COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

POST-HEARING BRIEF OF THE ATTORNEY GENERAL

Respectfully submitted,

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ATTORNEY GENERAL'S POST-HEARING BRIEF

Comes now the intervenor, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (the "Attorney General"), and hereby tenders the following post-hearing brief in the above-styled matter.

I. STATEMENT OF THE CASE

Kentucky-American Water ("Kentucky-American" or the "Company") is an investor owned utility, operating as a wholly-owned subsidiary of American Water Works Company, Inc. ("American Water"),[1] which provides water service to 131,752 customers in Bourbon, Clark, Fayette, Gallatin, Harrison, Jessamine, Owen, Rockcastle, Scott, and Woodford counties.[2] On November 28, 2018, filed its application in the above-styled action, in which it sought, *inter alia*, permission to increase its revenues by $19,865,003 million, to implement a Qualified Infrastructure Program surcharge (the "QIP") as a tariff rate adjustment mechanism on certain capital improvement projects, and approval of a unified tariff for its entire service territory following its acquisitions of the former Eastern Rockcastle Water Association in 2018 and the City of North Middletown's water and wastewater assets in 2019.[3] On November 30, 2018, Commission Staff issued a letter stating that Kentucky-American's application met the minimum filing requirements and was accepted for filing as of November 28.[4] Later, on April 15, 2019, the Company filed its base period update, in which, *inter alia*, it modified its requested revenue requirement to $18,471,247.

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[1] Company Application ["Application"], *Electronic Application of Kentucky-American Water Company For An Adjustment of Rates*, Case No. 2018-00358, at 1 (Ky. Commission November 28, 2018).
[2] Kentucky-American 2018 Annual Report, at 54, 11.
[3] Application.
[4] Commission No Deficiency Letter, Case No. 2018-00358 (Ky. Commission November 30, 2018).

The Lexington-Fayette Urban County Government ("LFUCG") moved to intervene on December 11, 2018, and the Community Action Council for Lexington-Fayette, Bourbon, Harrison, and Nicholas Counties, Inc. ("CAC") moved to intervene on December 27, 2018. The Attorney General moved for intervention on December 28, 2018 and was granted the same on January 3, 2019. On that same date, the Attorney General filed a motion to amend the procedural schedule, which the Commission granted in part and denied in part. Also on January 3, 2019, the Commission ordered a hearing for January 9 to receive testimony from LFUCG and CAC in support of their motions for intervention and to determine whether the specialized interest of each movant was already adequately represented, and the relevant issues and facts that each would present to the Commission in furtherance of full consideration of the matter. The Commission also cautioned that it is unable to consider affordability as a factor under KRS 278.170(1) and U.S. Supreme Court precedent.[5] The Attorney General requested rehearing of that portion of his motion to amend the procedural schedule which was denied, but the Commission in turn denied rehearing by an order issued on January 8, 2019. At the January 9 motion hearing, CAC notified the Commission that it had withdrawn its motion to intervene, while LFUCG presented testimony regarding its specialized interest not otherwise represented by intervenors and how its presence would help to develop the record without unduly disruption. On January 10, 2019, the Commission granted LFUCG's intervention, and further required that the joint participation agreement between the Attorney General and LFUCG for the sharing of witnesses and the associated cost allocation be filed into the record. The agreement was filed into the record on February 19, 2019.

Two rounds of discovery took place, and the Attorney General and LFUCG submitted testimony through their joint witnesses on March 15, 2019, with the Company submitting rebuttal

[5] Commission Order, Case No. 2018-00358 (Ky. Commission January 3, 2019) (citing *Gainesville Util. Dept. v. Fla. Power Corp.*, 402 U.S. 515, 528 (1971)).

testimony on April 30, 2019. An evidentiary hearing was held from May 13 to May 14, 2019. The Company submitted its responses to Post-Hearing data requests from both the intervenors and Commission Staff on May 24, 2019, and subsequently submitted its Post-Hearing brief on May 31, 2019. Following the submission of the Attorney General's brief by June 11, the Company will have the option of filing a reply.

Under Kentucky-American's proposed rates, a residential customer with average usage will see their bill increase by $7.56, or 24%. A residential customer of the former Eastern Rockcastle water system with average usage will see their bills decrease by $3.93, or -11%. A residential customer of the former North Middletown water system with average usage will see their bills decrease by $14.47, or -27%.

II. ARGUMENT

Burden of Proof

Kentucky-American bears the burden of proof that its "increased rate or charge is just and reasonable."[6] Under Commission precedent, the applicant must prove its rates and other requested relief in its application are necessary.[7] Unless an intervenor "advances proposals in areas or on issues that Kentucky-American has not addressed in its application . . . [he] has no burden of proof to meet."[8] Thus, the Attorney General carries no burden in this case. The Commission may only approve rates that are fair, just, and reasonable.[9] The Commission may not grant approval to

[6] KRS 278.190(3).
[7] Commission Order, *In the Matter of: Proposed Adjustment of the Wholesale Water Service Rates of the City of Augusta*, Case No. 2015-00039, at 16 (Ky. Commission February 3, 2016) ("Although the applicant has the burden of proof, it is the Commission that decides whether the applicant has met its burden of proof based upon all of the evidence in the record and in light of the arguments of the parties made in their briefs").
[8] Commission Order, *In Re. Adjustment of the Rates of Kentucky-American Water Company*, Case No. 2004-00103, at 2 (Ky. Commission October 27, 2004) (referencing specifically the Attorney General as intervenor).
[9] KRS 278.030.

proposals in which the applicant has not sufficiently made its case.[10] There is no requirement that parties intervene in proceedings before the Commission, and no requirement that an intervening party must object and rebut an applicant's proposal in order for the Commission to deny the requested relief. In its post-hearing brief, the Company inexplicably repeated the assertion that a proposal "Has Not Been Contested" by intervenors, indicating that no intervenor expert evidence rebutted Kentucky-American's claims, thus ostensibly rendering its requested relief reasonable.[11] Kentucky-American's argument is misplaced. Citing to no law nor precedent in support, the Company is arguing that but for intervention *and* the proffer of contrary evidence, its application deserves approval by default. Again, the Attorney General has no burden or obligation to rebut Kentucky-American's arguments. Kentucky-American's application, as supported by the record and "in light of the arguments . . . made in [its] brief []," must stand on its own.[12]

Part and parcel of this burden is the process by which the petitioner submits its rate case and any other proposals. The application is the petitioner's forum for its requested relief. The Commission should not countenance granting the Company any relief that is unsupported, and not contemplated in its application, or relief that substantially modifies that which the application originally requested without additional support. Here, the Company made new proposals in its rebuttal testimony, including the alternative water loss standard it requested that the Commission consider. Although required by law, the application makes no reference to either 807 KAR 5:066 Section 6(3) or to the Commission's obligation to disallow unaccounted-for water production and purchase costs in excess of 15%. In fact, the Company's first voluntary discussion of the issue occurred in rebuttal testimony, where Kentucky-American postulates an entirely new 20%

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[10] *See Allen v KHRA*, 136 S.W.3d 54 (Ky. Ct. App. May 14, 2004) (regarding administrative agencies requiring an order to be supported by substantial evidence).
[11] Company's Post-hearing brief, Case No. 2018-00358, at 10, 12, 50 (Ky. Commission May 31, 2019).
[12] Commission Order, Case No. 2015-00039, at 16 (Ky. Commission February 3, 2016).

unaccounted-for water threshold.[13] By waiting to propose this in its rebuttal, Kentucky-American foreclosed upon the Attorney General's opportunity to question, address, or rebut the company's new request. The Commission must consider the manner and disregard with which the Company's modification took place, and reject it.

Additionally, the Company's new unaccounted-for water position set forth in its rebuttal testimony is just one instance where it directly violated the legal prohibition against updating forecasts in rate cases utilizing forecasted test years within thirty (30) days of a scheduled hearing.[14] On April 15, 2019, the Company filed its base period update. In the update, Kentucky-American included actual figures from the previously forecasted second six months of the base period in the application's forecasted test year. This is the purpose of the base period update, not to amend the utility's forecast.[15] However, the Company's update not only provided actual figures in lieu of projections, it also added entirely new projects to the forecast—for instance, the two tank paintings. While the Company noted that the new total for maintenance, $109,119, is incremental and not a new forecasted amount, this still represents a change to the original forecast, which is not permitted by relevant law.

As a general matter, if the Attorney General's Post-Hearing Brief does not address any particular issue raised during this proceeding, the Commission should not interpret or construe that fact as his acquiescence or support for that issue. For any issue the Attorney General does not specifically discuss herein, but was mentioned in his experts' testimonies, he supports the recommendations put forward by his and LFUCG's expert witnesses, Messrs. Kollen and Baudino.

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[13] Rebuttal Testimony of Brent E. O'Neill ["O'Neill Rebuttal"] at 16–17.
[14] 807 KAR 5:001 Section 16(6)(d).
[15] KRS 278.192(2)(b).

Furthermore, the Attorney General would welcome any other adjustments the Commission may deem necessary and reasonable in this matter in an effort to ensure affordable rates.

Affordability

The Company's proposals in this matter include a 10.80% ROE, a new scheme to increase the value of future water system acquisitions, and an increase to the Monthly Service Charge. Taken in concert with the rest of the application, Kentucky-American's ask amounts to an unaffordable increase to its ratepayers.

Revenue Requirement

In its simplest form, rate case revenue requirements are ordinarily calculated by adding expenses to operating income, with an allowance for statutory income tax on the operating income. Operating income is derived by taking the utility's net original cost rate base and multiplying it by a rate of return. The first item of this calculation to be addressed by the Attorney General in this brief concerns the issues regarding the Company's proposed net original cost rate base.

Rate Base Issues

A. Overstated Cash Working Capital

The Cash Working Capital allowance in rate base totaling $3.754 million, and based on a lead/lag study the Company performed, is incorrect due to multiple errors: (1) Kentucky-American's accelerated payments or prepayments to American Water Works Service Company ("AWWSC" or "Service Company"), (2) the Company's failure to reflect the correct amount of expense lag days for the cash dividend component of the net income "expense" item, and (3) the Company's further failure to remove non-cash items from Cash Working Capital—depreciation expense, deferred income tax expense, and the non-cash non-dividend component of the net income "expense." The combination of these errors has led to the Cash Working Capital allowance being overstated, and the Commission should correct this.

i. *Expense Lead Days for Service Company, Prepayment*

First, the Company argues that its method of prepaying expenses to AWWSC, followed by a monthly true up is no less efficient than paying actual expenses incurred at the end of a period. Ms. Schwarzell explained that even though the Company must true up these expenses each month, 2018 resulted in a net underpayment of expenses.[16] This is despite the fact that the total for 2017 showed a net overpayment, and that two separate months in 2018 also showed an overpayment of expenses, one by 19.1% and the other by 38.6%.[17] The driving force behind Kentucky-American's insistence that this process is reasonable is because "[t]he Service Company exists to provide services to American Water affiliates at cost."[18]

As Mr. Kollen's testimony explains, the structure of the arrangement results in the Company's prepayments going to the Service Company, while the benefit accrues to Kentucky-American shareholders. Because the carrying costs are paid for by Kentucky-American (or its ratepayers), and AWWSC doesn't have to float capital until the invoice is paid (because it is prepaid), any allocated capital is Kentucky-American's, not AWWSC's. Therefore, because of the prepayment, the carrying cost on the capital employed is at Kentucky-American's grossed-up return, instead of AWWSC's lower short-term debt cost. In other words, it matters which entity incurs the carrying costs. Neither the Company nor the Company's customers are indifferent or neutral on this issue. If the costs are incurred by Kentucky-American through the prepayment to

[16] VTE at 9:06:46—9:12:00.
[17] Rebuttal Testimony of Melissa Schwarzell ["Schwarzell Rebuttal"] at 12; Direct Testimony of Lane Kollen ["Kollen Direct"] at 8–9; Company's Response to Attorney General's Second Data Requests, Item 33.
[18] Schwarzell Rebuttal at 11.

AWWSC, they are substantially greater than if they are incurred by AWWSC and then billed as short-term interest to Kentucky-American. Thus, by requiring Kentucky-American to prepay these expenses to AWWSC, American Water benefits from built in arbitrage, to the detriment of Kentucky ratepayers. That is not reasonable, and the excessive cost incurred through cash working capital calculation should be disallowed. The Attorney General urges the Commission to adopt Mr. Kollen's recommendation and require the Company to use 45.63 lag days instead of the current negative 3.50 lag days, to protect customers by ensuring they only pay the Service Company cost of short-term debt and not Kentucky-American's grossed up rate of return, as is reflected in the current setup and the Company's requested revenue requirement.

ii. *Failure to Reflect the Correct Amount of Expense Lag Days for the Cash Dividend Component of the Net Income "Expense" Item*

Second, the Company did not properly account for the expense lag days related to the cash dividend component of the net income "expense" item. Instead, it classified the entirety of the net income "expense" item as a non-cash expense and reflected 0 expense lag days. Since the dividend is paid quarterly as cash by Kentucky-American to American Water, it should be considered separately from the non-cash non-dividend components of the net income "expense" in the Cash Working Capital study. Mr. Kollen recommends using the allocation ratios in American Water's dividend policy, specifically the American Water Subsidiary Dividend Policy, which requires a 75% payment of the Company's net income in dividends, with the remaining 25% representing the non-cash non-dividend expense.[19] Further, based on the Company's payment of a quarterly dividend in arrears, the Commission should employ 134.9 days for the expense lag instead of the 0 days the Company put

[19] Kollen Direct at 10–11.

forward.[20] The resulting effect is a reduction of the revenue requirement by $0.647 million. The Attorney General recommends that the Commission accept Mr. Kollen's adjustment in full.

iii. Failure to Remove Non-cash Items from Cash Working Capital

Finally, the Company did not properly remove non-cash items from the Cash Working Capital total. Kentucky-American incorrectly included $22.766 million in non-cash expenses in its calculation of the Cash Working Capital, including deferred income tax expense, depreciation and amortization expense, and the non-cash non-dividend component of net income expense.[21] At the hearing, Ms. Schwarzell confirmed that depreciation never gets paid in cash.[22] Further, she confirmed that depreciation expense is not paid at all.[23]

The Attorney General agrees with Mr. Kollen's recommendations that the Commission should remove the non-cash expenses from the Cash Working Capital Study. The effect of such reduces the revenue requirement by $0.273 million.

iv. The Commission Should Apply a Slippage Factor as Proposed by Mr. Kollen

In its application, Kentucky-American chose not to propose a slippage factor to reconcile the Company's forecasts of capital expenditures and plant additions with the actuals. In his direct testimony, Mr. Kollen proposed a slippage factor of 91.968%, which compared the Company's annual construction expenditures versus annual construction budget from 2008 through 2017.[24] He then applied this factor to all of the budget/forecast months from

[20] *Id*.
[21] *Id*. at 13.
[22] VTE at 9:11:53—9:12:20.
[23] *Id*.
[24] Kollen Direct at 16–19.

September 2018 through June 2020, which would result in a reduction to the revenue requirement of $0.554 million.[25] The data underlying his adjustment was provided by the Company in response to Commission Staff's third data request, item 2. Said differently, Mr. Kollen's adjustment applies the slippage factor explicitly requested by Commission Staff in discovery. The methodology is reasonable because it compares Kentucky-American's original construction budgets to actual expenses—the purpose of a slippage factor.

In response to Mr. Kollen's proposed adjustment, the Company, for the first time in this matter, proposed a slippage factor as part of its base period update which served to *increase* its revenue requirement in this case.[26] The Commission has a history of recognizing and applying slippage factors in prior Kentucky-American cases, especially if the utility's actual capital expenditures are less than those *initially* included in its budget.[27] The Attorney General does not understand why, if it wanted to apply a slippage factor, Kentucky-American's application did not reflect a slippage factor, regardless of whether it benefits shareholders. The Attorney General recommends that the Commission follow its established precedent, apply a reasonable slippage factor methodology, and make the adjustments Mr. Kollen initially proposed.

Rate of Return Issues

As part of its task in determining the Company's revenue requirement, the Commission must determine Kentucky-American's required net operating income. "In Kentucky a utility company's required net operating income for rate-making purposes is computed by applying

[25] *Id*.
[26] Company's Base Period Update, at 1 (April 15, 2019).
[27] *See* Kentucky-American Water, Case No. 2004-00103; Union Light, Heat and Power Company, Case No. 2005-00042.

its cost of capital to its capital structure."[28] In determining a utility's cost of capital, the Commission may impute hypothetical amounts for ratemaking purposes, so long as they are supported by substantial evidence of probative value.[29] For example, if there are no changes to debt during a test year, the current return on debt may be reasonable, but in a proceeding where a debt instrument will be issued during a forecasted test year, the Commission must consider, based on substantial evidence, what the reasonable cost is for ratemaking purposes.

A. Return on Equity

Determining a cost of debt is ordinarily straightforward as the required rates are prescribed by the instruments themselves. The required Return on Equity ("ROE"), is more difficult to ascertain. When calculating the return on equity, the Commission's initial guiding principle is rooted in the U.S. and state constitutions. "The federal and state constitutions protect against the confiscation of property, not against a mere reduction in revenue."[30] As the Kentucky Supreme Court has previously discussed:

> A confiscatory rate is one that is unjust and unreasonable. Rates are non-confiscatory, just and reasonable so long as they enable the utility to operate successfully, to maintain its financial integrity, to attract capital and to compensate its investors for the risks assumed even though they might produce only a meager return on the so-called 'fair value' rate base. . . . By long standing usage in the field of rate regulation the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense. Assuming that there is a zone of reasonableness within which the legislature or its designee is free to fix a rate varying in amount and higher than a confiscatory rate it is also free to decrease any rate which is not the 'lowest reasonable rate'.[31]

Thus, the constitutional limitation upon rates of return—whether they are confiscatory,

[28] *Public Service Comm'n of Kentucky v. Continental Telephone Co. of Kentucky*, 692 S.W.2d 794, 798 (Ky. 1985).
[29] *Id*. at 798–801.
[30] *Com. ex. rel. Stephens v. South Central Bell Tel. Co.*, 545 S.W.2d 927, 930 (Ky. Dec. 3, 1976).
[31] *Id*. at 930–31. (citing *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 62 S.Ct. 736, 86 L.Ed. 1037 (1942)).

thus unreasonable and unjust—speaks only to the floor the Commission must consider. As the U.S. Supreme Court has stated,

> What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.[32]

Therefore, even though there is a legal limit to how low a return on equity may be, there is no corresponding constitutional limit on how high the Commission may set it. As discussed below, Kentucky-American has indeed tested the upper bound regarding return on equity, offending any sense of reasonableness. Regarding the upper bound of return on equity, given a lack of constitutional constraint, the Commission is merely provided guidance under the relevant statute, that the rate must be fair, just and reasonable.[33]

i. Kentucky-American's Proposed Return on Equity as Supported By Ms. Ann Bulkley

In this proceeding, Kentucky-American retained Ms. Anne Bulkley as an expert witness to determine its proposed required ROE. ROE is the rate of return required by

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[32] *Bluefield Waterworks & Imp. Co. v. Public Service Comm'n of W. Va.*, 262 U.S. 679, 692–93 (1923).
[33] KRS 278.030(1).

shareholders on their investment in a utility's common stock.[34] Through direct testimony, Ms. Bulkley recommended that the Commission award the Company a 10.8% ROE. If adopted, Ms. Bulkley's ROE would be 30 basis points higher than the highest authorized water ROE since at least 2012.[35] Said differently, Kentucky-American Water is asking its customers to pay *the highest rate of profit for any water utility in the United States of America in the last seven years*. Ms. Bulkley's 10.8% ROE was based on her range of estimates for Kentucky-American from 10% to 10.8%.[36] Ms. Bulkley's range was estimated by employing versions of a Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses.[37] As discussed below, Ms. Bulkley's analyses are grossly inflated due to her improper use of projections and estimates, contrary to the Commission's consistent precedent.[38] Even though Ms. Bulkley refuses to acknowledge that excessive ROEs harm customers, her proposed, "nation's highest" water ROE is in excess of what shareholders require and would harm Kentucky-American's ratepayers.[39] As the Kentucky Supreme Court has previously noted, "one of the important objectives considered by the commission . . . is providing the lowest possible cost to the ratepayers."[40] Ms. Bulkley's and Kentucky-American's proposed ROE was calculated using procedures which this Commission and the Commonwealth's courts have

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[34] *South Central Bell Telephone Co. v. Utility Regulatory Comm'n*, 637 S.W.2d 649, 653 (Ky. 1982), stating, "the rate making process is to provide for the utility a reasonable profit on its operations so that its owners may achieve a return on their investment. Such matters are purely those of a financial nature."
[35] Rebuttal Testimony of Ann E. Bulkley ["Bulkley Rebuttal"] at 12.
[36] Direct Testimony of Ann E. Bulkley ["Bulkley Direct"] at 8.
[37] *Id*.
[38] Bulkley Direct at 8–9; Direct Testimony of Richard Baudino ["Baudino Direct"] at 11, 17, 40–41; Kentucky Power, Case No. 2017-00179; *See 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* , 2017-00321 (Ky. Commission April 13, 2018); Atmos, Case No. 2018-00281.
[39] May 13, 2019 VTE at 2:44:09; Baudino Direct at 40.
[40] *Public Service Comm'n of Kentucky v. Continental Telephone Co. of Kentucky*, 692 S.W.2d 794, 799 (Ky. 1985).

consistently and explicitly rejected.[41]

Primary Issues With Ms. Bulkley's Recommendation

1. <u>Ms. Bulkley removes low-end DCF results while including high-end results</u>

In calculating her Constant Growth DCF analysis, Ms. Bulkley "eliminated any ROE estimate that is below the yield on the 30-year Treasury Bond plus a minimum equity risk premium."[42] Ms. Bulkley cited no Commission precedent for such an exclusion, or any precedential calculation for creating such a "lower boundary." Instead, Ms. Bulkley's proposed "lower boundary" was based entirely "on a recent position established by the Minnesota Department of Commerce."[43] Ms. Bulkley's exclusion of low-end ROE results is inappropriate for a number of reasons.

First, Ms. Bulkley provides no basis in Kentucky law or practice for her exclusion of low-end DCF results, including not citing a single instance of the Commission having ever supported or adopted such an exclusion. Instead, Ms. Bulkley depends "on a recent position established by the Minnesota Department of Commerce." Other than to explain her calculation of the 7.00 percent "lower bound," Ms. Bulkley provided no other support for her low-end ROE exclusion. She failed to provide any context as to the Minnesota decision, or how similar or different the decision in Minnesota is to this matter. With no support from any Kentucky precedent, and a fleeting reference to another jurisdiction's "position," Ms. Bulkley threw out valid data, hoping the Commission will nevertheless adopt her inflated result.

Second, although Ms. Bulkley's arbitrarily excluded low-end ROE results from her

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[41] *See* Commission Order, Kentucky power, Case No. 2017-179; Commission Order, Duke Electric, Case No. 2017-00321; Commission Order, Atmos Gas, Case No. 2017-00349.
[42] Bulkley Direct at 57–58.
[43] Bulkley Direct at 57.

DCF analysis, "[s]he made no attempt to examine and exclude excessively high DCF estimates from her proxy group."[44] As Mr. Baudino noted, Ms. Bulkley's "asymmetric and biased" approach "overstates the median and mean values in her analyses."[45] These outliers, ranging from 14.70% to 17.01% are significant, and represent a more noteworthy delta from Kentucky-American's proposed ROE of 10.8% than Ms. Bulkley's low-end screen of 7%.[46] Most importantly, removing these "unreasonably high DCF estimates" results in an average range across her various groups of 9.09% to 9.47% ROE, and a median range of 9.18% to 9.49%. These ROE results are a far cry from Ms. Bulkley's 10.8%.

Finally, in support of her removal of low-end DCF results Ms. Bulkley argues that those low-end results are "inconsistent with the relative risk of owning common equity or debt instruments."[47] Ms. Bulkley further notes that certain DCF results, one as low as 4.64%, is "lower than KAWC's embedded cost of long-term debt of 5.9 percent for the test year," and "[b]ecause shareholders are the residual claimants on the firm's earnings and assets, the return to equity holders necessarily must be higher than the return to bond holders."[48] Ms. Bulkley's arguments miss the target completely. For starters, although a ROE estimate of 4.64% may be lower than the embedded long-term debt rate of 5.9%, it is nearly 50 basis points higher than Kentucky-American's *current* test-period proposed long-term debt rate of 4.16%.[49] The cost rate for equity is being determined in this case for the *current* period. Using the cost rates from an embedded long-term rate, which includes bonds issued more than 25 years ago as a

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[44] Baudino Direct at 44.
[45] *Id*.
[46] *Id*. at 44–45.
[47] Bulkley at 7–8.
[48] *Id*.
[49] Company's Post-Hearing Brief at 45.

screen in determining *current* capital rates is unconscionable.[50] Although Ms. Bulkley's testimony states in absolute terms that "the return to equity holders necessarily must be higher than the return to bond holders," the Kentucky Supreme Court has at least *twice* explicitly held the opposite. In *Public Service Commission of Kentucky v. Continental Telephone Company of Kentucky,* the Court noted:

> The company makes an interesting but unconvincing theoretical argument that because AAA-rated bonds were available at 15 percent, a rate of return of 14.25 percent on equity is unreasonable. No court has adopted such reasoning. [*Commonwealth, ex rel., Stephens v. South Central Bell]* affirmed a rate of return slightly less than the current interest rate on high-grade corporate bonds. The authorities cited by the company are unpersuasive.[51]

The Court in *Stephens* and *Continental Telephone* found not just that an equity rate can be lower than an embedded debt rate, but rather, that an equity can be lower than the *current long-term debt rate*. The Kentucky Supreme Court's 30-year old holding in this regard thus explicitly rejected an argument more rigid than that Ms. Bulkley asserts.

Ms. Bulkley's exclusion of *only* low-end DCF estimates in making her recommendation was unreasonable, asymmetric and based on arguments explicitly considered and rejected by the Kentucky Supreme Court. As noted above, excluding excessively high DCF estimates in addition to low-end results in order to provide a reasonable symmetry in Ms. Bulkley's DCF estimates, reduces the range of average and median ROEs to below 9.50%.

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[50] *See* Application, Exhibit 37, Schedule J-4, page 1 of 2, where in evidences a General Mortgage Bond issued in 1993 at 6.96%. *See also* a General Mortgage Bond issued in 1997 at 7.15%, which is 15 basis points ***higher*** than the 7% screen Ms. Bulkley set to remove DCF results.
[51] 692 S.W.2d 794, 799.

2. Ms. Bulkley inappropriately depends on forecasted values even though the Commission routinely rejects their usage and Ms. Bulkley's long-dependence on them has been incorrect.

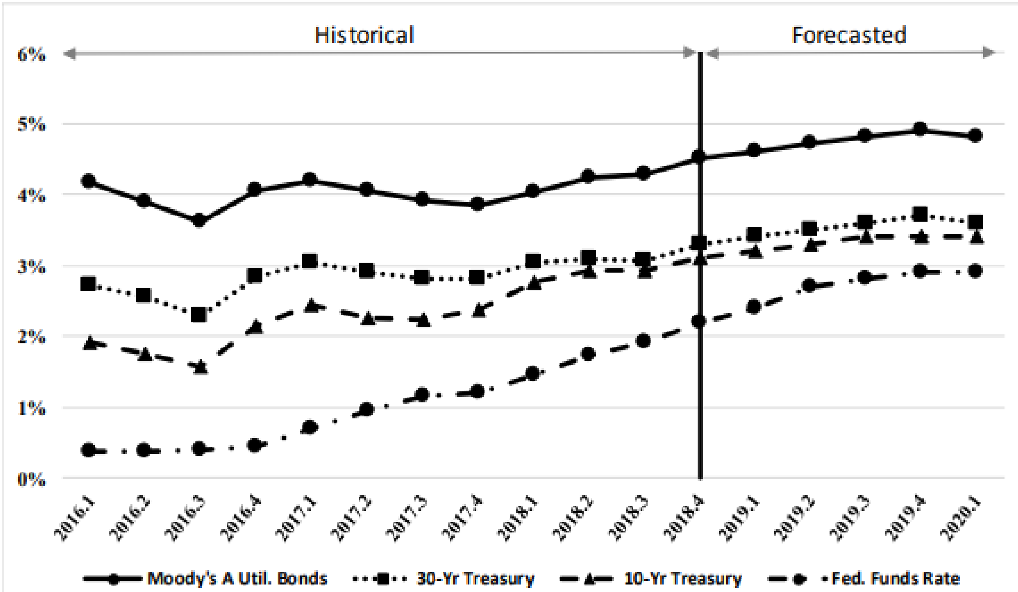
> With regard to the outlook for monetary policy beyond this [March 19-20] meeting, a majority of participants expected that the evolution of the economic outlook and risk to the outlook would likely warrant leaving the target range unchanged for the remainder of the year. – March 2019 FOMC minutes[52]

Ms. Bulkley's recommended ROE was determined based on analyses that included forecasted interest rates,[53] forecasted stock prices,[54] and a forecasted market risk premium.[55] What do all of Ms. Bulkley's forecasted numbers have in common? They all contribute to overstating Kentucky-American's required ROE, none of them is known and measurable, and a number of them have demonstrably proven to be unpredictable and poor indicators. The best indication of how erroneous Ms. Bulkley's preferred values have been is her dependency on interest rates, which she states are forecasted to increase.

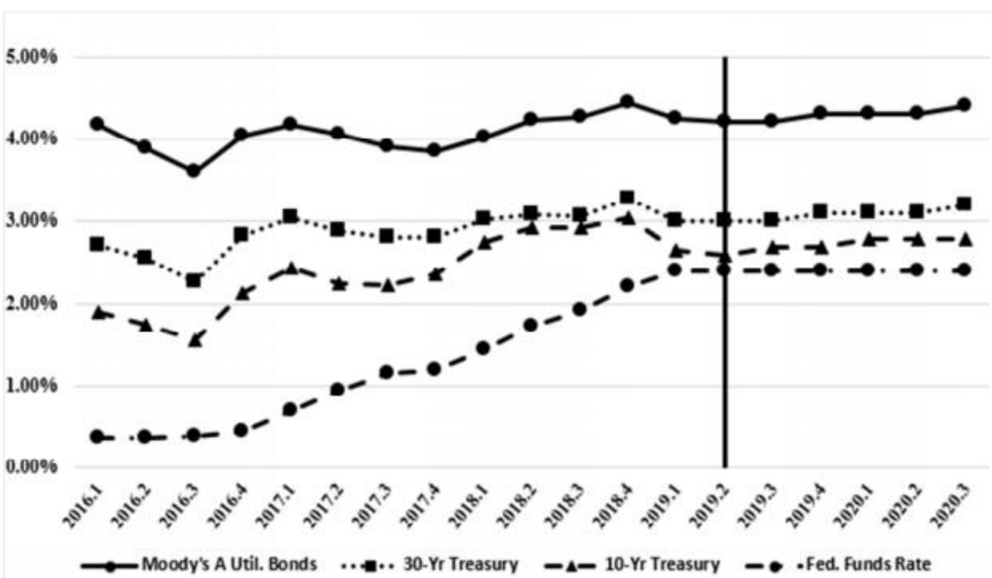
For instance, in her direct testimony filed November 28, 2018, Ms. Bulkley stated that "As shown in Figure 5 below, investors expect continued increases in rates on both government and corporate/utility bonds over the next few years."[56] Figure 5 is reproduced below.

[52] Attorney General Hearing Exhibit 1.
[53] Bulkley Direct at 8–9
[54] Bulkley Direct, AEB-3 and AEB-4; Baudino Direct at 45–47.
[55] Bulkley Direct at 8–9.
[56] Bulkley Direct at 25.

Figure 5: Interest Rate Conditions[31]



In response to the Attorney General's post-hearing data requests, Kentucky-American provided an updated Figure 5 from Ms. Bulkley's direct testimony.[57] The updated Figure 5 is reproduced below.



[57] Company's Response to Attorney General's Post-Hearing Data Requests, Item 1.

The consensus has changed. The most recent data shows just how unreasonable Ms. Bulkley's use of investor expectations and forecasted rates really is. The most recent data shows that as of the second quarter of 2019, and projected through the third quarter of 2020 (beyond the test year in this case), the Federal Funds Rate is now *forecasted* to remain steady, along with the 30-year treasury rate, 10-year treasury rate and Moody's A Utility Bond.[58] Expectations that interest rates will increase help form the basis of Ms. Bulkley's proposed 10.8% ROE. For instance, Ms. Bulkley's testimony states, "the Commission should consider recent evidence that interest rates have been increasing, and that capital costs over the period the rates will be in effect are expected to continue to increase."[59] We now know that just during the pendency of this case, the forecast has materially changed.

Ms. Bulkley's unfounded dependence on using forecasted increases in interest rates is not new. Ms. Bulkley has consistently argued for using forecasted interest rates in her analyses, having done so coincidentally over a time period when investors have routinely forecasted higher rates.[60] For instance, in her December 31, 2012 testimony before the Arizona Corporation Commission, Ms. Bulkley stated that there was a reasonable basis to conclude that interest rates will be increasing, citing "consensus estimate[s]" that the average 30-year Treasury yield will be 5.10 percent between 2014 and 2018.[61] Ms. Bulkley concludes that "rising interest rates would support selection of a return toward the upper end of a reasonable range of equity cost rate estimates."[62] Of course we now know that the "consensus estimates" Ms. Bulkley relied upon in that matter were incorrect, and some six and one half

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[58] *Id*.
[59] Bulkley Direct at 25.
[60] *See* Bulkley Direct, Appendix A (citing the dockets where she has provided Return on Equity testimony since 2010).
[61] Attorney General's Hearing Exhibit 12, at 44.
[62] *Id*. at 45.

years later the 30-year U.S. Treasury bond is where it was at the time of Ms. Bulkley's testimony.[63] Had the Arizona Corporation Commission adopted Ms. Bulkley's proposed ROE, customers would have paid, and shareholders received, more than the actual cost of equity. The same issue applies in this case.

At the time of her direct testimony, Ms. Bulkley noted that, [t]he yields on 30-year Treasury bonds are currently at 3.06 percent," going on to state that since the forecast (at that time) was for higher interest rates, "the Commission should consider the expected increases in interest rates when determining the authorized ROE for KAWC in this proceeding."[64] Respectfully, the Commission should not. As noted in the original and updated figure 5, above, the *new* forecast for the test year is unchanged interest rates, not increases. Nevertheless, the degree to which the forecast has changed just during the pendency of this case provides sufficient evidence that current, not forecasted, rates are the proper value to use when determining ROE estimates. Second, as respected expert Dr. Roger Morin has noted in his treatise, *New Regulatory Finance*, based on the "extensive literature concerning the prediction of interest rates . . . its appears that the no-change model of interest rates frequently provides the most accurate forecasts of future interest rates."[65] Mr. Baudino correctly notes that "investor expectations of higher future interest rates, if any, are already likely embodied in current securities prices."[66] As the Commission itself rightfully acknowledges, the change in recent FOMC policy "supports the Commission's view that forecasted interest rates are unpredictable and not guaranteed, and that current interest rates are the best measure as they

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[63] *Id*. at 44; Attorney General's Hearing Exhibit 9.
[64] Bulkley Direct at 28–29.
[65] Baudino Direct at 10, quoting Morin, Roger A., *New Regulatory Finance*, Public Utilities Reports, Inc. (2006) at 172.
[66] Baudino Direct at 11.

are unbiased and efficient."[67]

Using current, instead of forecasted, data has a significant effect on Ms. Bulkley's ROE estimates. The use of a projected treasury yield in lieu of a current yield can increase her CAPM ROE estimates by more than 30 points alone, and her novel use of an *estimated* market risk premium based on *expected* market returns significantly exaggerates her CAPM results.[68] For instance, the two charts below evidence solely the difference between the use of Ms. Bulkley's forecasted market risk premium (top) and a historic market risk premium (bottom) in her CAPM analyses.

Figure 12: Forward-Looking CAPM Results

	Current Risk-Free Rate (3.09%)	2018-2019 Projected Risk-Free Rate (3.52%)	2020-2024 Projected Risk-Free Rate (4.20%)	Mean Result
Water Proxy Group				
Including AWK				
Bloomberg Beta	12.66%	12.74%	12.89%	12.76%
Value Line Beta	12.41%	12.50%	12.66%	12.52%
Excluding AWK				
Bloomberg Beta	13.09%	13.16%	13.28%	13.18%
Value Line Beta	12.77%	12.86%	12.99%	12.87%
Combined Utility Proxy Group				
Including AWK				
Bloomberg Beta	11.31%	11.45%	11.67%	11.47%
Value Line Beta	11.76%	11.88%	12.08%	11.91%
Excluding AWK				
Bloomberg Beta	11.35%	11.48%	11.70%	11.51%
Value Line Beta	11.84%	11.95%	12.14%	11.98%

[67] Commission Order, *Electronic Application of Atmos Energy For An Adjustment Of Rates*, at 43 (Ky. Commission May 7, 2019).
[68] Bulkley Direct, AEB 9 and 10.

Figure 12: CAPM Results

	Current Risk-Free Rate (3.09%)	2018-2019 Projected Risk-Free Rate (3.52%)	2020-2024 Projected Risk-Free Rate (4.20%)	Mean Result
Water Proxy Group				
Including AWK				
Bloomberg Beta	8.71%	9.13%	9.81%	9.22%
Value Line Beta	8.56%	8.98%	9.67%	9.07%
Excluding AWK				
Bloomberg Beta	8.96%	9.38%	10.07%	9.47%
Value Line Beta	8.77%	9.20%	9.88%	9.28%
Combined Utility Proxy Group				
Including AWK				
Bloomberg Beta	7.92%	8.34%	9.02%	8.43%
Value Line Beta	8.18%	8.61%	9.29%	8.69%
Excluding AWK				
Bloomberg Beta	7.94%	8.36%	9.04%	8.45%
Value Line Beta	8.22%	8.65%	9.33%	8.73%

As is obvious from the record in this case, had Ms. Bulkley merely relied on known and measurable *current* data that has the benefit of certainty, her ROE recommendation would likely be in line with the ROEs the Commission has recently approved, instead of her inflated and "nation's highest" 10.8%.

3. Ms. Bulkley's Position Regarding Kentucky-American's Perceived risk is incorrect

Though 10.8% is the upper bound of Ms. Bulkley's ROE range, she maintains that this return is required due to the inherent risks of the Company, particularly *relative to her proxy groups*. This is incorrect. The Commission has previously held that Kentucky-American's frequency of rate cases, particularly as compared to its peers, and its use of forecasted test years, are a sign that Kentucky-American is less risky, not more, than its peers.[69] In this matter, Ms. Bulkley indicates that 58.8% of the companies in her combined utility proxy group used future test years, thus indicating that Kentucky-American is comparable to the proxy group in regards to its ability to recover costs similarly within rate cases, or even as Mr. Baudino notes,

[69] Baudino Direct at 17, quoting Commission Order, Case No. 2012-00520, at 51–52 (Ky. Commission Oct. 25, 2013).

"is slightly less risky due to the Commission's use of a future test year.[70] The Commission has recently reaffirmed its position that more-frequent forecasted rate cases, such as those employed by Kentucky-American, allows a utility "to mitigate the risk inherent to the regulatory process."[71] Additionally, the market does not perceive that Kentucky-American is more risky than it peer utilities, since the premium it pays for debt issuances is actually lower than the average charged for public utility bonds.[72]

Ms. Bulkley asserts numerous other reasons for why she incorrectly believes Kentucky-American is more risky than its peers:

- She claims that Kentucky-American's anticipated capital expenditures make it more risky, but failed to study the capital spending plans for the utilities in her proxy groups.[73]
- Ms. Bulkley, citing to Kentucky-American's lack of a QIP as an indicator it is more risky than the proxy groups,[74] notes "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,"[75] but nevertheless recommended such an extreme ROE "assum[ing] that the proposed QIP will be approved by the Kentucky Public Service Commission."[76]
- Ms. Bulkley notes the number of utilities in the proxy groups with QIP-like surcharges, but did not review the amount of capital actually recovered through

[70] Baudino Direct at 18.
[71] Commission Order, Case No. 2018-00281, at 46.
[72] Baudino Direct at 37, citing the Direct Testimony of Scott W. Rungren ["Rungren Direct"].
[73] March 13, 2019 VTE at 3:56:15.
[74] Bulkley Direct at 72–74.
[75] Bulkley Rebuttal at 70.
[76] Company's Response to Commission Staff's Second Request for Information, Item 87.

those surcharges, nor did she note the inherent difference between gas infrastructure replacement needs vs. water utilities.'[77]

- Ms. Bulkley claims Kentucky-American has no protection against volumetric risk, ostensibly ignoring the Company's proposal to increase its residential customer charge.[78]

Ms. Bulkley's position that Kentucky-American is not only more risky than the proxy group, but so risky relative to the proxy group that it deserves the highest supportable ROE Kentucky-American can muster is unfounded and contradicted by the record.

4. Ms. Bulkley's proposed ROE fails to comply with legal standards

As previously noted, the U.S. Supreme Court formulated the primary basis that return on equity *must* meet in order to ensure it is not confiscatory. The Court stated:

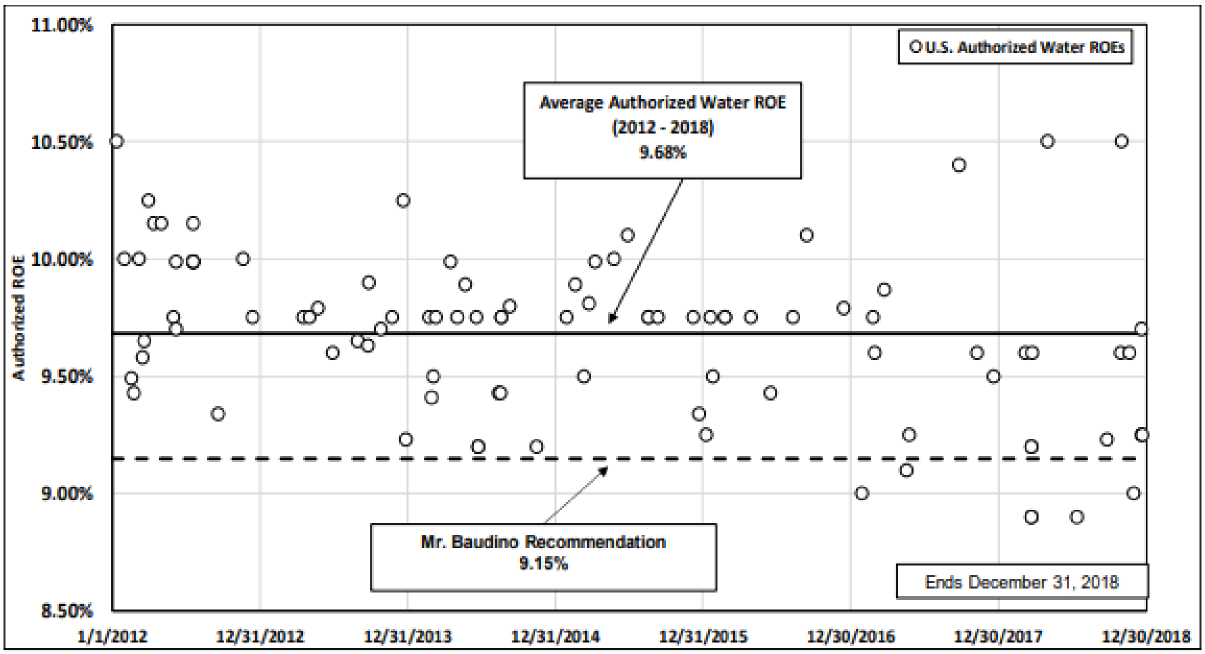
> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[79]

The portion of this basis that discusses that the return be equal to the return of similar firms, in similarly risky businesses in the same general part of the country is ordinary referred to as the comparable earnings standard. Although Ms. Bulkley discusses this standard at length, her proposed 10.8% hardly complies with such a standard. As evidenced by the figure below,

[77] Bulkley Direct at 73.
[78] Bulkley Direct at 74; Application, Exhibit 37, Schedule M-3.
[79] 262 U.S. 679, 692–93.

provided in Ms. Bulkley's rebuttal testimony, Kentucky-American's proposed ROE would be the highest authorized return in the nation since at least 2012.

Figure 1: Authorized ROEs from 2012-2018[5]



Furthermore, Ms. Bulkley's 10.8% ROE is more than 50 basis points higher than *every single utility included in her combined utility proxy group*, the same group Ms. Bulkley stated "consist[ed] of companies that face risk generally comparable to that faced by KAWC."[80] Clearly, 10.8% is not comparable to the returns similar firms of similar risk are receiving.

ii. Attorney General's Proposed Return on Equity as Supported By Mr. Richard A. Baudino

In order to provide a reasonable ROE estimate in this matter that the Commission could contrast with Kentucky-American's 10.8%, the Attorney General, along with LFUCG, supported the testimony of Mr. Richard A Baudino. Mr. Baudino summarized his testimony with the

[80] May 13, 2019 VTE at 3:59:08; Bulkley Direct at 4.

following.

> I recommend that the Kentucky Public Service Commission ("KPSC" "Commission") adopt a ROE of 9.15% for KAW in this proceeding. In arriving at this recommendation I performed a Discounted Cash Flow ("DCF") analysis using the same two proxy groups of companies used by KAW witness Bulkley. I also performed two Capital Asset Pricing Model ("CAPM") analyses, one based on expected returns for the stock market and one based on a risk premium using historical market returns. I relied on the DCF result for my ROE recommendation, although my CAPM analyses support my 9.15% recommendation as being reasonable.[81]

Mr. Baudino's 9.15% complies with the Supreme Court's *Hope* and *Bluefield* standards, including being comparable to the return of other firms engaged in similarly risky businesses. Mr. Baudino's ROE is comparable, and in some cases higher, than the authorized ROEs of the utilities in the proxy groups.[82] Further, Mr. Baudino's 9.15% ROE is comparable, and in some cases higher, than the authorized water ROE's between 2012 and 2018.[83] In providing his ROE recommendation, Mr. Baudino used industry standard methodologies that this Commission has previously explicitly approved.[84] Additionally, although his ROEs are forward-looking, in line with Commission precedent Mr. Baudino's calculations properly employ an appropriate amount of known and measurable current data, including current stock prices and bond yields.[85] Again, the Commission has recently stated that "forecasted interest rates are not reliable and the best estimate is the most current interest rate."[86]

The Commission's recent decisions, and its findings reinforcing those outcomes, support lower, not higher returns on equity.[87] Commissions across the nation are granting lower authorized

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[81] Baudino Direct at 3; Company's Responses to Commission Staff's Second Request for Information, Items 89, 90.
[82] May 13, 2019 VTE at 3:58:58.
[83] Bulkley Rebuttal, Figure 1. This Figure is reproduced on the previous page.
[84] *See e.g.*, Case No. 10498 (Ky. Commission Oct. 6, 1989) stating, "[t]he Commission has traditionally used the DCF model in estimating ROE. Although one cannot rely on a strict interpretation of the DCF model, the Commission finds that the DCF approach will provide the best estimate of an investor's expected ROE."
[85] Baudino Direct at 41.
[86] Commission Order, Case No. 2018-00281, at 44.
[87] *Id*., generally.

ROEs, indicating that a lower ROE for Kentucky-American is not only appropriate, but that a higher ROE would be out of step with those returns of firms with comparable risk.[88] The Company has historically been provided a reasonable opportunity to earn its authorized return on equity.[89] The Attorney General agrees with his expert that an ROE of 9.15% is satisfactory for Kentucky-American to attract and maintain the necessary capital. Investors are flocking to own American-Water's stock.[90] A 10.8% ROE is excessive and would merely serve to benefit shareholders to the detriment of Kentucky ratepayers, and thus the Commission should approve an ROE of 9.15% for Kentucky-American's base rates.

B. Excessive Long-term and Short Term Debt Rates

When Kentucky-American filed its application, it reflected excessive short-term and long-term debt interest rates on issuances forecast during the test year.[91] The Company relied on projected interest rates.[92] Mr. Kollen recommended the use of current, known, interest rates to calculate the Company's cost rates for the test year.[93] In acknowledgement that the original forecasted debt projections were inflated, and ultimately incorrect, the Company's rebuttal testimony revised its short-term and long-term debt rates accordingly.[94] The Company's new test year debt rates provided in its brief and in Mr. Rungren's rebuttal testimony have been reduced to reflect the reality of the capital costs and are reasonable. They should thus be approved.

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[88] *See Id*. at 44, citing to the recent RRA report that 2017's average ROE was 9.72%, whereas January 2018 through September 2018, the average was 9.62%.
[89] Company Response to Commission Staff's First Request for Information, Item 55 (Ky. Commission Dec. 12, 2018); Company's Supplemental Response to Commission Staff's First Request for Information, Item 55 (April 15, 2019).
[90] *See* Attorney General's Hearing Exhibit Nos. 10 & 11.
[91] Rungren Direct at 9.
[92] *Id*.
[93] Kollen Direct at 45–48.
[94] Company's Post-Hearing Brief at 45.

C. Capital Structure and Weighted ROE

The Company's proposed capital structure for the forecasted period as presented in its application consisted of 48.654% equity, .503% preferred stock, with the remainder in debt. Kentucky-American's equity percentage of total capital is comparable to the proxy groups used by Ms. Bulkley and Mr. Baudino. Kentucky-American's equity percentage of 48.654% is only slightly below the combined utility proxy group average equity percentage of 50.22% including American Water and 49.46% excluding American Water.[95] As Ms. Bulkley stated in her direct testimony, "KAWC's proposed common equity ratio of 48.654 percent is reasonable."[96] As Mr. Rungren testified, this common equity ratio is the highest that the Company has had in the past ten years, due to a Commission-ordered requirement which limited the equity portion of its capital structure to within a range of 35 to 45%, until such requirement was later terminated during the course of Case No. 2015-00418.[97]

In determining his ROE recommendation, Mr. Baudino concluded that, "KAW's requested common equity ratio is comparable to the CUPG and does not pose any significant additional financial risk to the Company."[98] Nevertheless, in her rebuttal testimony, Ms. Bulkley, for the very first time in this proceeding, discusses her perceived importance of weighted return on equity ("WROE").[99] Ms. Bulkley's newfound strict adherence to WROE goes well beyond the ordinary consideration of financial risk discussed by Mr. Baudino, wherein consideration is given to the risk created by a specific amount of debt in the capital structure.[100] As discussed, Mr.

[95] Bulkley Direct at 77.
[96] Bulkley Direct at 78.
[97] VTE at 7:08:49 *et seq.*; Commission Order, *Electronic Application Of Kentucky-American Water Company For An Adjustment Of Rates*, Case No. 2015-00418, at 4 (Ky. Commission Aug. 23, 2016).
[98] Baudino Direct at 46.
[99] Bulkley Rebuttal at 12–13.
[100] Baudino Direct at 20.

Baudino accepted the Company's actual anticipated equity ratio for the test year, and made no modification to the capital structure since it was in-line with those firms in the proxy group. Ms. Bulkley's novel argument that the Commission should focus on WROE instead of ROE is inappropriate and merely a distraction from how unreasonable her 10.8% recommendation really is. The Commission has recently noted that a capital structure is known and measurable, and consideration of making a change to it for ratemaking purposes can be made "to be comparable to its peers."[101] The Company's capital structure is already "comparable to its peers."

Operating Income Issues

Trane Lexington Plant Revenues Deferral and Amortization

In rebuttal testimony, the Company accepted Mr. Kollen's proposed adjustment to defer these revenues as a regulatory liability and amortize them over two years.[102] This reduction comes as a result of the Trane division of Ingersoll Rand closing its Lexington plant by the end of 2019, leading to the loss of $0.032 million in annual revenue.[103] This adjustment reduces the revenue requirement by $8,000.[104] The Attorney General agrees with this adjustment, as proposed by Mr. Kollen and accepted by the Company, and recommends that the Commission approve it.

The Company's Forecast of Full-Time Equivalent Employees, Payroll, and Payroll Related Expenses Are Excessive and Must Be Reduced

The Company proposed an increase in payroll and payroll related expenses, which jumped from $9.738 million in the twelve-month period ended August 2018 to $11.074 million in the test

[101] Commission Order, Case No. 2018-00281, at 34–35.
[102] Schwarzell Rebuttal at 13–14.
[103] Kollen Direct at 19–20.
[104] Schwarzell Rebuttal at 13–14.

year. This coincides with the Company's forecast of 14 additional full-time equivalent employees ("FTEs") from the calendar year 2018 to the test year—138 to 152. Kentucky-American's historical trend though, has been to maintain a staffing level of seven (7) fewer FTEs than originally budgeted or forecasted.[105] Mr. Kollen subsequently recommended a reduction to the forecast to reflect fewer actual FTEs, with corresponding reductions to payroll and payroll related expenses due to the Company historically employing fewer actual FTEs than its budget or forecast projects.[106]

In rebuttal testimony, Mr. Pellock argued that Kentucky-American has two methods through which it believed it can present an accurate cost structure for its employee forecast: "(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. The Company has chosen the first methodology and has presented its cost structure accordingly."[107] The Company did indeed reduce overtime, and Mr. Pellock agreed that the Company reduced its overtime hours in the same manner as it did in its prior rate case, Case No. 2015-00418.[108] However, the Company's reduction of overtime and associated expenses in this case does not account for the seven vacancies it has historically maintained. Instead, the forecast erroneously assumes full employment up to the forecasted 152 FTEs.

Mr. Pellock's direct testimony stated that expenses for labor and related expenses during the fully forecasted test period were based on 152 full-time positions.[109] Kevin Rogers' direct testimony states that Kentucky-American "identified 152 full-time positions as the appropriate

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[105] Company's Response to Attorney General's Supplemental Data Requests, Item 29; Kollen Direct at 20–23.
[106] Kollen Direct at 20–23.
[107] Rebuttal Testimony of James S. Pellock ["Pellock Rebuttal"] at 1–2.
[108] VTE at 7:30:48 *et seq.*
[109] Direct Testimony of James S. Pellock ["Pellock Direct"] at 4.

staffing level for the Company's operations. As of August 31, 2018, Kentucky-American had 143 employees (including five temporary employees filling vacancies) . . . The Company expects to reach an employee complement of 152 by the beginning of the fully forecasted test period."[110] The Company's post-hearing responses confirm Mr. Pellock's testimony at the hearing—that the Company will not achieve the 152 FTE count projected for the forecast period, which begins July 1, 2019.[111] Kentucky-American's actual full-time employee count as of May 15, 2019 was 138.[112] Thus, although Kentucky-American asserts its methodology is reasonable, it is not. A reduction in overtime can account for assuming a full complement of FTEs, but there was no consideration of the impact from the *new* FTE positions. If the reduction in overtime reflects only an assumption that the seven (7) ordinarily empty positions are full, then it is clear Kentucky-American was unable to take into account the effect of the new FTE additions. Therefore, the Commission should accept Mr. Kollen's adjustment as a more accurate barometer of the Company's true expenses, the effect of which reduces the revenue requirement by a total of $0.492 million.[113]

<u>Incentive Compensation</u>

Kentucky-American introduced its latest proposal to include the cost of incentive compensation through Company President and CEO, Mr. Nick Rowe.[114] In his Direct Testimony, Mr. Rowe first acknowledged that the Commission has regularly denied the Company's past requests to recover costs for the Company's incentive compensation, which it calls variable or performance pay.[115] Despite this, he went on to describe the importance of incentive compensation to the Company in rewarding and motivating its employees as a "reasonable, prudently incurred

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[110] Direct Testimony of Kevin Rogers ["Rogers Direct"] at 18–23.
[111] Company's Response to Attorney General's Post-Hearing Data Request, Item 3 (Ky. Commission May 24, 2019).
[112] *Id*.
[113] Kollen Direct at 20–23.
[114] Direct Testimony of Nick O. Rowe ["Rowe Direct"] at 3, 6, 9.
[115] *Id*. at 9.

expense designed to keep the organization focused on delivering clean, safe, reliable and affordable water service while improving performance at all levels of the organization."[116] Finally, Mr. Rowe introduced multiple other witnesses who provided testimony on behalf of the Company regarding its employee compensation.[117]

As an initial matter, the Attorney General notes that by statute the Company is bound to provide "adequate, efficient and reasonable service."[118] Thus, it is puzzling that the Company posits that it needs to provide monetary incentives to its employees to be able to meet the basic statutory threshold of adequate service.

Kentucky-American also produced testimony on incentive compensation through expert witness Robert Mustich. Mr. Mustich was retained in an effort to demonstrate that the target total remuneration provided to Kentucky-American employees, inclusive of short-term variable compensation is at the low end or below the competitive range of market.[119] Essentially, he was asked to conduct and opine on a study that the Commission did not ask be performed in order to qualify an expense the Commission has repeatedly denied in past decisions.[120]

Mr. Mustich's rebuttal testimony failed to establish the reasonableness of the Company's proposed incentive compensation. The bulk of it misused answers provided by Mr. Kollen in response to Company data requests in an absurd and shameful attempt to argue that Mr. Kollen actually favors recovery of the Company's proposed incentive compensation, something that is clearly not correct. For example, Mr. Kollen agreed in response to the Company's data requests that utility and other companies use incentive compensation.[121] That is a fact. The Company uses

[116] *Id.*
[117] *Id.*
[118] KRS 278.030(2).
[119] Direct Testimony of Robert V. Mustich ["Mustich Direct"] at 2.
[120] *See* Commission Order, Case No. 2017-00321, at 20–22 (Ky. Commission April 13, 2018).
[121] Attorney General/LFUCG's Response to Company's Data Request, Items 28, and 29.

incentive compensation; otherwise, it would not have incurred the expense and the recovery of the expense would not be at issue in this proceeding. However, Mr. Kollen's responses to factual inquiries clearly do not translate into support for recovery of incentive compensation expense tied to financial performance. Mr. Kollen's testimony on incentive compensation makes this abundantly clear.

Mr. Mustich claimed that Mr. Kollen answering in the affirmative that "it is in the interests of customers for a utility to be: efficiently run, safety conscious, and environmentally compliant," this somehow equates with him also agreeing with the Company's incentive compensation proposal.[122] Additionally, Mr. Mustich claimed that Mr. Kollen conceded the benefits of the Company's incentive compensation plan by answering in the affirmative to whether the retention of well-trained, dedicated employees is a benefit to the customers of a business.[123] These positions are not mutually exclusive. Mr. Kollen can agree with the factual inquiry and/or general proposition put forward in these questions, yet still maintain his position against incentive compensation as the Company has proposed.

Again, Mr. Kollen's position is directly in line with that of the Commission in its past decisions ruling against allowing this type of compensation for ratemaking. The Attorney General shares Mr. Kollen's position that it is not necessarily inappropriate that Kentucky-American pays its employees incentive compensation.[124] Rather, the Attorney General and Mr. Kollen assert that it is inappropriate to include these costs for ratemaking purposes. The Commission should give no weight to Mr. Mustich's testimony given that the study was not requested, the Commission has a clear, established position against incentive compensation, and his rebuttal amounted to

[122] Rebuttal Testimony of Robert V. Mustich ["Mustich Rebuttal"] at 7; Attorney General/LFUCG's Response to Company's Data Request, Items 47, 48, and 49.
[123] Mustich Rebuttal at 7; Attorney General/LFUCG's Response to Company's Data Request, Item 41.
[124] Mustich Rebuttal at 6.

intentionally mischaracterizing and putting words in Mr. Kollen's mouth based on good faith responses to generalized questions.

Finally, Kentucky-American addressed incentive compensation through Kurt Kogler, Director of Human Resources Business Partners for AWWSC. Mr. Kogler provided testimony in which he tried to portray the Company's variable compensation as reasonable despite the financial metrics underpinning the benefit. Mr. Kogler noted that the Company's compensation plans emphasize certain operational goals in addition to certain financial goals.[125] This avoids the fact that no portion of the Annual Performance Plan ("APP") is awarded unless American Water's earnings per share ("EPS") meets or exceeds 90% of its EPS target.[126]

The Company argues that the 50% split between performance measures and operational measures entitles it to all, or at least half of the requested amount.[127] This threshold, which triggers the funding pool and determines whether APP is even available, is a financial metric and shareholder oriented. Despite what operational gains might be achieved in any certain year, without achieving 90% of its EPS target, no APP is awarded. The Company claims this is irrelevant since "that threshold is a *funding* measure, not a *performance* measure. 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."[128] However, this description certainly seems to describe a funding measure which is itself based on financial performance, and should be disallowed. The Commission has previously disallowed compensation tied to financial performance based solely on the form (i.e. funding measure) of the compensation. In Case No. 2017-00321, the Commission denied recovery of Duke Energy's restricted stock units, even

[125] Direct Testimony of Kurt M. Kogler ["Kogler Direct"] at 4.
[126] Kollen Direct at 23; Company's Response to Commission Staff's Second Request for Information, Item 31.
[127] Company's Post-Hearing Brief at 34–37.
[128] *Id.*

though they were part of base compensation.[129] The Commission held, "in the absence of clear and definitive quantitative evidence demonstrating a benefit to the utility's ratepayers, the ratepayers should not be required to bear the program's costs."[130] No such evidence has been produced here.

Similarly, the Long Term Performance Plan ("LTPP") includes restricted stock units and performance stock units, both with three year vesting periods, which vest based on time and performance, respectively. Performance is measured through EPS growth and relative total shareholder return.[131] Due to the performance based measures inherent in LTPP, even the Company's own arguments favors disallowing this portion of the incentive compensation.

The Commission has a long history of denying this type of compensation,[132] and it should continue to do so here. In concert with Mr. Kollen's recommendation, the Commission should exclude the costs of the Company's incentive compensation, including both the APP and the Long Term Performance Plan. This exclusion results in a $1.927 million reduction to the revenue requirement, inclusive of $1.770 million in incentive compensation expense, and related reductions of $0.135 million in payroll tax expense and $0.022 million in bad debt and Commission assessment expenses.

<u>The Discount for Kentucky-American Employees to Purchase Company Stock Should Be Disallowed for Ratemaking</u>

In direct testimony, Kentucky-American described its employee stock purchase plan ("ESPP"), through which all employees of American Water and its subsidiaries are able to

[129] Commission Order, Case No. 2017-00321, at 5–6 (Ky. Commission May 23, 2018).
[130] *Id*. at 6.
[131] Kollen Direct at 24; Kogler Direct at 6.
[132] *See* Case No. 2017-00321; Case No. 2004-00103, *Adjustment Of Rates Of Kentucky-American Water*; Case No. 2010-00036, *Application of Kentucky-American Water Company For An Adjustment Of Rates Supported By A Fully Forecasted Test Year*; Case No. 2014-00396, *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*.

purchase shares of American Water common stock at a discount.[133] The stock purchases are made through voluntary payroll deductions, and are limited to a maximum of $25,000 per year.[134] As of May 2019, the discount on stock purchases that participating employees receive increased from 10% to 15%.[135] The corresponding expense for the base period totaled $14,837, while the expense for the fully forecasted test period is $17,459.[136] At the hearing, Mr. Pellock affirmed that Kentucky-American customers are expected to pay this expense through the cost of service.[137] This benefit, which adds to the already generous compensation package provided by Kentucky-American allows employees the opportunity to accumulate Company stock at a substantial discount. It is indefensible to propose that customers pay for a benefit such as this. The Attorney General *strongly* recommends that the Commission disallow this expense for ratemaking purposes, and explicitly put all utilities under its jurisdiction on notice that such a proposal will be summarily denied.

Dues Paid to Organizations for Covered Activities Should Be Disallowed According to Commission Precedent

During the hearing, the Attorney General questioned Mr. Pellock regarding the Company's response to a data request, which he sponsored, regarding the extent to which covered activities of organizations the Company is a member of and/or pays dues toward were removed for ratemaking purposes.[138] Mr. Pellock agreed to clarify these sums in a post-hearing data request.[139] The Company's response noted that "[t]he lobbying portion of the Commerce Lexington, Greater Lexington Apartment Association and Kentucky Chamber of

133 Kogler Direct at 13.
134 *Id*.
135 *Id*.
136 Pellock Direct at 10.
137 VTE at 7:25:05 *et. seq*.
138 VTE at 7:25:05 *et. seq*.; Response to AG 1-96.
139 *Id*.

Commerce in the amount of $3,453 was erroneously recorded to Company Dues/Memberships, and therefore should be removed from the forecast period."[140] The Attorney General agrees that this amount should be removed from the forecast period and recommends that the revenue requirement be adjusted accordingly.

Retirement Plan Expense Is Excessive, Certain Expenses Should Be Excluded

The Company proposes to recover from customers the expenses for employees that receive multiple retirement benefit packages.[141] This is in direct contravention of recent Commission precedent on this very issue.[142] The Commission has forcefully stated with clarity that it will not condone the cost recovery of multiple generous retirement plans for utility employees.[143]

The Company argued that it has sought to aggressively manage its retirement benefits costs and that its expenses should not be disallowed similar to a recent case wherein a utility demonstrated proactive steps to managing these same costs.[144] In the cited case, the utility closed its defined dollar benefit plan to new hires, and lock and froze final average pay benefit formulas for all non-union employees.[145] Conversely, here the Company confirmed during the hearing that while it did lock and freeze pension benefits for bargaining employees, for

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[140] Company's Response to Attorney General's Post-Hearing Data Request, Item 2.
[141] Company's Post-Hearing Brief at 39.
[142] *See* Commission Order, *Application of Inter-County Energy Cooperative Corporation For A General Adjustment Of Existing Rates*, Case No. 2018-00129 (Ky. Commission Jan. 25, 2019); Commission Order, Case No. 2016-00169, *Application Of Cumberland Valley Electric, Inc. For A General Adjustment Of Rates* (Ky. Commission Feb. 6, 2017); Case No. 2016-00370, *Electronic Application of Kentucky Utilities Company For An Adjustment Of Its Electric Rates And For Certificates Of Public Convenience And Necessity* (Ky. Commission June 22, 2017); and Case No. 2016-00371, *Electronic Application of Louisville Gas And Electric Company For An Adjustment Of Its Electric Rates And For Certificates Of Public Convenience And Necessity* (Ky. Commission June 22, 2017).
[143] *Id*.
[144] Company's Post-Hearing Brief at 39 (citing Rebuttal Testimony of Kurt M. Kogler ["Kogler Rebuttal"] at 2; Case No. 2017-00321).
[145] Kogler Rebuttal at 2 (citing Case No. 2017-00321).

some reason it did not freeze the benefits for non-bargaining employees.[146] These non-bargaining employees are the executives and management at Kentucky-American. This goes directly to the Company's priorities, and is contrary to its claims of significant retirement cost management which would justify allowing recovery for these costs. The Company has offered no justification for allowing such a benefit to continue accruing for one class of employees over another, or why customers should be on the hook for paying such a benefit to that particular class. Regardless of this disparity of benefits between employees, Kentucky-American produced no compelling reason for the Commission to deviate from its precedent of denying the recovery of multiple retirement packages for utility employees. Kentucky-American is free to continue to provide these benefits as it sees fit, but that does not mean that ratepayers are required to pay for all of those costs.

As such, the Attorney General agrees and adopts the related adjustment proposed by Mr. Kollen to exclude certain retirement plan expenses incurred for Kentucky-American employees who participate in both a defined benefit and a defined contribution retirement plan. The effect is a reduction in retirement plan expense of $0.070 million, and a subsequent $0.071 million reduction in the revenue requirement, including the retirement plan expense which is incurred directly by Kentucky-American and the expense allocated and charged to Kentucky-American from AWWSC.

<u>Chemical Expense Correction</u>

Mr. Kollen's direct testimony identified an overstatement of the Company's forecast for chemical expense due to double-counting in the original workpapers, totaling $0.102

[146] VTE at 5:08:00—5:09:00.

million.[147] The Company confirmed the overstatement in discovery.[148] In the base period update, and in rebuttal testimony, the Company accepted Mr. Kollen's adjustment for a correction to the chemical expense amount due to an error.[149] This results in a reduction to the revenue requirement of $102,886.[150] The Attorney General agrees with this adjustment and recommends that the Commission accept it.

<u>Power Expense Correction</u>

Mr. Kollen proposed a reduction of $0.97 million to reflect the effects of the stipulated settlement in the Kentucky Utilities base rate proceeding, Case No. 2018-00294.[151] In the base period update, and in rebuttal testimony, the Company accepted Mr. Kollen's adjustment for a correction to the power expense amount to reflect the Commission approved settlement in the Kentucky Utilities rate case.[152] This results in a reduction to the revenue requirement of $97,027.[153] The Attorney General agrees with this adjustment and recommends that the Commission accept it.

<u>ADIT- State and Federal</u>

Kentucky-American proposes an amortization of "unprotected" excess ADIT over a twenty year period.[154] Furthermore, Kentucky-American has proposed a broad reading of "protected" excess ADIT that is beyond any legal requirement, and which serves to benefit the utility and its shareholders. Although Kentucky-American maintains its proposals on

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[147] Kollen Direct at 29–30.
[148] Company's Response to Attorney General's Supplemental Data Requests, Item 25.
[149] Kentucky-American Base Period Update, at 1; Schwarzell Rebuttal Testimony, at 3.
[150] *Id*.
[151] Kollen Direct at 30–31.
[152] Kentucky-American Base Period Update, at 1; Schwarzell Rebuttal Testimony, at 2–3; *See also* Commission Order, *Electronic Application of Kentucky Utilities Company For An Adjustment Of Its Electric Rates*, Case No. 2018-00294 (Ky. Commission April 30, 2019).
[153] Kentucky-American Base Period Update, at 1.
[154] Company's Post-Hearing Brief at 17.

excess ADIT is in “the best interests of its customers,” respectfully, it is the Attorney General, not the Company, who has the pleasure of representing the interests of its ratepayers.[155] These excess ADIT represent an “interest free loan from customers.”[156] The 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, than replace the interest free “loans” they’ve received from customers over the years.[157]

Amortization Period of Unprotected Excess ADIT

An extended amortization delays the return of funds to the sole source from which they were collected, the ratepayers themselves. Moreover, over the course of decades many ratepayers from whom the funds were collected will no longer be available to receive the payback if it is delayed for such a long period, either having moved away from the service territory or from being deceased. Kentucky-American’s unsupported 20-year amortization of unprotected excess ADIT is out of line with the Commission’s precedent on this issue. The Commission has never granted a 20-year amortization of unprotected excess ADIT resulting from the TCJA, and the company-specific risks to Kentucky-American support a shorter, not longer, amortization than that authorized to other utilities.[158] The chart below shows the amortization periods the Commission approved for certain vertically integrated electric utilities in Kentucky, and some of the relevant metrics.

[155] *See* Company’s Post-Hearing Brief at 17, and generally (wherein Kentucky-American maintains that its proposals are in the best interests of customers at least six (6) times).
[156] May 13, 2019 VTE at 4:33:15.
[157] May 14, 2019 VTE at 9:17:51—9:19:15.
[158] *See*, *e.g.*, Attorney General’s Hearing Exhibit No. 16, page 13, wherein Kentucky Power witness Horeled sets forth the number of troubling company-specific risks that support a 18-year amortization period of unprotected excess ADIT.

	KU	LG&E	Duke	Kentucky Power
Unprotected Excess ADIT (12/31/2017)	$12,762,150	$24,282,660	$33,032,786	$95,282,425
Commission-Approved/Proposed Amortization Period	15 years	15 years	10 years	18 years
Total Equity (12/31/2017) ($000)	$3,357,000	$2,527,000	$319,052[2]	$670,263
Unprotected Excess ADIT as Percent of Equity	0.38%	0.96%	10.35%	14.2%
Moody's Credit Rating	A3 Stable	A3 Stable	Baa1 Stable	Baa2 Negative
Total Debt/Total Capitalization (12/31/2017)	41.41%	43.02%	46.87%	56.75%

Of the three different periods above, only the Duke case was litigated, while the other three periods were subject to Commission-approved settlements. The Company's debt to capitalization is 50.843%, which is more comparable to Duke's than Kentucky Power's. Kentucky-American's Moody's credit rating is Baa1 with a stable outlook, and on the cusp of an A3, which makes it much less risk than Kentucky Power, and more comparable to Duke.[159] Kentucky-American's total net excess ADIT is $31,113,118.[160] If the Commission adopts Kentucky-American's position regarding unprotected excess ADIT, the annual refund of the unprotected excess ADIT is $1,122,888, and if it adopts the Attorney General's position, it is

[159] Bulkley Rebuttal at 71.
[160] Rebuttal Testimony of John R. Wilde ["Wilde Rebuttal"], JRW-4R

$3,882,425.[161] Each party's position as to unprotected excess ADIT as a percentage of the forecasted 13-month average common equity is .5% for Kentucky-American, and 1.7% for the Attorney General's.[162] These amounts clearly argue for a shorter, not longer, amortization period than the Commission has previously approved.

The Attorney General agrees with his expert Mr. Lane Kollen regarding the amortization period of excess ADIT, and asserts that a three year amortization is a long enough period for the Company to successfully mitigate any cash flow issues stemming from this return, while also ensuring that the maximum amount of ratepayers whose funds were previously collected will be able to receive this return.

Designation of Excess ADIT as "Unprotected" or "Protected"

The Attorney General disagrees with Kentucky-American's designation of certain excess ADIT as "protected" and thus subject to a normalized method of accounting ("ARAM"), rather than a different amortization period as determined by the Commission. Specifically, the Attorney General disagrees with Kentucky-American witness John Wilde, that the categories "Tax Repairs" and "Repair 481a" are "protected" and subject to ARAM.[163] Kentucky-American maintains that the utility's excess ADIT related to repair allowances are subject to an IRS consent agreement, although they've provided no support that the agreement covers any *excess* ADIT resulting from a subsequent reduction in the federal income tax rate.[164] Although Kentucky-American states that amortizing these accounts using a period other than ARAM, "could result in a violation" of the consent agreement, or "could result in

[161] Wilde Rebuttal, JRW-4R; May 14 VTE at 11:22:25—11:30:00.
[162] Application, Exhibit 37, Schedule j-1, page 1 of 1; Wilde Rebuttal, JRW-4R.
[163] Wilde Rebuttal, JRW-4R; VTE May 14, VTE at 11:22:25—11:30:00.
[164] Company's Post-Hearing Brief at 20.

a normalization violation apart from the "Consent Agreement," it again provides no basis in law for those assertions.[165] As this Commission has previously, and correctly, held, "The TCJA normalization rules only apply to the protected ADIT, which is defined as public utility property subject to accelerated depreciation under IRC Sections 167 and 168."[166] Neither of those sections relate to repairs. Nowhere does the text of the TCJA indicate that ARAM applies to excess ADIT created by any other instance other than those differences caused by sections 167 and 168 of the Internal Revenue Code. The Attorney General believes the excess ADIT designated as "Tax Repairs" and "Repair 481a" are "unprotected," and as with the other excess ADIT that the Attorney General agrees with the Company is "unprotected", should be amortized over three (3) years. Consistent with his previous positions in other matters, the Attorney General will not dispute using ARAM to amortize those regulatory assets that are in question as to whether they are "protected" or not.[167] As these are amounts owed from customers, a longer amortization period is beneficial to ratepayers, and thus ARAM is reasonable.[168]

Therefore, the Commission should rule that of those categories presented in Mr. Wilde's rebuttal testimony, only the following should be amortized using ARAM:

- "COR"
- "M/L"
- "Repair M/L"

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[165] *Id*.
[166] Commission Order, *KIUC v. KU/LG&E*, Case No. 2018-00034, at 15 (Ky. Commission Sept. 28, 2018), citing Tax Cuts and Jobs Act, Pub. L. No. 11 5-97, § 13001 , 131 Stat 2054, 2099 (2017); Tax News Update, Power and Utility concerns under the TCJA, January 25, 2018 2018-0186, https://taxnews.ey.com/news/2018-0186-power-and-utility-concerns-under-the-tcja.
[167] Commission Order, Case No. 2018-00034, at 16 (Ky. Commission Sept. 28, 2018).
[168] May 14, 2019 VTE at 11:27:08.

- "Taxable CIAC"
- "Net Operating Loss (Plant in Service)"

The remaining categories are "unprotected" and should be amortized over three (3) years. As Mr. Wilde acknowledges, if the Commission's order does somehow create an inadvertent normalization violation, there is an opportunity to seek relief from the error and cure the violation.[169] Unless expressly modified of discussed specifically herein, the Attorney General adopts the positions advanced by Mr. Kollen regarding the TCJA and excess ADIT.

<u>Rate Case Expense</u>

The Company's rate case expense has increased significantly since its last rate case—approximately 39%, from $0.884 M in Case No. 2015-00418, to $1.231 M in the present case.[170] Moreover, the Company has included $0.312 million for internal labor support services. The inclusion of internal labor expense by Kentucky-American is in stark contrast to the other major investor-owned utilities in Kentucky, who did not include such expenses in their most recent rate cases.[171] In turn, the Attorney General recommends that the Commission accept Mr. Kollen's recommendation to remove these costs, resulting in a $0.105 million reduction in the revenue requirement—$0.104 million in amortization expense and a reduction of $0.001 million in related bad debt and Commission assessment expense.

As part of its application, the Company also included expenses for engaging experts to produce studies which were neither required nor requested by the Commission.[172] One such

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[169] May 13, 2019 VTE at 4:38:14.
[170] Kollen Direct at 41–44.
[171] Kollen Direct, at 43 (referencing similar filings from Kentucky Power Company, Duke Energy Kentucky, Atmos Energy, Kentucky Utilities, and Louisville Gas & Electric).
[172] *See* Exhibit 37, Schedule F, at 10 (showing compensation study costing $85,000, and the Support Services Study costing $55,000).

study goes toward justifying the inclusion of incentive compensation, which the Commission has explicitly and continuously denied the recovery of, for both Kentucky-American and other utilities. The other was to support the use of internal labor support services, which is not regularly sought by any other major investor-owned utility in the Commonwealth, discussed *supra*.

Cost of Service

Ms. Heppenstall confirmed in responses to the Attorney General's data requests that the Company directed her to consider only the cost of service for the entirety of Kentucky-American's service territory, stating "[t]he Company did not request a separate cost of service results [sic] for Eastern Rockcastle and North Middletown because the Company planned to propose single tariff treatment."[173] By not considering the separate cost of service for the acquired systems, there is no justification for a unified tariff.

Moreover, the Company's actions are in direct contravention of the Commission's previous orders and direction to Kentucky-American to perform separate cost of service studies when acquiring other water systems, Case No. 2012-00520.[174] In a previous order the Commission expressed serious concerns regarding the Company's future water system acquisitions, writing:

> Kentucky-American's acquisition of small water systems that are in need of infrastructure improvement presents a critical question: What is the obligation of Kentucky-American's existing customers to finance system improvements to these acquired systems through higher rates for service? The answer depends upon the circumstances of each system acquisition. We recognize, however, that limits exist and that Kentucky-American's existing ratepayers should not be considered a deep pocket that is available in all cases to finance the

[173] Company's Response to Attorney General's Supplemental Data Requests, Item 36.
[174] Commission Order, *Application Of Kentucky-American Water For An Adjustment Of Rates Supported By A Fully Forecasted Test Year*, Case No. 2012-00520, at 72–75 (Ky. Commission Oct. 25, 2012).

> improvements of acquired small water systems.[175]

The Commission further opined:

> We place Kentucky-American on notice that the consolidation of an acquired system's rates with Kentucky-American's rates should not be presumed. Kentucky-American must demonstrate the appropriateness and reasonableness of consolidating the rates. It should expect to maintain a separate set of records for acquired water systems for a reasonable period of time after the acquisition to enable the Commission to assess the cost of service for the acquired and acquiring systems and to better assist the Commission in determining the appropriateness and reasonableness of a unified/consolidated schedule of rates.[176]

The Commission went on to cite a prior decision, Case No. 9283, as a basis for affirming its position in Case No. 2012-00520. Nevertheless, the record in the instant case evinces that the Company did presume that consolidation of its acquired system's rates with those of its established service territory were, in fact, presumed.

<u>Monthly Service Charge</u>

The Attorney General is also against the imposition of a higher customer charge, which will impair the ability of Kentucky-American customers to conserve through reduced water usage, simultaneously hindering their ability to lower bill costs. Ms. Heppenstall stated that in formulating the rate design, one of her guidelines was to "increase customer charges to recover a greater percentage of customer costs including ready to serve costs."[177] The Attorney General is especially concerned that the Company seeks an increase to the customer charge, moving further toward full cost-based rates, while also proposing the QIP surcharge, and in the midst of filing rate cases every few years. The effect of these increased costs upon

[175] *Id*. at 73.
[176] *Id*. at 74.
[177] Direct Testimony of Constance E. Heppenstall ["Heppenstall Direct"] at 8–9.

ratepayers is compounded when they all increase so drastically, and the Attorney General urges the Commission to rely upon its preference for gradualism in considering the customer charge increase. Should the Commission, over the Attorney General's strenuous objection, increase the Monthly Service Charge, it should take the reduction in volumetric risk in to account when determining the Company's ROE.

Ancillary Issues

The Qualified Infrastructure Plan

The Attorney General is strongly opposed to the implementation of Kentucky-American's proposed QIP. The Company has proposed the QIP before, as well as a similar scheme: the DSIC. The Commission rejected the DSIC,[178] and has strictly declined to allow utilities to operate infrastructure replacement programs on an open ended basis and without serious customer safeguards and cost caps built in.[179] Open-ended infrastructure replacement programs are inherently dangerous to customers and lucrative for shareholders, as the Commission's past experience has indicated.[180] The Company is again proposing the QIP, and is again proposing it in such a way as to deny any meaningful customer protection, or even consumer input, rejecting all of the recommendations put forth by the Attorney General's expert, Mr. Baudino.

Kentucky-American has failed to meet its burden to show that the QIP is necessary. The Company maintains that American-Water will provide Kentucky-American with the necessary capital, but that it seeks the QIP so that it can receive discretionary funding for certain projects that the Company alternates on whether they are "needed or "discretionary." The Company's argument

[178] Commission Order, Case No. 2012-00520 (Ky. Commission Oct. 25, 2012).
[179] *See generally* Commission Order, *Electronic Application of Atmos Energy Corporation For An Adjustment Of Rates And Tariff Modifications*, Case No. 2017-00349 (Ky. Commission May 3, 2018); Commission Order, *Electronic Application Of Atmos Energy Corporation For An Adjustment Of Rates*, Case No. 2018-00281 (Ky. Commission May 7, 2019).
[180] *Id*.

effectively seems to be that it has continually deferred infrastructure replacement, but it will start investing what it needs to in order to ascertain reasonable replacement rates, only if incentivized to do so through a QIP. If Kentucky-American is asserting that it will not replace and maintain its infrastructure unless incentivized to do so, the Commission should deny the QIP and institute an investigation to determine whether a separate entity will commit to investing the necessary capital to maintain what is now Kentucky-American's service territory. Taking Kentucky-American at its word, if the infrastructure need exists and the capital exists, the Attorney General trusts that the utility will do what is right and invest in its system in order to continue to comply with its legal requirements.[181]

Kentucky-American's "Need" for the QIP

The QIP is a regulatory mechanism. Mr. Rowe describes it as "a mechanism [that] gives us an opportunity as the Company to continue to invest in infrastructure that's needed."[182] Therefore, by Mr. Rowe's own words, Kentucky-American sees the underlying investments it plans to make via its proposed QIP as "needed." Yet, during the pendency of the case, Mr. Rowe and Kentucky-American have maintained that "American Water always ensures that each of its water utilities is afforded access to capital to provide safe, adequate, and reliable service," and that the QIP is "critically important" so that Kentucky-American can compete for American Water's "discretionary capital."[183] Whether Kentucky-American will actually make the investments it has indicated it will make if the QIP is approved, or whether those planned investments are even necessary should be entirely separate considerations from the QIP. Therefore, the Attorney General will address them separately, below. The question before the Commission regarding the

[181] KRS 278.030(2).
[182] May 13, 2019 VTE at 9:12:03—9:12:12.
[183] Rowe Direct at 10.

QIP mechanism is whether the Company has carried its burden and proven to the Commission that the proposed QIP mechanism is needed. The Attorney General maintains it is not needed, and should be rejected.

Kentucky-American is engaged in a capital-intensive business, and investments in infrastructure are literally a utility's business model. Making it easier for a utility to recovery investments, which a QIP will do for Kentucky-American, when it has failed to show it has no problem today recovering its investments, is unreasonable. Kentucky-American has historically earned, or has had an opportunity to earn, a reasonable return on equity.[184] Kentucky-American has had a positive track record recovering investments due, in part, to its use of forecasted test years, dating back to 1992. Further, the Company can have "infrastructure investment of more than $100 million" that is not yet included in rates, and still have a reasonable opportunity to earn its ROE.[185] Although Kentucky-American promises that if given the QIP they will spend what they've outlined in the case, such a response is an easy answer to a simple question.[186] The question the Commission must ask of this utility is, is Kentucky-American able to attract and retain capital enough capital to meet its infrastructure needs without the QIP, <u>and if not</u>, is the QIP the best fix to that issue?

The Company has painted a picture, whereby declining water usage and rapidly increasing infrastructure replacement needs necessitate that capital infrastructure can no longer be replaced solely through base rates. The Company asserts that it must have a separate mechanism through

[184] Company's Response to Attorney General's Initial Data Requests, Item 55. Although the Company makes much about the inclusion of land sales in the calculation of the ROE, it ignores the number of expenses it continues to incur, and for which the Commission continues to deny rate recovery for, in the calculation of the ROE.
[185] Rowe Direct at 7.
[186] May 13, 2019 VTE at 11:14:05.

which it can more steadily address its infrastructure. In its post-hearing brief, Kentucky-American also mused:

> [t]he 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 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.[187]

What is clear from the record is that Kentucky-American has already been deferring pipe replacements.[188] The Company has not even tried to replace its system in a reasonable manner, and thus it is disingenuous to claim that it cannot replace it and have a reasonable opportunity to recover its investments. Kentucky-American seemingly has not even tried in the absence of a QIP. The fact that Kentucky-American needs to be incentivized to do its job, and increase its replacement rate of infrastructure to the level it is depreciating that infrastructure is astounding, and calls into question the purpose of customers even paying the utility a return on equity.[189] If increasing the rate of replacement is so crucial to the long-term viability of the system—in other words, a need—then it should continue to do so even without any requirement for additional financial incentives.

Discretionary Capital

The Attorney General calls into question the Company's entire argument for the QIP, which is to attract "[d]iscretionary allocations within American Water."[190] Allocations to American-Water subsidiaries are not based solely on need, but rather on "need and how do you get recovery."[191] Although Kentucky-American maintains that the investments underlying the QIP

[187] Company's Post-Hearing Brief at 67–68.
[188] *See* Rowe Direct at 11 (wherein he states the Company has reduced the main replacement rate from the astounding figure of 500 years, to a nearly as high 377 years).
[189] Schwarzell Rebuttal at 18.
[190] Rebuttal Testimony of Nick O. Rowe ["Rowe Rebuttal"] at 3.
[191] May 13, 2019 VTE at 10:55:08.

in this case are needs, apparently American-Water will not allocate the necessary capital to rehab the infrastructure without a QIP because the investments can be deferred.[192] Kentucky-American states that because its affiliates "can recover infrastructure renewal investments between rate cases," it is at a disadvantage in receiving monies for "asset renewals that can be deferred."[193] Notably, although much is made in this docket of the fact that most American-Water subsidiaries have QIP-like mechanism, not even a third of American-Water's capital is recovered through such a mechanism, and 43% of its capital over the next five years will not be initially captured through a forecasted test year *or* surcharge mechanism.[194] If it is prudent that the cited "discretionary" asset renewals can be deferred, then the Commission shouldn't join this multi-state "race to the bottom," because it will undoubtedly lead to higher, unreasonable rates.[195] If these investments that are deemed "discretionary" are nevertheless needed, again, why must Kentucky-American entice American-Water to give them the money to make them?

Further, the Company touts the QIP as a "best practice." Kentucky-American's employees make assertions by way of wide platitudes, such as the QIP "benefits the customer with reduced costs," or that it "will result in lower costs to customers over time." [196] Nevertheless, the Company has failed to provide a single iota of evidence that the imposition of a QIP *will result in cost savings to customers.* The Company has not submitted a cost-benefit analysis which demonstrates that the QIP is squarely in the customers' interest, nor did it supply a comprehensive breakdown of comparative costs of scheduled repairs to mains versus repairs on main breaks. Instead, Kentucky-American employees make misleading statements that give the air that the QIP would be cost

[192] May 13, 2019 VTE at 9:45:20.
[193] Company's Response to Commission Staff's Post-Hearing Request for Information, Item 11.
[194] Company's response to Attorney General's Initial Data Requests, Item 92.
[195] *Id.*
[196] O'Neill Direct at 24, 32.

beneficial, like saying "planned pipe replacements are much less costly on a unit cost basis than are the costs of increasing pipe breaks, with the attendant service disruptions, health risk from potential drinking water contamination, property damages, community health and economic development opportunity costs."[197] Is this the choice Kentucky-American has given the Commission? 'Give us the QIP because in the long-term it is cheaper for customers than Kentucky-American letting the system fail by not investing necessary capital, and just fixing items once they break?' The Attorney General can hardly believe that is the case. The Company is the one who chose to defer pipe replacement so that the replacement rate was every 500 years.[198] The utility should not be now incentivized to act as the firefighter so soon after playing the arsonist. Instead of further increasing capacity on the system, at great cost and in the face of plummeting demand, the Company should have been incrementally increasing the replacement rate of its infrastructure. To now say it's necessary to both increase the rate and collect a financial incentive on that progress is disingenuous.

Lastly, although strapped for cash to make asset renewals, Kentucky-American, and thus American Water, apparently has a significant amount of discretionary capital available to bid for and purchase water systems across the state. The fact that this case includes two such acquisitions, to the tune of a significant amount of money (including a premium), and the records in other proceeding reflect significant bids by Kentucky-American to acquire other utilities, evidence that Kentucky-American has plenty of discretionary capital available, but would nevertheless prefer to be incentivized to spend it anyway. The Attorney General discusses another municipal system that Kentucky-American is in discussions with regarding acquisition below, which the Company knows will take millions of dollars to rehabilitate. If Kentucky-American can travel the state

[197] O'Neill Direct at 32.
[198] Rowe Direct at 3.

offering millions of dollars to acquire other systems, why should it need to be incentivized to provide money for needed investments to serve its *current* customers, and how hard is it really for Kentucky-American to receive this coveted "discretionary" capital? Additionally, why isn't Kentucky-American using all of this money it apparently has available to purchase other systems to stop deferring asset renewals and invest in its own infrastructure? These questions must be asked and answered before Kentucky-American is given a blank check in a mechanism like the QIP.

The Company's Narrative That The Sky Is Falling

Mr. Roach confirmed that water usage has been broadly declining in the U.S. since about the year 2000.[199] Therefore, this issue is neither newly discovered, nor limited to Kentucky-American. In fact, most if not all water utilities nationwide are facing these very same issues.[200]

As the Vice Chairman pointed out at the hearing, the Company, by repeatedly noting that even after the first annual approximate 10 miles of main were replaced under the QIP there would still be 1,990 miles of main left, and one year older, effectively diminished the efficacy of its proposed QIP.[201] While arguing for its necessary approval, Kentucky-American admitted that even after ten years of main replacement under the QIP as proposed, a reasonable estimate of only 130 miles of mains will have been replaced.[202] For the Company to maintain that this program is so necessary to replace its aging infrastructure, and to argue that the program should not be limited in time, such a replacement rate does not seem likely to have much of an immediate effect on Kentucky-American's system.

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[199] VTE May 14, 7:57:02—7:57:30 PM.
[200] See generally Direct Testimony of Gregory P. Roach ["Roach Direct"]; *see also* Exhibit GPR-4.
[201] VTE May 14, 9:29:10—9:30:27; 10:46:38—10:54:05.
[202] VTE May 14, 10:46:38—10:54:05.

The QIP Would Not Directly Address Water Loss On Kentucky-American's System

Despite Kentucky-American's insistence that the QIP would contribute to reducing the Company's water loss, Ms. Schwarzell confirmed that water loss is not the primary focus of the proposed QIP.[203] Additionally, the 2009 Gannett-Fleming study found that Kentucky-American's QIP as proposed *will not significantly reduce water loss*.[204] While the gradual replacement of mains, even at a rate of 10–13 miles per year may have some residual impact on water loss, Ms. Schwarzell was clear to point out that about 1,990 miles of mains would be another year older.[205] Thus, any incremental gains in improving water loss reductions that might be achieved through the QIP would be offset by the natural degradation on the rest of the system, where water loss would likely only increase. Replacing mains was known 10 years ago to not be a realistic fix to Kentucky-American's on-going water loss problem, thus, any expectation that infrastructure investments recovered through the QIP will make a dent in such a problem is misplaced.

Safeguards if QIP Approved

If the Commission decides to approve any or all of the QIP as proposed by the Company over the strenuous objections of the Attorney General, he recommends that certain safeguards be instituted for the protection of ratepayers. As Mr. Baudino's testimony stated, the 90 day review process put forward by the Company is not adequate without further limits to the extent of the program.

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[203] VTE May 14, 9:29:10—9:30:27.
[204] O'Neill Direct, Exhibit 3, page 8 ("The analysis by Gannett Fleming found that replacing specific main sizes or types of material that exhibit a high concentration of breaks would not have a substantial impact on reducing non-revenue water. Gannett Fleming concluded that other factors should be considered with regard to replacement of problematic main rather than trying to control non-revenue water.")
[205] VTE May 14, 9:29:10—9:30:27; 10:46:38—10:54:05.

Annual and Cumulative Cost Caps

The QIP proposal should be modified to institute cost caps on both an annual and a cumulative basis. Cost caps would ensure that infrastructure replacement, and the associated cost would be incremental and more affordable for ratepayers. These caps may be reasonably be based on a percentage (bill increase or rate base) or dollar denominated. These caps would serve to avoid severe rate shock and comports with the Commission's preference for gradualism. Furthermore, other Kentucky-American affiliates have cost caps in their jurisdiction,[206] thus indicating Kentucky-American's familiarity with them and another Commission's perception that such caps are reasonable.

Pilot Program for Two Years, Not For an Unlimited Term

Kentucky-American also argues that the QIP would need between five to ten years "to fully ramp up", and so a pilot program of two years, as recommended by Mr. Baudino, would not suffice. If the Commission were to approve the QIP on a pilot basis, a term of between five and ten years would be a de facto approval considering the investment Kentucky-American would put into the program and the momentum it would build administering it over such a long period. While a two-year pilot may not be ideal for the Company in terms of determining the best ways to increase efficiencies and select projects, it is long enough to determine whether the mechanism would be workable without having a detrimental impact on ratepayers. Thus, any approval of a pilot program for the QIP should be limited in time to two years.

[206] Company's Hearing Exhibit 2 (Public Service Commission of West Virginia Order, Case No. 16-0550-W-DSIC, at 7, Dec. 2, 2016).

Alternative Water Loss Standard

In its application and direct testimony, the Company did not propose any adjustment for the disallowance of costs for the production or purchase of unaccounted-for water over the 15% threshold as mandated in 807 KAR 5:066 Section 6(3). In Mr. Kollen's Direct Testimony, he recommended that the Commission make such an adjustment to remove those costs from customers' rates as required by law.[207] Only after Mr. Kollen suggested this adjustment did the Company directly address the issue in rebuttal testimony, where it also proposed an alternative standard for measuring water loss by which it says the Commission should use in its determination.

As the Company notes, Section 6(3) does indeed contemplate that a utility may propose an alternative method for measuring water loss.[208] However, the Company's inability to plead an alternative method in its initial application should foreclose its ability to propose one in rebuttal testimony. Kentucky-American is the largest, most sophisticated water utility in the Commonwealth. It is concerning Kentucky-American did not address this issue at all in the application, and it gives no reason for neglecting to do so. Furthermore, the alternative method it proposes is based on the water loss figures for Kentucky's twenty largest municipal water systems, entities that inherently do not have the same access to capital and are not incentivized to invest in infrastructure through a separate, and higher, equity return.[209]

The Company asserts that it "has aggressive plans in place to combat its water loss that it has demonstrated throughout this proceeding [and that] [p]enalizing the company for production costs is counter-intuitive to KAWC's water loss reduction program."[210] The truth of the matter though, is that Kentucky-American's unaccounted-for water has been steadily rising for almost a

[207] Kollen Direct at 44–45.
[208] Company's Post-Hearing Brief, at 43.
[209] Schwarzell Rebuttal at 16–18.
[210] Company's Post-Hearing Brief, at 43–44.

decade, nearly unabated. Its unaccounted-for water measurement has increased from 11.41% in 2009 to 19.95% in 2018.[211] The unaccounted-for water level in the forecasted period of the current rate case is 19.37%, though the Company provides no support for why it believes it will decrease.[212] Though the Company now touts aggressive plans to address water loss in the face of a statutory reduction in recoverable production expenses,[213] its neglect in addressing the issue in the application, and the continuous rise year over year, both seem to indicate that it has not taken this seriously.

The Company suggests that a 20 percent alternative standard is appropriate because Kentucky-American has only recently exceeded the 15 percent threshold. The Attorney General observes that since exceeding 15 percent in 2016, the percentage has steadily climbed.[214] As noted earlier, with the exception of two years, the percentage has risen every year since 2009.[215] Robust leak detection and other plans to mitigate water loss seem appropriate, but they should not relieve the Company from having to disallow production costs above the 15 percent threshold, especially when these plans likely should have been implemented far earlier than now.

As Ms. Schwarzell noted, and later confirmed in a response to the Attorney General's post-hearing data requests, the adjustment amount the Commission would make for purchase and production costs of unaccounted-for water over 15% would equal approximately $315,743.[216] The Attorney General recommends that the Commission reject the Company's proposed alternative water loss measurement and disallow the costs for unaccounted-for water in keeping with its historical, established precedent for water utilities. If the Commission is going to routinely make

[211] Company's Response to Attorney General's Supplemental Data Requests, Item 39 (Ky. Commission March 1, 2019).
[212] *Id.*
[213] Company's Post-Hearing Brief at 43–44; O'Neill Rebuttal, Exhibit 2.
[214] Company's Response to Attorney General's Supplemental Data Requests, Item 39
[215] *Id.*
[216] Company's Response to Attorney General's Post-Hearing Data Requests, Item 4.

such an adjustment for utilities that have no allowance for profit, Kentucky-American should not be allowed to avoid this disallowance. Only by requiring the Company to adhere to the legal requirements, will the Commission be able to convince Kentucky-American to address its water loss issues directly and timely.

Reasonableness of Affiliate Charges

The Company retained Mr. Patrick Baryenbruch to conduct a study on the reasonableness of the charges from AWWSC to Kentucky-American. Mr. Baryenbruch's study examined these charges on an average regulated retail per-customer cost in comparison to the per-customer cost of other utilities.[217] He did not look to the reasonableness of any of the Service Company's individual charges in isolation.[218] Furthermore, the comparison group did not include any water utilities due to the dearth of water utilities with dedicated service companies.[219] Mr. Baryenbruch argues that by concentrating on customer account services activities, which all utilities must perform regardless of the service they provide, it makes his comparison of Kentucky-American with electric and combined electric-gas utilities appropriate.[220]

This is yet another instance in which the Company performed a study at significant cost that the Commission did not request and one in which does not even support the proposition for which it is asserted; namely, that its affiliate charges are reasonable. The limitations of the study render it less useful to the Commission than it may have been had it been tailored with specific charges scrutinized. As it is, the Commission should not give substantial weight to this study.

[217] VTE May 13, 6:33:46—6:43:36.
[218] *Id*.
[219] *See* Direct Testimony of Patrick L. Baryenbruch ["Baryenbruch Direct"].
[220] *Id*.

The Company Insists On Continuing To Acquire Water Systems

The Company has been following a pattern for many years in which it has acquired other water systems, folding them into its existing service territory, and then placing the new customers into a unified rate structure, essentially socializing the cost to serve the new system across the entirety of its existing customer base. As it has in this case, such an approach often lowers the rates on the newly acquired systems, here Eastern Rockcastle and North Middletown, while raising the rates of current Kentucky-American customers.[221] The current base of customers will end up paying even more if the acquired system is in need of significant repair, and the Company shows no signs of slowing down in its acquisitions. The Mayor of Midway, Kentucky, Grayson Vandegrift, submitted a letter in this matter which detailed his city's struggle to raise revenue and reduce expenses while simultaneously investing in badly needed infrastructure.[222] Mayor Vandegrift estimates that Midway's water and sewer system requires between $10 to 20 million in infrastructure upgrades in the next twenty years.[223] Despite this, he writes that Kentucky-American has offered to purchase this system "[o]n multiple occasions … the most recent being in a meeting with KAW executives within the last 2 years."[224] Mayor Vandegrift goes on to ask a pertinent question: "why would a company that needs more money to fix infrastructure also want to purchase some that they know to be ready for investment? Why would a company want to take on more debt if it can't meet its current obligations?"[225]

Additionally, the Company has reportedly expressed an interest in at least managing, if not possibly acquiring, Southern Water & Sewer District.[226] At bottom, the Company has committed

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[221] Application; Application, Exhibit 37, Schedule M-3, Pages 23–38.
[222] Commission Response E-mail to Grayson Vandegrift, Public Comments (Ky. Commission May 15, 2019).
[223] *Id.*
[224] *Id.*
[225] *Id.*
[226] 20190325_PSC Notice of Filing, Transcript of January 8 and January 24, 2019 Hearings, at 256 (Ky. Commission March 25, 2019).

to spend the capital necessary for these acquisitions while also claiming that it does not have sufficient capital for infrastructure replacement.

Acquisition Premium/Fair Market Value

In response to data requests, the Company put forward its belief that it had fulfilled all factors of the Delta test in its acquisition of the North Middletown system.[227] However, instead of simply making this argument, it also felt the need to propose an alternative scheme for valuing acquisitions, one which incorporates a premium based on the fair market value of the transaction.[228] In its post-hearing brief, Kentucky-American argued that the North Middletown acquisition qualifies for approval under the Commission's Delta test "or under the fair market value method KAWC proposed in Ms. Schwarzell's direct testimony."[229] Notwithstanding the Attorney General's previously stated concerns about unsupported proposals in rebuttal testimony, the method put forward by Ms. Schwarzell is not, at base, an arm's length transaction. The framework the Company proposes is one in which both parties to the acquisition are equally incentivized to negotiate an inflated sale price in order to recover the maximum value and reduce transaction costs. This does not benefit ratepayers in any way; in fact, it only harms them.

Had Kentucky-American wanted the Commission to give full consideration to a fair market value approach to acquisition, it should have proposed an administrative case. As it stands, it is wholly inappropriate to consider such an approach within the context of one investor-owned utility's rate case. Consideration and deliberation without those other utilities and parties for whom this same rule would apply necessarily deprives them of due process. Further, if the Commission were to rule on this proposal without providing due process, the record would be insufficient and

[227] Company's Responses to Commission Staff's Second Request for Information, Item 72; Company's Responses to Commission Staff's Third Request for Information, Item 49.
[228] Schwarzell Direct at 29–30.
[229] Company's Post-Hearing Brief, at 59.

the decision would be arbitrary and capricious by definition. Finally, the Kentucky Legislature had the opportunity to pass a bill during this year's session which would have approved the fair market value methodology as presented by Kentucky-American, but it chose not to do so.[230] As such, the Commission should refrain from ruling on Kentucky-American's fair market proposal, as this is not the proper forum, the record is insufficient, other potential parties have not had the chance to speak on the proposal's merits, and the proposal itself is not substantive enough upon which to base a ruling.

CONCLUSION

The Commission has often acknowledged its long history of reliance on the principle of gradualism in ratemaking in order to mitigate the financial impact of individual rate increases on customers and Kentucky families.[231] In the event that the Commission decides to approve any or all of Kentucky-American's proposals, the Attorney General asks that the Commission continue to follow that precedent here and to appropriately consider affordability.

WHEREFORE, the Attorney General respectfully request that the Commission deny Kentucky-American's requested rates, accept the adjustments proposed by the Attorney General, and grant all further relief requested herein.

[230] S. 163, General Assem. (Ky. 2019).

[231] Case No. 2014-00396, *In the Matter of Application of Kentucky Power Company for: (I) A General Adjustment of its Rates for Electric Service; (2) An Order Approving its 2014 Environmental Compliance Plan; (2) An Order Approving its Tariffs and Riders; and (4) An Order Granting All Other Required Approvals and Relief*, Order (Ky. PSC June 22, 2014) ("the Commission has long employed the principle of gradualism"); *See also*, Case No. 2000-080, *In the Matter of: The Application of Louisville Gas & Electric Company to Adjust its Gas Rates and to Increase its Charges for Disconnecting Service, Reconnecting Service and Returned Checks*, Order (Ky. PSC September 27, 2000) ("the Commission is adhering to the rate-making concepts of continuity and gradualism in order to lessen the impact of these increases on the customers that incur these charges.").

Respectfully submitted,

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