

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION OF KENTUCKY

In the Matter of:

Application of Water Service Corporation)
of Kentucky for a General Adjustment)
in Existing Rates) Case No. 2013-00237

**BRIEF OF
WATER SERVICE CORPORATION OF KENTUCKY**

Water Service Corporation of Kentucky (“WSCK”) is requesting an overall increase to pro forma present rates of \$233,411 for both its Clinton and Middlesboro operations.¹ In addition, it seeks an appropriate recovery for the Fern Lake Company water rate increase for WSCK’s Middlesboro operations.

I. The Company

WSCK provides potable water service to approximately 6,507 customers² located in and near the cities of Middlesboro and Clinton, Kentucky, in Bell and Hickman counties.³ It also provides contractual services to the City of Clinton related to Clinton’s sewer treatment facilities.⁴ WSCK is a wholly owned subsidiary of Utilities, Inc. (“UI”).⁵

¹ See Post Hearing Schedules attached hereto as Exhibit 1. The only change to these schedules in comparison to the revised rebuttal schedules filed on April 4, 2014, is the adjusted rate case expenses, for which documentation was provided in response to Item 9 of the hearing data requests, filed on April 18, 2014, and other flow-through adjustments associated with the adjusted rate case expense.

² WSCK Response to Item 1 of the Attorney General’s Initial Request for Information.

³ Direct Testimony of Lowell Yap at 2:16-18.

⁴ See Wastewater Privatization Agreement Including Service Agreement, Article VII, Section 9(a), which was WSCK Exhibit 1 at the April 9, 2014, hearing.

⁵ Direct Testimony of Lowell Yap at 2:14.

UI owns approximately 70 systems that provide utility service in 15 different states.⁶ WSCK, and other UI operating subsidiaries, has a services agreement with Water Service Corporation (“WSC”), whereby WSC provides certain services to WSCK. These services include corporate management, engineering, operations, legal, and billing and customer relations.⁷ Based on this contract, all personnel providing services to WSCK are employed by WSC; UI and WSCK have no employees.

Costs incurred by WSC are charged to its operating subsidiaries, including WSCK, via two methods. First, all costs that are “incurred in connection with services rendered by the Service Company [WSC] for the Operating Companies [including WSCK] which can, without excessive effort or expense, be identified and related to services rendered to a particular Operating Company, shall be charged directly to such company. Examples of such costs to be directly allocated include salary and other expenses incurred for specific projects such as rate cases, construction projects, legal proceedings, etc.”⁸ Second, remaining costs are “prorated on the basis of the proportion of Equivalent Residential Customers (‘ERCs’) served by the Operating Company to the total number of active ERCs served by the Parent and its affiliates (including, without limitation, the Operating Company), determined as of the end of each month.”⁹ WSCK witness testimony further verifies this process.¹⁰ There were 265,278 total ERCs in the UI/WSC system as of December 31, 2012, and 7,362 of those ERCs were within the WSCK operations.¹¹ By being part of this larger community of utilities, WSCK benefits by

⁶ Direct Testimony of Lowell Yap at 3:4-5.

⁷ A copy of the agreement is Exhibit A to the Direct Testimony of Gary Shambaugh (hereinafter referred to as “Services Agreement”). See also Rebuttal Testimony of Gary Shambaugh at 7:19-22.

⁸ Services Agreement, *supra* note 7 at 3.

⁹ *Id.* at 4.

¹⁰ Video Recording Transcript of April 9, 2014, hearing (“VR”) at 12:11:30-12:12:17.

¹¹ See WSCK Supplemental Response to Item 3 of Commission Staff’s Initial Request for Information (“Allocation Calc”), which shows that WSCK was had 7,362.4 ERCs out of 265,278.49 total ERCs in the WSC system.

having access to economically reasonable industry resources through the economies of scale that a larger organization can provide.¹²

II. Procedural Posture

On September 27, 2013, WSCK filed its application for an adjustment of rates using a historical test period. In its application, WSCK proposed the new rates to become effective on October 27, 2013. By order dated October 18, 2013, the Commission suspended the operation of the proposed rates for five months, until March 26, 2014. WSCK waived its right to implement the proposed rates until the Commission had rendered a final decision in this case in a filing made on November 27, 2013. The Attorney General of Kentucky (“AG”), Hickman County Fiscal Court, and the City of Clinton (collectively, the “Intervenors”) have been permitted to intervene in this matter.

On April 9, 2014, the Commission held an evidentiary hearing in this matter in Frankfort, Kentucky, at which public comment was also received. Testifying at the hearing on behalf of WSCK were Dimitry Neyzelman,¹³ Helen Lupton, Patrick Baryenbruch, Gary Shambaugh, Bruce Haas, and Steven Lubertozzi and on behalf of the Attorney General was Andrea Crane. At the hearing, the parties agreed to submit written briefs no later than May 9, 2014. Thereafter, the case will stand submitted for a decision unless the Commission orders otherwise.

III. Analysis

WSCK proposes to use a 12-month period ending December 31, 2012, as the test period to determine the reasonableness of rates. WSCK has made adjustments for known and

¹² See Direct Testimony of Andrea Crane at 25:12-13 (admitting that “smaller independent systems may not benefit from the economies of scale available to WSCK”).

¹³ Dimitry Neyzelman adopted the pre-filed direct and rebuttal testimony of Lowell Yap. VR: 10:18:30.

measurable changes, as permitted by regulations.¹⁴ The following discussion pertains to topics addressed at the evidentiary hearing held on April 9, 2014.

A. Indirect Corporate Allocated Expenses

1. WSCK's corporate structure has mechanisms in place for appropriate review of expenses.

As discussed above, WSCK is a wholly-owned subsidiary of UI and has a services agreement with WSC, whereby WSC provides certain services to WSCK.¹⁵ WSC employs individuals to perform these services on behalf of WSCK and other operating subsidiaries.¹⁶ Costs incurred by WSC are charged to its operating subsidiaries, including WSCK, via two methods: specific services rendered to a particular subsidiary are charged directly to that subsidiary and remaining costs are charged on a prorated basis.¹⁷ For the purposes of this rate case, WSCK was assigned approximately 2.775% of the indirect corporate costs of WSC based on its proportion of ERCs.¹⁸

AG witness Andrea Crane recommends disallowance of \$146,255 of WSC allocated expenses, which are comprised of certain WSC salaries and non-labor expenses less corporate costs charged to plant and non-labor expenses for which WSCK did not seek recovery in rates.¹⁹ Crane's recommendation on this issue in this case stands in stark contrast to the recommendation that she made in the only other case that she has testified before this Commission. In Case No. 2004-00103, Crane recommended that Kentucky-American Water Company, an entity with a similar corporate structure as WSCK, prepare simple summary reports that would assist regulators in reviewing costs allocated from its service company rather than complete exclusion

¹⁴ 807 KAR 5:001, Section 16(1)(a)(1).

¹⁵ See Services Agreement, *supra* note 7; see also Rebuttal Testimony of Gary Shambaugh at 7:19-22.

¹⁶ Services Agreement, *supra* note 7, at 3 ¶ H.

¹⁷ See *supra* notes 7-10 and accompanying text.

¹⁸ See WSCK Supplemental Response to Item 3 of Commission Staff's Initial Request for Information ("Allocation Calc").

¹⁹ See Updated Schedules of Attorney General's Witness Andrea Crane, ACC-6.

of a set of expenses allocated from its service company.²⁰ Crane does not dispute costs other than certain WSC salaries and non-labor expenses that are allocated from WSC to WSCK, such as operations and customer services costs.²¹

In order to address questions raised by the Commission, Intervenors, and Commission Staff in this case and previous WSCK rate cases regarding the review of WSC allocated expenses, WSCK has gone to great lengths to explain how expenses are reviewed to ensure proper allocation to various companies within the WSC corporate structure. First and foremost, corporate management reviews potential expenses and only approves those potential expenditures that will be prudently incurred.²² Any expense over \$250 requires a purchase order, and there is an escalating scale of value for expenses that requires higher levels of managerial approval for the purchase order.²³ Potential expenses can be rejected at this early stage.²⁴ The value in this initial review process cannot be understated because it ensures that projects and planned spending is reasonable before resources of any subsidiary, including WSCK, are committed. Thereafter, as explained in data responses,

[t]here are multiple corporate levels at which expenses are reviewed to determine that all costs are reasonable and appropriate. At the corporate level, each manager reviews expenses for his or her respective department. Directors oversee the department managers' review process, and the executive team has final approval of those expenses. There is a similar process for expenses on a regional level. Area Managers and Regional Managers review and approve expenses for their respective areas. The Regional Finance Manager performs a high-level monthly review and analysis of expenses within each region compared to budget,

²⁰ See Direct Testimony of Andrea C. Crane at 80:16, Kentucky-American Water Co., Case No. 2004-00103 (filed Aug. 27, 2004)(relevant portions are attached hereto as Exhibit 2).

²¹ See, e.g., Crane Direct Testimony at 25:3-4.

²² VR: 13:49:45-13:50:00. Using an ERC allocation of 2.775%, because any corporate expense of \$250 or more requires a purchase order approval by a member of management, WSCK is not allocated any individual corporate expense greater than \$6.94 without review. See VR: 13:40:30-13:40:40 (discussing purchase orders of greater than \$250).

²³ VR: 13:37:35-13:38:03.

²⁴ Id.

obtaining explanations for variances from the operations team. The Regional Director and Regional Vice President oversee this process. The corporate executive team ultimately provides supervision over the Regional Vice President.²⁵

Not only does the actual practices of WSCK's corporate affiliates demonstrate that expenses are appropriately reviewed, the utility has appropriate mechanisms in place to ensure that WSCK (and the Commission) can review expenses. In Case No. 2008-00563, the Commission quoted with approval the following provisions from the agreement between Kentucky-American Water Company ("Kentucky-American") and its service company:²⁶

4.2 Service Company agrees to keep its books and records available at all times for inspection by representatives of Water Company or by regulatory bodies having jurisdiction over Water Company.

4.3 Service Company shall at any time, upon request of Water Company, furnish any and all information required by Water Company with respect to the services rendered by Service Company hereunder, the costs thereof, and the allocation of such costs among Water Companies.

WSCK has the same ability of oversight. One of the provisions in the agreement between

WSCK and WSC states:

The Service Company will also at any time, upon request of the Operating Company, furnish to it any and all information required by the Operating Company or by any governmental authorities having jurisdiction over the Operating Company with respect to the services rendered to the Service Company hereunder, the cost thereof, and the allocation of such cost among the Operating Companies.²⁷

In addition, WSC has further committed that the "utility's books and records will be maintained and housed in Kentucky or will otherwise be maintained in a manner to be easily accessible to

²⁵ WSCK Response to Item 13(b) of Commission Staff's Third Request for Information; see also Items 4 and 8 of Commission Staff's Third Request for Information; VR: 13:38:03-13:38:33; Lupton Direct Testimony at 4-7.

²⁶ Water Serv. Corp. of Kentucky, Case No. 2010-00476, at 16 (Ky. PSC Nov. 9. 2009).

²⁷ Services Agreement, supra note 7, at 4.

the Commission for inspection at reasonable times upon reasonable notice.”²⁸ As evidenced by the Commission’s support for American Water’s service company agreement in Case No. 2008-00563, WSCK has appropriate oversight provisions in the agreement with its service company necessary to review and question costs that are being charged by related subsidiaries.²⁹

2. The underlying components of the allocated corporate salaries from WSC are necessary and reasonable for the provision of water service to WSCK customers.

WSCK is requesting recovery of \$167,131 in rates for WSC allocated expenses related to corporate salaries. This total includes salary, payroll taxes, and employee benefits.³⁰ These salaries can be broken up into the following components:³¹

Department	Allocated Salary
Accounting	\$ 18,094
Accounts Payable	11,075
Billing	4,352
Clerical	2,602
Executive	38,180
Finance	11,913
HR, Admin & Payroll	19,150
Information Technology	12,608
Legal	10,241
Operations and Safety	2,736
Regulatory Accounting	29,914
Tax	6,266
Total	\$167,131

As explained by WSCK President Steven Lubertozi, these costs are necessary for the provision of safe and reliable utility service.³² Each of these components is necessary in order for a water utility to operate properly. AG witness Andrea Crane even acknowledged that these

²⁸ Water Serv. Corp. of Kentucky, Case No. 2012-00133, at 10 (Ky. PSC Aug. 13, 2012).

²⁹ See Case No. 2010-00476, at 15-16.

³⁰ See Updated Schedules of Attorney General’s Witness Andrea Crane, ACC-6.

³¹ Rebuttal Testimony of Steven M. Lubertozi at 3:3. The underlying costs of allocated expenses were also identified in Exhibit B to Gary Shambaugh’s Direct Testimony that was filed with the Application.

³² Id. at 3:7-8.

components are necessary for the operations of a water utility.³³ Lubertozzi elaborated that WSCK's vendors would not be paid without WSC's Accounts Payable Department, WSCK customers would not receive bills without WSC's Billing Department, and WSCK utilizes the tax professional resources of WSC in order to prepare its tax returns.³⁴

In addition to evidence being presented on the need for these services, Lubertozzi and Crane provided testimony supporting the reasonableness of the expenses. Lubertozzi also testified that WSCK would not be able to obtain the same services for such a low cost if WSCK was a stand-alone company.³⁵ Crane likewise testified that "smaller independent systems may not benefit from the economies of scale available to WSCK."³⁶

3. A comparison of other water utilities in Kentucky further demonstrates that WSCK's expenses are reasonable.

In WSCK's last rate case, WSCK presented testimony on the reasonableness of allocated expenses through a study comparing costs with electric service companies.³⁷ The AG criticized WSCK's evidence on the topic, stating that WSCK's witness

was free to make any inquiry into Water Service Corporation's allocations or WSCK, he did not look at comparably-sized utilities in Kentucky for testing the reasonableness of WSC's cost-allocations. He chose not to look for any material, relevant evidence bearing directly upon the issue based upon an allegation that (despite annual reports on file with the Kentucky Public Service Commission, rate orders of the Kentucky Public Service Commission, and information available from municipal utility providers) information is lacking.³⁸

³³ VR: 17:00:55-17:03:15.

³⁴ Rebuttal Testimony of Steven M. Lubertozzi at 3:8-4:17.

³⁵ *Id.* at 4:14-15.

³⁶ Crane Direct Testimony at 25:12-13.

³⁷ See Supplemental Testimony of Patrick L. Baryenbruch, Water Serv. Corp. of Kentucky, Case No. 2010-00476 (filed Jan. 31, 2011).

³⁸ Attorney General's Post-Hearing Brief, Case No. 2010-00476, at 5 (filed Aug. 22, 2011).

The Commission agreed with the AG’s criticism of the comparative “study as failing to involve similar type and sized utilities.”³⁹

Based on the Commission’s and the AG’s guidance,⁴⁰ WSCK retained an outside consultant to perform a comparative study analyzing similarly sized water utilities in Kentucky. Gary Shambaugh performed this study and demonstrated that the allocation of WSC corporate salaries and wages amounted to \$1.55 per ERC per month to WSCK customers.⁴¹ In comparison, Shambaugh reviewed rate cases to find comparable information on management and office staff salaries and wages for similarly sized water utilities.⁴² Shambaugh adjusted the costs for inflation and demonstrated that the monthly costs of these water utilities’ management and office staff salaries were higher than WSCK’s costs.⁴³

	<u>Monthly Cost</u>
Muhlenberg County Water District	\$3.29
Jackson County Water Association	2.87
Henry County Water District	1.92
Bullock Pen Water District	2.06
Water Service Corporation of Kentucky	1.55

This information demonstrates that WSCK’s costs for officers and directors, as compared to other water utilities are reasonable.

Shambaugh also performed a comparison of salary information that was contained in annual reports of similarly sized water utilities. This analysis revealed that WSCK’s salary costs totaled \$6.22 per ERC per month⁴⁴ as compared to an average of \$7.32 monthly cost per

³⁹ Water Serv. Corp. of Kentucky, Case No. 2010-00476, at 11-12.

⁴⁰ Rebuttal Testimony of Gary Shambaugh at 3:11-12.

⁴¹ Testimony of Gary Shambaugh at 6:12-14 and Exhibit B. If the number of customers (6,507) were used in place of ERCs (7,362), the amount would total approximately \$1.75 per month for corporate salaries. $(\$1.55 \times 7,362) / 6,507 = \1.75 .

⁴² Testimony of Gary Shambaugh at 8:14.

⁴³ Id. at 8:22-25 and Exhibit E.

⁴⁴ This total would be \$7.06 if using the total number of customers: $\$551,341 / 6,507 / 12 \text{ months} = \7.06 . This monthly total is still below the average monthly cost per customer of similarly sized water utilities.

customer for the eleven other water utilities with reported customer bases of approximately 6,000 to 8,000.⁴⁵ This evidence further supports the reasonableness of WSCK salary costs that are allocated from WSC.

Opponents may attempt to argue that page 2 of Exhibit D to Shambaugh's testimony indicates that WSCK's corporate costs are unreasonably high because it shows WSCK's monthly cost per customer for officer and director salaries to be \$0.67 and the range of eleven other similarly sized utilities to be between \$0.13 and \$0.75. There are several points that must be made to address these concerns. First and foremost, ten of the utilities that were within the range of similarly sized water utilities are water districts, which have statutorily set maximum salaries for board members.⁴⁶ The other two utilities—Rowan Water, Inc., and South Eastern Water Association—are non-profit water associations created under KRS Chapter 273. These entities' officers and directors have different responsibilities and do not share in the same day-to-day duties as WSCK's officers and directors engage. There were no private, for-profit water utilities within the "similarly sized" range used by Shambaugh; however, a comparison of the most similar private, for-profit water utility in size to in Kentucky to WSCK further demonstrates the reasonableness of WSC's officer and director salaries allocated to WSCK. South Shore Water Works Company ("South Shore") has approximately 2,259 customers.⁴⁷ In 2012, the company reported \$179,853 in salaries for officers and directors.⁴⁸ This averages \$6.63 per customer per month, which is ten times higher than the WSCK's 2011 costs of \$0.67 per ERC per month.⁴⁹

⁴⁵ Direct Testimony of Gary Shambaugh at Exhibit D.

⁴⁶ KRS 74.020 sets the maximum annual compensation for water district commissioners are \$3,600 unless they receive minimum annual water district management training, after which they can receive up to \$6,000 in annual compensation for their services.

⁴⁷ 2012 Annual Report for South Shore Water Works Company at 30.

⁴⁸ *Id.* at 31.

⁴⁹ Even if the comparison were made using only the annual salary of the President of South Shore that was approved by this Commission for ratemaking purposes (\$63,096), the average cost per customer per month of \$2.33 is still

Second, Shambaugh used the most current information that was available on the Commission's website at the time he performed his study. WSCK's annual report for the 2012 is not available on the Commission's website, and it shows that WSCK had \$46,296 in officer and directors salary costs, down from the 2011 annual reporting of \$59,748, which would be approximately \$0.52 per ERC per month.⁵⁰ This figure is more appropriate to use because it mirrors the test year used in this case.

4. The AG's witness Andrea Crane has previously recommended the inclusion of corporate salaries for another UI subsidiary.

Andrea Crane's recommended disallowance of the corporate salaries is surprising because she has previously recommended these types of expenses to be included in rates for another UI operating subsidiary in New Jersey. Crane testified before the New Jersey Board of Public Utilities in a matter involving the Montague Water and Sewer Companies. She explained that "the vast majority of payroll expenses incurred by Montague are allocations based on customer equivalent"⁵¹ and she recommended that the utility be able to recover the salaries and wages of these allocated payroll expenses plus a three percent increase.⁵² There is no distinction between allowing the "General salaries," which were UI corporate allocated salaries, in the Montague Water Company case from New Jersey and UI corporate allocated salaries in the present WSCK rate case.⁵³

significantly higher than the officer and director salaries allocated to WSCK. See South Shore Water Works Co., Case No. 2011-00039, at 4-5 (Ky. PSC Aug. 12, 2011).

⁵⁰ 2012 Annual Report for Water Service Corporation of Kentucky at 31. The total would be \$0.59 per month per customer based on 6,507 customers.

⁵¹ Testimony of Andrea Crane, Montague Water and Sewer Companies, NJ BPU Docket Nos. WR 03121034(W) and WR03121035 (S), at 25 (filed May 21, 2004) (attached to the Rebuttal Testimony of Steven Lubertozzi).

⁵² Id. at 26, Schedule ACC-9W.

⁵³ See Rebuttal Testimony of Steven Lubertozzi at 5:8-16.

5. The Commission has recently allowed another water utility to recover similar allocated costs.

The Commission recently allowed Kentucky-American Water Company to recover \$9,324,323 annually in rates for allocated costs from its service company.⁵⁴ As described by the Commission, Kentucky-American's service company provides support services, including "information technology support, accounts payable and accounts receivable, tax support and insurance, as well as corporate governance."⁵⁵ These are the same services provided by WSC through UI's corporate office.

In its rate case, Kentucky-American itemized the components of the charges from its service company, American Water Works Service Company ("AWWSC").⁵⁶ It also provided detailed explanations of the job functions of each department.⁵⁷ In comparing the functions of AWWSC's departments with the components of UI's corporate office,⁵⁸ there is significant overlap. Taking a conservative approach, the AWWSC's departments of Business Development, Finance, Human Resources, Information Technology Systems (ITS), Business Transformation, Legal, Regulated Operations, Regulatory, Shared Services Center (SSC), and presumably⁵⁹ Administration provide the same services that UI's corporate office provides WSC. Costs for these AWWSC departments total \$5,907,230.⁶⁰ Factoring in Kentucky-American's 124,344 customers, AWWSC allocates \$3.96 per Kentucky-American customer per month, as compared

⁵⁴ Kentucky-American Water Company, Case No. 2012-00520, at 38 (Ky. PSC Oct. 25, 2013).

⁵⁵ Id.

⁵⁶ KAWC Response to Item 88 of the Attorney General's First Request for Information, Case No. 2012-00520 at 2, Kentucky-American Water Company, Case No. 2012-00520 (filed Feb. 20, 2013)(attached hereto as Exhibit 3).

⁵⁷ Id. at Item 89 (attached hereto as Exhibit 4).

⁵⁸ Most of the categories listed in the table corresponding with note 31 above are self-explanatory; however, it should be noted that the Finance Department is not involved in financing, but rather, performs functions such as assisting in the preparation of budgets, monthly revenue accruals, and comparing monthly revenues and expenses to the budget. Detailed job descriptions for all WSC corporate employee positions were provided in response to Item 11 of the Commission Staff's Initial Request for Information.

⁵⁹ There is no detailed description of Administration.

⁶⁰ See Exhibit 3, supra note 56.

to \$1.75 that WSC allocates per WSCK customer per month for equivalent services.⁶¹ Even if one was to compare only AWWSC's departments of Administration, Finance, Human Resources, Legal, Regulated Operations, Regulatory, and Shared Services Center (SSC), the average would still be \$1.83 per customer per month, which is higher than the per-customer allocated costs to WSCK.

6. Non-labor allocated expenses

AG witness Andrea Crane recommended disallowance of \$21,907 in non-labor corporate allocated expenses that were incurred during the test period.⁶² Prior to filing the rate case, similar expenses were reviewed, and WSCK removed \$12,945 of expenses of which \$9,004 were already included in Crane's recommended disallowed amount.⁶³ The Company is agreeing to the removal of the remaining amount of \$12,904.⁶⁴

7. The indirect costs allocated to WSCK from WSC are reasonable, and necessary for the provision of water service to WSCK's customers.

As the discussion above indicates, WSCK has a corporate structure in place that enables it and its corporate parent to ensure that only reasonable and prudent expenses are incurred by WSCK. Corporate allocated salaries and non-labor costs are included within those reasonable and prudent expenses. The AG's own witness even admitted that WSCK's "overall level of costs may be low relative to other companies,"⁶⁵ and this is demonstrated by Shambaugh's study, which was tailored to address the exact factors articulated by both the Commission and AG in WSCK's last rate case. It is now the AG who has presented a witness who, in the AG's own words, "chose not to look for any material, relevant evidence bearing directly upon the issue . . .

⁶¹ See *supra* note 41.

⁶² Direct Testimony of Andrea Crane at Schedule ACC-4.

⁶³ See WSCK's Response to Item 3 of the Commission Staff's Initial Request for Information, w/p [r].

⁶⁴ See Exhibit 1, *supra* note 1.

⁶⁵ Direct Testimony of Andrea Crane at 25:19.

(despite annual reports on file with the Kentucky Public Service Commission, rate orders of the Kentucky Public Service Commission, and information available from municipal utility providers)”⁶⁶ Moreover, the reasonableness of the salaries is further demonstrated by reviewing the underlying components of the allocated expenses, as presented by both Shambaugh and Lubertozzi. The only testimony on point in the record is that WSCK could not obtain the underlying components as a stand-alone company for a cost less than what WSC provides those services. As such, those expenses should be recovered in rates.

B. Project Phoenix

WSCK is seeking recovery for depreciation of expenses associated with Project Phoenix, whereby UI implemented comprehensive renovation of its financial and customer information technology (“IT”) systems.⁶⁷ This project included “the installation of IT hardware and software necessary to run these systems and establish network connections to IU locations, and changes to financial and customer service processes aligned with the new systems.”⁶⁸

1. UI conducted a reasonable and thorough review process.

In 2006, UI retained an outside consultant, Deloitte Consulting LLP (“Deloitte Consulting”), to review the then-existing state of UI’s financial application and customer information systems, which is utilized by all UI subsidiaries including WSCK, and make recommendations thereon.⁶⁹ UI had its own internal team dedicated to the implementation

⁶⁶ Attorney General’s Post-Hearing Brief, Case No. 2010-00476, at 5 (filed Aug. 22, 2011).

⁶⁷ Direct Testimony of Patrick Baryenbruch at 4.

⁶⁸ Id.

⁶⁹ Id.; see also WSCK Response to Item 34 of the AG’s Initial Request for Information.

process.⁷⁰ UI received bids from various vendors and performed a detailed evaluation of each vendor and their services offered.⁷¹

2. The need for and benefit of Project Phoenix.

Deloitte Consulting documented the risks if UI were to maintain its legacy system in numerous documents.⁷² WSKC witness Patrick Baryenbruch further explained the need for Project Phoenix in his rebuttal testimony.

(1) The customer care and billing system was over 10 years old, had been developed in-house, used old “green screen” technology and was being run without vendor support. It lacked functionality needed to provide responsive customer service. The lack of vendor support means UI was unable to get help in resolving complicated technical issues that the Information Technology (“IT”) organization could not readily resolve. Consequently, in-house IT personnel had to troubleshoot issues with no assurance of a timely resolution. Unresolved issues could become critical if they held up important processing, delayed the monthly close and the preparation of financial and regulatory reports. The lack of a support arrangement also left UI dependent on a few employees with the specialized expertise to maintain the customer system. If these employees left the company it jeopardized the ability keep the customer system up and running.

(2) The financial system was also over 10 years old, used old “green screen” technology and was being run without vendor support. This system only included modules for accounts payable, cash management, capital projects and general ledger. Other accounting functions (e.g., project accounting, fleet management, procurement, asset accounting and reporting) were performed with Excel or Access. Operating the financial system without vendor support offered the same problems described above for the customer system.

⁷⁰ See, e.g., Project Phoenix Newsletter (Feb. 2007); Deloitte Consulting, “Project Phoenix Kick-Off Presentation for Field Staff” (2007). These two documents were produced by WSKC in response to Item 34 of the AG’s Initial Request for Information.

⁷¹ See, e.g., Deloitte Consulting “Utilities, Inc. Finance Operations Assessment – Business Case” (Sept. 15, 2006); Deloitte Consulting, “Financial, Customer Information System and Business Intelligence Vendor Evaluation” (Sept. 26, 2006). These two documents and other relevant documents were produced by WSKC in response to Item 34 of the AG’s Initial Request for Information.

⁷² Id.

(3) Important financial functions such as allocations and project accounting were run on Excel and Access. These functions involve some of a utility's most complex accounting and data intensive processes. It is unthinkable that a utility of UI's size (over \$680 million in plant in service at December 31, 2006) would depend on tools that run on personal computers for critical information processing and storage. Allocations and project accounting should absolutely be run on a well-controlled system where such voluminous processing can be closely managed and monitored and data backups made routinely.

(4) The entire IT infrastructure was fragmented. All UI locations were not network connected, and access to the financial and customer systems was limited. Systems were not interfaced with one another to allow data to be transferred automatically. This situation created additional work because data from one system (e.g., project accounting) had to be manually entered into another (e.g., general ledger).

(5) Financial, management and regulatory reports were prepared manually. This process involved accountants compiling data from various sources and putting the information into Excel spreadsheets. If late journal entries were made, the data compilation process had to be repeated. This situation was inefficient and susceptible to error.

In 2006, most utilities could prepare financial statements directly from their financial system where all processing was completed before reports were run.

(6) The old financial and customer systems did not include automated controls found in newer systems which embed internal controls into the applications. Newer systems provide for more effective segregation of duties and better controls over access to applications, servers and data. For example, newer financial systems do not allow the originator of a journal entry to be the same person who approves that journal entry before it is recorded. Around the time Project Phoenix was being considered, the Sarbanes-Oxley Act (SOX) had become effective and obligated UI management to be attentive to IT-related internal controls. Maintaining an up-to-date IT infrastructure is a critical factor in ensuring SOX compliance. All of this weighed in favor of the decision to replace the old financial and customer systems.

(7) The old financial and customer systems did not have up-to-date security capabilities to protect them from external threats.

Furthermore, their lack of vendor support that includes regular security updates left UI vulnerable to hackers and cybercriminals looking to exploit IT weaknesses.⁷³

Similarly, Schumaker & Company, Inc., (“Schumaker”) an independent consulting firm, performed a management audit ordered by the South Carolina Public Service Commission of the UI subsidiary operating in South Carolina. It reviewed UI’s billing and accounting systems and noted the antiquated nature of both systems.⁷⁴ The South Carolina Schumaker report recommended the development of an IT plan to cover items that were ultimately addressed in Project Phoenix.⁷⁵ In addition, there is no criticism of Project Phoenix in the South Carolina Schumaker report, which had the opportunity to do so if it had found anything wrong with how UI was handling the planned technological improvements in 2007.

Five years later, Schumaker performed an audit of another IU subsidiary in Indiana, Twin Lakes Utilities. In this 2012 report, Schumaker reiterated the IT challenges facing UI immediately prior to Project Phoenix.⁷⁶ The report then commended the technological strides of the company, stating:

Technology and systems have improved significantly since we last reviewed these activities in 2007 for the South Carolina Office of Regulatory Staff (ORS). At that time, WSC was just beginning to network computers and there were no field deployment of technology, such as Panasonic Toughbooks subsequently provided to Field Technicians for accessing CC&B functions. The mix of computer technology included both Windows and Apple technology, now WSC has standardized on Windows computers. Application systems in place were home-grown applications that

⁷³ Rebuttal Testimony of Patrick Baryenbruch at 2:22-5:8 (internal citations omitted).

⁷⁴ Final Report on the Management Review Audit of Utilities, Inc. with Specific Focus on the Five Subsidiary Water and Wastewater Companies That Operate in South Carolina, at 88 (April 2, 2007)(“In the case of both the billing system and the accounting system, the underlying technologies are so old that it is difficult to get outside support for these systems at this time.”)(attached to the Rebuttal Testimony of Patrick Baryenbruch).

⁷⁵ *Id.* at 90-91; see Rebuttal Testimony of Patrick Baryenbruch at 8:7-8.

⁷⁶ Management and Operations Audit Of Twin Lakes Utilities, Final Report, at 70 (August 2012)(attached to the Rebuttal Testimony of Patrick Baryenbruch).

had minimal capability to efficiently and effectively perform necessary tasks.⁷⁷

The commendation of technological improvements related to UI in Schumaker's Indiana report is particularly relevant based on the similarity in size of operations to WSCK: Twin Lakes Utilities operations has 6,157 ERCs as compared to WSCK's 7,362 ERCs.⁷⁸

These technological strides directly benefit the WSCK customers. The implementation of Oracle's Customer Care and Billing system has brought about reduction in time to handle customer inquiries, increased availability of information to customers and customer care staff, more payment options, including electronic billing and bill payment via the internet, online access to customer information (e.g., payment history), reduction in the number of service order errors, easier to read and interpret invoices, and more consistent billing cycles.⁷⁹ The IT system allows for the automated dispatching of Field Orders/Field Activities to Operations Staff for quicker response.⁸⁰ The field personnel now have access to customer premise and service point information as well as meters and meter readings, which enable them to offer better service in the field, and they can provide real time updates to the system when they perform services in the field.⁸¹

In addition, the JD Edwards financial software provides a benefit to the WSCK customers by strengthening business applications that are the foundation for running UI's utility business and ensuring the delivery of high quality and consistent service to WSCK customers.⁸² The

⁷⁷ Id. at 43.

⁷⁸ See WSCK Supplemental Response to Item 3 of Commission Staff's Initial Request for Information ("Allocation Calc").

⁷⁹ Direct Testimony of Patrick Baryenbruch at 6; WSCK Response to Item 20 of the Commission Staff's Second Request for Information; WSCK Response to Item 15 of the Commission Staff's Third Request for Information; see also WSCK Response to Item 22(c) of the Commission Staff's Second Request for Information; WSCK Response to Item 10 of the Attorney General's Second Request for Information; VR: 15:22:20-15:25:10.

⁸⁰ WSCK Response to Item 22(c) of the Commission Staff's Second Request for Information.

⁸¹ Id.

⁸² Direct Testimony of Patrick Baryenbruch at 6.

system has enhanced record keeping and retrieval functions, making production of financial and regulatory reports easier. In addition, reports are more detailed, which benefits customers by improving the management decision making process and allowing WSKC to more efficiently deliver reliable information to regulators. The system also reduces manual effort and reliance on spreadsheets, which again improves the reliability of reports. The Capital Projects module allows employees to view and track projects in real-time. Employees should be able to manage projects and costs in a more effective manner, which benefits WSKC and customers. The JD Edwards software allows for better accruals and a three-way match process, which is standard for accounting systems.⁸³

3. The costs of Project Phoenix are reasonable.

The total cost of Project Phoenix was \$21,122,468.⁸⁴ Using the appropriate ERC factor identified in this case,⁸⁵ WSKC would be allocated a total amount of \$586,221 for Project Phoenix pursuant to the services agreement between it and WSC. This would translate into \$79.62 per ERC⁸⁶ within the WSKC system or approximately \$90 for each of the 6,507 customers. These costs can be divided into components: \$13,995,789 for the JD Edwards financial system and \$7,126,679 for the Oracle customer care and billing system.⁸⁷ These figures calculate down to \$52.76 and \$26.86 per WSKC ERC and \$59.69 and \$30.40 per WSKC customer.⁸⁸

The costs per customer are equivalent to or less than similar systems implemented by other utilities in Kentucky. Recently, American Water Works Company sought to “replace

⁸³ WSKC Response to Item 22(c) of the Commission Staff’s Second Request for Information.

⁸⁴ Rebuttal Testimony of Patrick Baryenbruch at 13:23.

⁸⁵ See WSKC Supplemental Response to Item 3 of Commission Staff’s Initial Request for Information (“Allocation Calc”).

⁸⁶ See Direct Testimony of Patrick Baryenbruch at 8; WSKC Response to Item 11 of the Attorney General’s Second Request for Information.

⁸⁷ WSKC Response to Item 11(b) of the Attorney General’s Second Request for Information.

⁸⁸ Id. at 11(c).

legacy information technology systems, promote greater efficiency, improve customer service, and increase employee effectiveness” through its Business Transformation (“BT”) Project.⁸⁹ The BT Project is estimated to cost \$320.3 million, of which \$12,290,381 is allocated to Kentucky-American Water Company (“Kentucky-American”).⁹⁰ This would equate to approximately \$100 per Kentucky-American customer, which is \$10 more than the \$90 per WSKC customer costs of Project Phoenix. One of the components of the BT Program is the customer information system, which this Commission identified as costing approximately \$30 per customer.⁹¹ Coincidentally, that is the same approximate per-customer cost of the customer care and billing system under Project Phoenix. In addition, the BT Program’s customer information system and Project Phoenix’s customer care and billing system are significantly less costly per customer than equivalent systems implemented by Louisville Water Company, which cost \$94.49 per customer,⁹² and Louisville Gas and Electric Company (“LG&E”) and Kentucky Utilities (“KU”), which cost approximately \$92 per customer.⁹³ These comparisons further demonstrate the reasonableness of the costs of Project Phoenix.⁹⁴

There is also testimony in the record to demonstrate that it is appropriate for a smaller operating subsidiary of a larger corporation to share in the costs of such a project. WSKC

⁸⁹ Kentucky-American Water Company, Case No. 2012-00520, at 8 (Ky. PSC Oct. 25, 2013).

⁹⁰ Id.

⁹¹ Id. at 10.

⁹² Pages 6 and 16 of the 2013 Annual Report for the Louisville Water Company reveal that the entity spent \$29 million on an Oracle customer care and mobile workforce system and has 306,927, for an average of \$94.49 per customer. Relevant portions of the Louisville Water Company’s Annual Report is attached hereto as Exhibit 5.

⁹³ Testimony from LG&E and KU indicates that the companies invested approximately \$83 million on this program through October 31, 2009. See Testimony of KU Senior Vice President Chris Herman, Louisville Gas and Electric Company and Kentucky Utilities, Case Nos. 2009-00548, 2009-00549, at 16:13 (filed Jan. 29, 2010) (attached hereto as Exhibit 6). The companies’ annual reports from 2009 indicate that they have 901,747 total customers. These numbers equate a total cost of approximately \$92 per customer for their Customer Care Solution system.

⁹⁴ The Commission previously accepted the testimony of a witness for Kentucky-American who suggested the per-customer costs of Louisville Water Company’s and LG&E and KU’s customer care systems were approximately \$92 and \$68 respectively. Kentucky-American Water Company, Case No. 2012-00520 at 10-11 (Ky. PSC Oct. 25, 2013). Even if these figures are accurate, Project Phoenix’s costs of approximately \$30 per customer for the Customer Care and Billing system are far below these two examples.

witness Patrick Baryenbruch testified that American Water subsidiaries in Michigan that has 3,500 customers, Maryland that has 5,000 customers, and Hawaii that has 9,200 customers, have all participated in the BT Program and a different solution was not applied to them based on their smaller size.⁹⁵ There has been no testimony in this case to contradict the position that it is reasonable for an entity the size of WSCK to benefit from and share in the costs of a technological renovation such as Project Phoenix.

4. The Commission has allowed recovery of costs for a similar project.

The Commission recently allowed Kentucky-American to recover its allocated share of the BT Project in rates.⁹⁶ Regarding the need of the BT Program, the Commission found:

The evidence of record indicates that Kentucky-American's information infrastructure was approaching the end of its useful life and a need to replace the system existed. Most of Kentucky-American's information system had been in service since the 1990s or the early part of the last decade. These systems were not integrated and had limited functionality. They could not perform many of the customer-service technology functions that the public has come to expect. Some supporting software for these systems was no longer available.⁹⁷

The same can be said for Project Phoenix. WSCK's witness Patrick Baryenbruch testified that WSCK's information infrastructure was approaching the end of its useful life and needed to be replaced.⁹⁸ These systems were not integrated and had limited functionality.⁹⁹ Both the customer care and billing system and the financial system had been in service since the 1990s,¹⁰⁰ and they could not provide the customer service technology functions that the public has come to expect.¹⁰¹ Vendors had withdrawn support for these systems.¹⁰²

⁹⁵ 14:45:50-14:46:50

⁹⁶ Case No. 2012-00520, at 7-12.

⁹⁷ Id. at 9-10.

⁹⁸ VR: 15:34:50-15:35:16.

⁹⁹ VR: 15:35:17-15:35:23.

¹⁰⁰ Rebuttal Testimony of Patrick Baryenbruch at 2:22, 3:11.

¹⁰¹ VR: 15:35:23-15:35:30.

The Commission also determined that American Water conducted an appropriate review process that included a competitive bidding from vendors and extensive evaluation of services to be provided by the potential vendors.¹⁰³ UI conducted the same type of process. As described above, it retained Deloitte Consulting to assist it in evaluating various vendors, their competitive bids, and implementing the systems internally. A variety of individuals from various UI departments, including Customer Service, were involved in the four phases of implementation: detailed design, build and data conversion, test and train, and roll-out and support.¹⁰⁴ In addition, James Leonard, who is dedicated solely to WSCK operations, was a trainer for the Mid-Atlantic Region during implementation of Project Phoenix.¹⁰⁵ WSCK has provided evidence of the alternatives considered and reasons why those alternatives were rejected,¹⁰⁶ as did Kentucky-American.¹⁰⁷

The Commission also identified several benefits of the BT Program that will inure to Kentucky-American customers, including:

- (1) Optimizing material availability to field personnel, which will enhance the quality and timeliness of field service;
- (2) increasing efficiencies in recruiting process to minimize work gaps and ensure continuity of service for customers;
- (3) improving asset reliability and fewer unexpected outages by optimizing reliability-centered maintenance programs;
- (4) proactively communicating to customers through automated phone messages about incidents in their area;
- (5) improving employee dispatch, thereby enhancing customer solutions and response times;
- (6) greater first contact resolution as a result of automation in the bill correction process

¹⁰² Direct Testimony of Patrick Baryenbruch at 4; Rebuttal Testimony of Patrick Baryenbruch at 3:1, 3:12.

¹⁰³ Case No. 2012-00520, at 10.

¹⁰⁴ See, e.g., Deloitte Consulting, “JD Edwards and SPL Implementation Project Scoping and Planning Discussion” at 23-24 (Nov. 20, 2006); Deloitte Consulting, “Project Phoenix Kick-Off Presentation for Field Staff,” at 8 (2007).

¹⁰⁵ See Utilities, Inc., “Project Phoenix Newsletter,” at 3 (Aug. 2007).

¹⁰⁶ See, e.g., Deloitte Consulting “Utilities, Inc. Finance Operations Assessment – Business Case” (Sept. 15, 2006); Deloitte Consulting, “Financial, Customer Information System and Business Intelligence Vendor Evaluation” (Sept. 26, 2006). These two documents and other relevant documents were produced by WSCK in response to Item 34 of the AG’s Initial Request for Information. WSCK witness Patrick Baryenbruch also discusses the alternatives considered by UI at the April 9, 2014, hearing. VR: 15:05:30-15:08:20.

¹⁰⁷ Case No. 2012-00520, at 11.

and redirected resources providing the opportunity to resolve customer requests in a timely manner; (7) opportunities for enhanced bill presentment options; (8) ability to introduce tools that would assist customers in resolving debt issues and eliminate manually intensive collection processes; (9) improving scheduling between field service representatives and customers; and (10) the ability to track service orders that will allow customers to monitor the progress online.¹⁰⁸

WSCK has provided evidence of these same or similar benefits in the present rate case.¹⁰⁹ The upgrades associated with Project Phoenix have enabled call centers to automatically initiate service calls, which enable rapid service order dispatches.¹¹⁰ Field personnel can immediately upload data from completed field service tasks to a centralized integrated database for call center personnel to access in real time.¹¹¹ The system is also enabled to redirect field personnel to respond to emergency calls for service.¹¹² These benefits are all similar to the enumerated items 1, 2, 3, 5, and 9 from the BT Program list above. In addition, Project Phoenix's Oracle software ensure greater bill accuracy by automatically identifying and resolving issues before sending out billing statements, tailor bill formats according to customer preferences, provide easy-to-understand billing graphs that show how consumption varies over customer-specified time periods, and offer a variety of payment methods.¹¹³ It can also shorten call times and significantly cut down on callbacks by giving call center staff members complete and immediate

¹⁰⁸ Id.

¹⁰⁹ See, e.g., Direct Testimony of Patrick Baryenbruch at 6; WSCK Response to Items 20-22 of the Commission Staff's Second Request for Information; WSCK Response to Item 15 of the Commission Staff's Third Request for Information; WSCK Response to Item 10 of the Attorney General's Second Request for Information. VR 15:22:20-15:25:10.

¹¹⁰ Oracle, "Effectively Managing Change with Oracle Utilities Customer Care and Billing for Water Utilities," at 3 (2010). This document was filed by WSCK in response to Item 15 of the Commission Staff's Third Request for Information.

¹¹¹ Id.

¹¹² Id.

¹¹³ Id. at 4.

access to customer account histories.¹¹⁴ These benefits are all similar to the enumerated items 6, 7, and 8 in from the BT Program list above.

The Commission further founded its decision on the reasonableness of the BT Program's cost.¹¹⁵ It explained that American Water was appropriately allocating the total costs of the BT Program to its subsidiaries based on the agreement between Kentucky-American and its service company.¹¹⁶ The Commission then approved the total costs of the BT Program by comparing its component costs for the customer-service information system with those of Louisville Water Company and LG&E and KU. Once again, the same justifications apply to WSCK's allocated portions of Project Phoenix. WSCK is being allocated a portion of the Project Phoenix costs pursuant to the services agreement it has with WSC. Further, based on the allocation, the cost per WSCK customer for Project Phoenix's Customer Care and Billing system is approximately \$30, the same as Kentucky-American's customer-information system and one-third the cost of Louisville Water Company's and LG&E and KU's expenditure on their customer care systems. Accordingly, the Commission should likewise make a finding of reasonableness as to the costs of Project Phoenix allocated to WSCK.

AG witness Andrea Crane has articulated certain concerns about the evidence presented by WSCK, but the Commission's Order in the Kentucky-American case demonstrate that those concerns are meritless. First, Crane criticized WSCK witness Patrick Baryenbruch for not providing a cost-benefit analysis associated with Project Phoenix costs. Kentucky-American did not perform a cost-benefit analysis for its BT Program either,¹¹⁷ and the Commission

¹¹⁴ Id. at 2.

¹¹⁵ Case No. 2012-00520, at 8.

¹¹⁶ Id.

¹¹⁷ See id. at 9 n.35; KAWC Response to Item 69 of the Commission Staff's Second Request for Information, Kentucky-American Water Co., Case No. 2012-00520, at 1 (filed Feb. 20, 2013) ("Neither American Water nor Kentucky-American has performed any studies or analyses of the financial effects of the BT Program on Kentucky-American") (attached hereto as Exhibit 7).

nevertheless approved recovery for BT Program's costs.¹¹⁸ As explained by Baryenbruch, there are numerous benefits provided within programs like Project Phoenix that are unquantifiable and make a cost-benefit analysis impossible.¹¹⁹ Moreover, the Financial Accounting Standards Board echoes this sentiment:

One of the characteristics of an asset in FASB Concepts Statement No. 6 is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits. AcSEC recognizes that the specific future economic benefits related to the costs of computer software will sometimes be difficult to identify. However, AcSEC believes that this is also true for some other assets. For example, computer hardware or furniture used in back-office operations are indirectly related to future benefits. Likewise, corporate office facilities do not result in identifiable future benefits, but the facilities do support the operations of the company.¹²⁰

Accordingly, it is generally recognized that endeavors such as Project Phoenix are not conducive to a cost-benefit analysis, and the Commission's recent decision substantiates this point.

Second, Crane states that WSKC has "failed to demonstrate that Project Phoenix was necessary for Kentucky ratepayers," suggesting that there must be more Kentucky-specific analysis.¹²¹ WSKC disagrees with Crane's statement regarding the lack of evidence regarding the specific benefits of Project Phoenix articulated in this case related to WSKC customers. Those benefits have been discussed above and in the responses to information requests; they need not be repeated here.¹²² It is important to note, however, that the Commission approved expenses associated with American Water's BT Program in the Kentucky-American rate case even though the Commission specifically found that "the record does not indicate any Kentucky-

¹¹⁸ Order, Case No. 2012-00520, at 11-12.

¹¹⁹ Rebuttal Testimony of Patrick Baryenbruch at 13:18-17:3.

¹²⁰ FASB Accounting Standards Executive Committee's Statement of Position 98-1, Account for the Costs of Computer Software Developed or Obtained for Internal Use.

¹²¹ Direct Testimony of Andrea Crane at 35:1.

¹²² See supra notes 109-114 and accompanying text.

specific analysis of the BT Program.”¹²³ The Commission implicitly—and correctly—found that the benefits of the BT Program spanned across all of American Water’s operating subsidiaries, including Kentucky-American, and allowed recovery for that company. Similarly, the Commission should recognize the benefits of Project Phoenix to WSCK customers and allow recovery in rates for allocated expenses related thereto to WSCK.

C. Salary Increases

In its application, WSCK proposed a pro forma increase of \$58,761 from its test year ending on December 31, 2012, to salaries and wages to reflect actual annualized salaries.¹²⁴ These actual salaries were provided in response to Item 50 of the Attorney General’s Initial Request for Information. During the processing of this case, WSCK discovered that it had erroneously included \$1,133 in extra salary for one employee, and it reduced its requested recovery by that amount.¹²⁵ Most WSC employees have received salary increases effective April 1, 2014, and WSCK is not seeking recovery in rates in this case for those 2014 salary increases.

In her written testimony, AG witness Andrea Crane recommended the disallowance of a 3% post-test-year payroll increase. She apparently believed that WSCK was proposing such an increase because WSCK proposed a 3% increase in its last rate case¹²⁶ and because of an inaccurate footnote on workpaper [b] of WSCK’s filing, indicating that the identified salaries were annualized to include an estimated 3% increase.¹²⁷ This misconception could have been

¹²³ Case No. 2010-00520, at 11.

¹²⁴ See WSCK Supplemental Response to Item 3 of Commission Staff’s Initial Request for Information (“Schedule B” and wp-b).

¹²⁵ See WSCK’s Revised Rebuttal Schedules LY-R1-Rev and LY-R2 (filed Apr. 4, 2014); see also Exhibit 1, *supra* note 1.

¹²⁶ Direct Testimony of Andrea Crane at 14:2:3.

¹²⁷ See WSCK Supplemental Response to Item 3 of Commission Staff’s Initial Request for Information (wp-b).

easily reconciled by cross-referencing WSCK's responses to the Item 50 of the Attorney General's Initial Request for Information.¹²⁸

"Generally accepted rate-making principles permit matters within the test year to be both normalized and annualized."¹²⁹ It is also appropriate to make pro forma adjustments for known and measurable changes that occur outside the test year.¹³⁰ WSCK's pro forma adjustment to include actual salary increases meets the criteria of known and measurable changes that are generally accepted by this Commission.¹³¹

In addition, WSCK has submitted evidence that the salaries paid to its staff are reasonable. WSCK witness Gary Shambaugh reviewed similarly sized water utilities in Kentucky and showed that WSCK's salaries and wages totaled \$6.22 per ERC per month¹³² as compared to an average of \$7.32 monthly cost per customer for the eleven other water utilities in his study. Even using WSCK's customer count of 6,507, WSCK's salaries and wages totaled \$7.06 per customer per month, which is less than the average of the other utilities.

Comparing the total salaries of utilities is the best way to evaluate salary reasonableness because it more accurately reflects efficiencies in workforce. For example, ratepayers benefit from a utility that pays one employee \$50,000 to perform certain duties compared to another utility that has to pay two employees \$30,000 each to perform the same duties.¹³³ A comparison of those two utilities' overall salaries shows the reasonableness of the first utility's operations.

¹²⁸ Crane also made corresponding adjustments to Operating Expenses Charged to Plant, Pension, and Taxes other than Income that were inappropriately tied to the non-existent 3% increase for all WSC employees. Direct Testimony of Andrea Crane at 17:8-18:13, 20:16-21:7, 35:11-18.

¹²⁹ Pub. Serv. Comm'n of Ky. v. Cont'l Tel. Co. of Ky., 692 S.W.2d 794, 799 (Ky. 1985).

¹³⁰ Id.

¹³¹ See, e.g. Reidland Water and Sewer District, Case No. 96-314, at 11 (Ky. PSC May 22, 1997)(adopting the recommendations findings of the Commission Staff report, which states, "An adjustment based on documented increased cost or usage would constitute a known and measurable adjustment. . . . Also, in 1996 Reidland Sewer granted pay increases to all of its employees [outside the 1995 test year]. . . . [T]he 1996 wage increases would meet the rate-making criteria of known and measurable.")

¹³² See supra note 44 and accompanying text.

¹³³ See WSCK Response to Item 11(b) of the Commission Staff's Third Request for Information.

Any suggestion that WSCK should have provided documentation supporting the specific salary levels for employees is improper because such a study could improperly skew results. As the example above demonstrates, the first utility's salary for its employee may appear high based on an individualized comparison to the salaries of employees at other companies, but that utility's ratepayers would be benefiting from paying \$10,000 less in overall salary expenses for the same job performance.

Moreover, no party has offered any evidence to challenge Shambaugh's findings that WSCK's overall salaries and wages are lower on a per customer basis than other similarly sized water utilities in Kentucky. Where the testimony of utility's witness stands uncontradicted, the Commission is compelled to make a finding consistent with the testimony.¹³⁴

D. Rate Case Expense

WSCK proposes a (\$13,198)¹³⁵ pro forma adjustment to test-year rate case amortization to reflect the amortization over three years of the actual cost of this current case of \$231,591¹³⁶ and the unamortized rate case expense from its prior rate proceeding of \$27,505. The Commission has traditionally permitted a utility to recover its actual rate case expenses, and the Attorney General has previously made recommendations consistent with that approach.¹³⁷

In her written brief, AG witness Andrea Crane recommended that the Commission authorize recovery of rate case expense based on an average of previous rate case expenses.¹³⁸

¹³⁴ Kentucky Power Co. v. Energy Regulatory Comm'n of Kentucky, 623 S.W.2d 904, 908 (Ky. 1981).

¹³⁵ \$99,563 – 86,365 = 13,198

¹³⁶ This total does not include expenses incurred after WSCK filed its post-hearing data responses on April 18, 2014, including the invoice from the Public Service Commission for the video transcripts of the April 9, 2014, hearing; additional legal fees in drafting this brief; and capitalized time from internal staff assisting with the preparation of the brief.

¹³⁷ See, e.g., E. Kentucky Power Coop., Case No. 2010-00167, at 8-9 (Ky. PSC Jan. 14, 2011) (“The AG recommended that the amount EKPC should be permitted to include for rate-making purposes be its actual expenses, not the amount it estimated. The AG's recommendation is consistent with the Commission's long-standing practice regarding the rate-making treatment of rate case expenses.”).

¹³⁸ Direct Testimony of Andrea Crane at 18-20.

This approach is inconsistent with Commission precedent.¹³⁹ It fails to account for differences in various rate case proceedings,¹⁴⁰ which Crane even recognized by removing the 2005 rate case from her analysis.¹⁴¹ At the hearing in this matter, Crane did not change her recommendation of utilizing an average of rate case expenses from past cases for recovery,¹⁴² but she suggested that the Commission might consider further reducing rate case expenses if the Commission were to determine that WSCK's rates should be reduced.¹⁴³ The U.S. Supreme Court has rejected such a proposition, stating "[e]ven where the rates in effect are excessive, on a proceeding by a commission to determine reasonableness, we are of the view that the utility should be allowed its fair and proper expenses for presenting its side to the commission."¹⁴⁴

E. City of Clinton – Sewer Expense

In its application, WSCK proposed reducing its expense reduction related to the City of Clinton sewer operations by \$32,576 from \$153,285 to \$120,708.¹⁴⁵ Workpaper [q] of the WSCK's filing attempted to assign the proper costs to the Clinton contract sewer operations and detailed the adjustments that were made in order to calculate the total expense reduction.

The calculations contained in WSCK's application are remarkably close to the actual amounts that were billed and accrued during the test year. UI invoiced Clinton \$153,335.11

¹³⁹ See, e.g., E. Kentucky Power Coop., Case No. 2010-00167, at 9. (Ky. PSC Jan. 14, 2011). Crane admitted that she did not know what this Commission's precedent is. VR: 17:12:46-17:12:50 ("I just don't know what their [the Commission's] policy is.").

¹⁴⁰ Undoubtedly, there has been significantly more work required in this rate case than in WSCK's previous rate cases. See Rebuttal Testimony of Lowell Yap at 5:17-6:8.

¹⁴¹ Direct Testimony of Andrea Crane at 20.

¹⁴² VR: 17:12:24-17:12:30 ("I am still recommending that the Commission use the average of the last two cases.")

¹⁴³ VR: 17:12:50-17:13:02. Any suggested reduction to rate case expenses because Lowell Yap is no longer employed with the Company is also inappropriate because Yap was primarily involved in responding to and compiling documents for response to data requests. If he had not performed these duties, someone else would have been tasked to do so.

¹⁴⁴ Driscoll v. Edison Light & Power Co., 307 U.S. 104, 120-21 (1939).

¹⁴⁵ WSCK Supplemental Response to Item 3 of Commission Staff's Initial Request for Information ("Schedule B" and wp-q).

during 2012.¹⁴⁶ Of those costs, \$121,630.95 was for reimbursement of expenses. This adjustment is consistent with the Commission's orders in WSCK's past two rate cases.¹⁴⁷

The expenses that have been charged to the City of Clinton related to the sewer operations are consistent with the Service Agreement between the City and UI.¹⁴⁸ In Article VI, Section 9(a) of the contract, UI is entitled to receive “[p]ayments for expenses actually incurred in operating and maintaining the System,” including “the salary or wages of the person . . . having immediate day-to-day responsibility for all phases of operation and maintenance, the salary or wages of proper service, repair, billing and collecting personnel; the cost of materials and supplies actually consumed from time to time; premiums on surety bonds and policies of hazard insurance; and office rental and office utilities”¹⁴⁹ The City has been paying the invoiced amounts without any challenges and, as such, the parties' course of dealing confirms the expenses are consistent with the terms of the contract.¹⁵⁰

In her written testimony, AG witness Andrea Crane proposed an adjustment to reduce WSCK's operating expense based on WSCK's revenues from the City and a 15% profit margin. Crane admitted at the April 9, 2014, hearing that the provision in the contract that mentions a 15% profit has no relevance to the pro forma adjustments related to the test period.¹⁵¹ She acknowledged that the company should be able to profit based on the provisions contained in Article VI, Section 9(c) of the contract. Because WSCK's adjustment is consistent with prior Commission orders, the Commission should accept WSCK's adjustment.

¹⁴⁶ WSCK Response to Item 6 of the Hearing Data Requests, at 1 (filed Apr. 18, 2014).

¹⁴⁷ Water Serv. Corp. of Kentucky, Case No. 2010-00563 at 14-15 (Ky. PSC Nov. 23, 2011); Water Serv. Corp. of Kentucky, Case No. 2008-00563 at 20 (Ky. PSC Nov. 9, 2009).

¹⁴⁸ UI received an assignment of the contract when it acquired Aqua/KWS, Inc.

¹⁴⁹ Wastewater Privatization Agreement Including Service Agreement, Article VII, Section 9(a), which was WSCK Exhibit 1 at the April 9, 2014, hearing.

¹⁵⁰ See J.A. St. & Associates, Inc. v. Bud Rife Const. Co., Inc., 2009-CA-000091-MR, 2010 WL 2326538, at *5-6 (Ky. App. June 11, 2010); see also Willey v. Terry & Wright of Ky., Inc., 421 S.W.2d 362, 363 (Ky. 1967); Wehr Constructors, Inc. v. Steel Fabricators, Inc., 769 S.W.2d 51, 53-54 (Ky. App. 1988).

¹⁵¹ VR: 17:07:45-17:08:10.

F. Purchased Water Adjustment

In Case No. 2013-00172, the Commission approved a water rate increase for Fern Lake Company that increased WSCK's annual costs by \$38,004.¹⁵² WSCK applied for a purchased water adjustment in Case No. 2014-00065 and sought to have a line item added to its tariff for Middlesboro customers to recover the additional purchased water costs. The proposed line item was denied by the Commission.¹⁵³ The Commission, however, approved the purchased water costs to be embedded in rates in the final order of that case.¹⁵⁴ The rates approved by the Commission in Case No. 2014-00065 will be superseded by the rates approved by the Commission in this case.

Because the Fern Lake Company rate case had not concluded at the time of WSCK's application, WSCK was unable to include these costs in its application. These expenses are known and measurable and appropriately recovered in rates.¹⁵⁵ WSCK submits that these expenses should be borne only by Middlesboro customers because Fern Lake only serves WSCK's Middlesboro operations. Because this purchased water expense is an operating expense, it is subject to the 88% operating ratio and other appropriate adjustments made to all operating expenses.

IV. Conclusion

WSCK has met its burden of proof in this case. With respect to indirect allocated expenses, it followed the clear guidance from the Commission and the Attorney General as articulated in the last rate case and compared its expenses with those of similarly sized water utilities in Kentucky. This comparative study demonstrated that the expenses allocated to

¹⁵² Fern Lake Co., Case No. 2013-00172 (Ky. PSC Dec. 12, 2013).

¹⁵³ Water Serv. Corp. of Kentucky, Case No. 2014-00065 at 2 (Ky. PSC Mar. 18, 2014).

¹⁵⁴ Water Serv. Corp. of Kentucky, Case No. 2014-00065 at 2 (Ky. PSC Apr. 7, 2014).

¹⁵⁵ See, e.g., Alton Water Dist., Case No. 8914 at 2 (Ky. PSC Mar. 12, 1984).

WSCK from WSC are reasonable. There has been no other proof offered to rebut this study. In addition the Commission has accepted similar allocated expenses in a recent rate case by another privately owned water utility.

With respect to Project Phoenix, WSCK has provided testimony of Patrick Baryenbruch and—unlike previous cases—more than 600 pages of documentation revealing the detailed review that WSCK’s parent and consultant performed in determining its course of action. These documents demonstrate the need for IT renovations within UI’s system, including for WSCK, and the audit reports by Schumaker further confirm this. Moreover, WSCK has demonstrated that the costs were reasonable when compared to other IT projects instituted by Kentucky-American, Louisville Water Company, and LG&E and KU. Accordingly, it is appropriate for the Commission to allow WSCK to recover costs associated with Project Phoenix as it allowed Kentucky-American to recover costs associated with its BT Program.

There are several other issues that received less attention in this case, but are nevertheless, equally important. First, contrary to the direct testimony of Andrea Crane, WSCK has not proposed to recover a 3% increase for salaries that has not been implemented. WSCK made a pro forma adjustment to salaries for known and measurable changes that are actually in effect. The utility further demonstrated the reasonableness of these expenses as evidenced by the comparative study conducted by Gary Shambaugh. Second, WSCK should be entitled to recover its actual rate case expenses amortized over a three-year period, consistent with Commission precedent. Third, WSCK made appropriate adjustments to the City of Clinton sewer expenses, as has been previously approved in WSCK’s past rate cases. Fourth, WSCK should be entitled to recover its purchased water expenses from its Middlesboro customers, appropriately adjusted to reflect the 88% operating ratio and other flow-through adjustments.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "M. Todd Osterloh". The signature is written in a cursive style with a large, stylized initial "M".

M. TODD OSTERLOH
CHARLES D. COLE
STURGILL, TURNER, BARKER & MOLONEY, PLLC
333 W. Vine Street, Suite 1400
Lexington, Kentucky 40507
Telephone No.: (859) 255-8581
tosterloh@sturgillturner.com

ATTORNEYS FOR WATER SERVICE CORPORATION
OF KENTUCKY

EXHIBIT 1

Water Service Corporation of Kentucky
Case No. 2013 - 00237
Test Year 12/31/2012
Revenue Requirement Summary

Schedule LY-R1 Post Hearing

	WCK Pro Forma <u>Present Rates</u>	WCK Rebuttal Pro Forma <u>Adjustment</u>	WCK Rebuttal Pro Forma <u>Present Rates</u>	WCK Rebuttal Proposed <u>Adjustment</u>	WCK Rebuttal Pro Forma <u>Proposed</u>
Operating Revenues					
Service Revenues - Water	\$2,103,813		\$2,103,813	\$233,411 (J)	\$2,337,224
Service Revenues - Sewer					
Miscellaneous Revenues	78,995		78,995		78,995
Uncollectible Accounts	(38,028)	38,028 (A)	0		0
Total Operating Revenues	<u>\$2,144,780</u>	<u>\$38,028</u>	<u>\$2,182,808</u>	<u>\$233,411</u>	<u>\$2,416,219</u>
Maintenance Expenses					
Salaries and Wages	519,099	(\$1,133) (B)	517,966		517,966
Purchase Water/Sewer	85,200		85,200		85,200
Purchased Power	95,111		95,111		95,111
Maintenance and Repair	98,163		98,163		98,163
Maintenance testing	34,092		34,092		34,092
Meter Reading	0		0		0
Chemicals	145,421		145,421		145,421
Transportation	34,774		34,774		34,774
Operating Exp. Charged to Plant	(163,869)	- (K)	(163,869)		(163,869)
Outside Services - Other	30,001		30,001		30,001
Total	<u>\$877,992</u>	<u>(\$1,133)</u>	<u>\$876,859</u>	<u>\$0</u>	<u>\$876,859</u>
General Expenses					
Salaries and Wages	\$173,648	\$0 (B)	\$173,648		\$173,648
Office Supplies & Other Office Exp.	79,610		79,610		79,610
Regulatory Commission Exp.	73,660	12,705 (C)	86,365		86,365
Pension & Other Benefits	160,716	(79) (D)	160,637		160,637
Rent	6,254		6,254		6,254
Insurance	63,192		63,192		63,192
Office Utilities	54,273		54,273		54,273
Bad Debt Expense	0	38,028 (A)	38,028	4,225	42,253
Service Company - Allocated Expenses	0	(12,904) (E)	(12,904)		(12,904)
Miscellaneous	12,173	(500) (F)	11,673		11,673
Total	<u>\$623,526</u>	<u>\$37,250</u>	<u>\$660,776</u>	<u>\$4,225</u>	<u>\$665,000</u>
Depreciation	\$281,828	\$0 (L)	\$281,828		\$281,828
Amortization of PAA	0		0		0
Taxes Other Than Income	144,063	(87) (G)	143,976	369	144,346
Expense Reduction Related to Clinton Sewer Ops	(120,708)	0 (H)	(120,708)		(120,708)
Income Taxes - Federal	54,491	639 (I)	55,130	73,130	128,260
Income Taxes - State	10,230	120 (I)	10,350	13,729	24,079
Amortization of CIAC	(4,229)		(4,229)		(4,229)
Total	<u>\$365,675</u>	<u>\$672</u>	<u>\$366,347</u>	<u>\$87,228</u>	<u>\$453,575</u>
Total Operating Expenses	<u>\$1,867,193</u>	<u>\$36,789</u>	<u>\$1,903,982</u>	<u>\$91,453</u>	<u>\$1,995,435</u>
Net Operating Income	<u>\$277,587</u>	<u>\$1,239</u>	<u>\$278,826</u>	<u>\$141,958</u>	<u>\$420,784</u>
Other Income	0		0		0
Interest During Construction	(1,730)		(1,730)		(1,730)
Interest on Debt	171,809	0 (M)	171,809		171,809
Net Income	<u>\$ 107,508</u>	<u>\$ 1,239</u>	<u>\$ 108,747</u>	<u>\$ 141,958</u>	<u>\$ 250,705</u>

Sources:

(A) Bad Debt Expenses transferred from revenue reduction to expense increase.

(B) Schedule LY-R2

(C) Schedule LY-R7 Updated post hearing

(D) Schedule LY-R3

(E) Schedule LY-R4

(F) Schedule ACC-7

(G) Schedule LY-R5

(H) Adjustment not necessary since Company is not accepting AG adjustment related to Clinton Sewer Operations. The Commission accepted this methodology in Case No. 2010-00476.

(I) Schedule LY-R8 Updated post hearing

(J) Schedule LY-R6 Updated post hearing

(K) Adjustment not necessary since Company is not accepting AG adjustment to remove 3% salary increase.

(L) Adjustment not necessary since Company is not accepting AG adjustment related to Project Phoenix costs. In order to expedite this case, the Company is reverting back to original position using composite rates.

(M) Adjustment not necessary since Company is not accepting AG adjustment related to Project Phoenix costs.

Water Service Corporation of Kentucky
Case No. 2013 - 00237
Test Year 12/31/2012
Required Revenue Increase

Schedule LY-R6 Post Hearing

	(A)	
1. Operating Expenses	\$1,903,982	
2. Less: State and Federal Income Taxes	65,480	
3. Operating Expenses Net of Income Taxes	<u>\$1,838,502</u>	
4. Divide by Operating Ratio	0.88	(B)
5. Revenue to Cover Operating Ratio	<u>\$2,089,207</u>	
6. Less: Operating Expenses Net of Income Taxes	1,838,502	
7. Net Operating Income After Income Taxes	<u>\$250,705</u>	
8. Current Net Operating Income After Income Taxes	108,747	
9. Net Operating Income Adjustment	<u>-\$141,958</u>	
10. Multiplied by Gross Up Factor	1.644227	(C)
11. Revenue Adjustment (Increase)	<u>(\$233,411)</u>	

Sources:

(A) Schedule LY-R1 Revised

(B) Reflects Commission's 88% Operating Ratio Methodology.

(C) Schedule ACC-14.

Water Service Corporation of Kentucky
Case No. 2013 - 00237
Test Year 12/31/2012
Actual Rate Case Expense through 4/18/14

Schedule LY-R7 Post Hearing

				<u>Actual as of</u> <u>4/18/2014</u>
Legal Fees				79,923
Consulting fees				
AUS				41,145
Bayrenbruch				22,944
Customer Notices:				
Newspaper Publication				3,011
Fed Ex, mailings, postage, and miscellaneous costs				355
Travel				2,595
Water Service Personnel				
	<u>hours</u>	<u>rate</u>	<u>\$</u>	
Daniel, Carl	60	\$ 130.65	\$	7,839
Feathergill, Adam K	98	\$ 22.00		2,145
Guttormsen, Robert A	232	\$ 32.00		7,409
Haas, Bruce T.	142	\$ 81.00		11,502
Leonard, James R.	29	\$ 37.05		1,074
Liskoff, David	109	\$ 39.00		4,251
Lubertozi, Steven M.	60	\$ 103.00		6,148
Lupton, Helen C.	16	\$ 48.00		768
Neyzelman, Dimitry	270	\$ 48.00		12,970
Valrie, LaWanda N.	44	\$ 23.00		1,012
Vaughn, Stephen R.	23	\$ 37.05		852
Yap Jr., Lowell M.	802	\$ 32.00		25,648
Total				<u>81,619</u>
Total Cost of current case				231,591
Unamortized Rate Case Expense				27,505
Total Rate Case expense				259,095
Amortized over 3 years				<u>3</u>
Amortization Expense				<u><u>\$ 86,365</u></u>
Per Company's Original Filing				\$ 73,660
Rebuttal Adjustment				12,705

Water Service Corporation of Kentucky
Case No. 2013 - 00237
Test Year 12/31/2012
Income Tax Expenses

Schedule LY-R8 Post Hearing

1. Pro Forma Revenue Present Rates	\$2,182,808	(A)
2. Pro Forma Expenses	1,838,502	(A)
3. Pro Forma Interest Expense	<u>171,809</u>	(A)
4. Taxable Income	\$172,497	
5. State Taxes @ 6%	<u>10,350</u>	(B)
6. Federal Taxable Income	\$162,147	
7. Federal Taxes @ 34%	<u>55,130</u>	(B)
8. Total Income Taxes	<u>\$65,480</u>	

Sources:

(A) Schedule LY-R1-Revised

(B) Reflects statutory income tax rate, per Company Filing, w/p [g].

EXHIBIT 2

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:]
]]
ADJUSTMENT OF THE RATES OF] CASE NO. 2004-00103
KENTUCKY AMERICAN WATER COMPANY]

DIRECT TESTIMONY OF

ANDREA C. CRANE

RE: REVENUE REQUIREMENTS

ON BEHALF OF

THE OFFICE OF RATE INTERVENTION OF THE ATTORNEY GENERAL
FOR THE COMMONWEALTH OF KENTUCKY

August 27, 2004

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 1 North Main Street, PO Box 810,
4 Georgetown, Connecticut 06829.

5

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

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

12

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

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

19

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

21 A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 170

1 there are significant advances to opening the dialogue regarding normalization vs.
2 amortization now, since the parties may be in a better position to assess the reasonableness
3 of the normalization methodology without the emotional arguments that may ensue if
4 adoption of the new methodology were to result in a cost disallowance.

5
6 **B. Allocation Issues**

7 **Q. Does KAWC engage in any affiliated and/or unregulated transactions requiring cost**
8 **allocations to be made?**

9 A. Yes, it does. KAWC receives a variety of services from affiliated entities, including the
10 Shared Services Company, the Customer Care Center, and the Southwest Regional office.
11 In addition, KAWC performs certain unregulated services, some of which are booked
12 “above-the-line” and some of which are booked “below-the-line”. The Company has not,
13 however, provided a comprehensive report detailing affiliated and unregulated transactions.
14 While some information has been furnished in response to discovery requests, there does not
15 appear to be an on-going reporting requirement for affiliated transactions.

16
17 **Q. Should affiliated interest transactions be subject to greater regulatory scrutiny than**
18 **transactions between non-affiliated parties?**

19 A. Yes, they should. Transactions between non-affiliated parties are conducted at “arm's
20 length.” They are generally the result of a negotiation or bidding process, or they reflect
21 prices that are available to the public. With non-affiliated transactions, each party has an

1 incentive to make the best possible arrangement, and neither party has an incentive to
2 subsidize the other. Such safeguards are not present with affiliated interest transactions.

3 Cost allocation among regulated and non-regulated services of KAWC is especially
4 important to ensure that regulated water ratepayers are not subsidizing other activities. It is
5 necessary to ensure that the revenues being received from unregulated services are at least
6 sufficient to recover the associated costs. Moreover, it is important to ensure that all costs,
7 and not just incremental costs, are being allocated to unregulated activities.

8 Similarly, it is important to examine costs that are allocated to KAWC from other
9 entities, including the Shared Services Center and the Customer Care Center. Costs from
10 affiliated entities should be allocated in a manner that appropriately reflects cost causation.
11 The first step in establishing an appropriate cost allocation system is to obtain a clear
12 understanding of the corporate and divisional relationships and the magnitude of the costs
13 associated with providing various services.

14
15 **Q. What reporting requirements do you recommend be established?**

16 A. I recommend the preparation of simple summary reports that will assist regulators in
17 reviewing the costs allocated from, and to, affiliate and non-regulated operations. Such
18 reports should show, by department name, the total costs incurred by each entity, the amount
19 allocated to KAWC, and the basis for the allocation. Similar information should be provided
20 for unregulated services performed by KAWC. One of the problems in reviewing the
21 Company's filing is that much of the data on affiliated charges is presented based on expense

1 codes, making review difficult. Therefore, the PSC should require the Company to file
2 documentation annually regarding its affiliate and non-regulated transactions in a manner
3 that is concise and informative. My objective is not to make more work for the Company; it
4 is to facilitate the review of affiliated and non-regulated charges in the future. Moreover,
5 such reports would also help KAWC management to know exactly which departments and
6 entities are providing affiliated services, and at what cost, and to better assess the need for
7 such services.

8
9
10 **IX. REVENUE REQUIREMENT SUMMARY**

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

12 A. My adjustments result in a revenue requirement deficiency at present rates of \$111,933, as
13 summarized on Schedule ACC-1. This recommendation reflects revenue requirement
14 adjustments of \$7,185,510 to the Company's requested revenue requirement increase of
15 \$7,297,443.

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

19 A. Yes, at Schedule ACC-42, I have quantified the revenue requirement impact of the rate of
20 return, rate base, revenue and expense recommendations contained in this testimony.

21

1 **Q. Have you developed a pro forma income statement?**

2 A. Yes, Schedule ACC-43 contains a pro forma income statement, showing utility operating
3 income under several scenarios, including the Company's claimed operating income at
4 present rates, my recommended operating income at present rates, and operating income
5 under my proposed rate increase. My recommendations will result in an overall return on
6 rate base of 7.11%.

7

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

9 A. Yes, it does.

10

11

EXHIBIT 3

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2012-00520
ATTORNEY GENERAL'S FIRST REQUEST FOR INFORMATION

Witness: **Linda C. Bridwell**

- 88.** RR - Affiliate management fee charges. Please refer to the table attached as "A" and provide the equivalent actual 2010, 2011, 2012 information, and budgeted/forecast information for 2013 and for the 12 months ending 7/31/14 in similar detail that was used as the basis for the amount of National Service Company and Local Service Company charges reflected in KAWC's current Kentucky rate case. (Case No. 2010-00036; OAG 1 – 107)

Response:

The term "Local Service Company" and "National Service Company" or "NSC" is a misleading descriptive term for the set of services provided by the Service Company under the 1989 Service Company Contract and does not accurately describe to current organizational structure. The attached schedule is presented consistent with the presentation and work papers contained within the current rate proceeding and the 1989 Service Company Contract.

Kentucky American Water Company
Attachment to Response KAW_R_AGDR1_NUM88
Kentucky American Service Company Expenses by Function (OPEX)
For the 12 Months Ending December 31, 2010, 2011, and 2012 - Actuals
For the 12 Months Ending December 31, 2013 - Budget
For the 12 Months Ending July 31, 2014 -Pro forma

Function	Actual			Budget	12 Months Ended
	2010	2011	2012	2013	7/31/14
Administration	\$33,918	\$36,863	(\$228,360)	(\$18,389)	\$40,382
Audit	56,569	43,328	49,453	53,415	50,744
Business Development	219,156	136,830	80,631	126,089	101,160
Business Services	-	-	72,358	134,636	92,094
Central Laboratory	185,754	193,559	163,544	161,812	162,039
Customer Service Center (CSC)	1,662,709	1,601,552	2,289,529	2,661,627	2,690,877
External Affairs	310,400	156,138	204,650	204,490	195,789
Finance	1,034,050	753,957	1,047,493	1,041,732	960,862
Human Resources	373,341	379,731	413,504	317,253	258,888
Informational Technology Systems (ITS)	1,916,535	2,220,563	2,415,459	2,746,303	3,006,247
Business Transformation	0	696	35,991	66,914	66,379
BT Controls/OI	-	-	286,512	-	-
Investor Relations	25,911	22,958	47,364	55,467	47,319
Legal	360,497	247,112	348,396	381,230	379,109
Operations Services	415,090	224,892	311,947	313,621	300,530
Property	473,280	299,486	301,892	245,254	295,590
Regulated Ops - CD	-	-	188,657	-	(13,437)
Regulated Ops - MAD	-	-	42,831	-	(33,074)
Regulated Ops - NED	-	-	3,121	-	-
Regulated Ops	1,043,113	695,375	108,937	247,241	387,714
Regulatory	30,614	25,952	27,464	27,818	27,785
Shared Services Center (SSC)	619,205	604,772	701,118	733,311	678,704
Supply Chain	88,451	107,499	202,424	95,768	166,828
Total	\$8,848,594	\$7,751,264	\$9,114,913	\$9,595,593	\$9,862,529

Less: Possible Disputed P-Card Items (1,103)

Less: Incentive Pay (537,193)

Total Pro forma period \$9,324,233

EXHIBIT 4

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2012-00520
ATTORNEY GENERAL'S FIRST REQUEST FOR INFORMATION

Witness: **Linda C. Bridwell**

- 89.** RR - Please provide a detailed explanation of what is included in each operating expense function listed in the table above and the allocation methodology used to allocate those service company charges.

Response:

The detailed explanation for each Operating expense function in the table of Item 88 of this same data request is listed below:

Internal Audit – Responsible for performing a broad, comprehensive program of internal auditing within American Water, its subsidiaries and affiliates. Internal audit examines and evaluates the adequacy and effectiveness of the system of management controls implemented by American Water management, performs reviews of operational efficiencies and financial accounting to assist the Company in achieving its objectives in accordance with approved policies and organizational goals.

Business Development - Provides coordination, tools, training, and support to American Water subsidiaries by assisting in identifying acquisition opportunities that facilitate the orderly and continued growth of the Company in addition to seeking opportunities that create synergies that benefit customers, competitor and water market trend research, direct pursuit of strategic growth, development and communication of company growth strategy, sponsorship and support for Innovation Development Program, and support of Commercial Development process.

Business Services – By coordinating common activities and skill sets, engaging a broad base of employees and building common practices, Business Services supports many of the noncustomer-facing activities that are necessary to provide cost-effective, high-quality water and wastewater services to our customers.

Business Transformation Project – Optimizes and enhance process design and development of new technologies to include training and implementation. After process assessment and re-engineering is complete, the Business Transformation Program will ultimately focus on three areas:

- Business Applications – the software used to manage data (hire/retire, procure to pay, records/reports, asset management, etc.);
- Infrastructure – the foundation of information technology such as servers, storage, security, and disaster recovery;
- Customer Service – projects that enhance customer satisfaction.

External Affairs (Communications) - Responsible for developing, maintaining and protecting the American Water and its subsidiaries' brand and reputation among multiple external and internal stakeholders. Drives a strategic and coordinated program incorporating the company's key thoughts and messages to external and stakeholders on the state and national levels. The CCEA serves as a center of expertise giving American Water's operations and functions the tools and templates they need to provide effective and consistent messaging. Through thought leadership and tactical direction, CCEA engages in media relations, social media, educational campaigns, community events, public forums, customer communications, research, third-party advocacy, corporate responsibility, and employee communications and engagement. In addition, supports the distinct initiatives of the company's business development, investor relations and government relations functions.

Finance - Include accounting, rates, treasury, financial planning and reporting, compliance (Sarbanes-Oxley), risk management, and income tax department. These groups provide support, guidance and coordination in the preparation of financial statements, tax filings, etc.

Human Resources - Responsible for governance of recruiting, hiring, employee relations, managing compensation and benefits, training, organizational development including involvement in negotiations for new contracts with bargaining units, performance management, preparation of required reports to governmental agencies at the state and federal level regarding employees, and development and promulgation of policies and practices affecting employees of American Water.

Information Technology Services – Responsible for all corporate and regulated subsidiaries technology systems. These hardware and software systems support numerous business processes such as meter reading, customer billing, bill payment management, bill collection, and customer information systems (customer service systems), Enterprise Reporting and Planning systems (back office operation, planning and reporting), communication systems (telephone, cell phones and Blackberrys), field workforce management systems (Service First) and personal computer (PC) networks as well as connectivity systems for all employees using personal computers in the performance of their day-to-day activities.

Investor Relations – Responsible for preparation and distribution of financial information that is periodically released to current or potential holders of financial securities of American Water and/or its subsidiaries.

Legal - Provides legal guidance and support for Corporate and all subsidiaries of American Water. When specialized legal advice or counsel is required, members of the Legal function arrange for and retain qualified legal experts to participate in legal matters.

Process Excellence – Responsible for continuous improvement to benefit the customer, make data driven decisions, establish and improve processes within and across our core business. The methodologies used include: Lean, Six Sigma, Change Management and Project Management methods.

Regulatory Services – Provides strategic oversight in the preparation of rate applications to ensure adequate revenues, on a timely basis, to recover operating costs, taxes, and financing on capital invested in facilities used by regulated affiliates.

Regulated Operations Management

Provides corporate governance for the Company's regulated affiliates, and the Customer Service Center, organized as follows:

Central Division: Provides governance of the following affiliates: Iowa American Water, Illinois American Water, Indiana American Water, Kentucky American Water, Michigan American Water, Missouri American Water, and Tennessee American Water. Managed by an Executive VP with a direct reporting to the President of Regulated Operations.

Mid Atlantic Division: Provides governance of the following affiliates: Maryland American Water, Pennsylvania American Water, Virginia American Water, and West Virginia American Water. Managed by an Executive VP with direct reporting to the president of Regulated Operations.

Northeastern Division: Provides governance of the following affiliates: New Jersey American Water, and Long Island American Water. Additionally, the Edison, Liberty, ETown Services and ETown Properties entities. Managed by an Executive VP with direct reporting to the president of Regulated Operations.

Stand alone (not in division): California American Water, and Hawaii American Water. Have a direct reporting relationship to the president of Regulated Operations.

Customer Service Center (CSC): Two centers located in Alton, Illinois and Pensacola, FL performs customer service functions for all regulated customers except Michigan. Services include: customer call processing, service order processing, billing services, correspondence processing, customer relations, field resource coordination, and credit and collections. The CSC also supports billing, collection, and call handling support for a number of O&M contracts.

Shared Services Center - Supports American Water affiliates by performing essential business services in the areas of Accounting Services, Human Resources Services, and Procure to Pay Services. Included in these services are accounting, financial reporting, payroll administration, reporting, and processing, benefits, leave of absence, and service award administration, tuition reimbursement, relocation services, employee on/off boarding assistance, accounts payable and purchase card services, procurement, invoice payments, fixed asset accounting, cash management, tax related services including, but not limited to, sales & use and property taxes.

Operation Services – Responsible for developing and implementing a cost-effective capital improvement program, best operating practices, environmental management and compliance, maintenance services, network (pipe network operation and maintenance), production and water quality support for all subsidiaries. The Office of Risk Management provides physical security, employee health and safety, business continuity, event management and claims management support.

Lab: Employs chemists, lab technicians, analysts, and support employees to perform water quality testing and research. The lab, which is EPA and state certified, uses state of the art water testing equipment to test water, source water, and finished waters from all subsidiaries and is located in Belleville, Illinois.

Supply Chain - Provides support through comprehensive strategic sourcing and “fact based” negotiations to competitively procure goods and services from suppliers while leveraging American Water's national presence in the marketplace to obtain the optimal total cost of ownership. Additional responsibilities include: Energy Management, Fleet Management, Supplier Diversity and execution and monitoring of procurement internal SOX compliance controls. The function consists of a national team with team members located in various portions of the United States.

Property – Provides facility management services for owned and leased buildings in the Voorhees Corporate Campus. This includes directing and administering facility and space planning and utilization, developing and administering capital and expense budgets for facilities, negotiating and administering leases, completing large scale fit-outs of office space, housekeeping, utilities, receptionist, mail distribution, reprographics and related functions in addition to providing direction and capital program management to other Service Company locations. Also, property is responsible for procuring and overseeing maintenance such as landscaping, snow removal, electrical, HVAC, and other building repairs as well as building upgrades such as office reconfigurations and builds out, bathroom renovations, carpeting upgrades and furniture procurement. In addition, capital budgets for Service Company for furniture and building related capital expenses are managed by Property.

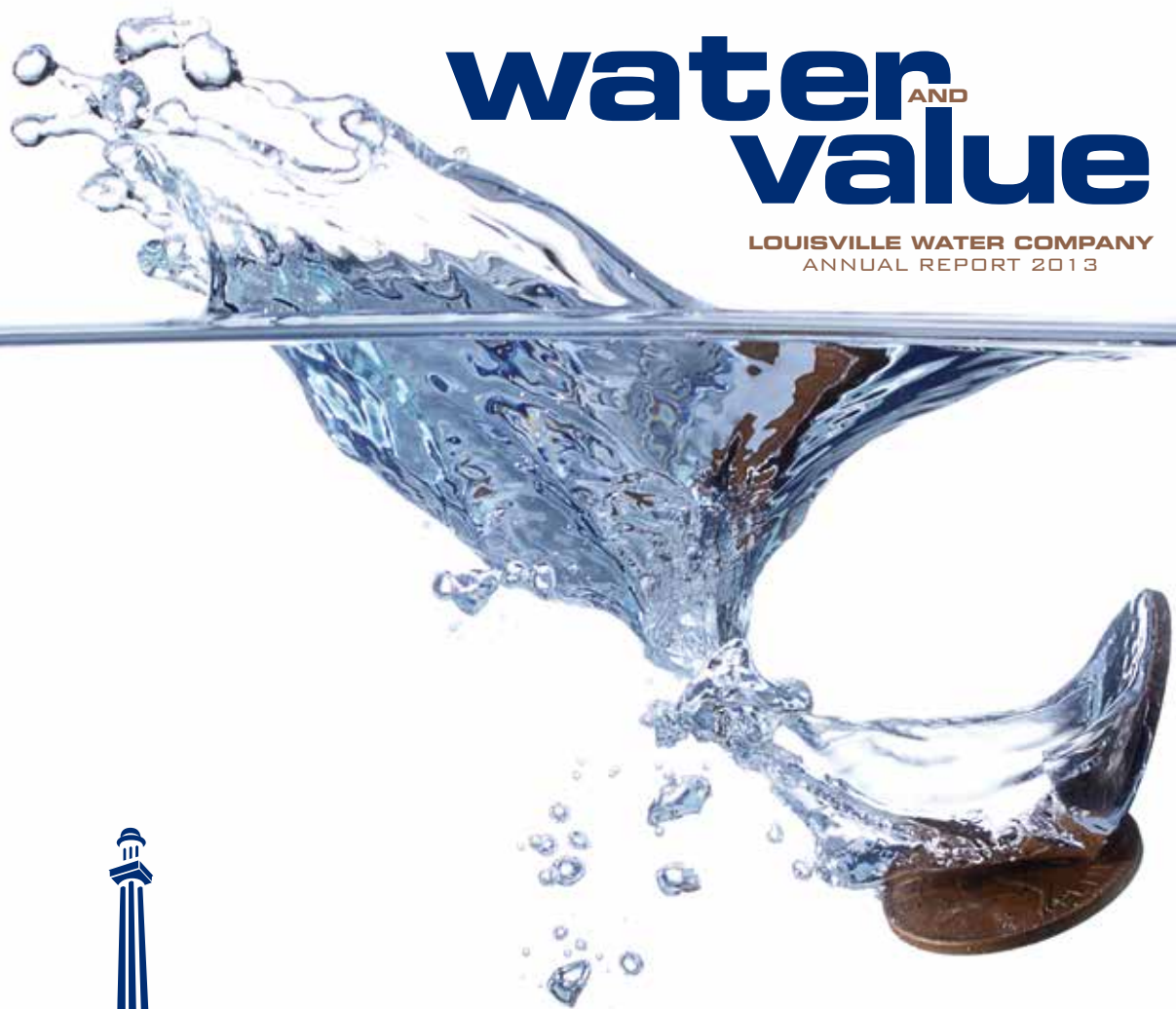
The methods of charging Service Company costs are generally outlined below.

Regardless of the entity to which service is provided, regulated or market based, the first approach is to direct charge the entities for the services provided, where those services can be related to a specific entity.

Services provided to market based entities that are not direct charged, as above, are charged through the use of the Tier 1 cost causative metrics relating to each functional area.

The costs associated with the services provided in common to the regulated utilities, that are not direct charged, are charged based on the number of customers.

EXHIBIT 5



water AND value

LOUISVILLE WATER COMPANY
ANNUAL REPORT 2013





*Dave Vogel
Vice President
Customer Service*

Customer Care and Billing Project

Louisville Water continues to see positive trends in how customers view our performance. In 2013, the Customer Satisfaction Index finished at its highest annual average since 2003. This opinion-based survey looks at customer attitudes towards quality, service, reliability, information and value. In addition, the service index of the survey noted its highest annual score on record. This survey measures perceptions of customers who had a transaction with Louisville Water through perhaps a bill question or a service order.

On the heels of this performance, Louisville Water launched its largest project to date for improved customer service. In July, we kicked-off the Customer Care and Billing Project, a \$29 million initiative to replace the company's billing and mobile work-force management systems. The project team is cross-functional and includes 40 employees from Louisville Water and MSD, along with members of Oracle and Five Point Consultants. When complete in early 2015, the new system will allow for improved customer interactions in-person, on the phone, and through web and mobile channels.

MSD is actively participating in the Customer Care and Billing Project, and in 2013 we executed a new billing agreement with the District. A cost-of-service and benchmarking study helped develop an annual fee schedule that MSD will pay to Louisville Water for billing services. The agreement capped months of negotiations that will ultimately benefit both organizations and represents the largest collaborative effort between the two entities.



Two work areas were constructed at the John L. Huber building to allow team members to collaborate on the Customer Care and Billing project.



The Customer Care and Billing System will provide additional options for Louisville Water's Customer Care Representatives.

VALUE



In 2013, Louisville Water service cost 72 cents a day for the average residential customer.



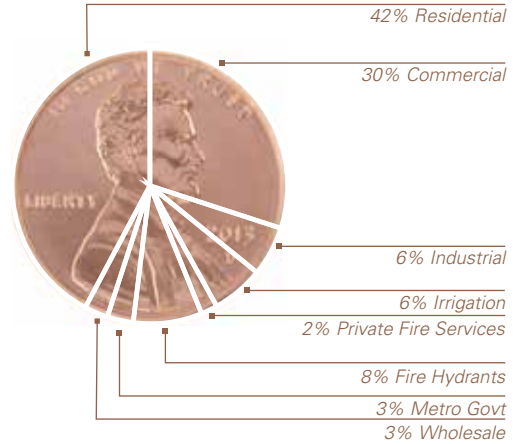
Amber Halloran
Vice President, Finance -
Treasurer

Louisville Water had a strong financial performance in 2013 and continued to provide some of the lowest water rates in the region. The success came in the midst of declining water sales as a cool irrigation season helped push water consumption down to 33.9 billion gallons— the lowest level since 1969. Despite the downward trend, we continue to see growth in water-related and regionalization revenue. Financial results provided for continued investment in our infrastructure and new technology and a return to our shareholder, Louisville Metro, of a \$19.6 million dividend and \$15.4 in free water and fire protection for a total value of \$35 million.

Standard & Poor’s Rating Services affirmed its “AAA” long-term and underlying ratings for the Board of Water Works’ revenue bonds. Standard & Poor continues to give Louisville Water its highest rating, noting the strong financial operations of the company, the long-term planning efforts and the risk management and controls.

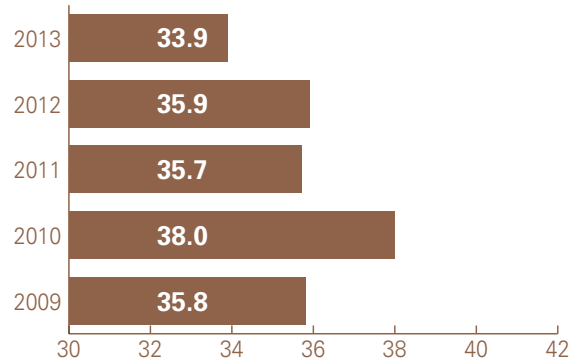
While the majority of United States water utilities continue to experience declining consumption, Louisville Water is firmly poised to address this challenge with a focus on regionalism, other sources of revenue growth, internal and external efficiencies and synergies, adjusting our budget and long-range plans.

2013 Water Revenue



Total Consumption

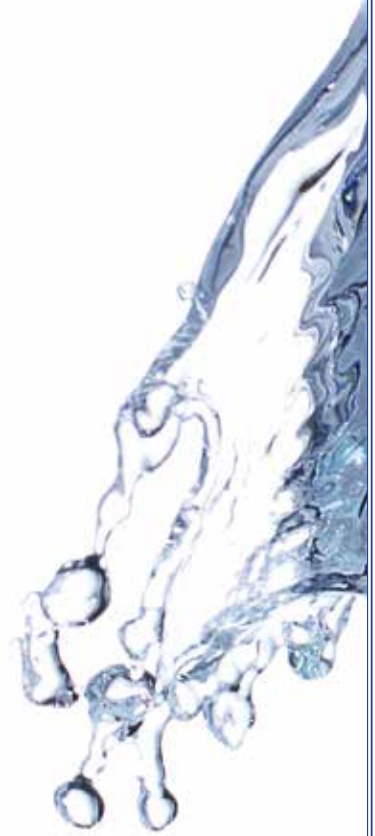
(in billion gallons)



Sale of Water Revenue Analysis

Louisville Water Company

	number of customers at December 31		consumption - ytd (1,000) gallons		revenue - ytd (in 000s)	
	2013	2012	2013	2012	2013	2012
Residential	243,187	242,007	13,227,765	14,067,469	\$ 62,046	\$ 62,269
Commercial	22,514	22,462	12,266,561	13,216,325	43,661	44,641
Industrial	330	307	3,613,971	3,157,508	9,522	8,177
Irrigation	12,159	11,512	1,756,470	2,334,456	8,695	10,436
Fire Services	4,255	4,202	30,630	33,452	2,616	2,523
Public Fire Hydrants	23,841	23,792	-	-	11,603	11,154
Metro Govt	635	644	1,188,173	1,299,109	3,834	4,129
Wholesale	6	6	1,814,687	1,825,359	3,719	3,558
GRAND TOTALS	306,927	304,932	33,898,257	35,933,678	\$145,696	\$146,887



550 SOUTH THIRD STREET
LOUISVILLE, KY 40202
502.569.3600
LOUISVILLEWATER.COM

EXHIBIT 6

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY)	
UTILITIES COMPANY FOR AN)	CASE NO. 2009-00548
ADJUSTMENT OF BASE RATES)	

In the Matter of:

APPLICATION OF LOUISVILLE GAS)	
AND ELECTRIC COMPANY FOR AN)	CASE NO. 2009-00549
ADJUSTMENT OF ITS ELECTRIC)	
AND GAS BASE RATES)	

TESTIMONY OF
CHRIS HERMANN
SENIOR VICE PRESIDENT – ENERGY DELIVERY
LOUISVILLE GAS AND ELECTRIC COMPANY AND
KENTUCKY UTILITIES COMPANY

Filed: January 29, 2010

1 outages occur. The devices can readily identify where a fault has occurred, which
2 simplifies restoration efforts and enhances the employees' ability to avoid hazardous
3 areas. Finally, the Companies have implemented a plan to mitigate animal-related
4 outages. Devices designed to prevent animals from reaching and affecting critical
5 equipment are installed on all new equipment. As a result of this effort, fewer animal-
6 related outages are expected to occur, which should lead to increased reliability and
7 decreased maintenance costs as equipment damage is reduced.

8 **Q. Are there any other actions the Companies have taken to maintain or improve their**
9 **performance?**

10 A. Yes. A new customer information system known as the Customer Care Solution system
11 ("CCS") was fully implemented in April 2009. Implementing CCS was a substantial
12 undertaking, with about \$45 million having been invested since the last rate case, and a
13 total investment of about \$83 million as of October 31, 2009. This commitment required
14 significant time, planning and resources from the Companies, but is well worthwhile due
15 to the many advantages of CCS. This is described in John Wolfram's testimony.

16 **Q. Are there any particular challenges for safety and reliability specific to LG&E's gas**
17 **business?**

18 A. Yes. With regard to LG&E's gas business, since 1996, LG&E has installed 386 miles of
19 distribution main as part of its large scale main replacement effort, including 25 miles
20 since LG&E's last gas rate case. The main replacement program helps ensure continued
21 safety, improved reliability, enhanced operating efficiencies, and lower operating costs
22 for LG&E's gas customers. There are 229 miles yet to be replaced in LG&E's gas
23 system. LG&E is also in the process of upgrading other components of the gas system,

EXHIBIT 7

KENTUCKY-AMERICAN WATER COMPANY
CASE NO. 2012-00520
COMMISSION STAFF'S SECOND REQUEST FOR INFORMATION

Witness: **Gary M. VerDouw**

69. a. State whether American Water or Kentucky-American has performed any studies or analyses of the financial effects on Kentucky-American of the BT Program or of the benefits that BT Program provides specifically to Kentucky-American.
- b. If the response to Item 69(a) is yes, provide all studies or analyses that were prepared.
- c. If the response to item 69(a) is no, explain why the allocated cost of the BT Program of \$12 million to Kentucky-American is reasonable.
- d. Explain why it is reasonable for a company of Kentucky-American's size to spend \$12 million on a software package.
- e. Quantify the benefits Kentucky-American receives from the BT Group. Show all calculations and state all assumptions made to quantify these benefits.

Response:

- a. Neither American Water nor Kentucky-American has performed any studies or analyses of the financial effects of the BT program on Kentucky-American. The benefits that BT Program will provide to Kentucky-American are described in the testimony of Gary VerDouw. Kentucky-American's IT systems were implemented in the early 1990s and 2000s. Those systems are used by the Company's various business departments, but are not integrated. In addition, they have limited automation and functionality. Accordingly, American Water undertook a comprehensive analysis of its current information technology systems, the results of which indicated it has fully maximized the software and systems used by its operating companies by implementing significant customizations or workarounds, in part, to meet requirements and expectations the original software is not equipped to support. This analysis is provided in response to Item 168 of the Attorney General's First Request for Information. That comprehensive analysis further demonstrated the current IT systems have reached a point where additional customizations would be inefficient and increasingly costly to maintain. As such, wholesale replacement of those antiquated IT systems is warranted. Replacement is necessary for another reason. Kentucky-American's customers today expect more functionality than they once did, and more functionality than Kentucky-American's existing IT systems can readily support. Business Transformation will enable Kentucky-American to meet the demand. The BT systems are anticipated to provide a host of benefits to Kentucky-American and its customers.