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	)	

REPLY BRIEF OF KENTUCKY-AMERICAN WATER COMPANY

Filed: June 14, 2019

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1. INTRODUCTION

Kentucky-American Water Company ("KAWC") submits this brief in reply to the June 11, 2019 Post-Hearing Briefs of the Attorney General by and through his Office of Rate Intervention ("AG") and Lexington-Fayette Urban County Government ("LFUCG").

When KAWC filed its November 28, 2018 Application and supporting testimony, that filing was the result of months of intensive work by dozens of employees and outside consultants. KAWC strove to achieve what it has always done when seeking a rate increase; it attempted to provide the Commission and any eventual intervenors with a robust initial filing that explained KAWC's position on the numerous issues that are most important to it, KAWC customers, the Commission, and intervenors.

KAWC provided detailed testimony and supporting documentation on critical issues such as: the need to replace aging infrastructure and how to pay for accelerated replacement in a way most palatable to customers; how KAWC total employee compensation levels are at or below market medians keeping employment expense reasonable for customers; how to handle the complex and wide-ranging effects of the Tax Cuts and Jobs Act ("TCJA") in a way that is in the long term best interests of customers; and what a fair return on investment should be so that KAWC can attract necessary capital to make investments to best serve the long term interests of its customers.

As this case progressed beyond KAWC's Application, KAWC did not balk at a single discovery request it received. Instead, it provided the best and most responsive data it had to voluminous discovery requests even though some of those requests exceeded the bounds of relevance. KAWC carefully considered the intervenor testimony it received, and, when the intervenors raised legitimate questions about an issue or a calculation, KAWC acknowledged that fact and adjusted the requested revenue requirement accordingly. For issues upon which

KAWC disagreed with intervenor testimony, KAWC described the factual and legal basis for that disagreement in data responses and in robust rebuttal testimony. It further provided Commission precedent as a basis for that disagreement when applicable.

At the May 13-14 evidentiary hearing, KAWC presented all of its witnesses, who fully and diligently answered all questions until there were no more to be asked. KAWC followed up by providing even more data in response to post-hearing data requests. Then, KAWC prepared and filed its Post-Hearing Brief in which it explained all of its positions to the Commission (with robust supporting citations) on every substantive issue in the case. In short, KAWC did exactly what the law, Commission precedent, and the concept of professionalism require it to do in prosecuting a rate case in order to meet its burden of establishing rates that are fair, just, and reasonable.

In contrast, Intervenors' Post-Hearing Briefs make arguments and take positions that are wholly inconsistent with each other. Those inconsistencies include:

- Providing a long (and incorrect) argument on the burden of proof on a utility in a rate case, while, at the same time, arguing that rate case expense should not be recovered due to KAWC's submission of "unrequested" expert reports and studies that go directly to KAWC meeting its burden of proof;
- Proposing a disallowance of production expense related to unaccounted-for water, while, at the same time, proposing a disallowance of requested employment positions, some of which can and will be used to work directly on reducing unaccounted-for water;
- Deliberately and inappropriately aggregating the costs for two different chemical improvement projects at two different water treatment locations in accusing KAWC of

violating Commission precedent regarding when a Certificate of Public Convenience and Necessity ("CPCN") should be sought;

- Accusing KAWC of violating the Commission's Order in Case No. 2012-00520 related to non-jurisdictional acquisitions when KAWC has complied with both the letter and spirit of the Order in that case;
- Making repeated "affordability" arguments when the Commission has already stated in the record of this case that "affordability is not a factor that the Commission can consider . . ."[1]; and
- Misconstruing a post-hearing data request in accusing KAWC of deliberately not providing time descriptions of the legal services performed by KAWC counsel in this case when KAWC has been and is ready, willing, and able to provide those unredacted descriptions on a moment's notice (and KAWC filed them shortly before this brief was filed).

Setting those inconsistencies aside, there are two critically important decisions before the Commission. First, the Commission must determine how much the increase in revenue requirement should be. The range established by the parties is an increase between $6.503 million[2] and $18.471 million.[3] Second, the Commission must decide whether to follow the evidence in this case, NARUC guidance, and the general regulatory trend in approving KAWC's proposed Qualified Infrastructure Rider ("QIP") as evidenced by the fact that numerous American Water subsidiaries have infrastructure mechanisms.[4] KAWC hereby incorporates its

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[1] January 3, 2019 Order at 3.
[2] $6.503 million is the revenue requirement increase proposed by Mr. Kollen (the Intervenors' revenue requirement witness). Direct Testimony of Lane Kollen ("Kollen Direct") at 4 (Ky. PSC Mar. 15, 2019).
[3] Base Period Update, Exhibit 37A, Page 2 of 2.
[4] Response to PSC 2-59.

Post-Hearing Brief filed on May 31, 2019 in full and offers the following in reply to the Intervenors' Post-Hearing Briefs filed on June 11, 2019.

2. THE QIP SHOULD BE APPROVED BECAUSE IT IS THE SUPERIOR METHOD OF ADDRESSING KAWC'S INFRASTRUCTURE NEEDS

No party to this proceeding disagrees that KAWC has compelling infrastructure needs that must be addressed. Similarly, no party alleges that the current rate of replacement (377 year replacement cycle) is preferable. The only dispute is the manner in which the infrastructure costs will be incurred and recovered from customers. Indeed, the AG framed the question as whether "Kentucky-American [is] able to attract and retain . . . enough capital to meet its infrastructure needs without the QIP, and if not, is the QIP the best fix to that issue?"[5] Although the AG and LFUCG offer arguments against the QIP, the record demonstrates that KAWC is unable to obtain enough capital to accelerate its rate of infrastructure replacement without the QIP, and that the QIP mechanism provides long term benefits for customers.

The AG's and LFUCG's briefs object to the QIP program on three new grounds: confusion over discretionary capital, an all or nothing approach to water loss mitigation, and objections to the Company pursuing infrastructure renewal while also supporting the consolidation of water systems in the Commonwealth. Glaringly absent is any counter to—or disagreement with—the testimony of Mr. O'Neill that described with particularity the infrastructure needs KAWC is facing and the manner in which the QIP would be deployed to alleviate the problem.

[5] AG Post-Hearing Brief at 50 (emphasis in original removed).

(a) **The Importance of Attracting Discretionary Capital Investment for Replacing Aging Infrastructure**

The concept of discretionary capital investment is straightforward. Discretionary capital investment is capital investment that could be postponed. Discretionary capital investment has represented more than half of American Water's capital investment over the past five years, and is the largest category associated with asset renewal investment.[6] Given the current and impending infrastructure renewal needs that have been well documented throughout the United States, this area of investment is a focus for American Water and the water industry in general.

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.[7] The best way to ensure that the appropriate levels of expenditures and capital investments on infrastructure replacement needs are consistently funded is through predictable and timely recovery of expenses and the return on the capital devoted to serving customers' needs. Ultimately, it is customers who will benefit from such a supportive regulatory environment because it allows water utilities to anticipate a consistency of regulatory oversight necessary to attract capital, with cost incurrence better matching cost recovery, and supports more consistent planning and deployment of the most efficient resources.[8]

The AG and LFUCG both argue that if capital investment is needed, then the Company must make it regardless of constructive regulatory support.[9] As Mr. Rowe testified, KAWC has always, and will continue, to make investments in KAWC's water infrastructure to ensure safe

[6] Response to PSC PH-11.
[7] 5/13/19 Hearing, VR 11:14:00 AM.
[8] Direct Testimony of Brent E. O'Neill ("O'Neill Direct") at 36 (Ky. PSC Nov. 28, 2018); *see generally* the 5/14/19 hearing testimony of Ms. Schwarzell.
[9] AG Post-Hearing Brief at 51 ("If increasing the rate of replacement is so crucial to the long-term viability of the system--in other words, a need--then [KAWC] should continue to do so even without any requirement for additional financial incentives."); LFUCG Post-Hearing Brief at 4 ("KAWC does not need a QIP in order to received capital from American Water if the project is 'what's needed for customers.'").

and adequate sources of supply, treatment, pumping, transmission, and distribution facilities.[10] But, the necessary rate of ongoing infrastructure investment to provide safe and adequate service is not the same as trying to attain the optimal rate of infrastructure investment that best serves the long-term interests of our customers. For example, when there is a break in the distribution system infrastructure, it is "necessary"—a must—that KAWC make the repairs. But it is "optimal" to replace infrastructure at a rate that more closely matches the estimated useful life of the respective assets. Discretionary capital investment is not a bright line test, as the AG and LFUCG suggest, whereby capital investment is either necessary to meet service obligations or can be ignored. Rather, discretionary capital is a level of investment above and beyond break-fix, and the Company is seeking to accelerate that level of investment in order to better serve customers.

Moreover, while the AG asserts that KAW should "increase its replacement rate of infrastructure to the level it is depreciating"[11] without a QIP, it fails to acknowledge that to do so would necessitate more frequent rate cases. It is an inefficient use of resources to repeatedly file time-consuming and costly rate cases when the QIP mechanism would properly match cost incurrence with cost recovery of the ongoing investments proposed to be included in the QIP.

The Company has amply demonstrated through the testimony of Mr. O'Neill that there is tremendous infrastructure renewal need, and that a thoughtful, well-planned approach to accelerating infrastructure replacement better serves the long term interests of our customers. A QIP is necessary to support more timely cost recovery and enhance the Company's ability to attract capital in an increased investment environment. With the approval of the QIP, the Company can plan and manage the consistent deployment of Company and contractor resources

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[10] Rebuttal Testimony of Nick O. Rowe ("Rowe Rebuttal") at 3 (Ky. PSC Apr. 30, 2019).
[11] AG Post-Hearing Brief at 51.

to more efficiently and effectively attain and maintain an optimal replacement program. This is the heart of the QIP, and no debate over semantics will undermine the importance of addressing aging infrastructure or the certainty that greater regulatory support is needed to improve capital attraction.

(b) **The Purpose of QIP and Its Relationship to Addressing Water Loss**

The AG and LFUCG raise a strawman argument when they seek to change the discussion of the QIP to its beneficial effect solely on water loss. The LFUCG claims, for example, that "it is unclear as to whether the QIP was even proposed to address KAWC's leak problem."[12] The AG claims that "Ms. Schwarzell confirmed that water loss is not the primary focus of the proposed QIP."[13] These assertions are beside the point. Although the Company consistently explained that one of the benefits of a QIP program is to address water loss, it is not the primary reason for the QIP nor is its beneficial effect on water loss the primary benefit. The direct testimonies of Mr. Rogers and Mr. O'Neill both discuss mitigation of water loss as one of the benefits of the QIP, and Mr. O'Neill's rebuttal testimony discusses the QIP as "one of the most significant of [the] steps"[14] to address unaccounted for water. Similarly, the AG incorrectly cites Ms. Schwarzell's hearing testimony, which stated that the QIP was an important step in addressing water losses and stopping the upward trend in water loss.[15] While the QIP has many benefits, the Company consistently explained that one benefit is to help address water loss, but that is hardly the only—or even the primary—benefit of the QIP.[16]

[12] LFUCG Post-Hearing Brief at 12.
[13] AG Post-Hearing Brief at 55.
[14] Rebuttal Testimony of Brent E. O'Neill ("O'Neill Rebuttal") at 16 (Ky. PSC Apr. 30, 2019).
[15] 5/14/19 Hearing, VR 9:29:10 AM.
[16] The AG also argues an "all or nothing" approach to water loss to reject the QIP. The AG states that "any incremental gains in improving water loss reductions that might be achieved through the QIP would be offset by natural degradation on the rest of the system." AG Post-Hearing Brief at 55. In other words, the AG seems to take the position that if you cannot fully offset water loss increases, then there is no point in partially offsetting them.

As Mr. O'Neill quoted in his testimony, the American Water Works Association's "Buried No Longer" study indicated:

> [T]he United States is reaching a crossroads and faces a difficult choice. We can incur the haphazard and growing costs of living with aging and failing drinking water infrastructure. Or, we can carefully prioritize and undertake drinking water infrastructure renewal investments to ensure that our water utilities can continue to reliably and cost-effectively support the public health, safety, and economic vitality of our communities.[17]

Mr. O'Neill's direct testimony went on to describe some of the problems the QIP is designed to address:

> To the extent that pipe replacement is deferred into the future, service quality will suffer from an increasing number of pipe breaks and the resulting service disruptions, health risks from potential drinking water contamination, property damage, and opportunity costs related to community health and economic development. Deferral of pipe replacements year by year has a cumulative effect on the future cost to customers for replacing these pipes, leaving future customers with much larger bills and significant rate shocks.[18]

The QIP is designed to preserve service reliability, prevent water quality contamination, protect community property, and ensure the overall economic and public health of our communities, while preventing an intergenerational inequity in bearing those costs. The record evidence in support of the QIP is strong and shows, beyond dispute, that reduction of water loss is but one of its many benefits.

(c) **<u>The Complementary Nature of Infrastructure Renewal and System Consolidation</u>**

Both the AG and LFUCG make the curious argument that KAWC should not acquire other systems if KAWC has infrastructure needs. Respectfully, this makes no sense because utilities always have infrastructure needs. A blanket rule that prohibited any such acquisition by

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The Company does not agree with this perspective. In contrast, the Company finds that water loss control efforts are *more* important in a rising water loss environment, not less important.

[17] O'Neill Direct at 21.

[18] *Id.* at 30.

a utility would have a chilling effect on any acquisition. Moreover, these parties assume that every utility KAWC acquires is in need of significant capital investment. That is not the case. Further, this argument ignores entirely that when KAWC acquires a water or sewer utility, it likewise acquires additional customers that provide new revenues that will offset the cost of the acquisition over time.

KAWC is clear in its intention to address both the problems of aging infrastructure as well as the challenges associated with serving customers through a fragmented network of separately managed water systems. These two goals are not mutually exclusive. The Company believes that all citizens in the Commonwealth deserve access to safe, clean, reliable, and affordable water service. Both of these business objectives support that ideal and both merit regulatory support.

3. THE COMMISSION SHOULD APPROVE KAWC'S TCJA PROPOSALS

The AG and KAWC agree that the excess accumulated deferred income taxes (excess "ADIT") resulting from the TCJA's reduction of the federal corporate income tax rate and the recent reduction of Kentucky's state corporate income tax rate should be amortized in a manner that best serves the long-term interests of the Company's customers. The parties part ways on the best way to achieve that shared goal.[19] KAWC has proposed that all plant in service-related excess ADIT be amortized pursuant to the average rate assumption method ("ARAM") prescribed by federal law for "protected" ADIT, and that all non-plant in service-related excess ADIT be amortized over a period of 20 years. This proposal, if adopted, will promote the long-

[19] The AG asserts that "[t]he issue here is that the Company would rather invest their money in other places, such as states that provide for recovery of investments before they're even in the ground, or in purchasing Kentucky municipal water systems," citing a portion of Ms. Schwarzell's cross-examination. AG Post-Hearing Brief at 41. This assertion is inaccurate, and it is not supported by the portion of the video record cited in the AG's brief, 5/14/19 Hearing, VR 9:17:51 AM - 9:19:15 AM (Examination of Schwarzell).

term best interests of the Company customers for a number of important reasons: KAWC's proposal will align the amortization of excess ADIT to the investment that gave rise to that tax benefit, and thus to the customers who will bear the cost of that investment over its life;[20] it will lower the total cost of capital recovered from customers over the underlying useful life of the investment;[21] it will avoid the risk of a normalization violation and the resulting loss of accelerated depreciation;[22] it will avoid the risk of a violation of the Company's IRS Consent Agreement and the resulting loss of repairs deductions;[23] it will mitigate degradation of the Company's credit metrics, thus preserving access to capital for infrastructure improvements at a reasonable cost;[24] it will promote intergenerational equity;[25] and it will avoid the rate spike and distortion of price signals produced by sharp, temporary rate reductions.[26]

In contrast, the AG urges that all "unprotected" excess ADIT—that is, excess ADIT not clearly subject to federal normalization rules—be amortized over three years. The AG also urges the Commission to risk violation of the Company's IRS Consent Agreement by amortizing some of the excess ADIT produced by the repairs deductions permitted by the Consent Agreement—specifically, the "Tax Repairs" and "Repairs 481(a)" line items—over a period much shorter than that produced by ARAM.[27] In order to achieve the parties' shared goal of serving the long-term

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[20] Rebuttal Testimony of John R. Wilde ("Wilde Rebuttal") at 11 (Ky. PSC Apr. 30, 2019); 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.").
[21] Wilde Rebuttal at 11.
[22] KAWC Post-Hearing Brief at 18-21; Wilde Rebuttal at 18.
[23] KAWC Post-Hearing Brief at 20; Wilde Rebuttal at 6, 13-15.
[24] KAWC Post-Hearing Brief at 19; Rebuttal Testimony of Ann E. Bulkley ("Bulkley Rebuttal") at 66-67 (Ky. PSC Apr. 30, 2019).
[25] KAWC Post-Hearing Brief at 18; Wilde Rebuttal at 10-11, 21-22; 5/13/19 Hearing, VR 4:36:01 PM (Examination of Wilde).
[26] KAWC Post-Hearing Brief at 18-21; Wilde Rebuttal at 21; 5/14/19 Hearing, VR 9:13:30 – 9:16:24 AM (Examination of Schwarzell).
[27] The AG has agreed with KAWC that the "Repairs M/L" category of excess ADIT is subject to federal normalization requirements and therefore must be amortized pursuant to ARAM. *See* AG Post-Hearing Brief at 44; KAWC Post-Hearing Brief at 20, n.77.

interests of customers, the Commission should reject the AG's positions and adopt KAWC's excess ADIT proposals.

(a) **Amortization Period of Unprotected ADIT**

The AG's witness, Mr. Kollen, offered no rational basis for his proposed amortization period of three years for unprotected excess ADIT.[28] The arguments offered by the AG's brief in support of Mr. Kollen's proposal are similarly insubstantial. First, the assertion that some customers who paid the rates that generated the excess ADIT "will no longer be available to receive the payback"[29] is immaterial because excess ADIT relates to deductions for asset costs not yet recovered in rates. Those costs will be recovered through book depreciation, and the customers paying the costs to which the deductions relate should receive the associated tax benefit.[30] Customers in the past did not bear the cost of these assets, and if the Commission returns the benefit faster than the life of those assets, customers who then leave the system will receive tax benefits related to asset costs that others will be expected to pay. Second, the fact that the cases in which the Commission approved amortization periods *five and six times* as long as Mr. Kollen's proposed 3-year period were settled rather than litigated[31] is irrelevant. What is both material and relevant is the harm to the long-term interests of KAWC's customers that would result from amortizing excess ADIT over a period so much shorter than the average lives of the underlying assets: generational inequities, consumption of capital that could be used for infrastructure replacement, weakening of the Company's cash flow and credit metrics, distortion

[28] KAWC Post-Hearing Brief at 22; Wilde Rebuttal at 8-9.
[29] AG Post-Hearing Brief at 41.
[30] *See* Wilde Rebuttal at 11; 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.").
[31] AG Post-Hearing Brief at 42.

of price signals and undermining of water efficiency efforts, and a rate spike of approximately $4 million upon expiration of the three year flow-back.[32]

(b) **Normalization of Repairs-Related Excess ADIT**

The dispute with respect to whether excess ADIT related to certain repairs deductions is subject to the IRS normalization rules is rooted in the parties' contrary interpretations of KAWC's IRS Consent Agreement. As Company witness Wilde explained at length in his rebuttal testimony, the Consent Agreement requires repairs-related ADIT, and therefore repairs-related excess ADIT, to be normalized in the same manner as "protected" ADIT and excess ADIT—that is, amortized no faster than ARAM amortization.[33] The Company submits that Mr. Wilde's interpretation of the Consent Agreement is consistent with a plain reading of that document, and if clarification is need that clarification should come from the IRS. In any event, KAWC expects that any uncertainty related to the application of its Consent Agreement will be resolved within the next 6-18 months as the result of IRS guidance becoming available.[34] Therefore, the Company has suggested that to avoid a possible normalization violation and the resulting harm to customer interests, the Commission should, as a matter of prudence, allow KAWC to treat all repairs-related excess ADIT balances as "protected" until the IRS guidance is issued.[35]

The AG casually asserts that "if the Commission's order does somehow create an inadvertent normalization violation, there is an opportunity to seek relief from the error and cure

[32] KAWC Post-Hearing Brief at 23-24; Rebuttal Testimony of Melissa L. Schwarzell ("Schwarzell Rebuttal") at 15-16 (Ky. PSC Apr. 30, 2019); Wilde Rebuttal at 19-22; 5/14/19 Hearing, VR 9:13:30 AM – 9:16:24 AM (Examination of Schwarzell).
[33] Wilde Rebuttal at 12-18.
[34] KAWC Post-Hearing Brief at 20-21; Wilde Rebuttal at 13; 5/13/19 Hearing, VR 4:39:10 PM (Examination of Wilde).
[35] KAWC Post-Hearing Brief at 20-21; Wilde Rebuttal at 13.

the violation."[36] To the contrary, *there will be no opportunity to "cure" a normalization violation if the Commission orders a shorter amortization period and the IRS subsequently rules that normalization pursuant to ARAM is required.* As Mr. Wilde explained at hearing, in order to take advantage of the IRS's "inadvertent error rule," the error must be "inadvertent" in the sense that it must be "unknown" and the taxpayer must be "unaware" of it.[37]

This so-called inadvertent error rule, which counsel for the AG raised for the first time at hearing, is the IRS's "Safe Harbor for Inadvertent Normalization Violations."[38] It protects against a regulatory commission order that *inadvertently* causes a taxpayer to commit a normalization violation. The scope of the safe harbor applies when a taxpayer has "inadvertently or unintentionally failed to follow a practice or procedure that is consistent with the Normalization Rules."[39] But the rule goes on to state:

> A Taxpayer's Inconsistent Practice or Procedure is neither inadvertent nor unintentional if the Taxpayer's Regulator specifically considered and specifically addressed the application of the Normalization Rules to the inconsistent Practice or Procedure in establishing or approving the taxpayer's rates even if at the time of such consideration the Taxpayer's Regulator did not believe the practice or procedure was inconsistent with the Normalization Rules.[40]

In other words, if, having considered the application of the normalization rules, the Commission adopts the AG's position and orders amortization of KAWC's repairs-related excess ADIT faster than the period permitted by ARAM, and that position ultimately proves to be wrong, the violation will not be deemed "inadvertent" and the safe harbor will be unavailable. Contrary to the AG's position, the safe harbor is not an invitation to take risks in making decisions about the

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[36] AG Post-Hearing Brief at 45.

[37] 5/13/19 Hearing, VR 4:38:19 PM (Examination of Wilde) ("If the normalization violation is inadvertent and unknown or you're unaware of it or you don't suspect there's a question to be asked, then there's relief that's granted under the inadvertent error rule.").

[38] Rev. Proc. 2017-47, 2017-38 I.R.B. 233 (2017) (2017 WL 4099476).

[39] *Id.*

[40] *Id.*

amortization of excess ADIT. It is instead intended to cover the situation where a violation occurs accidentally due to *failure to consider* the normalization rules. That would not be the situation here, where the normalization rules have been brought to the Commission's attention by the parties. The prudent course, and the only way to protect the Company and its customers from the loss of tax benefits resulting from a violation of the Consent Agreement, is to treat all repairs-related excess ADIT balances as "protected" until IRS guidance is issued.

While the AG's excess ADIT proposals, if adopted, would ultimately increase the Company's earnings per share,[41] they would not serve customers' long-term best interests. The Commission should instead allow KAWC to use ARAM to calculate the amortization periods for all plant in service-related excess ADIT, and to amortize all other excess ADIT over a 20-year period. If the Commission determines that ARAM should be used to amortize only "protected" federal excess ADIT and excess ADIT subject to normalization pursuant to the Consent Agreement, then the balance of unprotected federal and state plant in service-related excess ADIT—($2,621,456)—could be amortized over 20 years rather than pursuant to an ARAM calculation.[42] However, no repairs-related excess ADIT should be amortized over a period shorter than that produced by ARAM absent further guidance by the IRS.

4. KAWC'S BASE PERIOD UPDATE IS APPROPRIATE AND BENEFITS CUSTOMERS BY ALLOWING THE COMMISSION TO SET RATES BASED ON THE MOST CURRENT INFORMATION

At page 6 of the AG's Post-Hearing Brief, the AG takes exception with KAWC's longstanding practice of updating the revenue requirement in rate cases at approximately the time the base period update is due. The AG argues that it violates the legal prohibition against

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[41] 5/13/19 Hearing, VR 4:37:13 PM (Examination of Wilde); 5/14/19 Hearing, VR 9:13:30 PM – 9:16:24 PM (Examination of Schwarzell).
[42] Wilde Rebuttal at 23.

updating forecasts in forecasted test year cases. Of course, what the AG fails to include in his argument is that the overall net effect of KAWC's revised revenue requirement resulted in a *decrease* of the overall revenue requirement.

With full knowledge of 807 KAR 5:001, Section 16(6)(d), KAWC has, in all recent rate cases, updated its revenue requirement at the approximate time of its base period update for a simple reason. If KAWC is aware of changes to the existing numbers in a case, it has repeatedly chosen to advise the Commission and intervenors of those changes in its past rate cases and revised the revenue requirement accordingly[43]—but always with the caveat that the resulting revised revenue requirement can never be *above* what was originally noticed in the case. In other words, if the net effect of those changes results in a revenue requirement greater than the originally noticed revenue requirement, KAWC would not seek recovery of that excess. KAWC has only *lowered* its requested revenue requirement in the process of updating.

KAWC has engaged in this practice for an obvious reason—from the time a rate case is filed until the time a base period update is due, KAWC frequently learns of facts (projected pension expense is a typical one) that have changed. KAWC believes it should share those changes with the Commission and revise its revenue requirement accordingly so that its decision is based on the most accurate, up-to-date information available. KAWC has no interest in advocating for a revenue requirement that it knows is based on outdated facts. And KAWC's practice on this point can only benefit customers because KAWC has never and would not claim a revenue requirement higher than what was originally noticed. This is precisely what happened

[43] *See* KAWC's June 7, 2016 filing in Case No. 2015-00418 reducing the proposed revenue requirement; KAWC's May 15, 2013 filing in Case No. 2012-00520 reducing the proposed revenue requirement; KAWC's July 15, 2010 filing in Case No. 2010-00036 reducing the proposed revenue requirement; and KAWC's March 9, 2009 filing in Case No. 2008-00428 showing an increase in the revenue requirement but with no effort by KAWC to actually adjust the proposed revenue requirement upwards (as discussed by the Commission in its June 1, 2009 Order at 1).

in Case No. 2008-00427, when changes supported a higher revenue requirement but KAWC did not pursue that excess.[44]

In other recent rate cases, the net effect of updating the revenue requirement based on the most accurate and complete information available has been a decrease in the requested revenue requirement. The AG, however, would have this process be a "one-way street" only. To the contrary, if adjustments to the revenue requirement are to be considered, it is only fair to include the net effect of *both* increasing and decreasing adjustments. Speaking inconsistently, the AG claims a legal prohibition against an *incremental* increase to the revenue requirement for tank paintings or CIAC gross up that will occur in the test year, but makes no claim of legal prohibition against the *overall* revised revenue requirement in this case which includes all the incremental *decreases* (such as to pension and OPEB, labor, and excess ADIT amortization) that led to an overall reduction of the revenue requirement.

If the AG were consistent, then the revenue requirement could only be what was originally requested in the case except to correct math errors or to address a change in the law. Obviously, KAWC believes the best practice is to provide the Commission with the most accurate, updated, and complete information that affect the revenue requirement. One would think the AG would be supportive of a practice designed to provide full candor to the Commission that can only lead to a determination of the appropriate revenue requirement. Because it does not do so, the AG's argument here is both short-sighted and does a disservice to KAWC's customers.

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[44] *Adjustment of Rates of Kentucky-American Water Company*, Case No. 2008-00427, Order at 1 (Ky. PSC June 1, 2009).

5. KAWC'S RATE CASE EXPENSE IS REASONABLE AND SHOULD BE APPROVED

Mr. Kollen, on behalf of the AG and LFUCG, filed testimony recommending that the Commission disallow the $0.312 million in rate case expense associated with the costs incurred by the Service Company in supporting KAWC's case. In their briefs, however, both the AG and LFUCG urge the Commission to go even further in disallowing prudently incurred rate case expense.

First, LFUCG requests that the Commission place a cap on KAWC's rate case expense for the invoices that were available when the Company filed its response to hearing data requests on May 24, 2019. LFUCG erroneously suggests this represents the "actual" rate case expense KAWC has incurred. This is incorrect, as the invoices for May were not yet available at that time. May was the most intensive month of work during the case, as the evidentiary hearing, hearing data requests, and post-hearing brief were started and completed in that month. Moreover, rate case expense continues to accrue as the case is not under submission until this brief has been filed and there will be additional rate case expense even after a final order is issued. It is particularly egregious that LFUCG has made this recommendation given that KAWC was obligated to respond to, counting subparts, twenty hearing data requests submitted by LFUCG during May. Moreover, if LFUCG was concerned about rate case expense, it could have elected to share the cross examination of KAWC's witnesses as it did with its own witnesses, but elected not to do so.

LFUCG then goes a step further and asks the Commission to deny ***all*** of the rate case expense attributable to Stoll Keenon Ogden PLLC based on the inaccurate statement that "KAWC has not filed any invoices or other documentation that support the reasonableness of the

legal expenses as required and was requested."[45] This is patently incorrect. The Post Hearing Request for Information to which LFUCG refers requested that KAWC "Provide copies of contracts, invoices, ***or*** other documentation that support charges incurred in the preparation of this case."[46] KAWC provided LFUCG exactly what it asked for—invoices. If LFUCG believed KAWC's response was deficient in any respect, it could have notified KAWC. It did not and instead elected to wait until filing its brief to portray KAWC as having withheld information. In both the Louisville Gas and Electric Company[47] and Big Rivers Electric Corporation[48] proceedings cited by LFUCG, the issue of producing unredacted attorney time entries arose. Here, KAWC had no notice that LFUCG believed its response to the Hearing Data Request did not provide the information LFUCG was seeking. But in an effort to make this issue clear, KAWC has filed Stoll Keenon Ogden PLLC's unredacted time entries to correct any misimpression that the Company has not provided requested information.

Turning to the AG, his brief alleges that "the Company also included expenses for engaging experts to produce studies which were neither required nor requested by the Commission," and states that one of the studies "goes toward justifying the inclusion of incentive compensation, which the Commission has explicitly and continuously denied the recovery of."[49] The fallacies in this argument are numerous. First, the Commission does not provide utilities with a list of persons from whom testimony shall be filed. The AG inconsistently criticizes the Company for not adequately supporting certain issues, but then complains when the Company engages experts to support issues. But beyond that, the Willis Towers Watson Study and related

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[45] LFUCG Post-Hearing Brief at 22.
[46] LFUCG Hearing Request at 5(b) (emphasis added).
[47] *An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company*, Case No. 2003-00433, Order (Ky. PSC June 30, 3004).
[48] *Application of Big Rivers Electric Corporation for a General Adjustment in Rates*, Case No. 2011-00036, Order (Ky. PSC Jan. 29, 2013).
[49] AG Post-Hearing Brief at 45-46.

testimony are *precisely* the type of compensation and benchmarking information that this Commission expects, as indicated by the Vice Chairman's written comments on that issue. A link to those comments is posted on the *opening* page of the Commission's website.[50]

Second, it is disingenuous for the AG to criticize KAWC for engaging an expert in hopes of obtaining a different result on an issue than was decided in a prior case, when the AG has done precisely the same. As demonstrated at the hearing, the Commission has repeatedly rejected Mr. Kollen's arguments regarding cash working capital and employee vacancies, but the AG nevertheless engaged and presumably compensated Mr. Kollen to restate those arguments in this case. The fact remains that any party has the right to petition the Commission for a different result and the obligation to provide the Commission with all relevant facts necessary to effect that change.

Returning to the adjustment that the AG's and LFUCG's witness Mr. Kollen actually proposed in testimony, which was to disallow the rate case expense attributable to the Service Company resources that supported the preparation, filing, and litigation of a rate case, it remains unreasonable. As explained in its Post-Hearing Brief, 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 and there is no reasoned basis to exclude the costs from rate case expense.

6. KAWC'S SERVICE COMPANY EXPENSES ARE REASONABLE AND SHOULD NOT BE DISALLOWED

In its Post-Hearing Brief, LFUCG argues for the first time that the Company's entire $9.7 million in Service Company expense should be rejected for recovery. LFUCG bases this

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[50] https://psc.ky.gov/agencies/psc/speeches/cicero/VC_Cicero_KYChamber_Energy_Conference_1-18-18.pdf (stating that "[s]alaries should always be market competitive as supported by survey benchmarks that include both other utilities and general business").

argument entirely on an adjustment to indirect allocated Service Company charges made in a 2011 order for Water Service Corporation of Kentucky ("WSKY"), which found that WSKY failed to demonstrate the reasonableness of the indirect charges or indicate a review process existed.[51]

Setting aside for a moment that LFUCG is proposing a far more sweeping exclusion than just indirect allocated charges, this WSKY case is inapplicable to KAWC's current rate case for several reasons. First, KAWC provided the same or extremely similar information on Service Company expense in this case as it provided in Case Nos. 2012-00520 and 2015-00418. Neither case resulted in any disallowance of Service Company expense. While the order in Case No. 2015-00418 was silent on Service Company expense (it was a settled case), the order in Case No. 2012-00520 explicitly allowed every dollar.[52] LFUCG's allegation that KAWC failed to demonstrate the reasonableness of Service Company expense in this case when it provided the same information that the Commission previously found reasonable is illogical.

LFUCG also alleges that the Service Company charges are "not conducive to local review," but then bases the argument on billing practices and what it claims is a lack of evidence substantiating the option for review.[53] This allegation is not supported by the record. The Company explained in response to an LFUCG post-hearing data request that KAWC's ability to review Service Company bills each month is extensive and expressly stated in the Billing and Accounting Manual.[54]

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[51] *Application of Water Service Corporation of Kentucky for an Adjustment of Rates*, Case No. 2010-00476, Order (Ky. PSC Nov. 23, 2011).

[52] *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) ("[T]he Commission finds that Kentucky-American's forecasted support service fees of $9,324,323 is reasonable and should be accepted for ratemaking purposes.").

[53] LFUCG Post-Hearing Brief at 15.

[54] Response to LFUCG PH-14. The Billing and Accounting manual states: "Affiliates have the ability to view (via a

The Company further testified at the hearing that leaders in the Company review and question forecasted charges during the business planning process, which has increased efficiency.[55] The evidence of the success of these processes is ample in the case. Not only has KAWC's O&M expense largely remained flat from 2010-2017,[56] but its Service Company charges have remained relatively flat as well. This is a substantial accomplishment and is the result of concerted efforts to control costs for customers. As Ms. Schwarzell testified, efficiency is a significant theme at American Water.[57] For example, Ms. Schwarzell explained that a Service Company finance reorganization in 2014 cut staff by 30 percent through a collaborative process aimed solely at delivering efficiency in the Service Company business units.[58] These efforts were also independently evaluated in Mr. Baryenbruch's study, which concluded that the Service Company's review period cost per KAWC customer is reasonable compared to cost per customer for electric and combination electric/gas service companies.[59]

Finally, it is worth noting that the proposal to disallow all Service Company costs outright would exclude expense recovery of virtually the entire KAWC leadership team, including almost every local witness in the case (President Nick Rowe, Director of Engineering Brent O'Neill, and Director of Human Resources Kurt Kogler, for example). This kind of wholesale exclusion would also wipe out any cost support for the entire customer service and billing function, water quality lab, service order dispatch, and virtually all legal, IT, and

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drill down functionality in SAP) cost posting source detail such as originating Service Company Cost Center, associated WBS element details, and other data to provide transparency to Service Company originating costs." The response also explains other review processes that take place, including "(a) a monthly report showing actual and plan year-to-date amounts that identifies the primary drivers for variances between actual and plan; and (b) a monthly labor report that identifies the hours billed to KAWC by Service Company employee[s] for the month."

[55] 5/14/19 Hearing, VR 9:52:00 AM.

[56] Response to AG 1-88.

[57] 5/14/19 Hearing, VR 9:54:10 AM.

[58] 5/14/19 Hearing, VR 9:54:00 AM.

[59] Direct Testimony of Patrick L. Baryenbruch ("Baryenbruch Direct") at 3 (Ky. PSC Nov. 28, 2018).

accounting staff. Such a sweeping and baseless confiscation of the Company's resources for public use would be in violation of United States Supreme Court precedent.[60] Thus, it should be rejected on its face. Because Service Company review processes have yielded exceptional cost control performance and because KAWC provided similar evidence in this case regarding Service Company expense that the Commission previously found reasonable, the Commission should reject LFUCG's proposed adjustment.

7. KAWC'S CASH WORKING CAPITAL ALLOWANCE IS REASONABLE AND IN ACCORDANCE WITH COMMISSION PRECEDENT

The AG continues to argue that KAWC's working capital allowance is "overstated" for the same reasons identified in Mr. Kollen's testimony.[61] The Company responded to each of these criticisms in its Post-Hearing Brief and the rebuttal testimony of Ms. Schwarzell, and incorporates these arguments herein.[62] The Company's lead/lag study in this proceeding uses the same methodology that the Commission has generally accepted since 1983 and the AG has provided neither a novel nor principled basis to reverse the Commission's long-standing precedent on this issue.[63] KAWC accordingly requests the Commission follow its well-established precedent and approve its cash working capital allowance.

8. THE AG'S SLIPPAGE ADJUSTMENT IS UNREASONABLE

All parties agree that the Company's budget should be used as the basis for a slippage measurement and both parties use the same budget figure.[64] However, the AG and LFUCG

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[60] *Federal Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944).
[61] AG Post-Hearing Brief at 7-11; Kollen Direct at 5-16.
[62] KAWC Post-Hearing Brief at 24-30; Schwarzell Rebuttal at 6-13.
[63] KAWC Post-Hearing Brief at 27 (quoting *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)).
[64] *See* O'Neill Rebuttal at Exhibit 1, which compares the budgets used by AG/LFUCG Witness Kollen versus what KAWC used. Note there is a *de minimus* budget variance between the data sets in 2011, the source for which is unknown.

simply ignored 21 million of actual capital spend from recent years (for items other than KRS II) to arrive at a reduced slippage factor.[65]

Although the underlying data response upon which the AG and LFUCG rely did ask for data that eliminated certain construction projects, KAWC explained in the response that such an exclusion "is not a reasonable representation of budgeted and actual spend."[66] Nonetheless, Mr. Kollen's testimony and the AG's brief refer to the slippage calculated as capturing "annual construction expenditures versus annual construction budget from 2008 through 2017."[67] Neither mentions the $21 million of excluded construction expenditures. A comparison of the AG/LFUCG data and the data used by the Company is clearly described in Exhibit 1 of Mr. O'Neill's rebuttal testimony. It is plainly evident that while the budgets are essentially the same, it is the actual capital expenditures which vary, due to AG/LFUCG's excluded spend data.

The Company's proposed slippage adjustment as shown in the Base Period Update follows the methodology that has been used by the Commission in all of KAWC's recent rate cases. That method compares budgeted capital spend to actual capital spend, adjusting only a few years for KRS II expenditures. The Company's calculation in this case is consistent with precedent and should be approved.

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[65] O'Neill Rebuttal at Exhibit 1.
[66] See KAWC's full responses to PSC 3-1 and PSC 3-2, which serve as the basis for the AG/LFUCG slippage calculation, as seen in Kollen Direct at Exhibit LK-6.
[67] AG Post-Hearing Brief at 10, quoting Kollen Direct at 16-19.

9. KAWC'S LABOR, COMPENSATION, AND BENEFITS ARE REASONABLE

KAWC's Post-Hearing Brief explained in detail why KAWC should be permitted to recover its requested expenses for performance pay, projected headcount, and retirement and welfare benefits.[68]

On the issue of performance pay, the record is replete with information KAWC has provided on both the reasonableness of performance pay and the benefits it provides to customers. That information includes the expert testimony and studies submitted by Messrs. Mustich and Willig of Willis Towers Watson. And despite the AG's curious protest about Mr. Kollen's admissions in discovery[69] related to performance pay, there can be no dispute that the AG's own witness admitted that the goals of the APP Plan (safety, efficiency, and environmental compliance) are beneficial to customers. The AG also takes the position that recovery of incentive compensation is contrary to Commission precedent. It is not. Although KAWC acknowledges the existence of some Commission cases denying recovery of performance pay, the AG conspicuously failed to substantially address in his brief a recent and directly applicable Commission ruling on this issue.[70] In that ruling, the Commission specifically allowed recovery of incentive compensation paid to Kentucky Power Company employees when that payment was based on performance measures.[71] Further, Commission Staff counsel specifically raised that holding in cross-examining Mr. Rowe when she asked whether, under that ruling, KAWC should be permitted to recover fifty percent of its performance pay expense because fifty percent of

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[68] KAWC Post-Hearing Brief at 34-41.
[69] AG/LFUCG Responses to KAWC 1-44, 1-45, 1-46, 1-47, and 1-48.
[70] *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 (Ky. PSC June 22, 2015).
[71] *Id.*

KAWC's performance pay is directly based on performance measures.[72] Indeed, Mr. Kollen relied on the Kentucky Power case in his testimony, yet in his brief, the AG fails to discuss it. That retreat speaks volumes.

The record also is replete with proof that KAWC should be allowed to recover all of its performance pay expense because all of it is a reasonable expense. This includes, but is not at all limited to, the fact that the entirety of the Company's employee expenses, including the performance-based component, is below the median for similarly situated employees at other utilities and businesses. Given the demonstrated benefits of performance pay—benefits acknowledged by the AG's own witness—this expense is by any measure, entirely just, reasonable, and fully recoverable. At a bare minimum, however, KAWC should be permitted to recover fifty percent of its performance pay expense which is the portion of the compensation that is related purely to specific performance measures.

As to the headcount issue, KAWC explained that its proposal for recovery of 152 full-time equivalents should not be adjusted at all due to any sort of "vacancy" rate. Such a vacancy rate is the driving force behind Mr. Kollen's proposed adjustment on this issue. As the AG acknowledges in his brief, Mr. Pellock explained in his rebuttal testimony that there is a direct relationship between recovery for a full complement of employees and reducing projected expenses for overtime, temporary employees, and contractor expense. Reducing full time employees increases overtime, temporary employees, and contractor costs, and vice versa. So, reducing one without a concomitant adjustment to the other is improper. KAWC further demonstrated in its brief that Mr. Kollen's proposed adjustment is the same type of disallowance

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[72] 5/13/19 Hearing, VR 11:09:00 AM.

that the Commission has repeatedly rejected in at least three prior KAWC rate cases.[73] The AG's proposed adjustment on this should be rejected once again.

Finally, as to the issue of all other retirement and welfare benefits, including the 401(k) matching contribution issue, KAWC's Employee Stock Purchase Plan, and KAWC's Long Term Performance Plan, KAWC stands by the arguments it has already made in its Post-Hearing Brief and otherwise in the record of this case. KAWC reiterates that the Commission's decision in the recent Duke Energy case[74] on the 401(k) matching contribution issue in which the Commission allowed recovery of matching contribution expense due to the retirement cost-savings measures Duke had taken is the applicable precedent given the similar cost-savings measures KAWC has taken—which include, but are not limited to, ceasing the accrual of pension benefits for certain employees as long ago as 2001.[75]

10. THE INVESTMENT PROJECTS RELATED TO CHEMICAL STORAGE ARE REASONABLE, PRUDENT, AND DID NOT REQUIRE A CPCN

LFUCG claims that the costs associated with two discrete investment projects related to chemical storage should be disallowed. Its arguments, however, are critically flawed in both fact and law. Beginning with the facts, LFUCG attempts to combine the two projects into one by creating the term "Chemical Complex," which suggests the projects are occurring at the same location, and by combining the respective costs of each project.[76] The projects, however, are distinct. Investment Project I12-020067 pertains to upgrading and replacing the chemical storage and delivery facilities at the Richmond Road Station, which is near downtown

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[73] KAWC Post-Hearing Brief at 37-38.
[74] *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).
[75] Response to PSC PH-10.
[76] LFUCG Post-Hearing Brief at 16-17.

Lexington. The goal of this project is to increase the safety of the Company's employees and customers and to minimize the risk of plant shutdown due to insufficient chemical storage.[77] The project began in 2018 and is expected to be placed in service by July 2019.[78]

Investment Project I12-020037, on the other hand, will address chemical storage safety and reliability concerns at Kentucky River Station I, which is near the Madison County line on the Kentucky River.[79] It is not expected to be placed in service until 2020.[80] Claiming that these two geographically and temporally distinct projects are one is simply untenable and facially insupportable.

LFUCG then utilizes its erroneous factual characterization to construct a strawman argument claiming that KAWC should have obtained a CPCN based on the combined costs associated with the two projects. This legal argument likewise fails. Using the net plant calculation relied on by LFUCG of $567,115,299, the Richmond Road Station investment project comprises **1.8 percent** of net plant at a cost of $10,500,001. The Kentucky River Station I project constitutes only **1.5 percent** of net plant at a cost of $8,500,001. Even assuming that LFUCG is correct in asserting that the "Commission applie[s] the '2% rule' to determine if projects were in the ordinary course of business,"[81] neither project individually meets or exceeds that threshold and there is no rational basis to view them as one project.

More broadly, KAWC explained in detail the process it follows in deciding whether to apply for a CPCN. In response to Item No. 5 of the Staff's Second Request for Information, KAWC explained that based on its consideration of the applicable laws and regulations,

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[77] O'Neill Direct at 16.
[78] *Id.*
[79] *Id.* at 15.
[80] *Id.*
[81] LFUCG Post-Hearing Brief at 17.

Commission orders, and Commission Staff opinions, the Company has traditionally felt that a project that is replacing an existing asset in kind or in general operation has not required submittal for a CPCN.[82] The replacement of existing chemical storage and feed processes falls squarely within this category as an ordinary course of business expenditure.

Moreover, the Commission has explained that the applicable laws and regulations principally consider three factors in determining whether a project is an ordinary extension of KAWC's existing systems in the usual course of business for which a CPCN is not required: (1) the project does not result in the wasteful duplication of plant; (2) the project does not compete with the facilities of existing public utilities; and (3) the project does not involve a sufficient capital outlay to materially affect the utility's existing financial condition or require an increase in utility rates.[83] The two chemical projects individually satisfy each of these criteria. First, the projects cannot be a wasteful duplication of plant because each project *replaces* existing plant. Second, the projects bear no relationship to competing with other public utilities. Third, even when applying LFUCG's "2% rule," each project falls below that threshold.

LFUCG further argues there is not sufficient evidence to support the reasonableness of the costs associated with the two projects. This argument is premised on misrepresentations of the legal standard associated with the Commission's review of expenses. LFUCG claims that because "no federal or state regulation or law requires" modifications to the chemical processes at the two plants, the projects are unneeded or constitute wasteful duplication.[84] There is no precedent to suggest that any expenditure not mandated by federal or state law is unreasonable.

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[82] Response to PSC 2-5.
[83] *In the Matter of: Application of Northern Kentucky Water District (A) For Authority to Issue Parity Revenue Bonds in the Approximate Amount of $16,545,000; and (8) A Certificate of Convenience and Necessity for the Construction of Water Main Facilities*, Case No. 2000-00481, Order (Ky. PSC Aug. 30, 2001).
[84] LFUCG Post-Hearing Brief at 18.

If that were true, many of the cooperative actions KAWC has undertaken with LFUCG, such as performing infrastructure upgrades when LFUCG has elected to perform a road project, would likewise be unreasonable.

LFUCG then claims that the costs are unreasonable because "no complete cost benefit analysis was performed."[85] Again, there is no precedent that suggests a utility is required to perform a "complete cost benefit analysis," before incurring a capital expenditure. At bottom, this is a replacement project that is designed to reduce the exposure of dangerous chemicals to KAWC's employees, customers, and the general public at large. Surely, LFUCG is not faulting KAWC for not comparing the costs of a harmed employee or customer with an unharmed employee or customer. The result of such a cost-benefit analysis speaks for itself.

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

(a) <u>The AG Fails to Recognize that KAWC's Authorized Return on Equity and Equity Ratio Need to be Considered Together in Setting a Fair Return</u>

A fundamental aspect of the financial regulation of utilities is assuring that the utility has a reasonable opportunity to earn a return on capital consistent with the return available on investments of similar risk.[86] As KAWC witness Ms. Bulkley has explained, the product of the return on equity ("ROE") and the equity ratio, i.e., the Weighted Return on Equity ("WROE"), ultimately defines the equity return to shareholders,[87] just as the product of the cost of debt and the debt ratio ensures that a company's debt obligations are met.[88] The AG has focused only on the ROE and does not recognize that KAWC has requested an equity ratio that is well below the

[85] LFUCG Post-Hearing Brief at 19.
[86] Bulkley Rebuttal at 12.
[87] *Id.* at 12-13.
[88] *Id.*

mean of the proxy group and certainly well below equity ratios authorized by this Commission.

At the hearing, Ms. Bulkley responded to questions from Vice Chairman Cicero about the Commission's recent Atmos decision, in which Atmos's authorized ROE was 9.65 percent with equity ratio of 58.06 percent.[89] As the summary table below demonstrates, the ROE range recommended by Ms. Bulkley in this case (10.0 percent to 10.8 percent)[90] is well within the range of reasonableness, while the AG/LFUCG's ROE recommendations in this case are well below the norm.

	Authorized / Recommended ROEs	Equity Ratios	Weighted Return on Equity (WROE)
Atmos[91]	9.65%	58.06%	**5.60%**
KAWC [92]	10.80%	48.65%	**5.25%**
Water Proxy Group Mean[93]			***4.88%***
KAWC[94]	10.00%	48.65%	**4.65%**
AG/LFUCG	9.15%	48.65%	**4.45%**

(b) **The Commission Should Ignore the AG's Remarks on KAWC's Cost of Debt**

The Company and AG agree the Commission should approve KAWC's proposed cost of debt. Contrary to AG's allegation, however, KAWC did not revise its projected interest rate expense because the initially filed rates were "excessive" or in "acknowledgement that the original forecasted debt projections were inflated."[95] As KAWC explained in Mr. Rungren's

[89] 5/13/19 VR at 4:13:50.
[90] Bulkley Rebuttal at 72.
[91] *In the Matter of: Electronic Application of Atmos Energy Corporation for an Adjustment of Rates* (Case No. 2018-00281) (Ky. PSC May 7, 2019). Atmos's authorized return was 9.65% with equity ratio of 58.06% resulting in an approved WROE in the recent Atmos decision of approximately 5.60% (9.65% x 58.06% = 5.60%).
[92] If the Commission were to approve an ROE of 10.80%, KAWC's resulting WROE would be 5.25% (10.80% x 48.654% = 5.25%).
[93] Bulkley Rebuttal at 13.
[94] If the Commission were to approve an ROE of 10.00%, KAWC's resulting WROE would be 4.65% (10.00% x 48.654% = 4.65%).
[95] AG Post-Hearing Brief at 28.

rebuttal testimony and its Post-Hearing Brief, KAWC updated its long-term and short-term debt rates using the most recent available information.[96]

12. KAWC'S RATE ALLOCATION AND RATE DESIGN ARE REASONABLE

(a) <u>Single Tariff Pricing is Fair and Reasonable for All Customers</u>

KAWC's Post-Hearing Brief explained the history of single tariff pricing for KAWC.[97] It explained that the Commission ordered KAWC to propose single tariff pricing in 2005; that KAWC did so in 2007; that the AG and LFUCG agreed to it in 2007; that LFUCG has opposed single tariff pricing since then; and that the Commission has rejected LFUCG's opposition. Now, both LFUCG and the AG argue against single tariff pricing even though they submitted no evidence or expert testimony (on cost of service or otherwise) on that issue. KAWC stands on its Post-Hearing Brief on this issue but adds that the Intervenors' accusations that KAWC's "actions are in direct contravention" of the Commission's Order in Case No. 2012-00520 are mistaken.

While the Intervenors correctly quote portions in the body of that Order related to how the Commission will consider future acquisitions (especially acquisitions of non-jurisdictional utilities such as municipal systems) and what presumptions can and cannot be made related to single tariff pricing, they fail to cite the single most important directive the Commission issued to KAWC. After the verbiage cited by the Intervenors, the Commission did what it always does to make its directives perfectly clear—it issued "Ordering Paragraphs." In that Order, the Commission's Ordering Paragraph 8 states, "[a]t least 90 days prior to the execution of any agreement to acquire a water system that is not subject to Commission jurisdiction, Kentucky-

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[96] Rebuttal Testimony of Scott W. Rungren ("Rungren Rebuttal") at 4-6 (Ky. PSC Apr. 30, 2019); KAWC Post-Hearing Brief at 45.
[97] KAWC Post-Hearing Brief at 65-67.

American shall advise the Commission in writing of the pending transaction, to include the name and location of the water system and a brief description of the transaction."[98]

KAWC has complied with that directive in every non-jurisdictional acquisition it has made since the Order was issued, including the acquisition of the municipal Millersburg system in 2014[99] and the acquisition of the municipal North Middletown system in 2019.[100] These notices provided the Commission with notice of a possible transaction so that the Commission could seek information about the acquisition if it chose to do so, and, in fact, it did seek additional information about the Millersburg transaction. Additionally, in all transactions, non-jurisdictional or otherwise, KAWC has filed a case with the Commission for any necessary tariff changes and the Commission has approved those requested tariff changes.[101] In doing so, KAWC has met the requirements of that Order.

Most importantly, KAWC has not "presumed" single tariff pricing will be applied to the former North Middletown and Eastern Rockcastle customers. Indeed, in the tariff adjustments KAWC made and the Commission approved for those customers, they are being charged the same rates they were paying before the acquisitions. Thus, there was no such "presumption" by KAWC. Based on that lack of a presumption, KAWC proposed single tariff treatment in this case where the Commission can do exactly what it said it wanted to do in Case No. 2015-00520—consider whether single tariff pricing should apply. It is conceivable that there may be

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[98] *Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year*, Case No. 2012-00520, Order at 79 (Ky. PSC Oct. 25, 2013).

[99] KAWC provided notice of the Millersburg acquisition by letter dated November 8, 2013 and the Commission confirmed that notice on November 27, 2013. At the Commission's request, KAWC provided further information by letters dated January 10, 2014 and March 21, 2014.

[100] KAWC provided notice of the North Middletown acquisition by letter dated October 9, 2015. The Commission did not request additional information about the North Middletown acquisition at that time. After several years of talks with North Middletown, the transaction was finally completed in 2019.

[101] *See* TFS 2014-00379 for Millersburg; TFS 2018-00657 for North Middletown; and Case No. 2017-00383 for Eastern Rockcastle.

acquisitions in the future for which single tariff pricing will not apply. But, without question, the small size of the Eastern Rockcastle and North Middletown acquisitions do not justify a departure from single tariff pricing. In sum, the accusations about failing to comply with the Order in Case No. 2012-00520 have no basis in fact, and for all the reasons stated in KAWC's Post-Hearing Brief and based on Commission precedent, single tariff pricing should be approved.

(b) **KAWC's Proposed Monthly Service Charge is Reasonable**

The AG's Post-Hearing Brief states that he opposes the imposition of a higher customer charge.[102] The AG did not file testimony regarding rate design, and did not cross examine KAWC's rate design witness, Ms. Heppenstall, at the hearing. The AG has demonstrated no deficiencies in Ms. Heppenstall's proposed rate design and has provided no evidence on this issue, only factually bereft opinion. As such, KAWC's monthly service charge should be approved as filed.

13. KAWC'S ACQUISITIONS ARE REASONABLE AND THE COMMISSION SHOULD REJECT THE AG'S AND LFUCG'S ARGUMENTS

As set forth above, the Commission should approve single tariff pricing for the former Eastern Rockcastle and North Middletown customers. But in addition to the arguments about single tariff pricing, the Intervenors make arguments in their briefs related to those acquisitions (with no supporting expert witness testimony), whether those acquisitions are appropriate, and whether a Utility Plan Acquisition Adjustment ("UPAA") should be approved for the North Middletown acquisition. The AG's primary complaint appears to be with KAWC's invitation for the Commission to apply a "fair market value" methodology to determine what should be added

[102] AG Post-Hearing Brief at 47.

to KAWC's rate base as a result of the North Middletown acquisition.[103] LFUCG argues that the proposed "fair market value" method in Ms. Schwarzell's direct testimony should be rejected and that KAWC does not meet the factors of the "Delta Test"[104] the Commission has used to evaluate UPAAs.[105]

In its Post-Hearing Brief, KAWC noted that, at least at the time the brief was filed, no intervenor had contested the proposed UPAA via witness testimony. Thus, in its Post-Hearing Brief, KAWC incorporated arguments it had already made in the record as to how the North Middletown UPAA does, in fact, meet the Delta test,[106] which included the following for each of the Delta factors:

(a) **The Purchase Was an Arms-Length Transaction Between KAWC and North Middletown**

The KAWC-North Middletown transaction was between a willing seller and a willing buyer and negotiations to reach the purchase price and conditions were conducted without conflict. Neither party was affected by any conflict of interest whatsoever. North Middletown issued an Invitation to Bid for all interested parties in The Bourbon County Citizen newspaper on March 29, 2018. KAWC responded prior to the deadline on April 17, 2018.

(b) **The Purchase Price Plus the Cost of Restoring the Facilities to Required Standards Will Not Adversely Impact the Overall Rates for New and Existing Customers**

The purchase price of the system and the cost of its operation are almost entirely funded by the system's present rate revenue, with only a $16,000 deficiency at the Company's requested rate of return. On a standalone basis, truing up this deficiency would cost the average residential

[103] *Id.* at 61-62.
[104] The Delta Test was established by the Commission in Case No. 9059.
[105] LFUCG Post-Hearing Brief at 24-28.
[106] KAWC Post-Hearing Brief at 59, citing to KAWC's responses to PSC 2-72 and PSC 3-49.

customer in North Middletown approximately $2.92 / month or 5.5 percent of present rate revenue. If included in the single tariff, North Middletown customers will experience a rate decrease of $14.47 / month and the Company's existing single tariff customers' bills would be *unaffected* (less than one penny per month of impact).[107] In terms of the cost of restoring the facilities, at this time, KAWC has not identified any significant expenditures necessary to restore facilities to required standards.[108]

(c) **Operational Economics Will Be Achieved**

North Middletown is currently a resale customer of KAWC, but KAWC is in the process of exploring the hydraulic conditions within the system. Notwithstanding that, integrating North Middletown's standalone SCADA system into KAWC's existing SCADA network will facilitate continuous monitoring of the system, increase awareness of changes within the system, and substantially reduce response time when issues arise. These are operational economies and efficiencies.

KAWC currently staffs three Class IV surface water plants 24/7 with 22 full time positions. Seven employees maintain Class IV water treatment licenses, and 38 maintain distribution licenses. In addition, KAWC currently has seven personnel that hold wastewater operator licenses.

KAWC's Field Operations department maintains a staff of over 60 employees who are experienced in multiple aspects of maintaining a distribution system and can support the North Middletown service area along with the other areas in Bourbon County KAWC currently serves. KAWC maintains 24-hour coverage by operating multiple schedules and has an after-hours emergency crew. The utility fleet consists of backhoes, excavators, dump trucks, utility trailers,

[107] Response to PSC 2-72.
[108] Response to PSC 3-49(a).

pick-up trucks, service trucks, and several other pieces of equipment. KAWC maintains numerous pieces of safety equipment such as: trenching and shoring equipment, highway and traffic safety equipment, and personal protective equipment. The mission is to maintain service with as little disturbance to the customer as possible. All of these resources can and will be used to provide North Middletown more efficient and more economical service than it has been receiving.

KAWC utilizes American Water's centralized laboratory as well as two local, in-house certified bacteriological labs reducing outsourced lab costs and increasing efficiencies and response time. KAWC also benefits from American Water's fully staffed research and development laboratory that remains on the forefront of emerging issues. Current customers have reaped the benefits of these operations for years and the North Middletown customers will now reap them similarly.

(d) **There is Clear Segregation of Utility and Non-Utility Purchased Property**

Non-utility property was not a part of the North Middletown acquisition.

(e) **The Purchase Will Result in Overall Benefits in the Financial and Service Aspects of the Utility's Operations**

As for financial benefits, as part of American Water, KAWC benefits from the national vendor contracts that leverage the purchasing power of a much larger organization. These savings on meters, pipe, hydrants, valves, equipment, and other supplies will benefit the customers in North Middletown. For existing customers, the acquisition will mean greater sharing of fixed overhead costs, expanded economies of scale, and rate-smoothing effects that result from having a larger customer base.[109]

[109] Response to PSC 3-49(b).

As for service benefits, KAWC has a well-equipped fleet of construction and maintenance equipment that can support the North Middletown service area along with the other areas in Bourbon County KAWC currently serves. KAWC also has treatment plant and distribution supervisors as well as emergency personnel on call, around the clock, for immediate dispatch. Under normal circumstances, KAWC personnel and equipment can be dispatched to North Middletown within approximately 45 minutes.

Finally, KAWC has a variety of customer service conveniences for customers including a toll-free line that is staffed 24 hours a day and can dispatch local crews for emergency calls. KAWC offers flexible payment options for its customers as well as enhanced self-serve options. Customers can opt in for advance notification for field service site visits. In addition, KAWC has a Customer Advocacy department available to provide an elevated level of customer care for escalated issues. These services will benefit the North Middletown customers. As for existing customers, they will benefit from the hiring of an additional employee who will supplement water quality resources and field work, and who will be available in times of emergency on a Company-wide basis.[110]

As demonstrated, the North Middletown proposed UPAA meets the Delta Test, so, if the Commission chooses, it can approve the UPAA on that basis and stop there. However, KAWC has invited the Commission to consider an alternative to the Delta Test in this case for the purpose of assessing proposed UPAAs. The AG opposes that "fair market value" test and claims that it should not be adopted as part of a general rate case and that an administrative case would have to be initiated to consider such a "fair market value" method. Of course, the Commission is fully authorized to asses a UPAA in any proceeding it chooses. Indeed, the Delta Test itself was

[110] Response to PSC 3-49(b).

first implemented as part of a general rate case. Certainly, the Commission can utilize a methodology other than the Delta Test if it sees fit.

As explained in Ms. Schwarzell's direct testimony and in response to PSC 2-74, the proposed "fair market value" approach could encourage water system consolidation in Kentucky. It would allow an addition to the acquiring utility's rate base in an amount deemed to be the "fair market value" of the assets being acquired. It would bring the financial risk associated with water system acquisitions into line with the financial risk of making other investments in water utility infrastructure. Additionally, given the differentiated circumstances of water system acquisitions compared to investor owned gas acquisitions, it would allow for a valuation of assets that is not dependent on the accounting accuracy and completeness of an acquired system's books in light of the reality that such books can be less than adequate, especially when 84 percent of small systems in Kentucky are not investor-owned and thus do not have the same protocols for keeping meticulous records of investment.

There is inherent inefficiency in serving the public through fragmented water systems. Small systems often suffer from resource deficiency, as they cannot always afford full time professional engineering, water quality, research, and operations professionals. Small, fragmented utilities likewise suffer inherent cost and operational inefficiency, as they cannot leverage the buying power and capital market access that larger utilities can provide. Finding ways to consolidate and regionalize the management of water systems in Kentucky can improve the efficiency, reliability, and safety of water service and is in the public interest.

Utilizing a "fair market value" approach would encourage water system regionalization and consolidation. In approving KAWC's acquisition of the Eastern Rockcastle customers, the Commission noted it was following the General Assembly's guidance set forth KRS

224A.300(1), which encourages the regionalization and consolidation of water and wastewater systems.[111] And the Commission itself has encouraged KAWC to become a regional water provider.[112] The Commission can facilitate that encouragement by using a fair market value approach, and KAWC urges the Commission to consider its use in this matter.

14. KAWC HAS SHOWN THAT A TWENTY PERCENT UNACCOUNTED-FOR WATER PERCENTAGE IS A REASONABLE ALTERNATIVE IN ACCORDANCE WITH 807 KAR 5:066

The AG and LFUCG argue that the Company's unaccounted-for water loss costs over 15 percent should be disallowed because the Company failed to appropriately propose an alternative water loss standard.[113] The AG asserts that such a request for an alternative water loss standard is "required by law" and the Commission has an "obligation to disallow unaccounted-for water production and purchase costs in excess of 15%."[114] Such an assertion ignores the plain language of the regulation. 807 KAR 5:066, Section 6(3) provides that "[u]pon application by a utility in a rate case filing or by a separate filing, or upon motion by the commission, an alternative level of reasonable unaccounted-for water loss may be established by the Commission."

Thus, the plain language of the regulation only requires that the utility apply for an alternative level of reasonable unaccounted-for water loss in the context of a rate case filing, not necessarily in the rate case application. At the hearing, Vice Chairman Cicero recognized the

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[111] *Electronic Verified Joint Application of Eastern Rockcastle Water Association, Inc. and Kentucky-American Water Company for the Transfer and Control of Assets*, Case No. 2017-00383, Order at 12 (Ky. PSC Jan. 19, 2018).
[112] *Application of Kentucky-American Water Company for a Certificate of Convenience and Necessity Authorizing Construction of the Northern Division Connection*, Case No. 2012-00096, Order at 19 (Ky. PSC Feb. 28, 2013); *Notice of Adjustment of Rates of Kentucky-American Water Company*, Case No. 89-438, Order at 24 (Ky. PSC June 28, 1990) ("The Commission has and will continue to encourage Kentucky-American to become a regional supplier of water . . . .").
[113] AG Brief at 5; LFUCG Brief at 9-12.
[114] AG Brief at 5.

Company's request for an alternative level of reasonable unaccounted-for water loss.[115] To disallow the Company's request for an alternative level of reasonable unaccounted-for water loss simply because it was not included in the Company's rate case application would place form over substance. The Commission has rejected such arguments that favor form over substance.[116]

The Company has shown throughout this proceeding the reasonableness of a 20 percent unaccounted-for water loss percentage. KAWC stands by the arguments it has already made in its Post-Hearing Brief and otherwise in the record of this case showing the reasonableness of a 20 percent unaccounted-for water loss percentage. Accordingly, the Commission should use a 20 percent unaccounted-for water percentage because the Company has shown it is a reasonable alternative in accordance with the regulation.

15. KAWC AGREES WITH CERTAIN OPERATING INCOME ADJUSTMENTS

(a) <u>Trane</u>

In order to limit the contested issues in the case, KAWC agreed to Mr. Kollen's proposed adjustment to defer and amortize revenues associated with the Trane industrial operation.[117] This adjustment reduces the revenue requirement by $8,000.[118] KAWC and the AG agree that this amount should be removed from the revenue requirement.

(b) <u>Dues Paid to Organizations for Covered Activities</u>

The Company explained in discovery that the "lobbying portion of the Commerce Lexington, Greater Lexington Apartment Association, and Kentucky Chamber of Commerce in

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[115] 5/14/19 Hearing, VR 10:46:45 AM.
[116] *The Application and Notice of Campbell County Kentucky Water District to Adjust Rates Effective May 1, 1991*, Case No. 91-039, Order at 1-2 (Ky. PSC May 15, 1991). In this case, a party moved to intervene and the applicant argued that the motion was untimely and the party had not cited the correct intervention regulation. The Commission stated: "Denial of [the party's] motion on the basis of an improperly cited regulation, furthermore, would elevate form over substance . . . ."
[117] Schwarzell Rebuttal at 13-14.
[118] *Id.*

the amount of $3,453 was erroneously recorded to Company Dues/Memberships, and therefore should be removed from the forecast period."[119] KAWC and the AG agree that this amount should be removed from the revenue requirement.

(c) **Chemical Expense Correction**

As KAWC explained in the rebuttal testimony of Ms. Schwarzell, KAWC reduced its chemical expense amount to correct an error.[120] KAWC and the AG agree that this amount should be removed from the revenue requirement.

(d) **Purchased Power Expense**

In its base period update and in rebuttal testimony, KAWC reduced its revenue requirement to adjust its power expense amount to reflect the Commission approved settlement in Kentucky Utilities Company's rate case.[121] KAWC does not contest the reduction of the revenue requirement to reflect the reduction in purchased power expense from Kentucky Utilities Company.

16. 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 and Service Company expense. The QIP that KAWC has proposed is critically important to the Company and its customers, as it will enable KAWC to accelerate the replacement rate of infrastructure that has reached the end of its useful life. To avoid multiple adverse issues, including cash flow issues, intergenerational inequities, and a possible normalization violation, it

[119] Response to AG PH-2.
[120] Schwarzell Rebuttal at 2-3.
[121] Base Period Update, Exhibit 37, Schedule C-1, Page 2 of 9; Schwarzell Rebuttal at 2-3.

is also especially important that the Commission consider and approve the use of the Average Rate Assumption Method 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 to address the impacts of the TCJA. Finally, the 10.8 percent ROE KAWC has requested is reasonable and is premised on the prudent application of a host of cost of equity estimation models. It is imperative that the Company's ROE is established at a level that will ensure that KAWC can attract the discretionary capital necessary to permit optimal ongoing capital investment in service of its customers. 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 that will permit it to provide safe, reliable and efficient water service to its customers.

Respectfully submitted,

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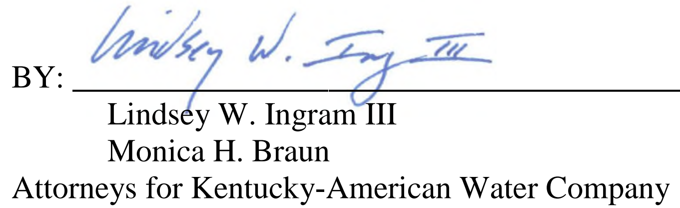

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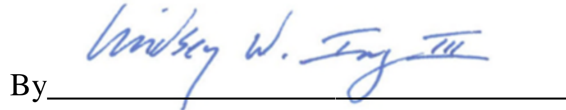
CERTIFICATE

This is to certify that Kentucky-American Water Company's June 14, 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 June 14, 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.

STOLL KEENON OGDEN PLLC



By______________________________

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