**COMMONWEALTH OF KENTUCKY**

**BEFORE THE PUBLIC SERVICE COMMISSION**

**IN THE MATTER OF:**

| | | |
|---|---|---|
| **ELECTRONIC APPLICATION OF** | **)** | |
| **KENTUCKY-AMERICAN WATER** | **)** | **CASE NO. 2018-00358** |
| **COMPANY FOR AN ADJUSTMENT OF** | **)** | |
| **RATES** | **)** | |

# POST-HEARING BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

**Filed: May 31, 2019**

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## 1. STATEMENT OF THE CASE

On October 26, 2018, Kentucky-American Water Company ("KAWC" or "Company") filed a Notice with the Public Service Commission of the Commonwealth of Kentucky ("Public Service Commission" or "Commission") in conformity with 807 KAR 5:001, Section 16(2), expressing its intention to file an application for an increase in rates no earlier than 30 days from the date of Notice. The Notice specifically provided that the application for an increase in rates would be supported by a fully forecasted test period as authorized by Kentucky Revised Statute 278.192.[1]

In keeping with prior practice, simultaneously with the delivery of its Notice to seek an increase in rates, KAWC submitted a Notice of Election of Use of Electronic Filing Procedures. The Commission's October 26, 2018 Acknowledgement Letter assigned a case number to the notice. KAWC filed its Application and supporting materials on November 28, 2018.

On December 11, 2018, Lexington-Fayette Urban County Government ("LFUCG") petitioned for full intervention and agreed to electronic transmission of all notices and messages in this proceeding. The Commission granted LFUCG's motion on January 10, 2019 after a hearing on this issue on January 9, 2019. On December 27, 2018, the Community Action Council of Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. ("CAC") moved for full intervention. CAC subsequently withdrew its motion to intervene on January 8, 2019 before the January 9, 2019 hearing.

On December 28, 2018, the Attorney General ("AG") filed a motion to intervene. The Commission granted the AG's motion on January 3, 2019, and ordered the AG to comply with

[1] The Notice was subsequently attached to the Application filed by KAWC in Case No. 2018-00358 as Exhibit No. 8.

the service and electronic filing requirements. The adjudication of this matter has proceeded with two intervenors: LFUCG and the AG.

In its Application filed with the Commission on November 28, 2018, KAWC sought the Commission's approval of an increase in its annual revenues of $19,865,003 by rates to become effective on or after June 28, 2019 (including a rate suspension period). Pursuant to the Commission's Order in Case No. 2007-00143, in which implementation of single-tariff pricing was approved, the proposed rates for each customer class are and will be uniform throughout the customer classes, regardless of the KAWC division to which the customer belongs.

By letter dated November 30, 2018, the Executive Director of the Commission informed all parties of record that the Application met the minimum filing requirements and was thus accepted for filing. By Order dated December 5, 2018, the Commission suspended the proposed rates for a period of six months and established a Procedural Schedule providing for two rounds of data requests to KAWC, the filing of intervenors' testimony, one round of data requests to the intervenors, and the filing of rebuttal testimony by the Company's witnesses. In its Order dated January 9, 2019, the Commission scheduled an evidentiary hearing in this matter on May 14, 2019. On April 26, 2019, the Commission ordered the evidentiary hearing to be rescheduled from May 14, 2019 to beginning on May 13, 2019 and continuing on May 14, 2019 after determining the hearing could not be completed in one day.

Although KAWC's November 28, 2018 Application requested an annual increase of $19,865,003, on April 15, 2019, KAWC filed its Base Period Update. As a result of the Base Period Update, the requested annual increase was revised to $18,471,247.[2] The base period updated revenue requirement is composed of a $4.1 million requested annual increase necessary

[2] Base Period Update, Exhibit 37A, Page 2 of 2.

to reset the temporary Tax Cuts and Jobs Act ("TCJA") credit that was commenced in September 2018 and which expires in June 2019. Only the remaining $14,371,247 represents a request for incremental revenue.

With its Application, KAWC presented the testimonies of: Patrick L. Baryenbruch; Ann E. Bulkley; Constance E. Heppenstall; Kurt M. Kogler; Robert V. Mustich; Brent E. O'Neill; James S. Pellock; Gregory P. Roach; Kevin Rogers; Nick O. Rowe; Scott W. Rungren; Melissa L. Schwarzell; John R. Wilde; and Timothy Willig. Subsequent rebuttal testimony was presented from Ann E. Bulkley; Kurt M. Kogler; Robert V. Mustich; Brent E. O'Neill; James S. Pellock; Nick O. Rowe; Scott W. Rungren; Melissa L. Schwarzell; and John R. Wilde.

The AG and LFUCG co-presented the testimony of Lane Kollen and Richard A. Baudino.

A hearing on the merits of the proposed increase was held at the Commission on May 13 and 14, 2019. The following witnesses for KAWC were presented and subject to cross examination: Nick O. Rowe; Brent E. O'Neill; Ann E. Bulkley; John R. Wilde; Robert V. Mustich; Kurt M. Kogler; Timothy Willig; Susan Lancho; Patrick L. Baryenbruch; Scott W. Rungren; Constance E. Heppenstall; James S. Pellock; Justin Sensabaugh; Gregory P. Roach; and Melissa L. Schwarzell.

The AG and LFUCG presented Lane Kollen and Richard A. Baudino. Throughout the course of the hearing, numerous hearing data requests were issued to KAWC. Pursuant to the Commission's Order dated May 14, 2019, the Company filed its responses to these requests on May 24, 2019.

## 2. QUALIFIED INFRASTRUCTURE PROGRAM

### (a) **Approval of the QIP is Critical to Addressing KAWC's Infrastructure Needs**

KAWC has presented a thorough and compelling case in support of its proposed Qualified Investment Program ("QIP"). As set forth in the record, the critical need for timely infrastructure replacement and the management thereof is a vexing problem facing the entire water industry. KAWC proposes to implement a QIP, which is a tariff rate adjustment mechanism that will allow the Company to make capital improvements to its aging system and recover the costs of such improvements on a timelier basis.[3] Consistent with many water service providers both in Kentucky and nationally, KAWC has a pressing need to replace distribution infrastructure that has met or exceeded its life expectancy.[4] Through the QIP, the Company seeks to further accelerate the rate of investment to replace its aging water infrastructure in a systematic, responsible manner that addresses the long-term replacement needs of the system in a cost-effective way. The QIP provides long-term benefits to customers and should be approved.

The value of continued accelerated infrastructure replacement would be substantial, benefiting customers today and well into the future with improved water quality, and fewer main breaks and service interruptions. Importantly, replacing pipes that are near the end of their useful lives will result in lower costs for customers over time than deferring replacement.[5] Responsible, systematic replacement is far more cost efficient.[6] Planned pipe replacements are much less costly on a unit cost basis compared to the steep increase in future pipe replacements resulting from prior deferrals of those replacements.[7] For example, a reduction in the number of

[3] Application at 2.
[4] Direct Testimony of Brent E. O'Neill ("O'Neill Direct") at 2 (Ky. PSC Nov. 28, 2018).
[5] Rebuttal Testimony of Brent E. O'Neill ("O'Neill Rebuttal") at 9 (Ky. PSC Apr. 30, 2019).
[6] *Id.*
[7] *Id.*

emergency projects will yield cost savings not only in terms of mobilizing manpower and equipment, but also in enabling the Company to leverage its ability to strategically source and procure materials in advance. In fact, it is approximately ***ten times*** more expensive for unscheduled pipe replacements than scheduled pipe replacements.[8] There are costs to increasing pipe breaks, service disruptions, property damage, and health risks from potential drinking water contamination exposure as well as related community opportunity costs tied to community health and economic development.

Furthermore, the approval of the QIP would likely reduce the frequency of rate cases, which would further reduce expenses and benefit customers. For other American Water subsidiaries with a similar infrastructure replacement mechanism, the length of time between rate cases generally increased significantly after approval of the mechanism[9] as set forth in table below:

| Subsidiary | Interval between rate cases before mechanism (years) | Interval between rate cases after mechanism (years) |
|---|---|---|
| Illinois-American | 2.5 | 3.5 |
| Indiana-American | 1.7 | 3 |
| Iowa-American | 2 | No rate case since mechanism implemented in 2017 |
| Missouri-American | 1.4 | 2.5 |
| New Jersey-American | 2 | 3 |
| New York-American | 3.3 | 5 |
| Pennsylvania-American | 1.4 | 2.75 |
| Tennessee-American | 1.7 | No rate case since mechanisms implemented in 2012 |
| Virginia-American | 2.5 | 2 |
| West Virginia-American | 2 | 2 |

[8] Response to PSC 2-50(c).
[9] Response to PSC 2-57.

The QIP includes the following distribution system components: structures and improvements, supply mains, power generation equipment, pumping equipment, distribution reservoirs and standpipes, transmission and distribution mains, services, meter and meter installations, and hydrants.[10] The Company developed a Main Replacement Model to prioritize the mains that will be replaced during the process.[11] The model utilizes eight criteria: Low Pressure, Number of Breaks/Leaks, Fire Flow, Age, Material Type, Size of Main, Water Quality, and Customer Impact.[12] External drivers, such as roadway paving schedules, weather, and construction considerations are also considered.[13]

KAWC also included plant accounts 320 – Water Treatment Equipment, 344 – Laboratory Equipment, 346 – Communication Equipment and 347 – Miscellaneous Equipment as part of the QIP. Utilities are not only faced with an aging distribution system infrastructure but also with the need to replace water treatment infrastructure. The Company believes that proactively and systematically investing in treatment plant replacement projects is in the public interest.[14] The inclusion of these additional plant accounts as eligible for the QIP supports the Company's efforts to proactively address potential threats to regulatory compliance, system reliability, documented structural deficiencies, and safety in a way that supports the long-term interest of its customers.[15] Although, in most cases, transmission and distribution main generally will require attention first and will be the priority of a QIP, a pump or treatment asset may require more immediate attention for a variety of reasons.[16]

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[10] O'Neill Direct at 33-34.
[11] *Id.* at 32.
[12] *Id.* at 32-33.
[13] *Id.* at 33.
[14] O'Neill Rebuttal at 14.
[15] *Id.*
[16] *Id.* at 13.

As the Company has shown throughout this proceeding, the QIP is a necessary regulatory mechanism to support the Company's efforts to accelerate the replacement of its aging infrastructure. The Company anticipates that the approval of the QIP will enable the Company to invest an additional $4 to $10 million (in present day dollars) annually to accelerate the replacement of aging distribution and water treatment infrastructure.[17] Without an alternative cost recovery method such as the QIP, the ability to sustain an accelerative infrastructure replacement program will be difficult.[18] With the approval of the QIP, the Company can plan and manage the consistent deployment of Company and contractor resources to more efficiently and effectively attain and maintain a replacement program that better serves the long term interests of customers.[19]

(b) **<u>The AG and LFUCG Have Not Provided Any Evidence that the QIP Should be Rejected</u>**

Despite the clear need for the QIP, AG and LFUCG witness Mr. Baudino has recommended that the Commission deny the Company's proposal. Mr. Baudino's direct testimony provides nothing other than superficial objections to the QIP. None of his objections provides a reasoned basis to deny the Company's customers the long-term benefits of the QIP.

Mr. Baudino claims that he is not addressing the "reasonableness or prudence of the Company's proposed QIP as described by Mr. O'Neill,"[20] but, without providing any evidence that contradicts KAWC regarding replacement needs, asserts that KAWC failed to show that the QIP is necessary.[21] This is false – the Company has presented extensive evidence to show that a constructive regulatory mechanism like the QIP is necessary to support the Company's proposed

[17] O'Neill Direct at 36. *See also* 5/13/19 Hearing, VR 11:14:00 AM when KAWC President Nick Rowe committed to invest $6 to $10 million annually to the QIP if approved.
[18] O'Neill Direct at 36.
[19] *Id.*
[20] Direct Testimony of Richard A. Baudino ("Baudino Direct") at 51 (Ky. PSC Mar. 15, 2019).
[21] *Id.* at 49.

accelerated infrastructure replacement program. The Company has improved its main replacement rate from the almost 500 years needed to replace all of its mains identified in its last rate case, to 377 years.[22] But as Mr. O'Neill has demonstrated and Mr. Baudino has not contested, KAWC's mains have a life expectancy of only 60 to 100 years, and the current replacement rate of mains is not sustainable without more timely cost recovery.[23] KAWC is one of the few subsidiaries in the American Water system to have neither an infrastructure surcharge nor a multi-year future test year for capital recovery.[24] As Mr. Rowe explains in both his direct and rebuttal testimony, with KAWC being among the last of American Water's regulated subsidiaries without a mechanism to achieve timely recovery of its investment in accelerated infrastructure replacement, it is at a significant disadvantage to attract discretionary capital allocations from American Water as compared to its affiliates.[25] Mr. Rowe committed at the hearing that if the Commission approves the QIP, it will receive the necessary capital from American Water to fund the infrastructure replacements.[26] The Company has provided ample evidence that the QIP is a constructive regulatory mechanism that is necessary to allow KAWC to attract the discretionary capital needed to fund its accelerated infrastructure replacement program.

Mr. Baudino also claims that a QIP Rider is unnecessary because of KAWC's use of a future test year in rate cases. This argument is unavailing because the ability to use a forecasted test year does not eliminate the regulatory lag associated with capital improvements in between rate case test periods, unless the utility files new rate cases as soon as the prior cases are

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[22] Rebuttal Testimony of Melissa L. Schwarzell ("Schwarzell Rebuttal") at 18 (Ky. PSC Apr. 30, 2019).
[23] *Id.*
[24] *Id.*
[25] Direct Testimony of Nick O. Rowe ("Rowe Direct") at 16 (Ky. PSC Nov. 28, 2018); Rebuttal Testimony of Nick O. Rowe ("Rowe Rebuttal") at 4-5 (Ky. PSC Apr. 30, 2019).
[26] 5/13/19 Hearing, VR 11:14:00 AM.

complete. The QIP will allow more timely recovery of the costs required to fund KAWC's proposed accelerated infrastructure replacement program. A future test year alone cannot achieve this outcome.

Mr. Baudino claims that he is not addressing the "reasonableness or prudence of the Company's proposed QIP as described by Mr. O'Neill,"[27] but goes on to take issue with KAWC's proposed categories of QIP-eligible plant as overly broad without providing any evidence that contradicts KAWC regarding replacement needs.[28] He argues that if a QIP is approved, it should be limited to "distribution mains only that are non-revenue producing and non-expense reducing plant and that serve to replace existing plant."[29] Mr. Baudino's recommendation is vague and ambiguous. Consequently, if language of this kind were introduced into the tariff or order, without definition, it would call into question the recoverability of virtually any investment the Company could plan for the QIP.[30] Traditionally, the term "non-revenue producing and non-expense reducing plant" is plant that is not constructed or installed for the purpose of serving new customers.[31] The Company's proposed QIP meets this criteria.

KAWC included the proposed categories of QIP-eligible plant to allow KAWC to address the problem of aging infrastructure across its system.[32] Although in most cases transmission and distribution main will be the priority of the QIP, a pump or treatment asset may

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[27] Baudino Direct at 49.
[28] *Id.* at 51.
[29] *Id.* at 58.
[30] Schwarzell Rebuttal at 21.
[31] *Id.*
[32] O'Neill Rebuttal at 12-13.

require more immediate attention for a variety of reasons.[33] In his direct and rebuttal testimony, Mr. O'Neill further explains why certain plant accounts were included as eligible for the QIP.[34]

Mr. Baudino's third objection is that the QIP does not include an adequate review process to ensure reasonableness of costs for eligible facilities.[35] KAWC has shown that a review window of approximately 90 days is sufficient for two reasons.[36] First, the cost drivers in the mechanism (including depreciation rates, cost of capital, and property tax rates) are proposed to all be derived from the most recent rate case authorization.[37] Thus, there is no need to review depreciation rates or employ cost of capital witnesses.[38] The Company would bear the risk of fluctuation in these figures.[39] Second, the projects to be included in the mechanism are all infrastructure replacement projects for the production and distribution system.[40] Mr. O'Neill robustly demonstrated the need for these projects.[41] Moreover, this Commission has recently held that infrastructure projects are best reviewed in a targeted proceeding rather than a rate case.[42] Given the nature of the projects and the recent adjudication of the cost drivers, the Company's proposed QIP program is well suited to a simple, streamlined review.[43]

Next, Mr. Baudino argues that KAWC's proposed QIP fails to provide adequate protections to customers from unreasonable costs and unnecessary rate increases.[44] This

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[33] *Id.* at 13.
[34] O'Neill Direct at 33-34; O'Neill Rebuttal at 13-14.
[35] Baudino Direct at 51.
[36] Schwarzell Rebuttal at 21.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates*, Case No. 2018-00281, Order (Ky. PSC May 7, 2019) ("During a base rate case, a multitude of issues are examined in detail by the parties and the Commission. If PRP projects are also included in the base rate case then the Commission and the intervenors may not have adequate time to review and analyze the proposed projects.").
[43] Schwarzell Rebuttal at 21-22.
[44] Baudino Direct at 52.

argument also lacks merit. As previously explained, the proposed 90-day review process is sufficient and provides an adequate and efficient opportunity to review. As proposed, the QIP includes both an approval procedure and a reconciliation procedure, which allows time for stakeholder inquiry and Commission review. Additionally, the planned infrastructure improvements will prevent inevitable, costlier repairs in the future. Thus, the QIP should result in lower rate increases to customers in the long run than customers would otherwise experience without the QIP.

### (c) **Mr. Baudino's Proposed Modifications to the QIP are Unnecessary and Counterproductive to Addressing KAWC's Infrastructure Needs**

Mr. Baudino recommends seven modifications to the QIP, if the mechanism is approved.[45] Mr. Baudino proposed the same modifications in opposition to West Virginia-American Water Company's infrastructure replacement program surcharge request before the West Virginia Public Service Commission.[46] The West Virginia Commission rejected every modification Mr. Baudino proposed and instead approved an infrastructure replacement program surcharge that was similar to that proposed by the utility.[47]

Mr. Baudino's first recommendation is that the QIP should be limited to a two-year program. Such a proposal is counterproductive and unnecessary. The Company anticipates that the QIP program will not be fully ramped up until after year five. In other words, it will take five years: to determine the efficient mix of projects that will allow contractors and company personnel to develop procedures and practices that ensure an effective deployment of resources; to ensure that the effect on adjacent customers is considered and the projects provide sufficient

[45] *Id.* at 48.
[46] *West Virginia-American Water Company; Petition for Approval of the 2017 Infrastructure Replacement Program Surcharge Mechanism*, Case No. 16-0550-W-P, Order (W. Va. PSC Dec. 2, 2016).
[47] *Id.*

communication and coordination with all stakeholders; and to ensure that the Company's contractors and resources are provided time to develop their additional workforce.[48] Two years is not an adequate time period for the Company to operationally execute the targeted QIP program, let alone examine its success.[49] It would be an inefficient deployment of resources to procure the contractors, train the workforce, contract for the supplies, and coordinate with community stakeholders for a program that would end in two years.[50] Mr. Baudino's second recommendation, which would limit the types of assets that would be eligible for the QIP, would unduly restrict KAWC's ability to address critically aging infrastructure. Mr. Baudino's third recommendation, which is to limit the yearly cap on QIP-related rate increases from current authorized tariff rates to 2.5 percent, with a cumulative cap of 5 percent,[51] would have the same adverse effects. These artificial caps are not based on KAWC's long-term infrastructure needs and would likely have the effect of limiting the QIP to an unduly brief timeframe.

Mr. Baudino's fourth recommendation, which is to reduce the return on equity for QIP-eligible plant by one percent from the return on equity authorized in this proceeding, should be rejected because it is nothing other than his opinion that is devoid of any supportable basis. As Ms. Bulkley explains in her rebuttal testimony, "Mr. Baudino has not conducted any analysis to determine if the QIP results in a lower overall risk profile for KAWC's investments than the risk exposure of the proxy companies. Therefore, the recommendation that these investments receive a lower return, by any amount, is unsubstantiated."[52] Ms. Bulkley goes on to demonstrate "that the proxy group companies have mechanisms similar to the QIP in approximately 63 percent of

[48] Response to PSC 2-55.
[49] Schwarzell Rebuttal at 24.
[50] *Id.*
[51] Baudino Direct at 58.
[52] Rebuttal Testimony of Ann E. Bulkley ("Bulkley Rebuttal") at 70 (Ky. PSC Apr. 30, 2019).

the jurisdictions that they operate in. Therefore, if the Company's request to implement a QIP were granted, its risk profile would simply be consistent with the risk profiles of the proxy group companies."[53] Accordingly, Ms. Bulkley concludes that there is no basis for an adjustment of ROE for QIP eligible investments.[54] To the contrary, if the QIP were to be rejected, KAWC would continue to have a higher risk profile, which would support an ROE that is greater than the average for the proxy group.[55]

Mr. Baudino's fifth proposed modification is that the Company be required to file a general rate case within two years of QIP implementation. Mr. Baudino confirmed at the hearing that he was not aware of the Commission ordering any utility to file a rate case by a date certain.[56]

The Commission just recently rejected Mr. Baudino's sixth recommendation, which would require KAWC—which has filed forecasted test years for decades without deviation—to file historical QIP proceedings.[57] Mr. Baudino's final recommendation, which is to allow for a "reasonable review process," is already reflected in KAWC's proposed program. Mechanisms such as the QIP proposed here have been successfully utilized in other jurisdictions and have even been recognized as a "best practice" by the National Association of Regulatory Utility Commissioners ("NARUC").[58] The Company respectfully requests the Commission approve KAWC's proposed QIP.

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[53] *Id.*
[54] *Id.* at 71-72.
[55] *Id.* at 72.
[56] 5/14/19 Hearing, VR 1:53:40 PM.
[57] *Electronic Application of Atmos Energy Corporation for an Adjustment of Rates*, Case No. 2018-00281, Order (Ky. PSC May 7, 2019) (holding that Atmos should continue using forecasted estimates for its pipeline replacement program and noting that the Commission has never before withdrawn approval of a forward-looking pipeline replacement mechanism in favor of historical recovery).
[58] Rowe Direct at 14-16.

### 3. EXCESS ADIT

While the most obvious impact of the TCJA is the reduction in KAWC's annual federal tax expense beginning in 2018 resulting from the federal corporate tax rate decrease from 35 percent to 21 percent, a related major impact is on the Company's Accumulated Deferred Income Taxes ("ADIT"). For over thirty years, KAWC's ADIT was calculated based on the 35 percent federal tax rate. With the TCJA's reduction of that rate to 21 percent, KAWC's estimated ADIT balance is in a net excess position, meaning that the Company's balance overstates the taxes that will be payable in the future related to prior operations of the Company. The Company has detailed its proposed return of TCJA and state tax reform benefits in the direct and rebuttal testimonies of Mr. Wilde and Ms. Schwarzell. Three issues are of paramount importance: (1) the treatment of plant in service related ADIT; (2) the classification of ADIT as "protected" or "unprotected"; and (3) the amortization period for unprotected excess ADIT. KAWC's proposal ensures that the excess ADIT is returned to customers in a manner that comports with Internal Revenue Service requirements and serves the long-term best interests of its customers.[59]

#### (a) KAWC's Proposal for Plant in Service Related ADIT is in the Long-Term Best Interests of Customers

KAWC proposes to use the Average Rate Assumption Method ("ARAM") to normalize all state and federal excess ADIT related to plant in service, and a 20-year amortization period for non-plant in service-related excess ADIT.[60] KAWC has used ARAM to normalize all excess ADIT related to plant in service because it is in the long-term best interests of its customers to do

[59] For both protected and unprotected excess ADIT, KAWC computed the normalization/amortization beginning from January 1, 2018, the effective date of the TCJA and HB 487. For the period from January 1, 2018 until the start of the forecast year for this case (the "stub period"), the amortization/normalization was treated as deferred, and the Company is proposing to amortize it over a three-year period beginning at the start of the forecast year. Rebuttal Testimony of John R. Wilde ("Wilde Rebuttal") at 4 (Ky. PSC Apr. 30, 2019).

[60] Wilde Rebuttal at 10.

so.[61] This excess ADIT is a permanent tax benefit accrued as a result of the Company making investments in plant in service and claiming tax deductions in excess of book at a time when the federal and state income tax rates were higher. KAWC believes this permanent difference, which relates to the deduction of costs not yet recovered in rates from customers, should be returned to those customers who will be required to pay the costs of the plant to which those permanent differences and associated tax benefits relate.[62] In other words, as Mr. Wilde explained on the stand, the permanent savings should be shared by all customers that will use that plant over its life.[63] The use of ARAM closely aligns the normalization of these permanent differences to the investment that gave rise to the benefit, and thus to the customers who will bear the cost of that investment over its life.[64] Furthermore, the use of ARAM will lower the total cost of capital recovered from customers over the underlying useful life of the plant in service investment.[65] The use of ARAM also will add to the stability of cost of service rates over the useful life of the property.[66]

On the other hand, severing the amortization of excess ADIT from the related plant in service, as Mr. Kollen recommends, will *increase* cost of service recovered from customers over the life of the property, distribute a tax benefit to customers that is disproportionate to the cost to which the benefit relates, and thus benefit customers during the abbreviated amortization period to the detriment of customers who continue to pay for these investments over the property's remaining useful life.[67]

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[61] *Id.* at 10-11.
[62] *Id.* at 11.
[63] 5/13/19 Hearing, VR 4:36:07 PM ("The permanent savings should be shared by all customers that will use that plant over its life.").
[64] Wilde Rebuttal at 11.
[65] *Id.*
[66] *Id.*
[67] *Id.*

In addition to creating these inter-generational inequities, accelerating the period of amortization would decrease cash flow from operations, requiring additional debt and potentially equity financing.[68] As Witness Ann Bulkley explains in her rebuttal, this would potentially have an even greater negative impact on American Water's credit rating and weaken KAWC's ability to attract and acquire discretionary capital than the TCJA has had to date.[69] Conversely, amortizing plant-related excess ADIT pursuant to ARAM (and amortizing non-plant related excess ADIT over 20 years) will mitigate the impact of a decreased cash flow;[70] and the benefit of that preserved cash flow will be given to customers, rather than reflected in increased earnings per share, through the corresponding reduction of rate base.[71]

(b) **<u>KAWC's Protected vs. Unprotected ADIT Proposal Comports with Internal Revenue Service Requirements</u>**

KAWC's proposal ensures that the excess ADIT is returned to customers in a manner that comports with Internal Revenue Service requirements. As Mr. Kollen recognizes, the TCJA contains strict requirements that ADIT that is considered "protected" cannot be amortized more quickly than the underlying temporary differences would have reversed.[72] Protected excess ADIT must be amortized using ARAM. Failure to use ARAM could result in IRS normalization violations. As stated above, KAWC has used ARAM to determine the amortization periods for all plant in service-related excess ADIT, not just protected federal excess ADIT, because it

[68] *Id.*
[69] Bulkley Rebuttal at 66-67.
[70] *See* Wilde Rebuttal at 11-12.
[71] 5/13/19 Hearing, 4:37:13 PM (Examination of Wilde).
"Q: It's a benefit to the company in terms of cash flow, correct, the longer it is an asset?
A: But the benefit of that cash flow is given to customers by a reduction in rate base.
Q: So there's no benefit to cash flow in earnings per share for the utility?
A: So the earnings per share would actually be better if you paid it back faster because you'd increase rate base."
[72] Direct Testimony of Lane Kollen ("Kollen Direct") at 33 (Ky. PSC Mar. 15, 2019).

believes it is in the long-term best interests of its customers to do so.[73] In addition, because there is uncertainty from the IRS about whether certain items can be considered "unprotected," this approach also avoids the risk of a normalization violation.

Particularly in dispute is the Company's treatment of plant in service-related excess ADIT balances related to repairs deductions. Mr. Kollen argues that these excess ADIT balances should be treated as unprotected and amortized over three years.[74] KAWC believes it should, consistent with the reading of its IRS Consent Agreement, treat all of these excess ADIT balances as protected.[75] First, failure to use ARAM to normalize the excess ADIT related to repairs could result in a violation of the Company's IRS Consent Agreement.[76] Second, Mr. Kollen's recommendation could result in a normalization violation apart from the Consent Agreement. One of the tax repairs balances flows from previously-claimed accelerated tax depreciation including bonus depreciation and thus appears to fit even Mr. Kollen's narrow test for "protected" ADIT.[77] Third, Kentucky American believes the use of ARAM to determine the amortization of plant in service-related excess ADIT is in the long-term best interests of its customers.

As Mr. Wilde describes in his rebuttal testimony, KAWC is concerned that if it fails to treat any of these excess ADIT balances as protected, it could be subject to expensive normalization violations and lose favorable accounting treatment, to the detriment of its customers.[78] KAWC suspects that uncertainty related to the application of its Consent Agreement will be addressed within the next 6-18 months as a result of additional IRS guidance

[73] Wilde Rebuttal at 4.
[74] Kollen Direct at 35.
[75] Wilde Rebuttal at 6.
[76] *Id.* at 13-15.
[77] *Id.* at 6, 13. This balance is labeled 1012 Fed – Repair M/L on Attachment JRW-4R.
[78] *Id.* at 18.

becoming available.[79] As a matter of prudence, KAWC suggests the Commission should wait for the uncertainty to be addressed and allow KAWC to treat these excess ADIT balances as protected in the interim. If the IRS advises that the plant in service-related excess ADIT balances related to repairs and other uncertain items may be treated as unprotected, the Commission could consider a method of isolating those excess amounts and returning all unprotected plant in service excess ADIT using a method and life other than ARAM without the threat of a normalization violation. Customers will not be harmed in the interim because ADIT is a deduction from rate base, and customers will continue to pay rates based on the lower rate base.[80] Such an approach is in the best interest of customers.

(c) **<u>KAWC's Unprotected Excess ADIT Should be Amortized Over a 20-Year Period</u>**

The TCJA does not require a certain amortization period for unprotected excess ADIT. The Company has advocated that unprotected excess ADIT be amortized over a 20-year period.[81] The direct and rebuttal testimony of Mr. Wilde and the rebuttal testimony of Ms. Schwarzell demonstrate the appropriateness of this period.

First, a 20-year period is consistent with the life of the underlying assets and liabilities.[82] These excess ADIT balances are related to deductions claimed with respect to three primary types of assets and liabilities: regulated deferred assets and liabilities, plant not yet in service or plant related amounts subject to refund, and assets and liabilities related to providing employee benefit programs.[83] The vast majority of the excess ADIT balances that fall into these categories would be associated with assets and liabilities that will reverse over periods greater than 15

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[79] *Id.* at 13.
[80] Direct Testimony of John R. Wilde ("Wilde Direct") at 14 (Ky. PSC Nov. 28, 2018).
[81] Wilde Rebuttal at 11-12.
[82] *Id.* at 12.
[83] *Id.*

years, with a substantial portion reversing over 30 years.[84] Thus, it is reasonable to match the reversal or recovery period of the incurred costs that gave rise to the excess ADIT to the period the excess ADIT tax benefit is amortized.[85]

Second, a 20-year amortization period minimizes the rate shock at the end of the amortization period as well as the potential impact the resulting negative cash flow from operations could have on KAWC's cost of capital.[86]

Third, and perhaps most importantly, the Commission has considered the appropriate amortization period for unprotected excess ADIT and approved amortization periods similar to KAWC's proposed amortization period. The Commission approved unprotected excess ADIT amortization periods of 18 years for Kentucky Power Company,[87] 15 years for Kentucky Utilities and Louisville Gas and Electric Company,[88] 15 years for Delta,[89] and 10 years for Duke.[90] KAWC's proposed 20-year amortization period is consistent with these decisions.

Mr. Kollen recommends that all unprotected excess ADIT be amortized over only three years. Mr. Kollen offers no rationale for his recommendation, which is a drastic departure from the Commission's recently approved amortization periods for other utilities, other than the three-

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[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Kentucky Industrial Utility Customers, Inc. v. Kentucky Power Company*, Case No. 2018-00035, Order (Ky. PSC June 28, 2018); *see also* Mr. Kollen's hearing admission as to this amortization period (5/14/19 Hearing, VR 12:02:57 PM).
[88] *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Company and Louisville Gas and Electric Company*, Case No. 2018-00034, Order (Ky. PSC Sep. 28, 2018); *see also* Mr. Kollen's hearing admission as to this amortization period (5/14/19 Hearing, VR 12:04:40 PM).
[89] *Electronic Investigation of the Impact of the Tax Cuts and Jobs Act on the Rates of Delta Natural Gas Company, Inc.*, Case No. 2018-00040, Order (Ky. PSC Sep. 21, 2018); *see also* Mr. Kollen's hearing admission as to this amortization period (5/14/19 Hearing, VR 12:05:30 PM).
[90] *Kentucky Industrial Utility Customers, Inc. v. Duke Energy Kentucky, Inc.*, Case No. 2018-00036; *Electronic Application of Duke Energy Kentucky, Inc. for: 1) An Adjustment of the Electric Rates; 2) Approval of an Environmental Compliance Plan and Surcharge Mechanism; 3) Approval of New Tariffs; 4) Approval of Accounting Practices to Establish Regulatory Assets and Liabilities; and 5) All Other Required Approvals and Relief*, Case No. 2017-00321, Order (Ky. PSC Apr. 13, 2018).

year period is "consistent with the Company's proposed amortization period for rate case expenses."[91] Amortizing rate case expenses over three years has nothing to do with the appropriate period to amortize excess ADIT tax benefits that accrued as a matter of investing in utility property. When questioned about the Commission's approval of amortization periods drastically longer than three years, Mr. Kollen replied that certain approvals were the result of settlements.[92] But even when approving settlements, the Commission has explicitly reviewed and approved the reasonableness of amortization periods.[93]

As Ms. Schwarzell explains, Mr. Kollen's proposal would harm KAWC's customers' interests in at least five different ways. First, a three-year amortization creates generational inequities.[94] It distributes all of the excess deferred tax benefit associated with long-lived plant to just three years of customers. This means that future generations of customers will be paying for the plant but not getting the associated tax benefit. Second, flowing back excess ADIT over such a short term consumes limited capital that could be used for replacement of aging water treatment and distribution infrastructure, as well as other investments in the provision of water service.[95] This rapid flow back could result in fewer investments in the near term, as limited capital allocations must be diverted to flowback of excess ADIT. Moreover, since liabilities on the balance sheet are not cash, the accelerated flowback of excess ADIT liabilities will have to be financed, thus consuming additional funds that could be used for infrastructure replacement.

Third, as Ms. Bulkley explains in her rebuttal testimony, Mr. Kollen's proposal, together with that of AG/LFUCG Witness Mr. Baudino's ROE recommendation, will serve to weaken

[91] Kollen Direct at 39.
[92] 5/14/19 Hearing, VR 12:04:30 PM.
[93] 5/14/19 Hearing, VR 1:14:00 PM.
[94] Schwarzell Rebuttal at 15.
[95] *Id.*

KAWC's cash flow metrics and adversely affect the Company's ability to attract discretionary capital, which would in turn be viewed as credit negative for American Water.[96] Fourth, the rapid flowback of excess ADIT over three years would distort price signals and thus undermine water efficiency efforts.[97] By artificially deflating the cost of water service, customers would not receive accurate messages about how to budget for and use water resources efficiently.

Fifth, when excess ADIT is returned to customers over the course of just a few years, a few things happen that set up conditions for a rate spike.[98] The biggest driver is that the immediate rate relief is temporary and causes a need for a rate increase upon expiration. Additionally, excess ADIT flowback increases rate base, and this compounds the looming revenue requirement spike. If Mr. Kollen's recommendation of a three year flowback for these items were adopted (and his figures were used), a rate spike of approximately $4 million would be necessary upon the expiration of the three year flowback.[99] This could force the filing of a rate case for no reason other than to reset the excess ADIT credit. It could also cause unnecessary and difficult to understand swings in customer bills.[100]

The Commission should reject Mr. Kollen's proposed amortization period for unprotected excess ADIT and approve the Company's recommended 20-year period.

### 4. KAWC'S WORKING CAPITAL CALCULATIONS SHOULD BE ACCEPTED BECAUSE MR. KOLLEN'S ADJUSTMENTS ARE UNREASONABLE AND CONTRARY TO COMMISSION PRECEDENT

KAWC proposed to include $3,754,000 of working capital in its rate base,[101] which was increased in the Base Period Update to $3,961,000.[102] Working capital is included in a utility's

[96] *Id.*
[97] *Id.* at 16.
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] Direct Testimony of Melissa L. Schwarzell ("Schwarzell Direct") at 25 (Ky. PSC Nov. 28, 2018).

rate base to recognize the cost of funding the lag between the provision of utility service and the time it takes to collect revenues from customers to pay for that service.[103] Thus, working capital represents the amount of investor-supplied resources that fund the daily operations of the business.[104] The Company calculates the appropriate amount of forecasted working capital by utilizing a lead/lag study, which was based on historical data for the twelve months ending August 31, 2018.[105]

Mr. Kollen, on behalf of the AG and LFUCG, alleges that KAWC overstated working capital and proposes three adjustments: (1) removing non-cash items from working capital; (2) retaining net income in working capital if it is used to pay dividends and imputing 134 lag days; and (3) imputing lag days on support services expenses.[106]

Mr. Kollen's adjustment to eliminate non-cash items from the calculation of working capital has repeatedly been proposed by the AG and rejected by the Commission in numerous KAWC rate cases for over 30 years:

- In **Case No. 92-452**, the AG recommended exclusion of all non-cash items from working capital.[107] The Commission denied the adjustment and described KAWC's methodology as "theoretically sound."[108]
- In **Case No. 95-554**, the AG proposed the exclusion of net income from working capital.[109] The Commission denied the adjustment and noted it did not accept the AG's same adjustment in Case No. 92-452.[110]

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102 Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
103 Schwarzell Direct at 19.
104 *Id.* at 19-20.
105 *Id.* at 20.
106 Kollen Direct at 13; Schwarzell Rebuttal at 7.
107 *Notice of Adjustment of the Rates of Kentucky-American Water Company*, Case No. 92-452, Order (Ky. PSC Nov. 19, 1993).
108 *Id.* at 20.

- In **Case No. 97-034**, the AG proposed the exclusion of depreciation expense and deferred income tax expense from working capital.[111] The Commission denied those adjustments.[112]
- In **Case No. 2004-00103**, the AG proposed the exclusion of depreciation expense from working capital.[113] The Commission denied the adjustment, stating that it "continues to hold its position as stated in previous Orders . . . ."[114]
- In **Case No. 2008-00427**, an AG witness stated in direct testimony that he disagreed with the inclusion of non-cash items and net earnings in calculating working capital, but did not propose an adjustment to remove these items because of the Commission's prior orders.[115]
- In **Case No. 2010-00036**, an AG witness stated in direct testimony that he took issue with the inclusion of non-cash items in calculating working capital, but did not propose exclusion of these items because the Commission has accepted this practice in previous rate proceedings.[116]
- In **Case No. 2012-00520**, the AG argued that non-cash expenses and common equity profits should not be included in the calculation working capital.[117] The

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[109] *Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 95-554, Order (Ky. PSC Sept. 11, 1996).
[110] *Id.* at 23-24.
[111] *Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 97-034, Order (Ky. PSC Sept. 30, 1997).
[112] *Id.* at 27-28.
[113] *Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, Order (Ky. PSC Feb. 28, 2005).
[114] *Id.* at 17.
[115] *Notice of Adjustment of the Rates of Kentucky-American Water Company Effective On and After November 30, 2008*, Case No. 2008-00427, Direct Testimony and Exhibits of Robert J. Henkes at 9-10 (Ky. PSC Feb. 23, 2009).
[116] *Application of Kentucky-American Water Company for an Adjustment of Rates On and After March 28, 2010*, Case No. 2010-00036, Direct Testimony of Ralph C. Smith at 17-18 (Ky. PSC June 11, 2010).
[117] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 13 (Ky. PSC Oct. 25, 2013).

Commission denied the adjustment, noting that "the AG has consistently presented, and the Commission has consistently refused to adopt, his argument regarding working capital."[118]

- In **Case No. 2015-00418**, an AG witness stated in direct testimony that she disagreed with the inclusion of non-cash items in calculating working capital, but did not propose removal of these items because the Commission permitted such components in past cases.[119]

The Commission has thus rejected the AG's adjustments to remove various non-cash items from KAWC's working capital calculation in ***five rate cases***, and the AG didn't propose such an adjustment in the remaining three rate cases cited above. At the hearing, Mr. Kollen admitted that the Commission has consistently rejected the exclusion of non-cash items in KAWC's working capital calculation.[120] When this issue was litigated most recently, the Commission affirmed KAWC's position again, explaining: "Kentucky-American's lead/lag study uses the methodology that the Commission has generally accepted since 1983."[121] The Company's lead/lag study proposed in this case follows the same process that the Commission has consistently approved. Nevertheless, Mr. Kollen has proposed to remove the non-cash items from KAWC's rate base by restating the very argument that this Commission has repeatedly rejected, which is that non-cash items are not necessary to fund the Company's daily operations. Because Mr. Kollen has provided neither a novel nor principled basis to reverse the

[118] *Id.* at 14.
[119] *Application of Kentucky-American Water Company for an Adjustment of Rates*, Case No. 2015-00418, Direct Testimony of Andrea C. Crane (Ky. PSC May 9, 2016).
[120] 5/14/19 Hearing, VR 11:40:00 AM; 5/14/19 Hearing, VR 11:47:30 AM; 5/14/19 Hearing, VR 11:48:45 AM.
[121] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 14 (Ky. PSC Oct. 25, 2013).

Commission's long-standing position with respect to this issue, KAWC respectfully requests the Commission deny Mr. Kollen's adjustment to the cash working capital calculation.

Two of the non-cash items that Mr. Kollen argues should be excluded from the working capital calculation are depreciation and deferred income tax. If depreciation and deferred taxes are not included in the working capital calculation, the Company does not have the opportunity to earn a full return on its investment. The Commission has explained that "depreciation expense represents the recovery of prior plant investment from the customers over the respective plant lives. But there is a considerable delay in the recovery of these depreciation charges from the customers."[122] The Commission further recognized that if "depreciation expense lag is not reflected in rate base, investors will not have an opportunity to earn a return on their full investment."[123]

Mr. Kollen also proposes to treat net income differently depending on how the Company elects to use it. This position is misguided; as the Commission stated in Case No. 92-452, "Investors are entitled to receive a return on their reinvested earnings on a daily basis" and "net earnings are earned when customer service is provided, and become the property of the stockholders. This requires that a cash working capital requirement should be recognized for the lag in receipt of operating income."[124] In contrast, Mr. Kollen implies that there are an "infinite number of expense lag days" that shareholders can wait for their cash return.[125] He further argues that if the Company pays a portion of net income out in periodic dividends, this net income can be treated differently and should have 134 lag days applied to it. These positions too

[122] *Notice of Adjustment of the Rates of Kentucky-American Water Company*, Case No. 92-452, Order at 18 (Ky. PSC Nov. 19, 1993).
[123] *Id.*
[124] *Id.* at 20.
[125] Kollen Direct at 14.

are misguided. The Commission has found that investors are entitled to a return when service is rendered and are entitled to daily reinvestment of the earnings. The cash is expected as soon as the service is rendered. How the Company finances its ongoing operations, relative to dividend payment (or share buyback, debt repayment, or debt and equity issuance), is purely a financing decision that has no effect on whether or not a cash return is expected at the time that service is rendered. The AG and LFUCG position on net income in working capital continues to conflict with Commission precedent, is unreasonable, and should again be rejected.

Mr. Kollen also argues that 45.63 lag days should be applied to American Water Works Service Company, Inc. ("Service Company") expense, despite recognition that KAWC prepays for services rendered by the Service Company. He contends that prepayment of the Service Company bill is not a reasonable provision for an affiliate agreement and that the prepayment results in excessive working capital cost, because it is reflected at KAWC's full cost of capital rather than a lower short term debt rate that could be used by the Service Company. He also contends that the estimation process is not accurate and causes harm.

Prepayment of the at-cost Service Company bill is a reasonable provision to support cash expenses and payroll incurred on behalf of KAWC. The Service Company exists to provide services to American Water affiliates at cost.[126] The Service Company makes no profit from the provision of these services.[127] In fact, even any interest income attributable to KAWC's prepayments flows back to KAWC.[128] The Service Company's billing terms are meant to match

[126] Schwarzell Rebuttal at 11.
[127] *Id.*
[128] 5/14/19 Hearing, VR 9:09:35 AM. *See also* Response to AG 1-2, which shows a $39,699 credit to KAWC's Service Company expense for some net working capital for the Service Company. This reduction to KAWC's cost of service is provided to customers in this proceeding and represents the net effect of prepayment.

expenses with the receipt of payments from affiliates which are the beneficiaries of the services.[129]

Additionally, the Service Company invoices are trued-up the month after services are rendered.[130] Affiliates are provided charge details that give them the ability to scrutinize the bills.[131] The Service Company billing practice does not interfere with normal management controls and produces an overall reasonable billing result.[132] Mr. Kollen's proposed adjustment would require an offsetting adjustment to Service Company expense, which he does not offer, and which, consequently, would unreasonably deprive the Company of recovery for this cost.

Mr. Kollen's proposed adjustments to working capital are unreasonable and conflict with Commission precedent and accordingly should be denied.

**5. KAWC'S SLIPPAGE CALCULATION SHOULD BE APPROVED BECAUSE MR. KOLLEN'S ADJUSTMENT IGNORES CRITICAL CAPITAL SPENDING KAWC HAS UNDERTAKEN**

In its Base Period Update, KAWC revised its revenue requirement to apply the slippage factor addressed in response to Item No. 3 of the Commission Staff's Second Request for Information.[133] This slippage information is also presented in Exhibit 1 to Mr. O'Neill's rebuttal testimony. Specifically, KAWC applied the slippage factors of 110.46 percent to all recurring capital expenditure projects, and a slippage factor of 91.08 percent to all investment project expenditures.[134] Cumulatively, KAWC is proposing a slippage factor of 101.89 percent, which is unequivocal proof of the accuracy of KAWC's management of its capital budget.

On the issue of slippage, the Commission has explained:

[129] Schwarzell Rebuttal at 11.
[130] *Id.*
[131] *Id.*
[132] *Id.* at 11-13.
[133] *Id.* at 3; O'Neill Rebuttal at 8.
[134] O'Neill Rebuttal at 4, 8.

> As part of the capital budgeting process, utilities will estimate the level of capital construction that will be undertaken during the year. Because of delays, weather conditions, or other events, the actual level of construction will often vary from the level budgeted. The difference between the actual and budgeted levels is reflected in the calculation of a "slippage factor," which serves as an indicator of the utility's accuracy in predicting the cost of its utility plant additions and when new plant will be placed into service.[135]

The slippage factor is normally applied to the utility plant in service balance and the CWIP balance to determine the slippage adjustment.[136]

The Commission has routinely applied a slippage factor in the forward-looking test period rate cases for KAWC.[137] KAWC's proposed slippage factor calculation follows the same process the Commission has historically used to calculate a slippage adjustment for KAWC by adjusting forecasted utility plant in service amounts to reflect 10-year historical trend percentages of actual-to-budgeted construction spending.[138] The Commission has stated: "The 10-year slippage factor is an average of the highs and lows that have occurred over time and it produces a more reliable estimate of the construction projects Kentucky-American will have in service or under construction in the forecasted period."[139] The Commission has consistently

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[135] *An Adjustment of the Gas Rates of the Union Light, Heat and Power Company*, Case No. 2005-00042, Order (Ky. PSC Dec. 22, 2005).
[136] *Id.*
[137] *See, e.g.*, *The Application of Kentucky-American Water Company to Increase its Rates*, Case No. 2000-00120, Order (Ky. PSC Nov. 27, 2000); *Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, Order (Ky. PSC Feb. 28, 2005).
[138] *See, e.g.*, *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 4-7 (Ky. PSC Oct. 25, 2013); *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2010-00036, Order at 4-7 (Ky. PSC Dec. 14, 2010); *Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, Order at 3-4 (Ky. PSC Feb. 28, 2005); *The Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 2000-120, Order at 2-4 (Ky. PSC Nov. 27, 2000); *The Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 97-034, Order at 3-7 (Ky. PSC Sep. 30, 1997); *The Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 95-554, Order at 2-3 (Ky. PSC Sep. 11, 1996); *Notice of Adjustment of Rates of Kentucky-American Water Company*, Case No. 92-452, Order at 9-11 (Ky. PSC Nov. 19, 1993).
[139] *The Application of Kentucky-American Water Company to Increase Its Rates*, Case No. 95-554, Order at 5 (Ky. PSC Sep. 11, 1996).

applied a slippage factor adjustment using this method, even when it results in an increase to Kentucky-American's forecasted utility plant in service.[140]

Mr. Kollen's proposed slippage calculation represents a drastic departure from the Commission's precedent and would ignore over $21 million in capital expenditures that no party or witness—including Mr. Kollen—contend is anything other than used and useful in providing service. Citing to ***his own exhibit*** as the basis for his contention that his calculation represents KAWC's slippage calculation, Mr. Kollen states that KAWC "calculated a slippage factor of 91.968 percent based on a comparison of the annual actual construction expenditures compared to the annual original construction budget for the years 2008 through 2017."[141] The critical error in Mr. Kollen's calculation is that he fails to compare KAWC's annual capital budget to KAWC's annual capital spend. Instead, he focuses on discrete projects that vary from their budgeted amount due to unexpected projects, delays, and cost increases or decreases. But, there can be no question that KAWC manages its annual budget prudently—101.89 percent over the past decade is strong evidence.

Mr. Kollen calculates his "slippage factor" by relying on the Company's response to Item 2 of Staff's Third Request, which is calculated from Item 1 of Staff's Third Request. In response to Item 1, the Company provided lists of construction projects for the calendar years 2008 through 2017 that eliminated construction projects that were approved by the Capital Investment Management Committee, but not included in the Company's original construction budgets. As the Company stated in response to Item 1, the information "reflect[s] only half of the equation

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[140] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 6-7 (Ky. PSC Oct. 25, 2013).
[141] Kollen Direct at 18.

when tradeoffs occur between projects" and "***the Company does not feel that the schedules reasonably reflect the variance between the budgeted and actual capital spend for a year***."[142]

The data used for Mr. Kollen's calculation only includes actual spend for projects that were originally identified on the Company's Strategic Capital Expenditure Plan. As Mr. O'Neill explained in his rebuttal testimony, the Company must reprioritize projects in its capital investment plan throughout the year due to changes in ongoing projects or unexpected expenditures. Certain projects must be reduced in priority and other projects must be given priority. Mr. Kollen's calculation ignores the expenditures on newly prioritized projects which is an unavoidable reality for a business such as KAWC.

The purpose of a slippage calculation is to compare budgeted spend to actual spend, not budgeted spend to some imaginary level of actual spend. Mr. Kollen and Mr. O'Neill use the same budget figures (with a de minimis exception in 2011 for $0.1 million.) It is the actual spend level that varies between Mr. Kollen and Mr. O'Neill's figures, as Mr. Kollen is ignoring $21 million of investment.[143] Mr. Kollen's calculation is not only incorrect, but also unnecessarily punitive. Mr. Kollen considers *all* budgeted projects, but only considers *some* projects to calculate spend. Thus, as the Company has explained, Mr. Kollen's slippage adjustment is illogical because it considers only half of the equation. Because the AG's objection is contrary to the Commission's prior orders and illogical, the Commission should follow its precedent and apply the slippage factor the Company has proposed that compares budgeted spend to *all* actual spend.

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[142] Response to PSC 3-1 (emphasis added).

[143] O'Neill Rebuttal at Exhibit 1. Exhibit 1 shows a variance between KAWC spend and AG/LFUCG observed spend of $21,326,253.

### 6. LABOR, COMPENSATION, AND BENEFITS

#### (a) **<u>KAWC's Performance Compensation Plans are Reasonable and Should be Approved</u>**

The Company's performance compensation plans align the interests of KAWC's customers, employees, and investors.[144] KAWC has shown throughout this proceeding that its total employee compensation, including base and performance pay, results in employee compensation levels that are at or below market medians.[145] Indeed, as Exhibit RVM-1 to his Direct Testimony, Mr. Mustich of Willis Towers Watson submitted his Total Remuneration Study which measured KAWC employee compensation against market medians. That study benchmarked KAWC compensation levels against utility and general industry sectors in both national and Midwest markets.[146] Mr. Mustich concluded that, with the *inclusion* of performance pay, KAWC employee compensation is twelve percent[147] *below* the national market median and eight percent[148] *below* the Midwest market median. And with the removal of performance pay, KAWC compensation is even lower than market medians (17 percent below national and 13 percent below Midwest).[149] Thus, performance pay is not in addition to KAWC employees' reasonable compensation; its inclusion makes KAWC employees' compensation reasonable.[150] By advocating for the removal of performance pay, Mr. Kollen is therefore proposing to disallow a reasonable, prudently-incurred operating expense.[151]

KAWC's performance-based compensation costs are not only reasonable, but also produce benefits to customers. First, the notion that financial metrics solely benefit investors is

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[144] Rebuttal Testimony of Kurt M. Kogler ("Kogler Rebuttal") at 13 (Ky. PSC Apr. 30, 2019).
[145] *Id.* at 17-19, 22-23.
[146] Direct Testimony of Robert V. Mustich ("Mustich Direct") at 5-9 (Ky. PSC Nov. 28, 2018).
[147] *Id.* at 6.
[148] *Id.* at 7.
[149] *Id.* at 7-8.
[150] *Id.* at 18.
[151] *Id.* at 23.

misguided. Achieving performance pay financial goals, such as targeted EPS performance, demands attention to operating efficiency. This ensures that employees at all levels of the organization remain focused on increasing efficiency, decreasing waste, and boosting overall productivity.[152] Overall, reducing operating costs through efficiency mitigates rate increases and benefits customers. In addition, where KAWC can reduce operating expenses, it can increase investment in infrastructure without increasing rates, because every dollar of operating expenses saved can fund approximately $8 of investment.[153] Mr. Kogler explained in his rebuttal testimony:

> Because water operations are capital-intensive and must constantly and consistently access the capital markets at reasonable costs, customers benefit when their utility has the financial health to do so. Having access to lower cost debt and internal funds to finance water infrastructure investment mitigates the financing costs that customers ultimately pay through rates. The availability of those sources of capital at reasonable costs, however, depends on the utility's financial performance, including credit and bond ratings. So it's important to focus utility employees on the financial health of the organization. Simply put, a financially healthy utility benefits customers because it enables the utility to meet its service obligations at reasonable financing costs, which can help the Company mitigate its requested rate increase.[154]

Mr. Kollen agreed that a financially healthy utility is in customers' best interest.[155]

Second, the Company's performance compensation plans contain tangible goals designed to measure and compensate employees for performance based on delivering clean, safe, reliable, and affordable water service and provide good customer service while doing so.[156] These operational components measure performance that can most directly influence safety (15

[152] *Id.*
[153] Kogler Rebuttal at 16.
[154] *Id.* at 16.
[155] AG-LFUCG Response to KAWC 1-49.
[156] Mustich Direct at 13.

percent), customer satisfaction (15 percent), drinking water quality (10 percent), and operational efficiency improvement (10 percent).[157] "For example, fewer OSHA incidents indicate improved safety for customers and employees. No one can credibly dispute the benefits of improved safety. Further, reduced accidents reduce the attendant costs—workers' compensation, damage repair, etc.—which mitigates the operating costs that customers pay through rates."[158] Mr. Kollen agreed that customers derive direct benefits from these key measures.[159] The West Virginia Public Service Commission recently allowed West-Virginia American Water Company to recover annual performance plan costs because the West Virginia Commission had been presented evidence that plans "that tie some portion of an employee's compensation to an employee's actual performance are prevalent in the compensation packages for larger businesses and has become the 'norm' for major utility companies," and the evidence showed that performance based compensation "is an integral part of the overall compensation plan," and that the "total compensation [was] at or near the market rate for each particular job or salary band."[160] The same is true for KAWC.

Mr. Kollen advocates for the total exclusion of the Company's performance-based compensation expense, but, in the exact case upon which Mr. Kollen relies, the Commission authorized a portion Kentucky Power's performance-based compensation expense. In Case No. 2014-00396 involving Kentucky Power, the Commission held:

> While the Commission agrees with the AG conceptually, we find that the amount that should be removed for ratemaking purposes should be based on the performance measures of the plan, not the funding measures. Among the funding measures, only 15 percent

[157] Direct Testimony of Kurt M. Kogler ("Kogler Direct") at 13 (Ky. PSC Nov. 28, 2018); The measures are also set forth at page 3 of the APP brochure (see attachment to PSC 1-33).
[158] Kogler Rebuttal at 13.
[159] AG-LFUCG Response to KAWC 1-44, 1-45, 1-46, 1-47, and 1-48.
[160] Case No. 15-0675-S-42T; Case No. 15-076-W-42T (W. Va. PSC Feb. 24, 2016).

> is based on financial performance. Accordingly, the Commission's adjustment removes only 15 percent . . . .[161]

Based on this Kentucky Power decision, at the very least, half of KAWC's performance-based compensation should be recoverable because it is based on performance measures.[162] However, as explained above, all of the Company's performance based compensation is what makes employees' compensation reasonable. Consequently, authorizing recovery of only half of the Company's performance based compensation expense still results in the disallowance of reasonable, prudently-incurred operating expenses.

Finally, it is irrelevant that performance compensation is not paid unless American Water achieves 90 percent of its EPS target because, again, that threshold is a *funding* measure, not a *performance* measure.[163] Besides, that particular funding measure is beneficial to customers in that it ensures that performance compensation is paid only when financial resources exist to do so, and, of course, a financially healthy utility is beneficial to customers. Because the entirety of KAWC's employee pay is reasonable, no portion of performance-based compensation expense should be disallowed.

(b) **<u>KAWC's Number of Full-Time Employees is Reasonable and Consistent with Commission Precedent</u>**

AG and LFUCG witness Mr. Kollen proposes a reduction in full time equivalent ("FTE") employees to reduce the revenue requirement by $0.492 million for payroll and payroll related expenses. Such a proposal ignores the fact that the Company's work must be completed by its available resources. KAWC has two methods by which it can present the cost structure to

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[161] *Application of Kentucky Power Company for: (1) A General Adjustment of its Rates for Electric Service; (2) An Order Approving its 2014 Environmental Compliance Plan; (3) An Order Approving its Tariffs and Riders; and (4) An Order Granting All Other Required Approvals and Relief*, Case No. 2014-00396, Order at 25-26 (Ky. PSC June 22, 2015).
[162] 5/13/19 Hearing, VR 11:09:00 AM.
[163] APP brochure at 3 (attachment to PSC 1-33).

accomplish its work: (1) assume no vacancies and reduce overtime, temporary, and contractor expenses accordingly or (2) assume a vacancy rate and include increased expenses for overtime, temporary, and contractor expenses to complete the work.[164] The Company has chosen the first method and presented its cost structure accordingly, including the reduction of overtime to only 16,000 hours in the forecast, compared to 27,500 hours in the historic period Mr. Kollen is examining.[165] Mr. Kollen, on the other hand, chose only a portion of the second methodology and reduced employee vacancies but did not provide for the corresponding increased overtime, temporary, or contract labor costs that would be incurred to accomplish the same level of work.

AG witnesses have proposed similar reductions in KAWC Case Nos. 1995-00554, 2004-00103, and 2010-00036. In those cases, the Commission upheld the Company's methodology and recognized that:

> If vacant employee positions exist, work will either be shifted to other employees and thus result in an increase in overtime costs or Kentucky-American will hire additional temporary/contract labor. Kentucky-American has shown that its forecasts for overtime and temporary/contract labor have been reduced to reflect a full workforce. The vacant employee positions to which the AG refers will result in decreased direct labor costs, but that decrease will be offset by increases in overtime or temporary labor costs.[166]

The Commission should continue to follow its precedent and approve the Company's projection of FTEs.

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[164] Rebuttal Testimony of James S. Pellock ("Pellock Rebuttal") at 1-2 (Ky. PSC Apr. 30, 2019).
[165] *Id.* at 3.
[166] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2010-00036, Order at 25 (Ky. PSC Dec. 14, 2010).

### (c) <u>**KAWC's Employee Benefits Expense is Reasonable**</u>

#### *(i) The Commission Should Not Reduce the Company's Retirement Plan Benefits*

Mr. Kollen recommends that the Company not be permitted to recover the costs of the 401(k) plan match for employees who also participate in the Company's defined benefit plan. He relies on the Commission's decisions in other rate cases that disallow matching 401(k) contributions for employees eligible for defined retirement plan benefits.

The Commission should not reduce the Company's retirement plan benefits. As the Company explained in Mr. Kogler's rebuttal testimony, the Commission recently addressed this matter directly and rejected such a disallowance because the utility had demonstrated that it had taken steps to manage retirement benefits costs.[167] The Company has also taken significant steps to manage retirement benefits. First, the Company replaced its defined benefit plan for employees hired after January 1, 2006 with a defined contribution plan.[168] This locked the number of participants in the defined benefit plan.[169] In addition, the Company also froze accruals for union employees in 2001.[170] In 2014, no longer active, but vested, participants through American Water had a limited time opportunity to accept a lump sum distribution in lieu of their retirement annuity under the plan.[171] Additionally, in 2019, a lump sum benefit option was introduced into the defined benefit plan for remaining plan participants.[172] Administratively, the lump sum payment option reduces plan expenses and employer risk.[173] For example, for each employee that takes the lump sum option, the Company avoids incurring the expense

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[167] Kogler Rebuttal at 2.
[168] *Id.*at 3.
[169] *Id.*
[170] Response to PSC PH-10.
[171] Kogler Rebuttal at 3.
[172] *Id.*
[173] *Id.*

associated with the Pension Benefit Guarantee Corporation annual premium associated with each plan participant.[174]

The Company also reduced retiree medical benefit costs by eliminating the availability of retiree medical benefits for non-union new hires in 2002 and union new hires in 2006.[175] In addition to eliminating the availability of retiree medical benefits, the Company has also shifted to a fixed cost model for providing retiree medical benefit to eligible employees.[176] The Company has capped its pre-65 retiree medical coverage cost at the fixed 2018 level for each employee, and shifted its post-65 retiree medical coverage from a self-funded program to a fixed dollar amount whereby employees can use the benefit to purchase their own health coverage on the Medicare Supplemental Exchange.[177] Based on recent actuarial projections, the Company estimates that this shift to fixed retiree medical costs has reduced American Water's overall long-term obligation by $211.9 million and its annual 2018 expense by $33.5 million.[178]

*(ii) KAWC Has Proactively Managed Its Other Employee Benefits*

Kentucky-American has taken additional significant steps to manage its other employee benefit costs. The Company regularly compares benefit offerings to the market and strives to provide competitive and cost reasonable benefits. The testimony from Mr. Mustich and Mr. Willig of Willis Towers Watson demonstrate the reasonableness and competitiveness of the Company's overall compensation and benefits, and demonstrate that all of the Company's compensation and benefits are reasonable and well within the median paid to similarly situated employees of other utilities and businesses.

[174] *Id.* at 4.
[175] *Id.*
[176] *Id.*
[177] *Id.*
[178] *Id.*

American Water has been proactive in seeking change and improvements in how healthcare is delivered and the costs associated with providing health insurance to employees.[179] This includes offering high-deductible health plans and a telemedicine option, both of which lower overall health insurance program costs.[180] American Water also became a founding member of the Health Transformation Alliance in 2016 with the goals of creating higher quality care by identifying facilities and physicians that have better outcomes, using its purchasing power to keep costs down, and helping every employee become a more engaged customer.[181] KAWC has shown that it is proactive, and takes appropriate steps to control its benefit costs. The Company's benefit costs should be recovered in full.

### 7. KAWC'S RATE CASE EXPENSE AMORTIZATION AND SERVICE COMPANY FEES ARE REASONABLE AND CONSISTENT WITH KAWC'S METHODOLOGY IN PRIOR CASES

AG and LFUCG witness Mr. Kollen recommends that internal labor costs be excluded from the deferred rate case expense total because he asserts that (1) they are higher than in the Company's last rate case; (2) they are somehow disproportionate to the size of the requested increase; and (3) internal labor costs generally are not requested because the costs are not incremental. Rate case expense, like every other expense item, should be recoverable if it is reasonable and prudently incurred by the Company. As KAWC has documented, its rate case expenses are reasonable, prudent, and should be recoverable.[182]

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[179] *Id.*

[180] *Id.*

[181] *Id.* at 4-5.

[182] KAWC has requested that its rate case expense and the unamortized costs from KAWC's last depreciation study be amortized over three years. Pellock Rebuttal at 10. No intervenor has contested the use of a three-year amortization period. KAWC has also included an adjustment to depreciation expense that was recommended as a result of the depreciation study submitted in Case No. 2015-00418. This adjustment was proposed to be completed over five years, beginning in 2016. In order to realign the amortization with other proposed short term amortizations in this case, the Company proposes amortizing the remaining balance over three years. Schwarzell Rebuttal at 26. In addition, several O&M and tax issues are uncontested. Relatedly, KAWC has requested a fifteen-year

The fact that expenses may be higher than in past cases is not grounds for disallowing a prudently incurred cost. The Company takes seriously its obligation to support the requests it has made in this rate case filing, many of which raise complex issues for the Commission's consideration. To that end, the Company commissioned and submitted a compensation study and support services study. These analyses are prepared periodically, as appropriate, to support the Company's position in its rate case filing and to aid the Commission in fulfilling its responsibility to set just and reasonable rates based on substantial evidence. KAWC secured the services of Willis Towers Watson to conduct a competitive review of total remuneration levels and practices. In addition, KAWC procured the services of Baryenbruch & Company, LLC to perform a market comparison study for the cost of services provided by the Service Company. In Case No. 2015-00418, these studies were either less comprehensive or not included in the scope of work performed for the case.[183]

Mr. Kollen also asserts that the Company's rate case expense is somehow excessive compared to the size of the requested rate increase. He articulates no basis for such a claim. Mr. Kollen's recommendation simply advocates for an arbitrary disallowance of expenses that are prudently and reasonably incurred to present and support KAWC's rate case.

Finally, Mr. Kollen's assertion that internal support services labor costs are not incremental is incorrect. The Company uses the Service Company resources to support the preparation, filing, and litigation of a rate case as an alternative to KAWC staffing and maintaining its own in-house expertise for the full scope of all rate case filings. The cost of providing these services is directly charged to KAWC and not otherwise included in the Company's revenue requirement. Consequently, these are, in fact, incremental costs.

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amortization period for the requested new tank painting projects. Pellock Rebuttal at 11. This issue is uncontested.

[183] Pellock Rebuttal at 4-5.

As Ms. Schwarzell explained at the hearing, Service Company employees performing work specifically for an affiliate like KAWC use a charge code specifically designated to capture costs for the preparation and support of the rate case.[184] Such costs are charged directly to that affiliate and not allocated to other affiliate companies. When Service Company personnel are performing work that is not company specific, time and costs are compiled under a charge code that allocates such costs across affiliates.[185] This represents the support services element of operations and maintenance expense included in the Company's rate case filing.[186] If employees are charging time directly to a rate case or any other affiliate, those charges are not included in the amounts calculated and billed to KAWC for support services.[187] Importantly, KAWC is able to review and contest all fees from the Service Company.[188] Accordingly, the costs specific to the rate case filing from Service Company resources are incremental and should not be excluded from rate case expense.

### 8. A TWENTY PERCENT UNACCOUNTED-FOR WATER PERCENTAGE IS REASONABLE GIVEN KAWC'S EFFORTS

Mr. Kollen suggests that the Commission adjust the Company's production costs for unaccounted-for water above 15 percent.[189] Pursuant to 807 KAR 5:066, Section 6(3), the Commission is able to establish an alternative level of reasonable unaccounted-for water loss rather than make an adjustment to production costs incurred by the Company for unaccounted-for water loss above 15 percent. The Commission should approve the Company's proposed alternative unaccounted-for water level of 20 percent because the Company has aggressive plans in place to combat its water loss that it has demonstrated throughout this proceeding. Penalizing

[184] 5/14/19 Hearing, VR 9:48:50 AM.
[185] Pellock Rebuttal at 6.
[186] *Id.*
[187] *Id.*
[188] Response to LFUCG PH-12.
[189] Kollen Direct at 44-45.

the Company for production costs is counter-intuitive to KAWC's water loss reduction program.[190]

A 20 percent alternative level is appropriate because the Company's exceedance of the 15 percent level is a fairly recent phenomenon. For most of the past decade, from 2009 through 2015, the Company's unaccounted-for water remained below 15 percent of system delivery.[191] It rose to 15.69 percent in 2016, 18.86 percent in 2017, and 19.95 percent in 2018.[192] To combat its water loss levels, the Company continues to pursue a consistent main replacement infrastructure plan and a robust leak detection plan.[193] KAWC is increasing its efforts to reduce water loss through programs such as the proposed QIP to replace aging water mains.[194]

### 9. KAWC'S RECOMMENDED CAPITAL STRUCTURE AND RATE OF RETURN ARE REASONABLE

#### (a) **<u>KAWC's Capital Structure is Reasonable and Has Not Been Contested</u>**

KAWC proposed a rate-making capital structure is composed of 48.654 percent common equity, 49.324 percent long-term debt, 1.519 percent short-term debt, and 0.503 percent preferred stock.[195] The Company's expert witness, Ms. Ann Bulkley, explained that KAWC's proposed common equity ratio of 48.654 percent is below the mean equity ratios of the proxy groups, and is reasonable, if not conservative.[196] Both the AG and LFUCG, through its witness Mr. Baudino,

[190] KAWC showed in discovery that its non-revenue water is similar to the non-revenue water numbers for all American Water affiliates combined. Response to PSC PH-12.
[191] O'Neill Rebuttal at 17.
[192] *Id.*
[193] A copy of KAWC's plan for its Southern Division is attached to the O'Neill Rebuttal as Exhibit 2.
[194] O'Neill Rebuttal at 17.
[195] Exhibit 37, Schedule J-1; Direct Testimony of Ann E. Bulkley ("Bulkley Direct") at 76 (Ky. PSC Nov. 28, 2018).
[196] Bulkley Direct at 77-78.

used KAWC's filed thirteen-month average capital structure for the forecasted test year without adjustment.[197]

(b) **<u>KAWC's Short-Term and Long-Term Debt Rates Should be Approved</u>**

Mr. Kollen, on behalf of the AG and LFUCG, has proposed to adjust KAWC's short-term and long-term debt rates.[198] Specifically, Mr. Kollen proposed a lower short-term debt interest rate, as well as a lower long-term debt interest rate.[199] When it filed its Application, the Company used 3.274 percent as the short-term debt cost rate.[200] Mr. Kollen, however, used 2.68 percent in his direct testimony.[201] As explained in Mr. Rungren's rebuttal testimony, the Company revised its projected cost of short-term debt for the forecast period to 2.585 percent.[202] Thus, the Company has proposed a short-term debt rate lower than that proposed by Mr. Kollen.

Mr. Kollen recommended a long-term debt rate of 4.22 percent, which is lower than the 4.55 percent the Company calculated for the forecast period.[203] In his rebuttal testimony, Mr. Rungren updates the long-term interest rate to 4.16 percent.[204] Thus, the Company has proposed a short-term debt rate lower than that proposed by Mr. Kollen. Given that the Company has recommended short-term and long-term debt rates lower than Mr. Kollen, these issues are not in dispute and the Company's debt rates should be approved.

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[197] Baudino Direct at 36.
[198] Kollen Direct at 45-48.
[199] *Id.*
[200] Direct Testimony of Scott W. Rungren ("Rungren Direct") at 9 (Ky. PSC Nov. 28, 2018).
[201] Kollen Direct at 47.
[202] Rebuttal Testimony of Scott W. Rungren ("Rungren Rebuttal") at 4 (Ky. PSC Apr. 30, 2019).
[203] Kollen Direct at 47.
[204] Rungren Rebuttal at 5.

### (c) **<u>KAWC's Proposed Cost of Equity is Reasonable and Should be Approved</u>**

The differences in the recommended rates of return on equity ("ROE") sponsored by the parties in this case are significant. The Company recommends an ROE of 10.8 percent, and the AG/LFUCG recommends an ROE of 9.15 percent. The key consideration in determining the cost of equity is to ensure that the methodologies employed reasonably reflect investors' views of the financial markets in general and of the subject company (in the context of the proxy group) in particular.

The Company's ROE recommendation is estimated by using multiple analytical techniques that rely on market-based data to quantify investor expectations regarding required equity returns, adjusted for certain incremental costs and risks. Quantitative models produce a range of reasonable results from which the market-required ROE is selected. That selection is based on a comprehensive review of relevant data and information, and does not necessarily lend itself to a strict mathematical solution. The range recommended by Ms. Bulkley is 10.0 percent to 10.8 percent.[205]

The infirmities of the AG/LFUCG approach are based almost entirely on insupportably low Discounted Cash Flow ("DCF") results.[206] As set forth below, there are very serious consequences of entertaining a rate of return on equity as low as AG/LFUCG recommends. Instead, Ms. Bulkley's recommendation of 10.8 percent is the most reasonable presented and should be adopted.

[205] Bulkley Direct at 8
[206] Baudino Direct at 3.

(d) **Overview of Cost of Equity Recommendations**

*(i) The Company's Estimated Cost of Equity is Reasonable and Supported by Substantial Evidence*

Ms. Bulkley's analysis incorporates several equity estimation methods, including the Constant Growth DCF model and the Capital Asset Pricing Model ("CAPM") to groups of comparable risk companies, the Water Proxy Group ("WPG") and the Combined Utility Proxy Group ("CUPG").[207] Ms. Bulkley also considered the Value Line projected ROEs for the companies in the WPG, and a Constant Growth DCF analysis based on projected dividend yields and share prices. She also considered the Company's capital expenditure requirements and adjustment mechanisms as compared with the CUPG.

Ms. Bulkley established proxy groups of companies that are both publicly-traded and comparable to KAWC in certain fundamental business and financial respects to serve as "proxy" for purposes of the cost of equity estimation process.[208] The proxy companies all possess a set of operating and financial risk characteristics that are substantially comparable to KAWC, and therefore provide a reasonable basis for deriving the appropriate ROE.[209] Ms. Bulkley developed the WPG by first identifying U.S. utilities that Value Line classifies as Water Utilities and applying certain screening criteria.[210] Because of the trend towards consolidation in the utility industry and the resulting small number of companies available for inclusion in the WPG, Ms. Bulkley also developed a CUPG that includes water utilities and natural gas distribution

[207] Bulkley Direct at 4.
[208] *Id.* at 36.
[209] *Id.*
[210] *Id.* at 37-38.

companies.[211] Ms. Bulkley similarly developed the CUPG by identifying U.S. utilities that are classified by Value Line as natural gas and water utilities and applied screening criteria.[212]

Ms. Bulkley first applied the DCF valuation model. The DCF method is premised on the assumption that a stock's current price represents the present value of all expected future cash flows.[213] The Constant Growth DCF model requires the following assumptions: (1) a constant growth rate for earnings and dividends; (2) a stable dividend payout ratio; (3) a constant price-to-earnings ("P/E") ratio; and (4) a discount rate greater than the expected growth rate.[214] For the WPG, the mean Constant Growth DCF results range from 8.27 percent to 9.23 percent and the mean high Constant Growth DCF results are in the range of 10.64 percent to 11.30 percent.[215] For the CUPG, the mean Constant Growth DCF results range from 9.19 percent to 9.58 percent and the mean high Constant Growth DCF results are in the range of 11.70 percent to 11.85 percent.[216]

Ms. Bulkley also performed the CAPM method of estimating the cost of equity, which is a risk premium approach that estimates the cost of equity for a given security as a function of a risk-free return plus a risk premium to compensate investors for the non-diversifiable or "systematic" risk of that security.[217] To estimate her risk-free rate, Ms. Bulkley used (1) the current 30-day average yield of 30-year U.S. Treasury bonds; (2) the projected 30-year U.S. Treasury bond yield for 2018 through 2020; and (3) the projected 30-year U.S. Treasury bond yield for 2020 through 2024.[218] Ms. Bulkley used the average Beta coefficients for the

[211] *Id.* at 39.
[212] *Id.* at 42.
[213] *Id.* at 53.
[214] *Id.* at 54.
[215] *Id.* at 59.
[216] *Id.*
[217] *Id.* at 64.
[218] *Id.* at 65.

companies in the WUPG as reported by Value Line and Bloomberg.[219] She estimated the Market Risk Premium based on the expected total return on the S&P 500 Index less the 30-year Treasury bond yield.[220] Ms. Bulkley obtained a range of CAPM results for the Water and Combined Utility Proxy Groups of 11.31 percent to 13.28 percent.[221]

*(ii) AG's and LFUCG's Estimated Cost of Equity is Unreasonably Low and Does Not Reasonably Reflect Investors' Views of the Financial Markets in General and of KAWC in Particular*

The AG and LFUCG filed direct testimony regarding KAWC's return on equity through its jointly sponsored witness, Mr. Richard A. Baudino. Mr. Baudino reached this recommendation by performing a DCF analysis using the same proxy groups Ms. Bulkley used.[222] While Mr. Baudino investigated many cost of equity estimation methodologies, he disregards most of those estimates without cause and set his cost of equity range and recommendation at the low end of his analytical results based entirely on the mean and median result of his Constant Growth DCF analysis using the CUPG.[223] Although Mr. Baudino's DCF analyses establish a cost of equity that is within a range from 8.38 percent to 11.49 percent using the CUPG, Mr. Baudino arrived at an ROE recommendation of only 9.15 percent. As discussed in the testimony of Ms. Bulkley, recent market conditions have affected the results of the cost of equity estimation models.[224] As such, it is important to consider the results of multiple cost of equity estimation models in determining the appropriate ROE.[225]

Mr. Baudino's simple reliance on the mean and median Constant Growth DCF results is inconsistent with recent determinations of many regulatory agencies that have been working to

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[219] *Id.* at 66.
[220] *Id.*
[221] *Id.* at 68.
[222] Baudino Direct at 3.
[223] *Id.*
[224] Bulkley Direct at 12-23; 45-52.
[225] *Id.* at 45-47.

develop reasonable estimates of the investor expected return on equity. Utility commissions across the nation are struggling with this issue. Even though the DCF model is currently producing return estimates that are below 8.5 percent, utility regulators recognize that such low returns are not compensatory for investors. As discussed in the testimony of Company witness Ms. Bulkley, many regulatory commissions have considered the results of other cost of equity estimation models in addition to the DCF model to establish equity returns that more likely reflect investor expectations.

For example, the Federal Energy Regulatory Commission ("FERC") has recently begun applying equal weight to four cost of equity estimation methodologies: the DCF, CAPM, Risk Premium, and Expected Earnings methodology. Simply applying the FERC methodology to the proxy groups that have been considered in this case results in a mean return of 10.72 percent, which is within the range established by Ms. Bulkley.[226] In addition, the result from the FERC methodology is consistent with the range of authorized ROEs for water distribution companies for the period from 2016-2018, suggesting that regulators recognize that the DCF model may not produce reliable results in the current capital market environment and are relying on multiple ROE estimation methodologies. In fact, Mr. Baudino's recommendation is below most of the authorized ROEs for water utilities from 2012 to the end of 2018,[227] and Mr. Baudino has presented no evidence in this case to demonstrate that the risk profile of KAWC is lower than the vast majority of water utilities that have been authorized ROEs from 2012-2018.

When other methodologies are considered, the fact that Mr. Baudino's recommended ROE is unreasonably low becomes readily apparent. For example, even reasonable modifications to Mr. Baudino's own CAPM analysis demonstrate that the investor required return is

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[226] Bulkley Rebuttal at 4.
[227] *Id.* at 10-12.

substantially higher than the mean Constant Growth DCF analysis, suggesting that the appropriate range for the ROE is between the mean and mean high results of Mr. Baudino's Constant Growth DCF analysis. As Ms. Bulkley demonstrated, using investor expectations for the market return to estimate the Market Risk Premium, the range of results of the CAPM for the CUPG is between 9.67 percent and 11.13 percent with median results between 9.98 percent and 10.21 percent. Moreover, using the average of the modified versions of Mr. Baudino's DCF and CAPM analyses as well as the expected earnings and risk premium approaches, as has been recommended by the FERC, results in a range of 9.96 percent to 10.29 percent. These results are all well above the range of DCF results established by Mr. Baudino.[228]

(e) **Framework for Deciding the Company's Cost of Equity**

The United States Supreme Court's *Hope* and *Bluefield* decisions established the standards for determining the fairness or reasonableness of a utility's authorized ROE. Among the standards established by the Court in those cases are: (1) consistency with other businesses having similar or comparable risks; (2) adequacy of the return to support credit quality and access to capital; and (3) the principle that the specific means of arriving at a fair return are not important, only that the end result leads to just and reasonable rates.[229] In the oft-cited *Hope* decision, the United States Supreme Court stated:

> From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[230]

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[228] *Id.* at 5.
[229] Bulkley Direct at 10.
[230] *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944) (internal citations omitted).

These decisions set forth three standards,[231] each of which must be met in order for the return to be considered just and reasonable:

1) Comparable return standard

2) Financial integrity standard

3) Capital attraction standard

It is important to recognize that investors make rational decisions regarding investments of comparable risk and therefore if an investment does not receive a comparable return to other investments of similar risk, it will be difficult to attract capital.[232] While KAWC is an operating subsidiary of American Water, this principle is still upheld in that operating companies compete for discretionary capital from the parent company. An authorized return on equity for KAWC that fails to account for the financial risks of tax reform on cash flow metrics and is substantially below the returns of other operating companies would disadvantage KAWC in the allocation of that discretionary capital.[233]

Although Mr. Baudino claims to recognize the comparable return, financial integrity and capital attraction standards that are established by the United States Supreme Court in the *Hope* and *Bluefield* cases, he abandons these standards when establishing his range and ROE recommendation. These decisions determined that the authorized ROE must meet all three standards: financial integrity, capital attraction, and comparable returns. Mr. Baudino’s ROE recommendation of 9.15 percent does not provide a return on equity that is comparable to those

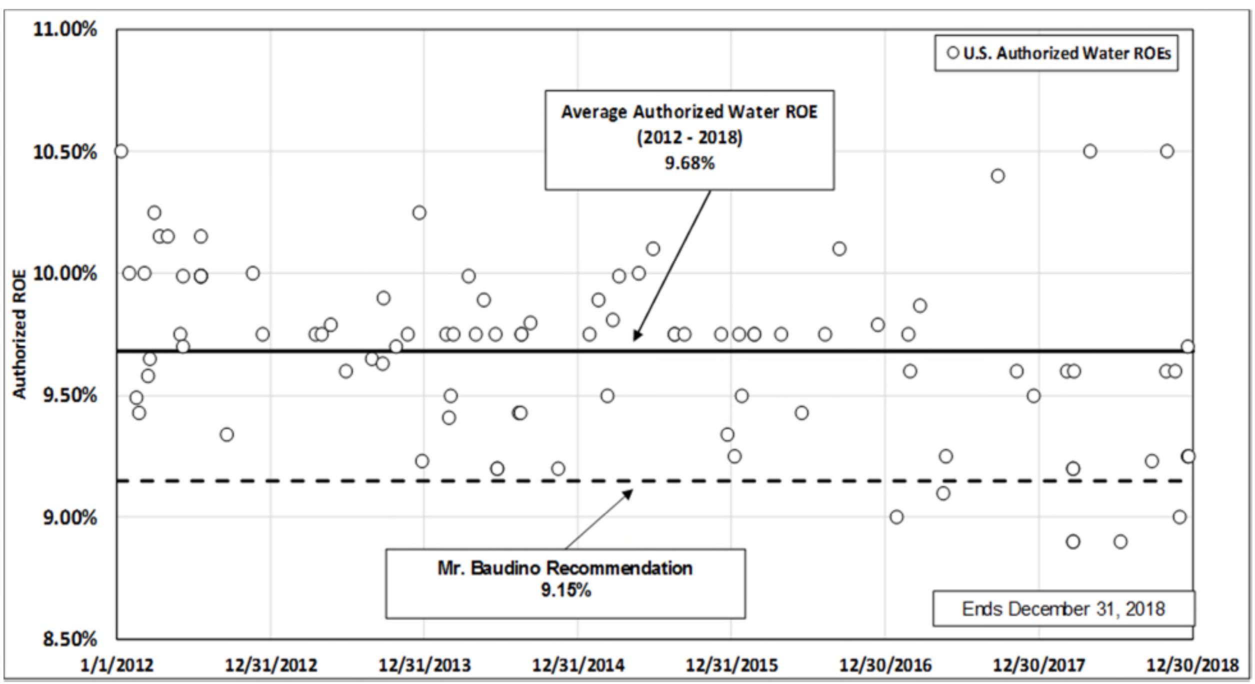
[231] Bulkley Direct at 12.
[232] Bulkley Rebuttal at 9; Rowe Rebuttal at 8-12
[233] Bulkley Rebuttal at 9-10; Rowe Rebuttal at 1-2.

available to investors in companies with commensurate risk and is not sufficient to allow KAWC to compete for capital with other similar risk firms.[234]

*(i) Comparable Return Standard*

Although rates of return on equity provided to utilities around the country are certainly not dispositive on this Commission, they do provide a valuable framework with which the issue of the Company's cost of equity can be evaluated and decided. A fundamental aspect of the financial regulation of utilities is assuring that the subject utility has a reasonable opportunity to earn a return on capital consistent with the return available on investments of similar risk. As shown below in Figure 1, the recommendations of the AG/LFUCG in this case are well below the norm.

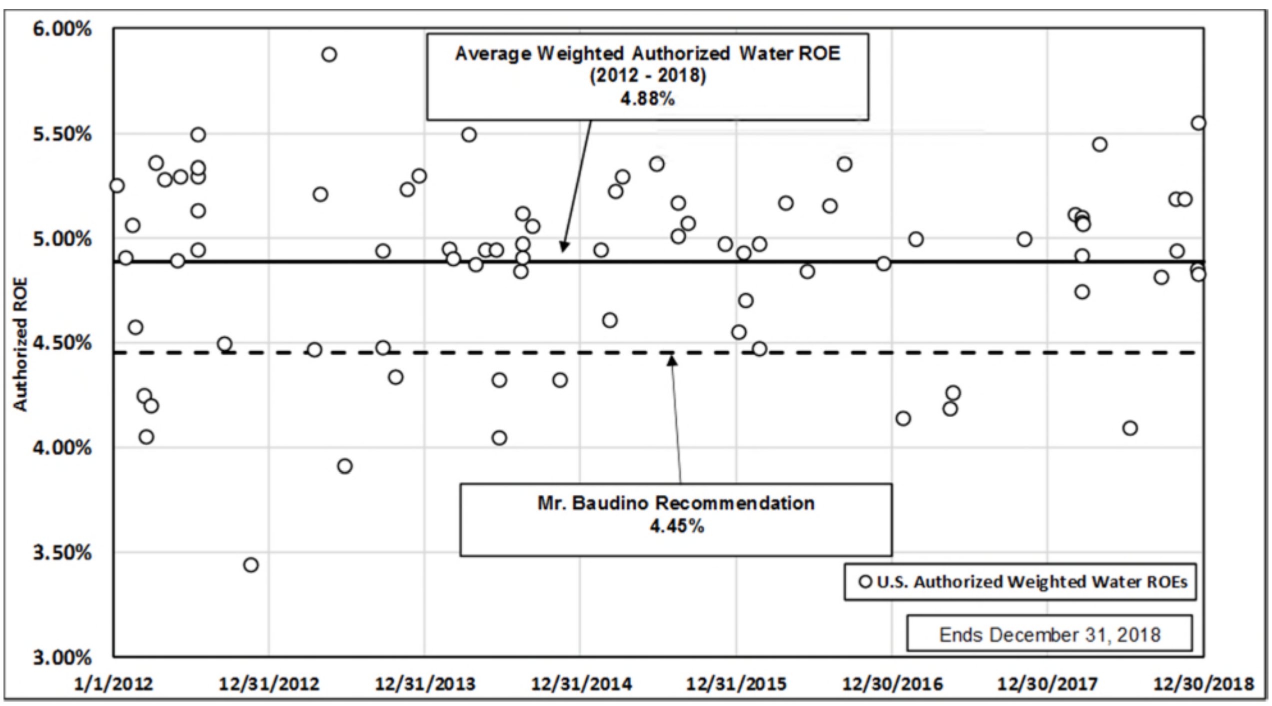
**Figure 1: Authorized ROEs from 2012-2018**[235]




234 Bulkley Rebuttal at 12.
235 *Id.*; Source: SNL Financial.

It also is important to consider authorized recommended ROE in conjunction with KAWC's equity ratio to determine whether it meets the comparable return standard.[236] A fundamental aspect of the financial regulation of utilities is assuring that the subject utility has a reasonable opportunity to earn a return on capital consistent with the return available on investments of similar risk. The equity return, the product of the ROE and the equity ratio, (i.e., the Weighted Return on Equity ("WROE")), ultimately defines the return to shareholders and the product of the cost of debt and the debt ratio ensures that a company's debt obligations are met. As shown below in Figure 2, the recommendations of the AG/LFUCG in this case are again well below the norm.

**Figure 2: Comparison of Mr. Baudino's recommended WROE and U.S. Authorized Weighted Equity Ratios for Water Utilities[237]**

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[236] Bulkley Rebuttal at 12-13.

[237] Id. at 15. Rate cases in Arkansas, Florida, Indiana, and Michigan have been excluded from Figure 2 since the authorized capital structure approved in the cases includes deferred taxes and other credits at zero or low cost. The additional items have the effect of reducing both the equity and debt ratios used to establish the rate of return which, in turn, produces results that are not comparable to allowed equity ratios in other states.

Taken together, the Company's proposed common equity ratio of 48.654 percent and Mr. Baudino's recommended ROE of 9.15 percent, results in a WROE of only 4.45 percent. As shown in Ms. Buckley's Attachment AEB-7-R, the average WROE of the operating subsidiaries of American Water, excluding KAWC, is 4.83 percent.[238] Mr. Baudino's proposed WROE, is below the WROE established for ten of the operating subsidiaries of American Water.[239] Based on this, it would be reasonable for American Water to allocate discretionary capital to two-thirds of the operating subsidiaries before considering discretionary spending for KAWC.[240]

*(ii) Financial Integrity Standard*

The recommendations of Messrs. Baudino and Kollen, taken together, fail to consider the overall risk related to the TCJA for utilities in general and KAWC, in particular, and demonstrate that Mr. Baudino's recommended ROE will adversely affect the financial risk of KAWC. Throughout 2018, the rating agencies identified the risks of tax reform on the cash flow metrics of specific utilities and the industry overall and downgraded the credit ratings of several companies based on the financial risk created by the TCJA. In January 2019, Moody's noted credit challenges for American Water based on increased leverage and cash flow leakage resulting from tax reform. In April, Moody's downgraded American Water from A3 to Baa1, citing concerns about increased leverage and cash flow leakage resulting from tax reform. Mr. Baudino's overall recommendation ignores this risk. At a time when the rating agencies have identified the need for constructive regulation that helps to stabilize cash flow for the utilities, including higher equity ratios and rates of return on equity, following the effects of the TCJA, Mr. Baudino is, inconsistently, recommending a reduction in the ROE. Mr. Kollen's

[238] *Id.* at AEB-7-R.
[239] *Id.* at 15-16.
[240] *Id*. at 16.

recommendation to amortize excess ADIT over a three-year period would further exacerbate the cash flow concerns identified by rating agencies.[241]

Furthermore, the recommendations of Messrs. Baudino and Kollen undermine two important strengths that were identified for American Water in the Moody's downgrade. Moody's indicated that one credit strength for American Water was the supportive regulatory environments that provide timely cost recovery mechanisms. In addition, Moody's projected that American Water would be able to maintain cash flow coverage ratios in excess of 15 percent.[242] Acceptance of Mr. Baudino's low recommended ROE, rejecting the proposed QIP, and accelerating the amortization of excess ADIT would further weaken the KAWC cash flow metrics, and would be viewed as credit negative.[243] The proposals offered by Messrs. Baudino and Kollen cannot be viewed as constructive regulation at a time when the American Water cash flow metrics are projected to be the weakest.

*(iii) Capital Attraction Standard*

Mr. Rowe explained how Mr. Baudino's recommended ROE would place KAWC at a disadvantage for securing capital from American Water.[244] The collective needs of the American Water utilities exceed available capital.[245] Capital needs for maintaining service quality and reliability in accordance with laws and regulations always get top priority.[246] The shareholder is committed to investing in projects necessary to maintain safe and adequate service. But the shareholder has the opportunity to invest in many discretionary projects, and available returns influence the shareholder's decision of where to invest discretionary funds. It does not make

[241] *Id.* at 67.
[242] *Id.* at 6.
[243] *Id.* at 6-7.
[244] Rowe Rebuttal at 9-10.
[245] *Id.* at 9.
[246] *Id.* at 10.

sense for the shareholder to invest discretionary capital in Kentucky if greater returns are available in other states.

The need for discretionary capital is real. The Company explained the confluence of factors contributing to the need to address aging water infrastructure in a more proactive, accelerated fashion.[247] This need exists throughout the United States. The subsidiaries with competitive authorized rates of return are more likely to attract the capital necessary to address these needs proactively.[248] Less competitive subsidiaries (like KAWC) will have to settle for what is needed to address these issues reactively.

American Water's customers in Kentucky have been provided with exceptional service and the Company has demonstrated the efficiency of its operations.[249] If the Company is to continue to provide such exceptional service and efficient operations, it must be provided with the continued means to do so. In considering the appropriate ROE for KAWC, it is important to note that the Company was only able to achieve its authorized ROE[250] once in the last nine years absent the sale or donation of its assets (such asset sales occurred in 2011, 2017, and 2018).[251] In 2011, 2017, and 2018, the Company's ROE would have been 8.9 percent, 8.9 percent, and 8.8 percent respectively without the asset divestitures. KAWC already has a low equity ratio relative to its water industry peers.[252] Acceptance of Mr. Baudino's low recommended ROE, rejecting the proposed QIP, and accelerating the amortization of excess ADIT would likely limit the

[247] *Id.* at 2-3.
[248] *Id.* at 8-11.
[249] Rowe Direct at 18-20.
[250] This statement presumes an authorized ROE of 9.7 percent was authorized in Case Nos. 2010-00036 and 2012-00520. No cost of equity was specifically authorized in Case No. 2015-00418.
[251] Schwarzell Rebuttal at 20. The one year that the Company achieved its authorized ROE without asset sales or donation was 2016. During 2016, dry weather prompted a spike in sales, as can be seen in the Company's Base Period Update, Exhibit 37, Schedule I-4.
[252] Bulkley Rebuttal at 8.

discretionary capital that is allocated to KAWC. Such a result would harm the Company, customers, and the Kentucky economy.[253]

KAWC, through the expert testimony of Ms. Bulkley, has shown that the range of reasonable market-required ROEs results is 10.0 percent to 10.8 percent.[254] KAWC also has shown that an ROE in the upper end of the zone of reasonableness is appropriate. KAWC respectfully requests the Commission likewise reject Mr. Baudino's unreasonably low ROE and instead adopt Ms. Bulkley's recommended ROE of 10.8 percent.

### 10. REMAINING RATE BASE ISSUES

#### (a) **<u>KAWC's Calculated Rate Base is Reasonable</u>**

KAWC calculated its rate base by utilizing a thirteen month average of projected plant and rate base as of the end of the forecast year, which is June 30, 2020.[255] Further, many of the rate base elements were analyzed from actual, per books data as of August 31, 2018,[256] and were later updated to include actual data through February 28, 2019.[257]

KAWC proposed $790,806,081 of Utility Plant in Service as a thirteen month average for the forecasted test year.[258] This amount was revised to $791,593,957 in the Base Period Update.[259] This was calculated through June 30, 2020, by adding net additions and retirements throughout the forecast period.[260] The thirteen month average was calculated to arrive at the utility plant balance for the forecasted test period.[261]

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[253] Rowe Rebuttal at 12.
[254] Bulkley Direct at 8; Bulkley Rebuttal at 72,
[255] Schwarzell Direct at 3.
[256] *Id.* at 3, 18.
[257] Base Period Update.
[258] KAWC Filing Exhibit 37, Schedule B-1, Page 2 of 2.
[259] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[260] Schwarzell Direct at 19.
[261] *Id.*

### (b) **<u>The Utility Plant Acquisition Adjustment KAWC Has Proposed is Proper</u>**

The Company proposed a Utility Plant Acquisition Adjustment ("UPAA") associated with its North Middletown acquisition of $225,195.[262] This was revised to $229,290 in the Base Period Update.[263] Although no party object to the proposed UPAA, KAWC emphasizes that it should be approved based on the fact that the proposed UPAA meets the Commission's requirements for such approval under the Commission's "Delta test"[264] or under the fair market value method KAWC proposed in Ms. Schwarzell's direct testimony.[265]

### (c) **<u>KAWC's Accumulated Depreciation Has Not Been Contested</u>**

KAWC developed the amount of accumulated depreciation to include in rate base by starting with the actual balance as of August 31, 2018.[266] The Company then adjusted the balance to account for plant retirements, salvage credits, and cost of removals.[267] Because KAWC last commissioned a full depreciation study in 2015, it did not perform a new study in this proceeding.[268] The Company used the depreciation rates from the 2015 depreciation study, which were adopted in the settlement in Case No. 2015-00418.[269]

After KAWC made its adjustments, the forecasted test year accumulation was calculated by averaging the month end accumulated depreciation balances from June 30, 2019 to June 30,

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[262] *Id.* at 21-22; KAWC Filing Exhibit 37, Schedule B-1, Page 2 of 2.
[263] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[264] In response to PSC 2-72 and PSC 3-49, Ms. Schwarzell provided a detailed explanation of how the proposed UPAA meets the Commission's factors of the "Delta test" set forth in Case No. 9059 involving Delta Natural Gas Company. As this issue is not contested, KAWC incorporates that explanation here.
[265] Schwarzell Direct at 29-30.
[266] *Id.* at 22.
[267] *Id.*
[268] *Id.*
[269] *Id.*

2020. The thirteen month average forecast for Accumulated Depreciation was calculated at $197,770,499.[270] This was revised to $197,811,983 in the Base Period Update.[271]

### (d) **<u>KAWC's Construction Work in Progress Has Not Been Contested</u>**

KAWC has requested the inclusion in rate base of $7,859,210 of construction work in progress ("CWIP").[272] The Company calculated CWIP by starting with the actual August 31, 2018 balance, and then adjusted for construction expenditures and transfers to Utility Plant in Service that are expected to occur through the forecasted test year.[273] This was revised to $7,947,078 in the Base Period Update.[274]

### (e) **<u>KAWC's Revised Contributions in Aid of Construction Calculation Has Not Been Contested</u>**

Also included in KAWC's forecasted test year rate base is an amount for Contributions in Aid of Construction ("CIAC"), which reflects non-refundable money or physical property that is received from third parties, and thus is not considered to be investor supplied capital.[275] Following the enactment of the TCJA in 2017, the Company had originally forecasted a gross-up of CIAC receipts in the test period.[276] Under this assumption, the Company collected gross-ups on developer contributions.[277] However, through discovery, Commission Staff brought to the Company's attention that Administrative Case No. 313 ordered Class A and Class B water utilities to use the "no gross-up" method for CIAC and customer advances.[278] The Company

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[270] KAWC Filing Exhibit 37, Schedule B-1, Page 2 of 2.
[271] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[272] Schwarzell Direct at 19.
[273] *Id.*
[274] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[275] Schwarzell Direct at 23.
[276] *Id.*
[277] Response to PSC 3-12.
[278] PSC 2-18; PSC 3-11; PSC 3-14; PSC 3-15.

ceased taking in gross-up for new contributions and has begun refunding gross-up contributions collected. These changes are now reflected in the Base Period Update.

KAWC calculates the CIAC balances by adjusting the prior months' account balances for activity related to contributions received and CIAC amortizations.[279] The forecasted thirteen month average balance when the application was filed was $73,319,577[280] which was revised to $72,211,322 in the Base Period Update.[281]

### (f) KAWC's Customer Advances Calculation Has Not Been Contested

Similar to CIAC, customer advances are a reduction to rate base for funds collected for new mains that are held in an account and refunded to the original customers as new customers tap onto a main.[282] Like CIAC, the Company originally grossed-up customer advances.[283] After learning that the Company should instead use the "no gross-up method" for customer advances, the Company stopped collecting gross-up for new customer advances and began refunding gross-up customer advances collected. The forecasted test year customer advances balance is based upon an average of the thirteen month end balances from June 2019 to June 2020, which was $13,508,680 when the application was filed,[284] and decreased to $12,466,299 in the Base Period Update.[285]

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[279] Schwarzell Direct at 23.
[280] *Id.*
[281] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[282] Schwarzell Direct at 23.
[283] *Id.*
[284] *Id.* at 24.
[285] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.

#### (g) **<u>KAWC's Deferred Income Taxes Calculation is Reasonable and Should be Approved</u>**

KAWC included $90,721,671 of deferred income taxes as a reduction to rate base in its application.[286] In the Base Period Update, this number was revised to $89,932,604.[287] This includes both the forecasted ADIT balance, as well as the forecasted balance of excess ADIT, which is a regulatory liability associated with changes in tax rates.[288]

Mr. Kollen proposes to reduce the Company's revenue requirement for excess ADIT amortization. As previously explained, Mr. Kollen's proposals regarding excess ADIT amortization should be rejected. A three-year amortization of unprotected, state, and repairs related excess ADIT would create intergenerational inequity, consume limited capital that could be used for infrastructure repairs, weaken KAWC's cash flow metrics, distort price signals, and reduce rate stability.[289]

Mr. Kollen also appears to omit reflecting a rate base offset for the flowback of excess deferred taxes.[290] Excess ADIT flowback must be financed and increases rate base; Mr. Kollen's adjustment fails to consider a corresponding rate base adjustment. Accordingly, Mr. Kollen's adjustments are unreasonable and should be rejected.

#### (h) **<u>KAWC's Deferred Investment Tax Credit Calculation Has Not Been Contested</u>**

KAWC calculated its deferred investment tax credit ("ITC") in accordance with its practice in previous cases.[291] The calculation is the average of the thirteen month-end balance of unamortized 3 percent ITCs for the forecasted year ending June 30, 2020, which is the end of the

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[286] Schwarzell Direct at 24.
[287] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[288] Schwarzell Direct at 24.
[289] *Id.* at 15-16.
[290] *Id.* at 14.
[291] *Id.* at 21.

forecasted test year.[292] The thirteen month average amount in the forecasted test year of 3 percent ITC is $10,001.[293] This amount was not revised in the Base Period Update.

(i) **<u>KAWC's Deferred Maintenance Calculation Has Not Been Contested</u>**

KAWC calculated the forecasted thirteen month average for deferred maintenance based upon both actual projects deferred and projects forecasted to be deferred.[294] The projects include the repainting and repairs of system water storage tanks, and other major repairs.[295] The types of expenses included in deferred maintenance are analogous to those that have been afforded base rate treatment in prior Commission proceedings.[296] The forecasted thirteen month average, adjusted for amortizations, for these deferred maintenance items is $11,816,493.[297] This average was increased to $13,402,763 Base Period Update.[298]

(j) **<u>KAWC's Deferred Debits Have Not Been Contested</u>**

KAWC is requesting a rate base addition of $1,198,681 for deferred debit items.[299] This figure was unchanged in the Base Period Update. These amounts are offset by corresponding deferred taxes.[300] The Company developed its thirteen month average for deferred debits in accordance with the practice previously recognized by the Commission in prior proceedings.[301]

(k) **<u>KAWC's Other Rate Base Elements Have Not Been Contested</u>**

The final adjustment KAWC proposes in its Application is for Other Rate Base Elements.[302] In Case No. 2010-00036, the Commission adjusted the Company's rate base for

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[292] *Id.*
[293] *Id.*
[294] *Id.*
[295] *Id.*
[296] *Id.*
[297] *Id.*
[298] Base Period Update, Exhibit 37, Schedule B-1, Page 2 of 2.
[299] Schwarzell Direct at 21.
[300] *Id.*
[301] *Id.*
[302] *Id.* at 25.

Contract Retentions; Unclaimed Extension Deposit Refunds; Retirement Work in Progress; and Accrued Pension.[303] Pursuant to this precedent, KAWC has calculated a rate base deduction of $14,660 for these items.[304] This amount was unchanged in the Base Period Update.

## 11. FORECASTED TEST YEAR REVENUES

### (a) **<u>KAWC's Residential, Commercial, and Industrial Consumption Forecasts are Reasonable and Have Not Been Contested</u>**

The Company's forecasted test year revenues were calculated by forecasting water usage meter counts, fire services, fire hydrants, and customer counts and multiplying these billing determinants by the Company's current water tariffs to derive present rate Water Revenue. In support of its Application, KAWC submitted Gregory Roach's testimony along with Mr. Roach's weather normalization study. No party has criticized or contested the results of his study which were used to project customer usage for the residential and commercial classes.[305] Present rate Other Revenue is based actual data for the twelve months ended August 31, 2018, with the exception of Late Fees which are forecasted based on a ratio of 0.92 percent of present rate revenue. Exhibit 37, Schedule C-1, shows present rate Water Revenue of $85,481,609 and present rate Other Revenue of $2,483,215. Exhibit 37, Schedule M provides further detail.

## 12. RATE ALLOCATION AND RATE DESIGN

### (a) **<u>KAWC's Cost of Service and Rate Design is Reasonable</u>**

To fairly allocate the proposed rate increase among KAWC's customer classes, Ms. Constance E. Heppenstall performed a cost of service allocation and rate design study for

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[303] *Id.*
[304] *Id.*
[305] Also uncontested is the reduction in the revenue requirement for Trane revenues. KAWC accepted Mr. Kollen's proposal to defer and amortize Trane revenues and to reduce the revenue requirement by $8,000. Schwarzell Rebuttal at 13-14.

KAWC.[306] The cost of service study allocated the total costs among the residential, commercial, industrial, public authority, sales for resale, private fire protection, and public fire protection customer classes.[307] The AG and LFUCG did not sponsor testimony regarding cost and service and rate design. Accordingly, the Company's cost of service and rate design should be approved.

(b) **<u>KAWC's Proposed Tariff Changes are Reasonable and Straightforward</u>**

KAWC has proposed several revisions to its tariffs, which are referenced in the direct testimony of Ms. Schwarzell and explained in Exhibit 37 L.[308] Specifically, in addition to the QIP, KAWC is proposing to apply the same meter charges by the size of the meter to all customer classifications; eliminate the separate rates for the former customers of the Eastern Rockcastle Water Association; clarify that the rates and charges will apply to all customers with KAWC's service territory unless otherwise noted; clarify that Service Classification No. 6 applies only to the portion of the service territory supplied from the Kentucky River and state the purpose of the rate for Kentucky River Authority withdrawal fees; add three additional counties for service availability; and revise its tap fee.[309] Other than Mr. Baudino's objection to the QIP, no party has objected to the proposed tariff changes.

(c) **<u>Single Tariff Pricing is Consistent with Commission Precedent and Fair and Reasonable for All Customers</u>**

KAWC used single tariff pricing and recommends a rate structure applicable to all divisions, including the former Eastern Rockcastle Water Association and North Middletown customers. Although neither Mr. Kollen nor Mr. Baudino propose a departure from single tariff

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[306] Direct Testimony of Constance E. Heppenstall ("Heppenstall Direct") (Ky. PSC Nov. 28, 2018).
[307] *Id.* at 3.
[308] Schwarzell Direct at 13.
[309] Exhibit 37 L. Pursuant to the Commission's request, KAWC filed a revised Exhibit 37, Schedule L in response to PSC PH-18.

pricing, at the hearing, it became evident that at least LFUCG may argue for a departure from single tariff pricing. Such a departure would be inconsistent with Commission precedent and short-sighted.

In 2005, KAWC did not have single tariff pricing. Then, in Case No. 2005-00206, when the Commission addressed KAWC's acquisition of the Owenton system, the Commission required KAWC to propose single tariff pricing in its next rate case when it said, "the Commission places KAWC on notice that KAWC's next application for a general rate adjustment should contain a proposal for a single rate schedule applicable to all KAWC customers . . . .[310] Given the Commission's unequivocal directive, in the Company's next rate case, which was Case No. 2007-00143, KAWC proposed a single tariff structure. The parties to that case (which included LFUCG) proposed an agreed resolution of the case to the Commission that included a move to a single tariff structure that was approved by the Commission.[311] The single tariff pricing structure has remained in place since that time because it constitutes sound rate design despite LFUCG's argument to the contrary. In Case No. 2012-00520, LFUCG opposed KAWC's single tariff pricing and the Commission rejected that opposition:

> Based on our review of the record, we find that Kentucky-American's unified rate structure should remain in place. The Commission has consistently supported the concept of a unified rate structure to encourage consolidation of water systems and to improve the quality of water service in the Commonwealth. Reversal of this policy would discourage further water system consolidation.[312]

[310] *The Verified Joint Application of the City of Owenton and Kentucky-American Water Company for Approval of the Transfer of the Ownership of the Assets of the City of Owenton to Kentucky-American Water Company*, Case No. 2005-00206, Order at 6 (Ky. PSC July 25, 2005).
[311] *Adjustment of Rates of Kentucky-American Water Company*, Case No. 2007-00143, Order at 3 (Ky. PSC Nov. 29, 2007).
[312] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 70 (Ky. PSC Oct. 25, 2013).

Ms. Schwarzell testified in support of single tariff pricing.[313] Then, at the hearing, she noted that, while some costs incurred for KAWC's Southern Division customers would be borne in part by Lexingtonians, it is also true costs incurred exclusively to serve Lexingtonians (such as the chemical treatment improvement projects discussed at the hearing) would be borne, in part, by Southern Division customers.[314] Single tariff pricing is in the public interest and advantageous for its customers because it spreads the costs across a larger customer base creating economies of scale, smoothing the impact of periodic investments in various geographies, eliminating the administrative burden of keeping multiple sets of books, and lowering administrative costs and regulatory costs.[315] All of this helps achieve rate stability for all KAWC customers.[316] In addition to these public interest benefits, the effect on KAWC customers of these acquisitions are minimal – moving former Eastern Rockcastle Water Association and North Middletown customers to the single tariff has only a $0.07[317] and $0.00[318] monthly impact, respectively, on the average residential customer. Given the public interest benefits of single tariff pricing, the Commission should approve the tariff structure the Company has proposed.

**13. CONCLUSION**

KAWC supported the entirety of its request for rate relief through record evidence in this proceeding. The Company has met its burden of proof with respect to demonstrating that its operation and maintenance expenses are prudent and reasonable, including its performance pay expense. The QIP KAWC has proposed is critically important to the Company and its customers, as it will enable and incentivize KAWC to increase the replacement rate of

[313] Schwarzell Direct at 28.
[314] 5/14/19 Hearing, VR 11:13:36 AM.
[315] Response to AG 1-63(d-e).
[316] *Id.*
[317] Response to LFUCG 1-93.
[318] Response to LFUCG 2-25.

infrastructure that has reached or exceeded the end of its useful lives. The water industry is aware of this mounting concern and the QIP has proven to be a best practice means by which to solve this pressing issue. Additionally, a large portion of this case is driven by the impacts of federal tax reform. To avoid cash flow issues, intergenerational inequities, and a possible normalization violation, it is especially important that the Commission consider and approve KAWC's requests regarding the TCJA.

The ROE KAWC has requested is reasonable and is premised on the prudent application of a host of cost of equity estimation models. KAWC would be placed at a competitive disadvantage if Mr. Baudino's recommended ROE is adopted. KAWC respectfully requests that the Commission approve the requested increase in rates to ensure that the Company is afforded the fair, just, and reasonable rates to which it is entitled.

Respectfully submitted,

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**CERTIFICATE**

This is to certify that Kentucky-American Water Company's May 31, 2019 electronic filing is a true and accurate copy of the documents to be filed in paper medium; that the electronic filing has been transmitted to the Commission on May 31, 2019; that a paper copy of the filing will be delivered to the Commission within two business days of the electronic filing; and that no party has been excused from participation by electronic means.

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