company's shareholders, not  
15 its ratepayers. Ratepayers have the right to expect that the utility will be managed in such a  
16 way as to comply with all applicable local, state, and federal requirements. Therefore, at  
17 Schedule ACC-26, I have also made an adjustment to eliminate these fines and penalties  
18 from the Company's revenue requirement claim. This adjustment reduces the Company's  
19 going-level expense by \$33,955.

20

1           **P.     Transportation Costs**

2           **Q.     How did the Company determine its claim for transportation costs?**

3           A.     According to page 15 of Mr. Ware’s testimony, the Company made a going-level adjustment  
4           to update its gasoline costs to reflect “the drastic price increase in gasoline that has recently  
5           been experienced by the Company.” The Company’s adjustment was based on the actual  
6           gallons of each grade of gasoline used the test year, repriced at more current gasoline prices.

7  
8           **Q.     Are you recommending any adjustment to the Company’s claim?**

9           A.     I am not recommending any change to the methodology used by the Company, but I have  
10          updated its adjustment to reflect more recent prices for gasoline. Since the Company’s  
11          testimony was filed, there has been a substantial drop in prices for all grades of gasoline.  
12          Therefore, it is appropriate to utilize a more recent update to determine the Company’s  
13          going-level costs.

14  
15          **Q.     How did you quantify your adjustment?**

16          A.     For most grades of gasoline, my adjustment is based on the same source as the Company’s  
17          fuel cost estimate. For each grade, I used an average price based on the prices reported on  
18          the website [www.charlestongasprices.com](http://www.charlestongasprices.com). Gasohol prices are not reported on that website.  
19          However, based on the Company’s workpapers, it appears that the gasohol prices have  
20          generally been mid-way between prices for unleaded regular and unleaded plus grades of  
21          gasoline. Therefore, I used the average of the updated rates for unleaded regular and

1           unleaded plus grades of gasoline as the going-level rate for gasohol. My adjustment, which is  
2           shown in Schedule ACC-27, reduces the Company's going-level expenses by \$236,398.

3

4           **Q.     Maintenance and Security Costs**

5           **Q.     Please explain the Company's going-level adjustment relating to maintenance and**  
6           **security costs.**

7           A.     In Adjustment No. 25, the Company included a \$250,000 adjustment for "tank site access  
8           road, maintenance and security" costs. The Company did not provide any discussion of this  
9           adjustment in its filing except to state that this adjustment "recognizes costs associated with  
10          maintaining the access roads to various tank sites, plus the security costs to protect these sites  
11          from vandalism and terrorism." The Company included the same adjustment in its filing in  
12          Case No. 07-0998-W-42T. According to WVAWC's response to CAD 1-E-6, the Company  
13          did not incur any incremental costs associated with this claim in the test year. Accordingly, it  
14          does not appear that these issues are high priority for the Company.

15

16          **Q.     Has the Company justified its proposed \$250,000 post-test year adjustment?**

17          A.     No, it has not. The Company did not provide any supporting documentation for the costs in  
18          its testimony or workpapers. In response to CAD 1-E-6, the Company identified five  
19          categories of costs included in the \$250,000 claim, including grass cutting, fence and gate  
20          maintenance, and road maintenance. However, these are routine items and the Company has  
21          not explained why they should be given any extraordinary ratemaking treatment in this case  
22          relating to these costs. Moreover, no supporting documentation was provided relating to the



1 cost estimates included in the Company's response. With regard to the last two items,  
2 hardware and software upgrades and repair, the Company again failed to provide any  
3 description of the proposed hardware and software, or to provide adequate support for its cost  
4 claim.

5  
6 **Q. What do you recommend?**

7 A. I recommend that the Company's proposed adjustment be rejected by the PSC. The PSC  
8 should not include such speculative costs in rates even if the Company characterizes them as  
9 "security costs". The Company has not demonstrated that these costs are either known or  
10 measurable at this time. Moreover, the Company has not shown that these costs should be  
11 given special ratemaking treatment. In fact, the costs outlined in the referenced data request  
12 appear to relate to normal, routine maintenance by water utilities. In addition, the Company  
13 has not demonstrated that it has actually incurred any of these incremental costs or entered  
14 into contracts for incremental services relating to the cost claim. For all these reasons, I  
15 recommend that the Company's claim be denied. My adjustment is shown in Schedule  
16 ACC- 28. My adjustment reduces going-level expense by \$250,000.

17  
18 **R. AWWSC Management Fees**

19 **Q. Is CAD recommending any adjustments to the Company's going-level claim for**  
20 **management fees from the Service Company?**

21 A. Yes. As discussed earlier in my testimony, Scott J. Rubin is providing testimony regarding  
22 CAD's recommended going-level AWWSC management fee costs. Mr. Rubin's proposed

1 expense adjustments total \$944,250, as shown on Schedule SJR-2. Accordingly, at Schedule  
2 ACC-29, I have made an adjustment to eliminate this amount from my recommended  
3 revenue requirement. The specific rationale for each adjustment is discussed in the  
4 testimony of Mr. Rubin.

5  
6 **S. Property Taxes**

7 **Q. What level of property taxes did the Company include in its claim?**

8 A. As stated in the response to CAD 3-E-46, WVAWC included its actual test year property tax  
9 expense of \$5,120,312 in its revenue requirement claim. However, in that response, the  
10 Company indicated that it has since received its 2008 property tax bill. In 2008, the  
11 Company's property taxes increased by \$271,395, to \$5,391,707. Therefore, at Schedule  
12 ACC-30, I have made an adjustment to increase WVAWC's going-level costs by \$271,395 to  
13 reflect the actual 2008 property tax expense, which constitutes a known and measurable  
14 change to the test year.

15  
16 **T. Depreciation Expense**

17 **Q. How did the Company calculate its going-level depreciation expense claim in this case?**

18 A. WVAWC applied its current depreciation rates to its proposed utility plant-in-service  
19 balances, which reflected the use of a terminal test year balance for certain accounts. In  
20 addition, the Company included depreciation expense on the \$4 million of post-test year  
21 plant additions that it is proposing to include in rate base. The Company did not include  
22 depreciation expense on contributions in aid of construction or on advances for construction

1 in its depreciation expense claim. The Company appropriately excluded depreciation  
2 expense on this plant since it was not financed by investors and therefore ratepayers should  
3 not provide a return of this investment to WVAWC through depreciation charges.  
4

5 **Q. Are you recommending any adjustment to the Company's depreciation expense claim?**

6 A. Yes. Since I am recommending the use of an average utility plant-in-service balance for all  
7 plant accounts, it is necessary to recalculate the Company's depreciation expense claim based  
8 on the utility plant-in-service balances that I have included in rate base. In addition, since I  
9 am recommending that the PSC reject the Company's \$4 million post-test year plant  
10 addition, I have also excluded this plant in determining going-level depreciation expense for  
11 WVAWC. Therefore, at Schedule ACC-31, I have determined the Company's going-level  
12 depreciation expense consistent with the utility plant-in-service balances that I have included  
13 in rate base. My adjustment reduces the Company's going-level expense by \$116,497.  
14

15 **U. Federal Income Taxes**

16 **Q. Has the PSC required utilities to include a consolidated income tax adjustment in their**  
17 **filings?**

18 A. Yes, the PSC does require utilities that participate in a consolidated federal income tax return  
19 to include a consolidated income tax adjustment in their filings. The consolidated income  
20 tax adjustment recognizes that the utility's effective federal income tax rate is reduced as a  
21 result of filing a consolidated federal income tax return.  
22

1 **Q. Did WVAWC include a consolidated income tax adjustment in its filing?**

2 A. Yes, as described in the testimony of Mr. Miller, the Company included a consolidated  
3 income tax adjustment based on a five-year average of tax losses from the parent company.  
4

5 **Q. Before discussing the specific adjustment filed by WVAWC, please provide a brief  
6 discussion of consolidated income tax adjustments.**

7 A. By filing its taxes as part of a consolidated return, WVAWC can take advantage of tax losses  
8 experienced by other member companies. The tax loss benefits generated by one group  
9 member can be shared by the other consolidated group members, resulting in a reduction in  
10 the effective federal income tax rate. These tax savings should be flowed through to the  
11 benefit of West Virginia ratepayers.  
12

13 **Q. Why should these tax benefits be flowed through to WVAWC ratepayers?**

14 A. These tax benefits should be flowed through to ratepayers because these benefits reflect the  
15 actual taxes paid. Establishing a revenue requirement based on a stand-alone federal income  
16 tax methodology would overstate the Company's expense, result in a windfall to  
17 shareholders, and result in rates that are higher than necessary.

18 The filing of a consolidated federal income tax return has benefits for companies with  
19 positive taxable income, and these benefits should be recognized in the ratemaking process.  
20 In addition, the tax losses generated by group members can only be used if there is offsetting  
21 taxable income generated by other group members. Therefore, the taxable income of

1 companies like WVAWC is what gives value to the tax losses generated by other companies  
2 in the consolidated group.

3

4 **Q. How did WVAWC calculate its consolidated federal income tax adjustment?**

5 A. The Company calculated its adjustment based on a five-year average of savings in its  
6 effective federal income tax rate. These savings were based on net losses generated by the  
7 parent company, the Service Company, and other holding companies. The tax losses of other  
8 non-regulated entities were not included by WVAWC in its adjustment.

9 In addition, in calculating the tax losses to be included in its adjustment, WVAWC  
10 excluded certain costs that it contends the Commission specifically precluded the Company  
11 from recovering in regulated rates. These costs generally relate to various acquisitions and  
12 restructurings that have occurred at the parent level.

13

14 **Q. Are you recommending any adjustments to the Company's claim?**

15 A. Yes, I am recommending several adjustments. First, I recommend that all non-regulated  
16 companies with taxable losses be included in calculating the effective federal income tax  
17 savings. There is no rationale for excluding losses from any non-regulated subsidiaries. In  
18 fact, as stated above, the non-regulated losses only have value because the non-regulated  
19 subsidiaries file a consolidated return along with companies that have positive taxable  
20 income. Within a consolidated income tax group, tax losses have no value unless some  
21 other entity in the group has taxable income that can be offset by these losses. Therefore, the  
22 impact of tax losses on the effective federal income tax of WVAWC is the same whether

1 these losses are generated by the parent company or by one of the unregulated subsidiaries.

2 As shown in Exhibit MAM-6 to Mr. Miller's testimony, the majority of non-regulated  
3 subsidiaries did incur tax losses over the past five years. It is the positive taxable income of  
4 WVAWC, and other consolidated group members, that give these tax losses their value and  
5 result in the consolidated income tax savings. The consolidated income tax adjustment does  
6 not attempt to transfer to ratepayers the tax benefit of any unregulated entity, it simply  
7 recognizes that the filing of a consolidated tax return results in a collective benefit to all  
8 members of the consolidated income tax group, and that a portion of that benefit should be  
9 allocated to WVAWC and its ratepayers.

10  
11 **Q. Is there another reason why the tax losses from all non-regulated entities should be**  
12 **included in the adjustment?**

13 A. Yes. It is my understanding of Internal Revenue Service ("IRS") regulations that once the  
14 parent company decided that a consolidated income tax return would be filed, all members of  
15 the consolidated group became individually responsible for the entire annual tax liability.  
16 Therefore, it is entirely reasonable for the PSC to recognize that the consolidated filing  
17 results in a lower effective tax rate for WVAWC, since WVAWC can be held responsible for  
18 the group's entire tax liability.

19 If, on the other hand, the parent company wanted to retain the independence of each  
20 entity for income tax purposes, it should not have elected to file a consolidated income tax  
21 return. In that case, each entity would individually retain the benefit of any tax losses.

1           Moreover, in that case, each entity would only be responsible to the IRS for the taxes  
2           resulting from its own individual financial results.

3

4   **Q.   Do other states recognize the tax losses of non-regulated subsidiaries in their**  
5   **consolidated federal income tax adjustments?**

6   A.   Yes, they do. Two of the largest American Water systems are Pennsylvania American Water  
7   Company and New Jersey American Water Company. While the regulatory commissions in  
8   Pennsylvania and New Jersey use different methods to calculate consolidated income tax  
9   savings, both states include non-regulated losses in their adjustments. In addition, I  
10   understand that the Courts have upheld consolidated income tax adjustments in both  
11   Pennsylvania and New Jersey.

12

13   **Q.   Has the PSC included losses from non-regulated subsidiaries in calculating the**  
14   **consolidated federal income tax adjustment?**

15   A.   Yes, I understand that the PSC included losses from non-regulated subsidiaries in a 2007  
16   decision in Case No. 06-0960-E-42T.

17

18   **Q.   Do you agree with the Company that the consolidated income tax adjustment should be**  
19   **reduced to exclude costs that were disallowed for ratemaking purposes, as discussed on**  
20   **pages 39-41 of Mr. Miller's testimony?**

21   A.   No, I do not. The Company's position is based on the mistaken premise that consolidated  
22   income tax adjustments are an attempt to incorporate certain non-utility financial transactions

1 into the ratemaking process. However, consolidated tax adjustments do not attempt to  
2 impute non-regulated transactions to a utility's revenue requirement. Such adjustments  
3 simply recognize the benefits accruing to each group member as a result of participating in a  
4 consolidated return. The overriding fact is that the operating losses of members of a  
5 consolidated tax group are of little value without the income generated by the positive  
6 taxable income of other group members. In the case of WVAWC, that taxable income is  
7 provided by ratepayers and West Virginia ratepayers should share in any benefits generated  
8 by a consolidated tax filing. WVAWC's parent company could have chosen to file stand-  
9 alone returns, thereby retaining any benefits associated with operating losses for the  
10 companies giving rise to those losses. It chose not to do so.

11 Including all transactions in the calculation of the consolidated income tax adjustment  
12 is not inconsistent with a ruling by regulatory agencies that restructuring and acquisition  
13 costs should not be recovered from ratepayers. In fact, all costs incurred by non-regulated  
14 entities are generally excluded from recovery in regulated rates. I am not suggesting that any  
15 non-regulated (or parent company) transaction be imputed to WVAWC. The consolidated  
16 income tax adjustment only examines the impact on WVAWC of its participation in a  
17 consolidated federal income tax return. It does not address any specific transaction by either  
18 the parent company or any non-regulated entity.

19  
20 **Q. Do you have additional procedural concerns regarding the Company's proposal to**  
21 **make adjustments to certain transactions of entities with tax losses?**

22 **A.** Yes, I do. It strikes me that it would require numerous and significant discovery requests to



1 establish what activities of the parent company, holding company, or unregulated subsidiary  
2 were somehow to be excluded from the calculation of a consolidated income tax adjustment.  
3 We do not have the ability to propound discovery on non-regulated entities and I doubt that  
4 the Company would agree to share with us all the books and records of accounts for all  
5 entities. It is simply an unworkable suggestion from a procedural perspective. It is my  
6 opinion that excluding certain operating losses from consideration in the consolidated  
7 income tax adjustment opens the door to considering numerous other complications that  
8 could be introduced into the calculation. The current system is elegant in its simplicity in that  
9 ratepayers are compensated for the tax benefits accruing to WVAWC as a result of filing a  
10 consolidated return. I see no reason to establish an exception for operating losses associated  
11 with expenses disallowed in rates because all expenses of non-regulated entities are in fact  
12 generally excluded from rates.

13  
14 **Q. Aren't there tax-sharing agreements that govern the actual amount of taxes paid by**  
15 **each subsidiary to its parent?**

16 **A.** Yes, there are. However, the existence of such agreements does not negate the validity of a  
17 consolidated income tax adjustment. The tax sharing agreements are nothing more than  
18 contractual means to have the regulated and profitable subsidiaries subsidize unregulated  
19 ventures. These tax sharing agreements transfer the excess amounts collected from  
20 ratepayers for income tax expense from the utility to the affiliate that generated the income  
21 tax loss, effectively resulting in a subsidization of the unregulated affiliate by West Virginia  
22 ratepayers. The consolidated income tax adjustment should compensate ratepayers for this

1           subsidization, by crediting ratepayers with savings resulting from a lower effective federal  
2           income tax rate.

3

4   **Q    Are consolidated income tax adjustments a violation of the normalization requirements**  
5   **of the IRS?**

6   A.   No, they are not. Prior to 1990, there was some question as to whether or not consolidated  
7   income tax adjustments violated the normalization provisions of the IRS. However, around  
8   that time, the IRS determined that such adjustments do not necessarily violate the  
9   normalization rules and several jurisdictions subsequently adopted consolidated income tax  
10   adjustments. However, it is my understanding that including losses from regulated utilities  
11   in a consolidated income tax adjustment has possible implications with regard to the  
12   normalization rules of the IRS. Accordingly, tax losses of regulated utilities are generally not  
13   included in consolidated income tax adjustments.

14

15   **Q.   How did you quantify your recommended consolidated income tax adjustment?**

16   A.   As stated, my adjustment is based on the tax losses of all group members, except for  
17   regulated utilities. In addition, for the reasons discussed, I did not reduce tax losses to  
18   eliminate expenses associated with restructuring transactions or other factors. My  
19   adjustment is based on a three-year average, instead of the five-year average proposed by the  
20   Company. Finally, my adjustment includes data for the 2007 tax year, which was provided  
21   by the Company in response to CAD 5-C-10.

22

1 Q. Why did you use a three-year average instead of the five-year average proposed by  
2 WVAWC?

3 A. I used a three-year average because I believe it is more representative of going-level  
4 operations. Following are the percentage savings in each of the past five years:  
5

<u>Year</u>	<u>Percent Savings</u>
2003	205.84%
2004	122.08%
2005	81.89%
2006	102.11%
2007	57.94%

6  
7 The five-year average was heavily influenced by 2003, when the tax losses resulted in a net  
8 tax benefit of \$49.6 million instead of a tax payment of \$46.9 million, a difference of \$96.5  
9 million or 205% of the tax liability incurred by the companies with taxable income. Given  
10 the 2003 results, the use of a five-year average would eliminate all federal income taxes for  
11 WVAWC. Therefore, I believe that a three-year average is more reasonable in this case. I  
12 also understand that a three-year average has been used in the past by the PSC.<sup>19</sup>  
13

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<sup>19</sup> The use of a five-year vs. three-year average does not have a significant impact if the Company's methodology is adopted. For example, a three-year average would have resulted in an effective rate of 25.49% instead of the 26.31% included in its filing.

1 **Q. What is the result of your adjustment?**

2 A. As shown in Schedule ACC-32A, my adjustment results in an effective federal income tax  
3 rate of 6.77%. As shown in Schedule ACC-32, I have applied this rate to the Company's  
4 claimed going-level taxable income to determine the reduction in the Company's going-level  
5 federal income tax expense. My adjustment reduces the Company's going-level federal  
6 income tax expense by \$1,944,978.

7

8 **V. Interest Synchronization and Taxes**

9 **Q. Have you adjusted the going-level interest expense for income tax purposes?**

10 A. Yes, I made this adjustment at Schedule ACC-33. My interest synchronization adjustment is  
11 consistent (synchronized) with CAD's recommended rate base, capital structure, and cost of  
12 capital recommendations. CAD is recommending a rate base that is lower than the rate base  
13 reflected in the Company's filing. Therefore, CAD's recommendation results in lower  
14 going-level interest expense for WVAWC. Since interest expense is an income tax  
15 deduction for state and federal tax purposes, CAD's recommendation will result in an  
16 increase to the Company's income tax liability. Therefore, CAD's recommendations result in  
17 an interest synchronization adjustment that reflects a higher income tax burden for the  
18 Company, and a decrease to going-level income at present rates. As shown in Schedule  
19 ACC-33, the interest synchronization adjustment increases income tax expense by \$111,851.

20

21 **Q. What income tax factor have you used to quantify your adjustments?**

22 A. As shown on Schedule ACC-34, I have used a composite income tax factor of 14.70%,

1 which includes the state income tax rate of 8.50%, and my recommended effective federal  
2 income tax rate of 6.77%.

3

4 **Q. What revenue multiplier are you recommending in this case?**

5 A As shown in Schedule ACC-35, I am recommending a revenue multiplier of 1.2425. This  
6 revenue multiplier includes the state income tax rate of 8.50%, an effective federal income  
7 tax rate of 6.77%, the uncollectible rate of 1.308% and the business and occupation tax rate  
8 of 4.4%.

9

10 **VIII. REVENUE REQUIREMENT SUMMARY**

11 **Q. What is the result of the recommendations contained in your testimony?**

12 A. My adjustments result in a base rate revenue surplus at present rates of \$3,119,123, as  
13 summarized on Schedule ACC-1. This recommendation reflects revenue requirement  
14 adjustments of (\$18,996,888) to the Company's proposed deficiency of \$15,877,765.

15

16 **Q. Have you quantified the revenue requirement impact of each of your  
17 recommendations?**

18 A. Yes, at Schedule ACC-36, I have quantified the impact on WVAWC's revenue requirement  
19 of the rate of return, rate base, revenue and expense recommendations contained in this  
20 testimony.

21

1 **Q. Have you developed a going-level income statement?**

2 A. Yes, Schedule ACC-37 contains an income statement, showing utility operating income  
3 under several scenarios, including the Company's claimed operating income at present rates,  
4 my recommended operating income at present rates, and operating income under my  
5 proposed rate decrease. My recommendations will result in an overall return on rate base of  
6 7.28% for the Company, as recommended by Mr. Short.

7

8 **Q. Does this conclude your testimony?**

9 A. Yes, it does.